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Courts, Constituencies, and the Enforcement of Fiduciary Duties in the Nonprofit Sector

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ARTICLES

COURTS, CONSTITUENCIES, AND THE ENFORCEMENT OF FIDUCIARY DUTIES IN THE NONPROFIT SECTOR

Joseph Mead & Michael Pollack

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ARTICLES

COURTS, CONSTITUENCIES, AND THE ENFORCEMENT OF FIDUCIARY DUTIES IN THE NONPROFIT SECTOR

Joseph Mead* & Michael Pollack**

ABSTRACT

Directors of nonprofit organizations owe fiduciary duties to their organizations, but the content of these duties—and how and when courts should enforce these duties—has long been debated among scholars and courts. This debate emerges in several areas, including the level of deference to be shown by courts to nonprofit directors (the business judgment rule), who should be allowed to sue to enforce duties (standing), and the type of relief available to prevailing plaintiffs (remedies). Existing literature explores these legal rules in isolation and in abstraction, generally failing to consider how the rules interact with each other and ignoring the empirical reality of the nonprofit sector.

Because for-profit and nonprofit corporations evolved from a common ancestor, courts generally apply corporation law principles developed in the context of for-profit corporations to nonprofit corporations as well. But for-profit and nonprofit corporations often differ in key ways, including sources of income, constituencies, and other institutional characteristics. These differences make rote application of corporate law principles to nonprofit corporations a conceptually

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questionable endeavor. Rather than setting nonprofit rules through strained analogies to for-profit concepts of ownership and profit-maximization, we propose employing an analysis of institutional features that can operate in a whole range of governance contexts, including the nonprofit sector. This approach considers opportunities for voice and exit, impact range, homogeneity, and comparative competence between boards and courts, and it does so among different types of nonprofit actors, like directors, members, employees, donors, customers, and beneficiaries.

Using this institutional analysis with for-profit corporation law as the baseline, we compare emerging legal rules in the nonprofit sector against existing empirical literature. We find that, with one exception, institutional characteristics vis-à-vis nonprofit actors are reasonably comparable to their for-profit counterparts, and we therefore place the applicable legal regime with respect to those actors on a more conceptually sound footing. However, beneficiaries of a nonprofit organization tend to lack opportunities for exit or voice, face risk of considerable deprivation, and often differ considerably in relevant aspects from the individuals who manage the organization. We argue that the law should take into account the limited power of beneficiaries in nonprofit governance structures, and we analyze options for reform.

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INTRODUCTION

Nearly every American interacts with a nonprofit organization over the course of each year, perhaps as a customer of a nonprofit hospital or school, a donor to a charitable or political cause, or an attendee of a religious, social, or cultural event. Nonprofits employ 10% of the nation's labor force—not counting a jaw-dropping fifteen billion hours of volunteer labor each year—and manage trillions of dollars of assets.¹

Despite the sector's size and importance, the study and development of nonprofit law has historically languished behind that of the business and government spheres. Indeed, nonprofits have been called “corporate ‘Cinderellas,’” the “‘neglected stepchildren of modern organization laws,’ relegated to the hand-me-downs of their half-siblings, for-profit business organizations.”² Most of the two million nonprofit organizations in the country are incorporated under state law,³ and state nonprofit corporation laws typically mirror for-profit counterparts with little more than an occasional word substitution.⁴ The similarities in legal treatment are particularly stark when it comes to the fiduciary duties of the governing board of directors,⁵ but at the same time, as a descriptive matter, nonprofit organizations are quite different than for-profits. For example, they are centered on missions other than profit, they lack owners, and they often rely on different revenue streams.⁶ Given these differences, and more, do the hand-me-downs of corporate law fit the nonprofit form?

This question is of central importance, for while legal scholars are increasingly recognizing and studying the nonprofit as a distinct organizational form, with a few important exceptions,⁷ the study of the law of nonprofit

¹ *Nonprofit Almanac*, URB. INST., <http://www.urban.org/books/nonprofit-almanac-2012/index.cfm> (last visited Nov. 5, 2015).

² Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. LAW 631, 638 (1998).

³ URBAN INST., *Nonprofit Sector in Brief*, available at <http://www.urban.org/UploadedPDF/413277-Nonprofit-Sector-in-Brief-2014.pdf> (last visited Nov. 5, 2015).

⁴ Lizabeth Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 270 (1989).

⁵ See *infra* Part II.

⁶ See *infra* Part III.

⁷ See generally MARION R. FREEMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004); Evelyn Brody, *Agents Without Principals: The Economic*

governance has largely been limited to discrete issues, such as the role of donors in enforcing director fiduciary duties,⁸ the application of Sarbanes-Oxley-inspired reforms to nonprofit boards,⁹ or the standard by which conflicts of interest should be judged.¹⁰ We build and expand on this prior scholarship by taking a more comprehensive account of the various facets of the nonprofit board's fiduciary obligations and of the judicial enforcement of those obligations—including issues of standing, the business judgment rule, other forms of deference, and the tricky question of remedies. We do so by testing the fundamental assumption, which recurs in the literature, the law, and in recent law reform projects by the American Law Institute (“ALI”)¹¹ and the American Bar Association (“ABA”),¹² that for-profit corporate law is an appropriate baseline for the legal treatment of nonprofit organizations.

As we discuss, the assumption of nonprofit and for-profit equivalency is predominately based on historical accident, rather than on a systematic analysis of the different organizational forms.¹³ Of course, that does not necessarily doom the

Convergence of the Nonprofit and For-Profit Organizational Forms, 40 N.Y.L. SCH. L. REV. 457 (1996) [hereinafter Brody, *Agents Without Principals*]; Goldschmid, *supra* note 2, at 638; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981); Thomas Lee Hazen & Lisa Love Hazen, *Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors’ Fiduciary Duties*, 14 U. PA. J. BUS. L. 347 (2012). Law reform projects have also taken a comprehensive view. See Evelyn Brody, *U.S. Nonprofit Law Reform: The Role of Private Organizations*, 41 NONPROFIT & VOLUNTARY SECTOR Q. 535–59 (2012) [hereinafter Brody, *U.S. Nonprofit Law Reform*].

⁸ See generally Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998); Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993); Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing*, 41 GA. L. REV. 1183 (2007); Joshua B. Nix, *The Things People Do When No One Is Looking: An Argument for the Expansion of Standing in the Charitable Sector*, 14 U. MIAMI BUS. L. REV. 147 (2005).

⁹ Joseph Mead, Note, *Confidence in the Nonprofit Sector Through Sarbanes-Oxley-Style Reforms*, 106 MICH. L. REV. 881, 886 (2008).

¹⁰ Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 135–40 (1993); Goldschmid, *supra* note 2, at 648–49.

¹¹ PRINCIPLES OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS 3–4 (Tentative Draft No. 1, 2007) [hereinafter ALI (Draft No. 1)]; Brody, *U.S. Nonprofit Law Reform*, *supra* note 7, at 545. We sometimes refer to this ALI project as “the Restatement.”

¹² See generally REVISED MODEL NONPROFIT CORP. ACT (2008) [hereinafter RMNCA], available at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2008/black_letter.authcheckdam.pdf.

¹³ See *infra* Part II.A.

idea, as even an assumption reached by accident can turn out to be right. However, it does demonstrate the need for a careful study that either lends credence to that assumption and to the legal regime that is premised on it, or reveals its flaws. This Article draws on and applies an approach designed to do just that.¹⁴ Specifically, we explore a set of mechanisms of accountability that inhere within the institutions themselves—mechanisms like voice and the ability to exit, the relative expertise of boards versus courts, the type of impact the organization has with respect to its constituents, and the competing interests within the institution.¹⁵ These characteristics are the locus of our examination because they substantially inform the nature and degree of judicial review that may be warranted with respect to the institution's decision-making.

Our analysis of these characteristics, performed from the perspective of various constituents of the nonprofit corporation, indicates that, for the most part and with respect to most constituents, nonprofits are actually quite comparable to for-profit entities across these relevant institutional dimensions. Therefore, we conclude that the prevailing trend of judicial review is not only appropriate, but far more defensible than the bare assumption of equivalency has suggested. By placing this particular doctrine on firmer conceptual footing, we also demonstrate the utility of the internal-accountability model to not only critique the status quo, but to shore it up as well. However, there is one exception to this finding, and it is a relatively important one: beneficiaries of nonprofits—those who receive the benefit of the nonprofit's service without contributing the full cost—are limited in the access they have to institutional mechanisms of accountability, even though they face the specter of tremendous loss when nonprofit directors lose their way. The fact that the legal regime likewise deprives them of means of accountability thus leaves a significant gap that warrants further consideration.

This Article proceeds in three parts. In Part I, we introduce the nonprofit sector and the types of characters who give these institutions life. In Part II, we examine the status quo of nonprofit fiduciary law, tracing the history of its development and surveying the different approaches adopted by different jurisdictions and recent law reform proposals to issues of standing, deference, and remedies. In Part III, we apply our institutional model for evaluating the nonprofit legal regime.

¹⁴ Michael C. Pollack, *Judicial Deference and Institutional Character: Homeowners Associations and the Puzzle of Private Governance*, 81 U. CIN. L. REV. 839, 846–57 (2013).

¹⁵ *Id.* at 857–68.

Our discussion provides a fresh look at a sector that is increasingly faced with an identity crisis, as it sees its boundaries with for-profits blurred by mission-oriented businesses, low-profit limited liability corporations (“L3Cs”), and benefit corporations (“BCorps”).¹⁶ This Article also fits into a broader literature about the accountability of institutions and the relationship between the state and civil society.¹⁷ Accountability is a notoriously “squishy” concept,¹⁸ but so, too, is the rhetoric that the managers of the nonprofit sector should be exempt from governance mandates based on ill-defined notions of pluralism or sectoral independence.¹⁹ The institutional model applied here provides a measure of analytical rigor to these conversations through the lens of the substance and nature of fiduciary oversight in the nonprofit sector.

I. BACKGROUND

A. *Defining Nonprofit Organizations*

The nonprofit sector is vast and diverse. Numbering more than two million in the United States,²⁰ nonprofits range from the tiny organization without a storefront, webpage, or paid staff member, to the Kaiser Foundation Health Plan with its annual budget of \$41 billion²¹—an outlay larger than that spent by most states.²² This inclusive category simultaneously encompasses the corner soup

¹⁶ See generally Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619 (2010); John Tyler, *Negating the Legal Problem of Having Two Masters: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010).

¹⁷ See generally Alnoor Ebrahim, *Making Sense of Accountability: Conceptual Perspectives for Northern and Southern Nonprofits*, 14 NONPROFIT MGMT. & LEADERSHIP 191 (2003).

¹⁸ *Id.* at 193; Jonathan G.S. Koppell, *Pathologies of Accountability: ICANN and the Challenge of “Multiple Accountabilities Disorder,”* 65 PUB. ADMIN. REV. 94, 94 (2005).

¹⁹ James J. Fishman, *The Nonprofit Sector: Myths and Realities*, 9 N.Y. CITY L. REV. 303, 306 (2006).

²⁰ Amy S. Blackwood et al., *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering*, URB. INST. 1 (2012), available at <http://www.urban.org/UploadedPDF/412674-The-Nonprofit-Sector-in-Brief.pdf>.

²¹ NCCS—*Display Largest Public Charities*, URB. INST., <http://nccsweb.urban.org/PubApps/showTopOrgs.php?cat=ALL&amt=exps> (last visited Nov. 20, 2015).

²² NAT’L ASS’N OF STATE BUDGET OFFICERS, *THE FISCAL SURVEY OF STATES 4–6* (2013), available at https://www.nasbo.org/sites/default/files/NASBO%20Fall%202013%20Fiscal%20Survey%20of%20States_0.pdf.

kitchen and the National Football League, as well as the local humane society and Harvard University.²³

While the diversity of the nonprofit sector makes generalities about nonprofit organizations tough to come by, they do exist.²⁴ As a legal form, nonprofit corporations are predominantly creatures of state law.²⁵ Although the nuances of the law vary among jurisdictions, the common thread is the nondistribution constraint:²⁶ profits from the organization cannot be distributed to owners, but must be reinvested to further the organization's mission.²⁷ These limits bind both the large health plan and the tiny start-up, and distinguish both from their for-profit counterparts, where private benefit of owners is both lawful and expected.²⁸

Although state corporate laws give nonprofits life and set the ground rules for their governance, federal tax laws complement these rules by providing tax benefits to qualified nonprofit organizations that meet specific criteria.²⁹ One of the most notable requirements is that the corporation be organized to pursue one of a number of specific public purposes, such as charity, health care, education, scientific research, advocacy, or mutual benefit.³⁰ Thus, even though state laws commonly allow nonprofits to be formed for any lawful purpose,³¹ the combination of market forces—the need to raise capital and desire for profits—and the allure of tax

²³ Jami A. Maul, Comment, *America's Favorite "Nonprofits": Taxation of the National Football League and Sports Organizations*, 80 UMKC L. REV. 199, 199 (2011).

²⁴ Lester M. Salamon & Helmut K. Anheier, *In Search of the Non-profit Sector: The Question of Definitions*, 3 VOLUNTAS 125, 126 (1992).

²⁵ There are a small number of federally-chartered organizations, including the Boy Scouts of America and the American Red Cross. See generally Paul E. Lund, *Federally Chartered Corporations and Federal Jurisdiction*, 36 FLA. ST. U. L. REV. 317 (2009).

²⁶ Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838–40 (1980).

²⁷ OHIO REV. CODE ANN. § 1702.01(C) (West 2009); RMNCA, *supra* note 12, § 6.40(a). A small fraction of charitable entities are organized as trusts, which have distinct rules beyond the scope of this paper. See generally Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 597–98 (1999).

²⁸ Hansmann, *supra* note 26, at 838.

²⁹ Mark Ascher, *Federalization of the Law of Charity*, 67 VAND. L. REV. 1581, 1591–1606 (2014).

³⁰ I.R.C. § 501(c)(3) (2015).

³¹ Compare OHIO REV. CODE ANN. § 1702.03 (providing nonprofits can be formed “for any purpose or purposes for which natural persons lawfully may associate themselves”), with MASS. GEN. LAWS ANN. ch. 180, § 4 (West 2010) (specifying allowable purposes).

exempt status—a primary reason to seek the nonprofit form—means that most nonprofit organizations further a limited set of purposes.³²

B. *A Typology of Nonprofit Actors*

Both for-profits and nonprofits are formally governed by boards of directors, though how these directors are selected differs dramatically between sectors. In for-profits, the owners of the enterprise are entitled to elect board members, who govern the organization and act as fiduciaries on behalf of the owners.³³ In contrast, nonprofits do not have owners, so the nature of elections is more variable.³⁴ Some nonprofit organizations have formal membership rolls, where members are allowed to elect the organization's board of directors.³⁵ Mutual benefit organizations,³⁶ homeowners' associations,³⁷ and labor unions³⁸ are common examples of this type of organization.³⁹ The right to elect directors places these members in a position similar to for-profit shareholders, but unlike for-profit shareholders, they do not "own" the organization's assets and have no legal claim to any financial benefit from the organization.⁴⁰

³² However, we note that not every nonprofit seeks tax-exempt status. See Kirsten A. Grønberg, Helen K. Liu & Thomas H. Pollak, *Incorporated but Not IRS-Registered: Exploring the (Dark) Grey Fringes of the Nonprofit Universe*, 39 NONPROFIT & VOLUNTARY SECTOR Q. 925, 928–30 (2010).

³³ Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 448 (2001) (arguing that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value"); see *infra* Part II.B.3.

³⁴ Hansmann, *supra* note 26, at 842 (describing continuum between "mutual" and "entrepreneurial" control in nonprofits).

³⁵ RMNCA, *supra* note 12, § 6.30.

³⁶ Michael O'Neill, *Philanthropic Dimensions of Mutual Benefit Organizations*, 23 NONPROFIT & VOLUNTARY SECTOR Q. 3, 3 (1994).

³⁷ Pollack, *supra* note 14, at 861–62.

³⁸ Elections in labor unions are governed by federal law and monitored by the Department of Labor. See Labor-Management Reporting and Disclosure Act of 1959, Pub. L. No. 86-257, 73 Stat. 519, 532–35 (codified as amended at 29 U.S.C. §§ 401–04 (2012)).

³⁹ Membership organizations can usually extend or limit their membership in whatever way they see fit, yet the threats of undue meddling or even of hostile takeovers prevent most organizations from extending membership too readily. Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 ORE. L. REV. 829, 880 (2003).

⁴⁰ Hansmann, *supra* note 26, at 839. To complicate matters, some state laws actually allow a nonprofit organization to issue stock as a way of defining control of the organization. See, e.g., KAN. STAT. ANN. § 17-6002(4) (Supp. 2014). These stockholders have power of control over the organization but not a right to the organization's assets, essentially making them members by another name. *Id.*

Most nonprofits do not have voting members, though, which means that control over the organization is vested exclusively in a self-perpetuating board. Whether a nonprofit organization has a formal voting membership body or a self-perpetuating board is up to the organization, and most organizations opt out of internal democracy.⁴¹ This leads to the problem, identified by Professor Reiser, that “private-regarding for-profit corporations are required to have more democratic internal governance structures than are supposedly public-regarding public benefit [member-less] nonprofit corporations.”⁴² Indeed, as noted below, the absence of any external political check on most nonprofit boards often leads to lower quality board members, which then serves as a strong argument against giving board members unchecked discretion to manage the organization’s affairs.⁴³

The differences between sectors grow as we look beyond governance.⁴⁴ The for-profit story is a relatively straightforward one. Simply put, to achieve the wealth-maximization ends, the for-profit hires employees, commissions contractors, and supplies customers—all at fair market rates—with each expecting a *quid pro quo* out of the exchange. Under the ordinary contractarian model of corporate governance, the consumer and the employee receive full value for their

⁴¹ Karl S. Coplan, *Is Voting Necessary? Organization Standing and Non-Voting Members of Environmental Advocacy Organizations*, 14 SOUTHEASTERN ENVTL. L.J. 47, 55 (2005); Reiser, *supra* note 39, at 829, 865. There are also organizations that lack voting members but do have a semi-formal “membership” class without voting power. Museums, libraries, and zoos commonly offer yearly membership packages to interested patrons who wish to signal support for the organization. Audhesh K. Paswan & Lisa C. Troy, *Non-profit Organization and Membership Motivation: An Exploration in the Museum Industry*, 12 J. MKTG. THEORY & PRAC. 1 (2004). These nonvoting members may have a large amount of informal sway, but the lack of a formal vote places them on entirely different legal ground than voting members.

⁴² Reiser, *supra* note 39, at 864.

⁴³ See *infra* Part II.

⁴⁴ One of the most persistent debates in the field of nonprofit studies is about defining the scope of a nonprofit’s constituency, which often assumes a normative position about who “should” count. See Natalie Brown, *The Principal Problem: Towards a More Limited Role for Fiduciary Law in the Nonprofit Sector*, 99 VA. L. REV. 879, 881 (2013) (noting larger question of whether nonprofits should be accountable to beneficiaries). We largely bypass the value-laden questions imbedded in the constituency debate, and instead propose a descriptive typology based on the ways in which different categories of actors interact with the organization based on their respective contributions to, and receipts from, the organization. See DENNIS YOUNG, *IF NOT FOR PROFIT, FOR WHAT?* 110 (2013).

input in terms of the good purchased or wages received, and thus do not retain any residual claim as stakeholders in the organization's governance.⁴⁵

Like for-profits, nonprofits can have employees, contractors, and customers who expect to receive as much as they give.⁴⁶ In fact, the majority of the nonprofit sector's income, as measured in total dollars, is derived from fees for services. This phenomenon is largely driven by the massive scale of health-oriented commercial nonprofit organizations, such as hospitals and health plans, as well as tuition-charging nonprofit colleges.⁴⁷ These commercial nonprofits frequently compete directly with for-profits, charging similar market rates for the same services and often behaving very similarly.⁴⁸

However, nonprofits also obtain non-commercial revenue, as the nonprofit form facilitates donations of money and time in excess of a personal financial return.⁴⁹ It is this altruism that allows the nonprofit to provide goods and services to beneficiaries, who receive something from the organization without providing equal value in exchange. The potential separation between contributor and recipient makes nonprofits a unique part of society.⁵⁰ Under the standard economic account of nonprofit organizations, the ban on distributing the organization's surpluses to owners encourages people to trust the organization and facilitates donations of time

⁴⁵ Gerhard Speckbacher, *Nonprofit Versus Corporate Governance: An Economic Approach*, 18 *NONPROFIT MGMT. & LEADERSHIP* 295, 299–300 (2008). This point is actually the subject of an interesting debate: some contest the claim that all constituencies receive full value from the exchange, arguing that they continue to possess a residual claim on the organization. See, e.g., David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 *WASH. & LEE L. REV.* 1373, 1375–84 (1993).

⁴⁶ See Brody, *Agents Without Principals*, *supra* note 7, at 531–32. For nonprofit employees in particular, the issue of receiving full value is particularly tricky, since nonprofit wages are often lower than for-profit equivalents, potentially leading the nonprofit employee to be a partial donor of labor. *Id.*

⁴⁷ *Quick Facts About Nonprofits*, URB. INST., <http://nccs.urban.org/statistics/quickfacts.cfm> (last visited Nov. 5, 2015); Katie Roeger et al., *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering*, URB. INST. 3 (2011), available at <http://www.urban.org/UploadedPDF/412434-nonprofitAlmanacBrief2011.pdf>. The fact that a majority of the sector's revenue came from commercial transactions distorts a full picture of the field, as it is driven largely by the largest nonprofit organizations in terms of income. *Id.* These largest nonprofit organizations—those with spending more than \$10 million a year—constitute 85% of the sector's spending but only 4% of their number. *Id.*

⁴⁸ Brody, *Agents Without Principals*, *supra* note 7, at 511.

⁴⁹ YOUNG, *supra* note 44, at 28–35; Hansmann, *supra* note 7, at 500–04.

⁵⁰ Hansmann, *supra* note 26, at 850–51.

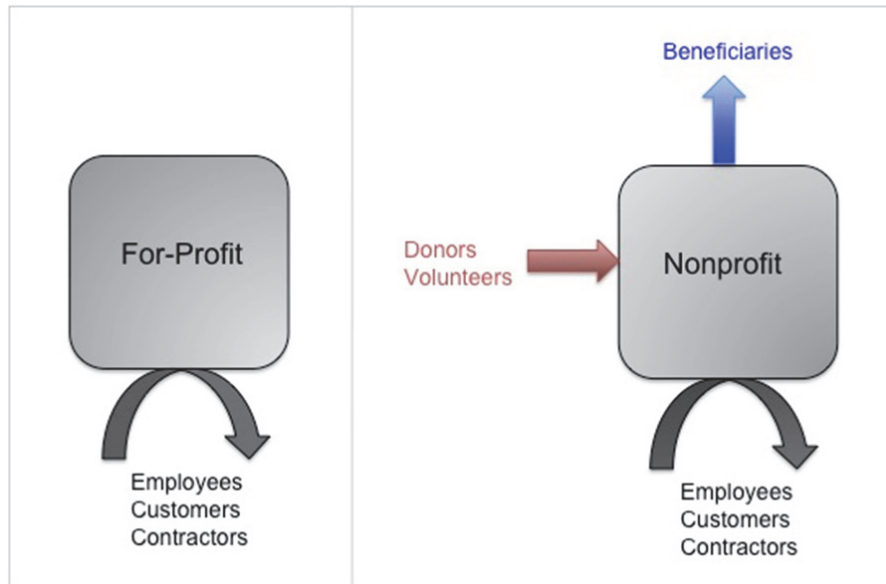
and money with the realistic hope that both will be used to further a valuable mission.⁵¹

By tracing resource inputs to and outputs from the organization, we describe the different stakeholders present in the nonprofit sector, as illustrated in Figure 1. Employees, customers, and contractors all provide input and receive output from the organization. When constructing these ideal types, we treat the input contributed as being of equal value to the output—that is, the employee receives a wage commensurate with the value of his labor, and the customer receives a good or service matching the amount paid. These types of market transactions are readily made in for-profit and nonprofit organizations alike. However, for the nonprofit, the link between input and output can be severed, giving rise to unique categories of constituencies.⁵² On the input side, we have donors of money and labor, who contribute to the organization without expectation of receiving *quid pro quo* in exchange. On the receiving side, we have the beneficiary, who receives something from the nonprofit without expectation of putting in equal value.⁵³ As we will see, these different constituencies have dramatically different levels and types of influence within the organization.

⁵¹ *Id.* at 838, 847.

⁵² YOUNG, *supra* note 44, at 110.

⁵³ We recognize that these are ideal types, and in many instances the precise line between customer and beneficiary will be hard to draw. For example, a client of a nonprofit whose care is partially subsidized through donations falls somewhere along a spectrum between beneficiary and customer. The point here is not to develop a rigid framework by which we can put every individual into a distinct box. That would not be feasible or useful. Rather, the framework we offer allows us to break down the flow of resources into and out of the organization and to conceptualize the various constituencies of these organizations.

Figure 1. A resource-based typology of actors between sectors.

II. GOVERNANCE OF NONPROFIT ORGANIZATIONS

Both nonprofit and for-profit organizations are typically formalized as corporations.⁵⁴ Under corporate law, both nonprofits and for-profits are governed by boards of directors who are responsible for selecting management, ensuring financial integrity, and otherwise guiding the organization. These directors must comply with fiduciary duties of care, loyalty, and obedience.⁵⁵ When it comes to the enforcement of these duties, the law does little to distinguish between for-profit and nonprofit organizations—an approach criticized by many commentators, who argue that similar treatment in terms of rules of governance leads to widely dissimilar outcomes for the nonprofit sector.

⁵⁴ George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1149 (2004) (“Nonprofit corporate statutes bear a strong resemblance to for-profit corporate statutes, notwithstanding the historical roots of charity regulation in trust law.”). See also Hansmann, *supra* note 7, at 501.

⁵⁵ Hazen & Hazen, *supra* note 7, at 346.

A. *The History and Sources of the Rules of Nonprofit Governance*

Legislation on nonprofit rules of governance commonly mimics the rules applicable to for-profit counterparts and simply makes minimal word substitutions.⁵⁶ Indeed, Delaware—the undisputed ruler of corporate law—forces the nonprofit sphere into its general corporation code rather than set out a distinct chapter for nonprofit corporations.⁵⁷ Moreover, state legislation on nonprofits is often outdated, terse, and ambiguous, leaving interpretation to the non-legislative arena.⁵⁸

This similar approach to for-profit and nonprofit governance is a development of relatively recent historical vintage. The early corporation in America was a servant of the public good. Prior to the American Revolution, little distinction was drawn between municipal (i.e., governmental) corporations and private corporations, which were overwhelmingly charitable, educational, or religious.⁵⁹ Business corporations existed, but with such constrained powers and purposes that they “would be considered cooperatives or quasi-philanthropic entities today.”⁶⁰ Originally, each corporation had to receive a specific corporate charter from the legislature, but even after general incorporation statutes were gradually enacted,⁶¹ the early corporation was greatly limited in the amount of property that could be held and the purposes for which it could act.⁶² However, these restrictions were liberalized by the end of the nineteenth century.⁶³

⁵⁶ Lizabeth Moody, *Revising the Model Nonprofit Corporation Act: Plus Ça Change, Plus C'est La Meme Chose*, 41 GA. L. REV. 1335, 1337 (2007).

⁵⁷ John Mark Zeberkiewicz & Blake Rohrbacher, *New Day for Nonstock Corporations: The 2010 Amendments to Delaware's General Corporation Law*, 66 BUS. LAW. 271, 274 (2011).

⁵⁸ Thomas Boyd, *Call to Reform the Duties of Directors under State Not-for-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 725 (1986) (“Directors’ duties and responsibilities are particularly ambiguous and obscure, leaving courts with insufficient guidance on what law to apply . . .”).

⁵⁹ JAMES J. FISHMAN, *THE FAITHLESS FIDUCIARY AND THE QUEST FOR CHARITABLE ACCOUNTABILITY 1200–2005*, at 242–43 (2007).

⁶⁰ *Id.* at 242–43.

⁶¹ *Id.* at 245–46.

⁶² *Id.*

⁶³ FREEMONT-SMITH, *supra* note 7, at 50.

Though sharing a common ancestor, the charitable and business corporations evolved at first on different tracks. As the business corporation developed under American law during the 1800s, it was “considered to be quite different” from the charitable corporations governed by stringent common law trust restrictions.⁶⁴ These differences became even starker as business organizations grew rapidly in size, and the fiduciary duties of for-profit directors were articulated and refined to revolve around shareholder maximization.

By contrast, the rise of the charitable corporation was largely driven by a period of judicial and legislative skepticism for charitable trusts in the nineteenth century.⁶⁵ The use of the corporate form became a way to evade this hostility toward legacy control over property.⁶⁶ However, form mattered less than purpose when setting the duties of charitable administrators, and the stricter law of charitable trusts⁶⁷ governed most aspects of charitable contributions, regardless of whether a corporate form was used.⁶⁸ While courts stressed deference to business decisions of for-profit managers, they scrutinized nonprofit decisions under the strictures of trust law.

The rules governing for-profit and nonprofit corporations would not stay separate for much longer, though. The modern law of nonprofit organizations is largely a product of private lawmaking groups in the last half of the twentieth century. The business corporate form was increasingly common, and corporate cases and scholars proliferated.⁶⁹ Business corporate lawyers were appointed to create the first Model Nonprofit Corporation Act, and they borrowed heavily from their experience on the for-profit side of the economy.⁷⁰ As a result, “[t]he first three versions (1952, 1957, and 1964) [of the ABA’s Model Nonprofit Corporation

⁶⁴ *Id.* at 50; James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 655 (1985).

⁶⁵ Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 474 (1996).

⁶⁶ See FISHMAN, *supra* note 59, at 244; FREEMONT-SMITH, *supra* note 7, at 51; see generally Thomas E. Blackwell, *Charitable Corporation and the Charitable Trust*, 24 WASH. U. L. Q. 1 (1938).

⁶⁷ Evelyn Brody, *Charity Governance: What’s Trust Law Got to Do with It?*, 80 CHI.-KENT L. REV. 641, 644–45 (2005). Trust law’s rigidity has been relaxed in recent years, to the point where leading scholar Evelyn Brody argues the difference between corporate and trust law standards is mostly non-existent in practice. *Id.* at 845.

⁶⁸ Fishman, *supra* note 64, at 655.

⁶⁹ *Id.* at 654–55.

⁷⁰ FISHMAN, *supra* note 59, at 268.

Act] almost slavishly followed either the effective or pending versions of the [Model Business Corporation Act].”⁷¹

More recent law reform efforts have gathered more input from the charitable sector, but they remain stuck using the business corporation as the example. The revisions of the Model Nonprofit Corporation Act in 1988 and 2000 largely followed the trend of the Act’s predecessors, expressly adopting “the policy of a parallelism, concluding that there were few basic differences, and that business law precedent was often applicable to nonprofit corporations.”⁷² Similarly, the ALI—publisher of the influential “Restatements on the Law”—is currently amidst a years-long effort to articulate the “Principles of the Law of Charitable Organizations” (“Restatement”) using the rules of business corporations as its model.⁷³ Both law reform efforts stated a willingness to depart from business law when the drafters felt it was necessary through *ad hoc* policy calls.⁷⁴ Due to a lack of legal sophistication and an absence of interjurisdictional competition, earlier private proposals have worked their way into state legislation with minimal input from the nonprofit sector.⁷⁵

In 1960, Professor Karst criticized the overreliance on the corporate form for setting the law of charity: “A distinction which gives such great weight to organizational form rather than operational need carries a substantial burden of justification, and as yet that burden has not been met.”⁷⁶ Even so, corporate similarities have tended to prevail, driven largely by the corporate label attached to

⁷¹ Moody, *supra* note 56, at 1346.

⁷² *Id.* at 1346; Moody, *supra* note 4, at 256 (“It was determined that the Revised Act would parallel the Revised Model Business Corporation Act except when the nature of nonprofit corporations or policy reasons applicable to nonprofit corporations dictated otherwise.”).

⁷³ ALI (Draft No. 1), *supra* note 11, at 8–10.

⁷⁴ *Id.* at 7–8.

⁷⁵ Garry Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1179–81 (2007) (“As a result of institutional norms and pressures, the legal elites of ALI, ABA, and NCCUSL have substantial influence on state law.”). However, the drafters of the recent ALI project and the most recent Revised Model Corporation Acts have sought input from the charitable sector during the drafting process. Brody, *Agents Without Principals*, *supra* note 7, at 540.

⁷⁶ Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 436 (1960).

nonprofit organizations—often with questionable consequences.⁷⁷ Fifty years later, the justification for these rules remains elusive.

B. *Judicial Enforcement of Duties*

In the ideal world, all directors comply with their fiduciary and moral obligations all of the time. In the real world, this does not always happen.⁷⁸ When the fiduciary fails, courts have some power—though limited—to remedy the failing. For example, a person with standing can bring an action against a director of a nonprofit to enforce a fiduciary duty, and the court may impose monetary liability against the director or exercise its equitable powers to correct an abuse. In this part, we survey the “who,” “what,” and “how” of judicial review of directors’ fiduciary obligations, paying particular attention to doctrinal ambiguities, recent proposals by law reform projects, and the manner in which the rules interact with each other to define the relationship between the courts and the organization.

1. Standing

Not everyone can bring a director’s breach of a fiduciary duty to the attention of a court. In fact, by statute and by court decisions, states have tended to severely limit who has standing to challenge a board’s decision.⁷⁹

The formalism of corporate law insists that fiduciary duties are owed to the organization and thus strains to treat suits to enforce those duties as being brought on the organization’s behalf.⁸⁰ Inspired by the ALI, we divide these causes of action that can be brought against a nonprofit’s fiduciaries into three categories.⁸¹ First, since pursuit of the nonprofit’s best interest rests foremost with its governing board, the board can bring a suit on behalf of the organization against a wayward fiduciary.⁸² Second, as the implicit guardian of charity, the state’s attorney general can use judicial machinery to remedy fiduciary breaches under a lengthy tradition

⁷⁷ Nina J. Crimm, *A Case Study of a Private Foundation’s Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1187 (2001) (“Historical circumstances caused differing fiduciary duty standards to develop in connection with the particular legal form selected when creating private foundations.”); *see generally* Fishman, *supra* note 64.

⁷⁸ *See generally* FISHMAN, *supra* note 59 (cataloging 800 years of fiduciary abuses).

⁷⁹ *See* ALI (Draft No. 1), *supra* note 11, at 9–10; *see also* PRINCIPLES OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 660, at 98 (Tentative Draft No. 3, 2011) [hereinafter ALI (Draft No. 3)].

⁸⁰ *See* Carlson v. Rabkin, 789 N.E.2d 1122, 1127–28 (Ohio Ct. App. 2003).

⁸¹ ALI (Draft No. 1), *supra* note 11, at 6.

⁸² *Id.* § 350, at 333.

grounded in English common law.⁸³ However, it is commonly believed that state enforcement is frequently hindered by political or financial considerations.⁸⁴ Third, if both the board and the attorney general fail to act, the organization's interest in enforcement of fiduciary duties can sometimes be asserted through a derivative action.⁸⁵ Such suits were originally recognized by the common law⁸⁶ and have been explicitly recognized by approximately half of the states.⁸⁷ Some jurisdictions follow the for-profit approach and require that a potential plaintiff must first present a derivative suit to the board, which has considerable power to decide whether it can be brought.⁸⁸

Thus, the range of possible actors who can bring suits against fiduciaries is narrow. Other than the board itself or the state's attorney general, the only possible actors are those who can bring derivative actions, and not many are qualified for that responsibility.⁸⁹ In the for-profit realm, only directors and shareholders can bring a derivative action.⁹⁰ Some states and the Revised Model Nonprofit Corporation Act apply this for-profit approach a bit too closely, simply replacing "shareholder" with "member."⁹¹ This similar treatment leads to wildly dissimilar results between the sectors, since many nonprofit organizations lack any members at all, creating a void where no one has standing to challenge the misbehaving board.⁹²

⁸³ See ALI (Draft No. 3), *supra* note 79, § 610, at 3–4; see generally Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004); David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 U. FLA. J.L. & PUB. POL'Y 131 (2000). In addition to state enforcement, at least one court held that the United States—through its attorney general—can enforce fiduciary duties. *Christiansen v. Nat'l Sav. & Trust Co.*, 683 F.2d 520, 528–30 (D.C. Cir. 1982).

⁸⁴ Hansmann, *supra* note 7, at 600–01.

⁸⁵ See ALI (Draft No. 3), *supra* note 79, §§ 640–660, at 68, 73–74, 98.

⁸⁶ Zechariah Chafee, Jr., *The Internal Affairs of Associations Not for Profit*, 43 HARV. L. REV. 993, 997 (1930).

⁸⁷ See ALI (Draft No. 3), *supra* note 79, at 46–47.

⁸⁸ *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 887 (Minn. 2003).

⁸⁹ ALI (Draft No. 3), *supra* note 79, §§ 640–660, at 68, 73–74, 98.

⁹⁰ FED. R. CIV. P. 23.1.

⁹¹ COLO. REV. STAT. ANN. § 7-126-401 (West 2015); RMNCA, *supra* note 12, § 13.02.

⁹² Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 240 (1999) ("But because of their limiting qualities [private rules of standing] have eviscerated the

Beyond these narrow classes of insiders, standing is, at best, a dubious prospect in the nonprofit realm. Several states and the ALI recognize a limited type of “special interest” standing.⁹³ “[T]he contours of the exception are ill-defined,”⁹⁴ but it is thought to be very rare.⁹⁵ Donors typically do not have standing,⁹⁶ nor do the customers or beneficiaries of the nonprofit’s programs.⁹⁷ For example, faculty and students of an educational institution have been held to lack standing to challenge the organization’s mismanagement.⁹⁸ That said, limited standing is not the universal rule: applying D.C. law, the D.C. Circuit allowed patients of a hospital to enforce fiduciary duties because “justice requires someone to have standing, and it was the patients or nobody.”⁹⁹ However, this more generous approach appears to be the exception rather than the rule.

In these ways, standing to enforce nonprofit duties is markedly different than standing in the federal courts. The rules applicable in federal court are rooted in the jurisdictional provisions of Article III of the United States Constitution, which the Supreme Court has explained requires a plaintiff to show that he has suffered an “injury in fact” that is particularized, that is “fairly traceable to the challenged action of the defendant,” and for which it is “likely . . . that the injury will be redressed by a favorable decision.”¹⁰⁰ While the state standing doctrine in the

ability of the already-tortured application of fiduciary rules to control nonprofit directors and managers.”). *See also* *Summers v. Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 506 (Tenn. Ct. App. 2002) (“This right, however, is not effective where, as here, a nonprofit corporation has no members.”).

⁹³ Brody, *supra* note 83, at 1031.

⁹⁴ *In re* United Effort Plan Trust, 296 P.3d 742, 750 (Utah 2013).

⁹⁵ *See* ALI (Draft No. 3), *supra* note 79, § 680, at 135; Blasko et al., *supra* note 8, at 76.

⁹⁶ Brody, *supra* note 8, at 1187.

⁹⁷ ALI (Draft No. 3), *supra* note 79, at 100 (“Conspicuously missing from the classes of potential plaintiffs to bring a derivative suit are current and potential beneficiaries, whom the law views simply as members of the general public.”). *See also* *Petty v. Hosp. Serv. Ass’n of N.E. Pa.*, 23 A.3d 1004, 1012 (Pa. 2011) (holding that subscribers to nonprofit health insurer lacked standing); *Consumers Union, Inc. v. State*, 840 N.E.2d 68, 80 (N.Y. 2005) (“Plaintiffs are merely purchasers of health insurance, parties to a commercial transaction with Empire.”).

⁹⁸ *FREEMONT-SMITH*, *supra* note 7, at 331 (citing *Warren v. Bd. of Regents of the Univ. Sys. of Ga.*, 544 S.E.2d 190 (Ga. Ct. App. 2001), *In re Barnes Foundation*, 684 A.2d 123 (Pa. Super. Ct. 1996), and *Steenek v. Univ. of Bridgeport*, 668 A.2d 688 (Conn. 1995)).

⁹⁹ *Christiansen v. Nat’l Sav. & Trust Co.*, 683 F.2d 520, 528 (D.C. Cir. 1982).

¹⁰⁰ *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–62 (1992) (citation omitted); *see* *Allen v. Wright*, 468 U.S. 737, 752 (1984) (“Is the injury too abstract, or otherwise not appropriate, to be considered

nonprofit context is not constitutionally based, which means it has the potential to be more flexible,¹⁰¹ it is in fact substantially stingier than federal court rules. For example, in federal courts and under the doctrine just discussed, a beneficiary of a government program would plainly have standing to challenge a change to that regulatory program.¹⁰² By contrast, although beneficiaries of nonprofit programs might satisfy Article III's requirement of particularized harm, they are still barred by state law from attempting to remedy their injury against the erring board.

Scholars love to hate the doctrine of Article III standing,¹⁰³ and the same holds true for standing in the context of nonprofit duties.¹⁰⁴ The argument for expanded standing in the nonprofit context notes that existing enforcement mechanisms are likely inadequate to police abuses. Some have convincingly argued that state attorneys general base their oversight on political reasons divorced from the best interests of the organization, the beneficiaries, or the public good.¹⁰⁵ Moreover, granting standing only to directors of an organization permits the very individuals who played a role in the decision to get a second bite at the apple, while denying any rights to beneficiaries who were not given a seat at the table, but who suffer a more personalized harm from the organization's action. Not surprisingly, the argument for increased standing often strikes a tone of fairness, positing that beneficiaries who are harmed by an organization's unlawful decisions should be

judicially cognizable? Is the line of causation between the illegal conduct and injury too attenuated? Is the prospect of obtaining relief from the injury as a result of a favorable ruling too speculative?"), *abrogated on other grounds by* *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 134 S. Ct. 1377 (2014).

¹⁰¹ See ALI (Draft No. 3), *supra* note 79, at 46–47; *In re Milton Hershey School*, 867 A.2d 674, 683–84 (Pa. Commw. Ct. 2005) (describing standing as “flexible”), *rev'd*, 911 A.2d 1258 (2006).

¹⁰² See *Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 7 (2000).

¹⁰³ See Joseph Mead, *Interagency Litigation and Article III*, 47 GA. L. REV. 1217, 1226 (2013) (“The standing doctrine has been criticized with a consensus and harshness without equal among other doctrines.”); see also Daniel E. Ho & Erica L. Ross, *Did Liberal Justices Invent the Standing Doctrine? An Empirical Study of the Evolution of Standing, 1921–2006*, 62 STAN. L. REV. 591, 594 (2010) (“[S]tanding remains one of the most contested areas of federal law, with criticisms of the doctrine nearing the number of commentators.”).

¹⁰⁴ See generally Nix, *supra* note 8.

¹⁰⁵ See, e.g., Brody, *supra* note 83, at 947–48; Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 758 (2008).

able to remedy the breach in court.¹⁰⁶ The common rationale that standing protects charity from judicial micromanagement through a flood of litigation is empirically ungrounded and better addressed by calibrating the standards of review or adopting fee-shifting provisions.¹⁰⁷

Like standing in federal court, the debate over nonprofit standing rules reflects important policy disagreements about the distribution of power between institutions and the types of interests that warrant judicial protection. In federal courts, what does or ought to constitute an “injury” is in large part linked to the conception of the role of the courts in a particular context.¹⁰⁸ Put another way, allocating standing forces courts to make judgments as to whose grievances are deserving of judicial attention, and in what circumstances they are so deserving.¹⁰⁹ Therefore, scholars have used the development of standing doctrine as a lens through which to examine the ways that courts regulate access to the judicial system, and, in turn, the ways that courts value certain injuries and define remedies.¹¹⁰ In particular, some argue that access to the courts through standing is especially important for individuals who lack points of access to raise their grievances in the political system.¹¹¹ The same can be said in the context of

¹⁰⁶ See Atkinson, *supra* note 8, at 670 (“Much of the power of the case for expanded standing lies in its appeal to fundamental fairness.”).

¹⁰⁷ See Nix, *supra* note 8, at 167.

¹⁰⁸ See *Allen v. Wright*, 468 U.S. 737, 752 (1984) (“[T]he law of Art. III standing is built on a single basic idea—the idea of separation of powers.”).

¹⁰⁹ See Antonin Scalia, *The Doctrine of Standing as an Essential Element of the Separation of Powers*, 17 SUFFOLK U. L. REV. 881, 892 (1983) (“The degree to which the courts become converted into political forums depends not merely upon what issues they are permitted to address, but also upon *when* and *at whose instance* they are permitted to address them.”).

¹¹⁰ See, e.g., CHRISTOPHER D. STONE, SHOULD TREES HAVE STANDING?—TOWARD LEGAL RIGHTS FOR NATURAL OBJECTS 35 (William Kaufmann ed., 1974), available at http://isites.harvard.edu/fs/docs/icb.topic498371.files/Stone.Trees_Standing.pdf (“Some of the most important questions of ‘right’ . . . turn into questions of degree: how much review, and of which sort, will which state agencies accord us when we claim our ‘right’ is being infringed?”); Richard H. Fallon, Jr., *The Linkage Between Justiciability and Remedies—and Their Connections to Substantive Rights*, 92 VA. L. REV. 633, 648–82 (2006); Mead, *supra* note 103, at 1275 (arguing that justiciability doctrines value some injuries more than others); Karen Orren, *Standing to Sue: Interest Group Conflict in the Federal Courts*, 70 AM. POL. SCI. REV. 723, 725 (1976) (“Standing . . . shifts the parameters within which groups may operate: what may now be asked of the court in the way of judgments, injunctions, and so on; and the range of social enterprises open to challenge.”).

¹¹¹ See Gene R. Nichol, Jr., *Standing for Privilege: The Failure of Injury Analysis*, 82 B.U. L. REV. 301, 322 (2002) (“[I]t is far better to come down on the side of those who are having the hardest time of it. . . . Standing law, regrettably, repeatedly violates this fundamental set of lessons.”); *id.* at 326 (“It is

nonprofits. As Rob Atkinson aptly summarized, “[t]he question of who should have standing to sue charitable fiduciaries ultimately comes round to what kind of charity we want to have, to what we think charity is, and what we want it to be.”¹¹² Accordingly, we consider standing not only as an instrument for enforcing specific duties, but as an important option to deploy when an institution does not provide its own internal accountability mechanisms and when we conclude from a normative or policy perspective that such a failure is in need of a remedy.

2. Standards of Judicial Review

As important as the question of “who” is the question “for what?” Following the for-profit model, injured parties with standing can ask the court to enforce fiduciary duties, but the law prescribes highly deferential standards for reviewing a board’s exercise of fiduciary duties, at least so long as the right process is followed.

Although scholars count and define the number of fiduciary duties differently,¹¹³ a common articulation is that nonprofit directors have duties of care, loyalty, and obedience.¹¹⁴ The duty of care requires each director to become appropriately informed and to act with the care that a reasonably prudent person would exercise in similar circumstances.¹¹⁵ The duty of loyalty requires directors to act to further the best interests of the organization.¹¹⁶ Finally, the duty of obedience requires that the directors adhere to the requirements of law and the organization’s governing documents.¹¹⁷ However, these standards are merely the default rules. Borrowing from a common practice in the corporate world, the ALI proposes that nonprofit boards may increase their insulation from judicial scrutiny by further

difficult to understand the eased standing requirements in . . . cases . . . filed in pursuit of majoritarian interests. It is not as if there is a structural reason to believe that such claims will fall on deaf ears in the halls of the legislature.”); Heather Elliott, *The Functions of Standing*, 61 STAN. L. REV. 459, 488, 490 (2008).

¹¹² Atkinson, *supra* note 8, at 698.

¹¹³ See, e.g., Julian Velasco, *How Many Fiduciary Duties are There in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1232–35 (2009).

¹¹⁴ Goldschmid, *supra* note 2, at 638–40.

¹¹⁵ ALI (Draft No. 1), *supra* note 11, § 315, at 91.

¹¹⁶ *Id.* at 40.

¹¹⁷ The duty of obedience is sometimes described as a subcomponent of the duty of loyalty. See, e.g., David Rigney, *Duties and Potential Liabilities of Officers and Directors of Nonprofit Organizations*, in NONPROFIT GOVERNANCE AND MANAGEMENT 83, 87–88 (Victor Futter ed., 2002). We find it useful analytically to discuss it separately.

relaxing the duties owed by members to the organization, albeit within certain limits.¹¹⁸ In contrast, the Revised Model Nonprofit Corporation Act does not permit charitable corporations to reduce the fiduciary duties owed by directors.¹¹⁹

a. Duty of Care

The duty of care requires directors to exercise reasonable judgment. This encompasses a duty to actually exercise judgment—total abdication of oversight of an organization would be a breach of the duty—and to be reasonable in decision-making. Reasonable reliance on information or counsel is typically acceptable.¹²⁰

While reasonableness is the standard prescribed for directors, courts employ an even more deferential enforcement posture under the business judgment rule.¹²¹ Although, as the name suggests, it has been most fully adopted in the business context, most jurisdictions also apply the rule to nonprofit organizations.¹²² Under the business judgment rule, a court does not second-guess the decision made by a board if the decision could reasonably be thought to be in the best interest of the organization and was the product of reasonable attentiveness.¹²³ Sometimes, as in

¹¹⁸ ALI (Draft No. 1), *supra* note 11, § 305.

¹¹⁹ RMNCA, *supra* note 12, § 2.02(c).

¹²⁰ *Id.* § 8.30(d)–(f).

¹²¹ Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299–300 (1999) (“[I]n practice the duty of care is all but eviscerated by a legal doctrine known as the ‘business judgment rule.’” (citation omitted)). Whether the business judgment rule modifies the standard of care, or instead simply prescribes a standard of *review*, is unimportant to our argument, which focuses on the standards used by reviewing courts. See Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1139 (2013) (noting “the enigmatic relationship between the duty of care and the business judgment rule”).

¹²² ALI (Draft No. 1), *supra* note 11, § 365 (“The business judgment rule—and the name—enjoys wide judicial acceptance in the nonprofit context.”); Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for the Conduct of Not-for-Profit Directors*, 33 J. HEALTH L. 455–84, 459 (2000) (“While most commonly associated with the actions of for-profit directors, there is a growing acceptance that the Rule is equally applicable to the actions of not-for-profit directors.”); see *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 883 (Minn. 2003) (“Other states have applied the business judgment rule to decisions of nonprofit corporations, explicitly or implicitly. We find no case denying a nonprofit organization the protection of the business judgment rule.”); cf. James Edward Harris, *The Nonprofit Corporation Act of 1993: Considering the Election to Apply the New Law to Old Corporations*, 16 U. ARK. LITTLE ROCK L.J. 1, 18 (1994) (“Uncertainty exists as to whether and under what circumstances the business judgment rule may be applied to nonprofit corporations.”). Some have suggested that the business judgment rule be renamed the “best judgment rule” for nonprofit organizations. FREEMONT-SMITH, *supra* note 7, at 209 n.110.

¹²³ Peregrine & Schwartz, *supra* note 122.

Delaware, this is articulated as a gross negligence standard.¹²⁴ However, at other times, it appears to provide effectively absolute protection, so long as the proper procedures were followed.¹²⁵ A common articulation is that directors are presumed to have “acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company,” absent evidence of “fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.”¹²⁶

Thus, the business judgment rule does not permit non-management; generally, it does not protect a director who unreasonably fails to attend meetings or participate in governing decisions.¹²⁷ However, it does provide protection to directors who make “honest mistakes of judgment.”¹²⁸ Courts worry that if an organization’s decisions were scrutinized with the benefit of hindsight, judges would too quickly find fault where there was error.¹²⁹ The business judgment rule is also based on the premise that directors have more expertise than courts and that investors prefer business decisions in the board room instead of the courtroom.¹³⁰ Finally, the business judgment rule reduces the risk of monetary liability for individual directors who make a mistake in judgment.¹³¹

¹²⁴ Goldschmid, *supra* note 2, at 642.

¹²⁵ Pollack, *supra* note 14, at 848; Denise Ping Lee, Note, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 965 (2003) (“When directors find themselves subject to a gross negligence standard under the business judgment rule, they realize that they are essentially subject to no standard of care at all regarding the substance of their decisions.”).

¹²⁶ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993) (quotations omitted), *decision modified on reargument on other grounds*, 636 A.2d 956 (Del. 1994).

¹²⁷ *Bank of Hartford v. Bultron, Inc.*, No. SP-H-9296-65684, 1992 WL 436242, at *9 (Conn. Super. Ct. Dec. 21, 1992). The business judgment rule also may have less of a role to play where there are allegations of disloyal or disobedient conduct, as we discuss further below. See *In re Fleming Packaging Corp.*, 351 B.R. 626, 634 (Bankr. C.D. Ill. 2006); HOWARD L. OLECK & MARTHA E. STEWART, *NONPROFIT CORPORATIONS, ORGANIZATIONS, & ASSOCIATIONS* 900 (6th ed. 1994).

¹²⁸ Jaclyn A. Cherry, *Update: The Current State of Nonprofit Director Liability*, 37 DUQ. L. REV. 557, 561 (1998).

¹²⁹ Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 119 (2004).

¹³⁰ These assumptions are tested by the institutional model, as laid out below in Part III.B.3.

¹³¹ *FDIC v. Castetter*, 184 F.3d 1040, 1044 (9th Cir. 1999).

Application of the business judgment rule to nonprofits is neither universal nor beyond controversy.¹³² Scholars have argued that nonprofit organizations lack some of the same means of accountability as for-profit boards and that they should be held to the far stricter standards of a charitable trustee,¹³³ or, at minimum, to the ordinary negligence standard.¹³⁴ Yet the trend among courts is to strongly favor the application of the business judgment rule to nonprofits.¹³⁵ Both the ALI's Restatement and the Model Nonprofit Corporation Act propose some version of the business judgment rule, but each articulates the standard in significantly different ways.¹³⁶ The Restatement emphasizes that the rule is only available to directors who are not personally interested in the transaction.¹³⁷ In contrast, the Model Nonprofit Corporation Act extends business judgment rule deference even to directors laboring under a conflict of interest, so long as the director reasonably believed that the decision was in the best interests of the organization.¹³⁸ Both formulations contemplate a highly deferential posture in fiduciary litigation alleging bad director judgment.

b. Duty of Loyalty

The duty of loyalty requires directors to act in the best interest of the organization, not their own self-interest.¹³⁹ The duty of loyalty is most regularly implicated by conflicts of interest, as a board considers a course of action affecting

¹³² FREEMONT-SMITH, *supra* note 7, at 210 (“In the nonprofit context, there is some debate whether courts should ever apply the business judgment rule.”); Peregrine & Schwartz, *supra* note 122, at 194 (“Another active duty-of-care controversy is the extent to which the [b]usiness [j]udgment [r]ule is applicable to nonprofit corporations. Despite the rather explicit position of the Revised Model Act and its drafters, and the views of commentators in the field, some attorneys general have resisted its application in certain circumstances. As such, it cannot be said with certainty that the [b]usiness [j]udgment [r]ule applies uniformly in all states to protect the decision making of nonprofit directors.”).

¹³³ Boyd, *supra* note 58, at 727.

¹³⁴ Lee, *supra* note 125, at 944.

¹³⁵ *Id.* at 927.

¹³⁶ ALI (Draft No. 1), *supra* note 11, § 365(a).

¹³⁷ *Id.* § 365(e).

¹³⁸ RMNCA, *supra* note 12, § 8.31.

¹³⁹ ALI (Draft No. 1), *supra* note 11, § 310.

a board member's financial interests or another obligation of the board member, such as a fiduciary duty owed to a competing nonprofit "trustees" organization.¹⁴⁰

At common law, trust law flatly banned trustees' self-dealing.¹⁴¹ Even self-dealing transactions in the best interest of the trust were prohibited.¹⁴² Although the trust law standard originally applied to corporate directors as well, the rules were relaxed for for-profit directors.¹⁴³ Today, transactions involving a director of a for-profit can be approved by disinterested directors, with minimal judicial review of the merits of a ratified transaction.¹⁴⁴ If an interested transaction is not approved by a majority of disinterested directors, then it must be fair to the organization; the burden of proving that an interested transaction is *unfair* rests on the party challenging the transaction.¹⁴⁵

As trust and corporate loyalty requirements diverged, nonprofits once more found themselves falling in an uncertain middle ground.¹⁴⁶ Although a majority of states apply the business standard to nonprofits, commentary has been sharply critical of the trend toward approving conflicted transactions, and "the majority of scholars who have analyzed modern formulations of the duty of loyalty . . . have decided that it is now too lenient."¹⁴⁷ Accordingly, some scholars call for "a flat prohibition against all self-dealing transactions" for nonprofit organizations.¹⁴⁸ Though some states are exceptions, most states have not heeded this call.¹⁴⁹ In

¹⁴⁰ State law standards have been supplemented by strict, specific IRS rules regarding self-dealing transactions for those organizations wishing to remain tax-exempt. FREEMONT-SMITH, *supra* note 7, at 237.

¹⁴¹ *Id.* at 195.

¹⁴² *Id.*

¹⁴³ ALI (Draft No. 1), *supra* note 11, § 330.

¹⁴⁴ *Id.*

¹⁴⁵ Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 923 (2011).

¹⁴⁶ FREEMONT-SMITH, *supra* note 7, at 216.

¹⁴⁷ *Id.* at 236.

¹⁴⁸ Hansmann, *supra* note 7, at 569.

¹⁴⁹ For example, Delaware makes the duty of loyalty stricter for nonprofit directors than for those on for-profit boards, scrutinizing the substance of a conflicted transaction even when approved by legally disinterested directors. *See Oberly v. Kirby*, 592 A.2d 445 (Del. 1991) (en banc); *see also DeMott*, *supra* note 10, at 143; Hansmann, *supra* note 7, at 568. That Delaware has grasped this nuance is all the more noteworthy given that Delaware does not even have a separate nonprofit corporation law, but

particular, the law reform projects suggest that directors can enter into transactions with themselves, escaping external oversight so long as they can establish that the transaction is “fair.”¹⁵⁰

c. Duty of Obedience

Whereas loyalty requires the exclusion of other influences on the director’s decision-making, obedience requires not simply a pure mind, but also that the decision substantively further the organization’s mission.¹⁵¹ Whether it is treated as a standalone duty or simply a subcomponent of one of the above, the requirement of director obedience plays an important and underappreciated role in both for-profits and, especially, nonprofits.

The conventional wisdom is that, in the for-profit world, the duty of obedience is almost a dead letter.¹⁵² Corporate charters regularly establish “any lawful purpose” as the organization’s aims,¹⁵³ and the phrase “duty of obedience” rarely appears in reported decisions. At times, though, courts still do intervene and hold for-profit directors and officers to obey one type of for-profit mission: the maximization of shareholder wealth.¹⁵⁴ This mandate was famously articulated nearly one-hundred years ago in *Dodge v. Ford Motor Company*, which opined that the managers of Ford were required by law to consider the interests of shareholders first and foremost.¹⁵⁵ In the years that followed, the judicially cognizable version of

instead folds nonprofit corporations into its for-profit corporate law scheme. See Mary A. Jacobson, *Nonprofit Corporations: Conversion to For-Profit Corporate Status and Nonprofit Corporation Members’ Rights*—Farahpour v. DCX, Inc., 20 DEL. J. CORP. L. 635, 635 (1995).

¹⁵⁰ RMNCA, *supra* note 12, § 8.60; see ALI (Draft No. 1), *supra* note 11, § 330 (allowing fairness review so long as the fiduciary disclosed the conflict).

¹⁵¹ Robert A. Katz, *Let Charitable Directors Direct: Why Trust Law Should Not Curb Board Discretion over a Charitable Corporation’s Mission and Unrestricted Assets*, 80 CHL-KENT L. REV. 689, 699–700 (2005). The decision also must comply with the law; all corporations, for-profit and nonprofit alike, are limited to the pursuit of lawful purposes only.

¹⁵² Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43, 54 (2008). In fact, some commentators argue that “[t]he duty of obedience . . . does not have a for-profit counterpart” at all. Peggy Sasso, Comment, *Searching for Trust in the Not-for-Profit Boardroom: Looking Beyond the Duty of Obedience to Ensure Accountability*, 50 UCLA L. REV. 1485, 1530 (2003).

¹⁵³ DEL. CODE ANN. tit. 8, § 101(b) (2011).

¹⁵⁴ Katz, *supra* note 151, at 699 (“Just as a for-profit board should aim to maximize shareholder value, so too should a charitable board aim to maximize the fulfillment of the organization’s mission.”); Sasso, *supra* note 152, at 1528.

¹⁵⁵ 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The

this mandate was enforced so infrequently in court that a robust academic debate developed as to whether it was extinct or ever really existed.¹⁵⁶ The debate was reinvigorated by a recent Delaware court, which found Craigslist's directors in breach of their fiduciary duties for expressly considering public benefit goals above shareholder value:

Having chosen a for-profit corporate form, the [C]raigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.¹⁵⁷

This duty of obedience to the norm of shareholder wealth maximization can be understood as a default rule of corporate law. Absent a more specific mission—agreed to by the owners and reflected in the organization's charter—the reasonable presumption is that the primary mission of the corporations is to make money for the owners.¹⁵⁸ However, state statutory regimes are flexible enough to allow modification to this default rule.¹⁵⁹ As for-profit organizations explicitly adopt non-financial missions, we might expect an increasing rise in the relevance of the duty of obedience to ensure compliance with non-financial missions as well.¹⁶⁰ On the flip side, we might presume that a corporation that declines to adopt a narrower mission is adopting the default mission of shareholder wealth maximization, and investors buy in to the company with that understanding.¹⁶¹ Notwithstanding what

discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.”)

¹⁵⁶ Ian B. Lee, *Efficiency and Ethics in the Debate about Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 535 (2006) (“[T]he question whether managers are obligated to maximize shareholder profits remains as ambiguous as ever.”).

¹⁵⁷ *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010); see also Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 438 (2013).

¹⁵⁸ Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 783–84 (2005).

¹⁵⁹ Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 4 (1990).

¹⁶⁰ See *Burwell v. Hobby Lobby*, 134 S. Ct. 2751, 2770–71 & n.23 (2014) (“[I]t is not at all uncommon for [for-profit corporations] to further humanitarian and other altruistic objectives.”).

¹⁶¹ James Nelson, *Conscience, Incorporated*, 2013 MICH. ST. L. REV. 1565, 1598–99 (2013).

might be, most for-profits today are oriented to maximize profits and adopt broad articles of incorporation for that purpose. Thus, it remains a rare event to see a for-profit case turn on the duty of obedience.

The landscape is dramatically different for nonprofit organizations, which are commonly aligned with far more limited purposes. For a nonprofit organization, the duty to obey a mission—a mission that cannot be shareholder wealth maximization—is its *raison d'être*. Organizations seeking tax-exempt status from the IRS must submit articles of incorporation that limit the organization to particular purposes.¹⁶² Donors are not buying a simple product, but offer a contribution based on an assumption—sometimes explicit, sometimes implicit—that the organization will use the donation to further that purpose.¹⁶³ As a result, the organization's managers are expected to act in furtherance of the organization's mission.¹⁶⁴ Based on the relatively narrow missions of many nonprofits and the greater reliance placed by investors/donors on those specific missions, courts actively police director mission obedience.¹⁶⁵

¹⁶² IRS, U.S. DEP'T OF THE TREASURY, PUB. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION 5, 24 (2015).

¹⁶³ Nat'l Found. v. First Nat'l Bank of Catawba Cnty., 288 F.2d 831, 836 (4th Cir. 1961) ("Every gift to The National Foundation, in a sense, is a gift in trust. Its use, with other gifts, is limited to activity in furtherance of the donee's corporate purposes, or to such other purposes to which they properly might be applied under the *cy-pres* doctrine. Donated funds are dedicated to the charitable objects of the corporation and may not be diverted to other use.").

¹⁶⁴ The implicit assumption that donors contribute in reliance on a nonprofit's mission is strikingly similar to the implicit assumption that shareholders invest in reliance on the for-profit's pursuit of profits. If a for-profit adopts a different mission, then investment decisions will presumably be driven in part on the basis of that new mission, and the courts should accordingly hold the for-profit to its stated ends.

¹⁶⁵ As one court put it:

It is axiomatic that the Board of Directors is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the "duty of obedience." It requires the director of a not-for-profit corporation to "be faithful to the purposes and goals of the organization," since "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d'être* of the organization."

Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999).

The expectation of nonprofit mission obedience may seem straightforward on the surface, but it is difficult in practice.¹⁶⁶ Translating an abstract mission¹⁶⁷ into concrete action is wrought with difficult judgment calls and interpretive dilemmas.¹⁶⁸ Indeed, given the complexities of both defining the mission and determining how to measure it, “[t]here are some who posit that fulfilling the nonprofit duties of care and obedience are actually more difficult and complex than focusing on maximizing profits.”¹⁶⁹ Still, notwithstanding the difficult judgment calls that inhere in complex and ambiguous missions, courts are willing to second-guess board decisions to police perceived deviations. For example, a New York court prohibited the sale of a charitable specialty hospital’s assets after finding that the sale would not further the organization’s mission.¹⁷⁰ At least in some jurisdictions, the question of whether an organization is complying with its mission is reviewed without the deference of the business judgment rule.¹⁷¹

Another difficulty with mission enforcement through a strong duty of obedience comes from the omnipresent march of time, threatening obsolescence to even the best of missions. For example, the March of Dimes was established to fight polio, but it found itself seeking new meaning following polio’s cure.¹⁷² A rigid focus on the existing mission, without a beneficiary-focused “duty to assure that the trust is meeting contemporaneous needs . . . does not set forth an appropriate standard.”¹⁷³ Corporate law allows the board to amend the articles of

¹⁶⁶ Johnny Rex Buckles, *How Deep are the Springs of Obedience Norms That Bind the Overseers of Charities?*, 62 CATH. U. L. REV. 913, 920–24 (2013).

¹⁶⁷ Indeed, there is often ambiguity with defining a nonprofit’s “mission.” See, e.g., Melanie DiPietro, *Duty of Obedience: A Medieval Explanation for Modern Nonprofit Governance Accountability*, 46 DUQ. L. REV. 99, 122 (2007) (distinguishing between mission, purpose, and public benefit, and noting that “[t]his author has not found a generally acceptable definition of ‘mission’ by commentators using the term”).

¹⁶⁸ Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 895 (2007) (“[T]he core of what makes charities unique, desirable, and worth subsidizing is somewhat ephemeral and virtually nonjusticiable.”).

¹⁶⁹ John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3c Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 161 n.103 (2010).

¹⁷⁰ *Spitzer*, 715 N.Y.S.2d at 597.

¹⁷¹ *Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 529 (Tenn. Ct. App. 2002).

¹⁷² David Rose, *A History of the March of Dimes*, MARCH DIMES (Aug. 26, 2010), <http://www.marchofdimes.com/mission/a-history-of-the-march-of-dimes.aspx>.

¹⁷³ FREEMONT-SMITH, *supra* note 7, at 226.

incorporation to revise the organization's mission, but there is a divide among academics and jurisdictions whether the act of revising is, itself, bound by the strictures of the existing mission.¹⁷⁴ For those jurisdictions that impose a duty to the original mission,¹⁷⁵ organizations can only adapt to modern problems by obtaining judicial approval through the cumbersome *cy pres* process.¹⁷⁶ The modern trend, and the one favored by the latest ALI Restatement,¹⁷⁷ gives the board expansive power to amend the organization's mission.¹⁷⁸

3. Remedies & Immunities

If there is both a plaintiff with standing and a breach of one of the fiduciary duties, then the courts must determine which remedy they will employ. Although the remedy stage occurs at the end of a case, the type of remedies at stake has important implications for who is able and willing to sue and what standard the court will use to judge the behavior. Indeed, remedies are important not only once an issue is in litigation, but as a form of *ex ante* deterrence before a breach even occurs. Like standing and standards, the types of remedies available reflect judgment calls about the relationship between judicial and corporate institutions.

Following the corporate model, the preferred judicial remedy in the case of a fiduciary breach in the nonprofit context is an equitable one—an accounting, specific performance, an injunction, or restitution—with the goal of undoing whatever act violates the fiduciary duty. This is often accompanied by a declaratory judgment that a breach occurred. For well-meaning but poor-acting boards, this slap on the wrist may be enough admonition to spur more attentive oversight in the future. Other equitable remedies may be more intrusive. A common type of relief

¹⁷⁴ *Id.* at 439–40; Katz, *supra* note 151, at 689–90.

¹⁷⁵ RMNCA, *supra* note 12, § 10.09(b); Attorney Gen. v. Hahnemann Hosp., 494 N.E.2d 1011, 1021 (Mass. 1986) (rejecting argument that board can amend charter and apply pre-amendment, unrestricted assets to new purpose because the public could not trust that the funds donated would be used for the intended purpose); Spitzer, 715 N.Y.S.2d at 595 (“[T]he duty of obedience . . . mandates that a Board, in the first instance, seek to preserve its original mission.”).

¹⁷⁶ See generally Rob Atkinson, *Reforming Cy Pres Reform*, 44 HASTINGS L.J. 1111 (1993). Although *cy pres* is typically a doctrine for revising specific bequests, it has been applied to the modification of an organization's mission as well. Christopher Lacovara, *Strange Creatures: A Hybrid Approach to Fiduciary Duty in Benefit Corporations*, 2011 COLUM. BUS. L. REV. 815, 848 n.140 (2011) (“The limitation on the ability of fiduciaries to alter the charitable purposes of a nonprofit organization, combined with the perpetual existence of a corporation, gave rise to the doctrine of *cy pres*.”).

¹⁷⁷ ALI (Draft No. 1), *supra* note 11, at 310 cmt. (a)(1).

¹⁷⁸ Katz, *supra* note 151, at 690–91.

involves a judicial mandate to change some aspect of the governance structure to prevent recidivism, often by implementing a new policy or procedure.¹⁷⁹ Although more disfavored, another remedy is to remove the offending board members from their posts.¹⁸⁰

Money judgments are highly disfavored as a matter of policy in the nonprofit sector—even more so than in the for-profit world. This is so whether the money damages are considered equitable, as in an order of restitution, or legal, as in an award of damages. At the federal level, concern that nonprofits were having difficulty recruiting qualified board members, or that board decision-making would be distorted by undue threats of liability, led to the enactment of the Federal Volunteer Protection Act (“VPA”), which immunizes all volunteers, including directors, from monetary liability for negligent acts.¹⁸¹ However, the VPA does not immunize directors against suits brought by the organization itself, and derivative actions—the very actions where a fiduciary duty can be asserted—likely fall within this exception, leaving the director exposed to monetary liability.¹⁸²

The vast majority of states also statutorily immunize volunteer directors from monetary liability for acts made in good faith within the scope of their role for the organization, though the scope of this protection varies from state to state.¹⁸³ Some states mirror the federal VPA and immunize directors for negligence, but not gross negligence.¹⁸⁴ Others immunize directors unless they act intentionally or willfully.¹⁸⁵ Although both of these immunities provide considerable protection against monetary judgments to individuals who fall within their scope, there are several limitations that make them relatively minor players in fiduciary litigation. Significantly, these statutes often do not extend immunity to suits brought by the attorney general, which is likely the biggest threat of monetary liability faced by

¹⁷⁹ *Stern v. Lucy Webb Hayes Nat. Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1018 (D.D.C. 1974); ALI (Draft No. 1), *supra* note 11, at 360 cmt. (b).

¹⁸⁰ ALI (Draft No. 1), *supra* note 11, at 360 cmt. (b).

¹⁸¹ 42 U.S.C. §§ 14501–14505 (2012).

¹⁸² *Melucci v. Sackman*, 961 N.Y.S.2d 359 (Table) (N.Y. Sup. Ct. 2012).

¹⁸³ Jill R. Horwitz & Joseph Mead, *Letting Good Deeds Go Unpunished: Volunteer Immunity Laws and Tort Deterrence*, 6 J. EMPIRICAL LEGAL STUD. 633–35 (2009).

¹⁸⁴ OHIO REV. CODE ANN. § 2305.38(C) (West 2009).

¹⁸⁵ OKLA. STAT. ANN. tit. 18, § 867 (West 2012).

nonprofit directors given the relative lack of standing of other interested parties.¹⁸⁶ Moreover, it is less certain how immunity applies in suits brought by an organization, which, technically, is how fiduciary litigation is viewed.¹⁸⁷ Finally, as a practical matter, an allegation that a director breached a duty of loyalty will likely fall outside the scope of the immunities because it will be deemed intentional misconduct or an act in bad faith.¹⁸⁸ Thus, although seemingly broad at first glance, director immunity from monetary judgments provides fairly weak protection to volunteer directors.

Beyond statutory immunity is contractual immunity—a concept aggressively developed in the for-profit context.¹⁸⁹ Many jurisdictions permit a nonprofit to indemnify directors for judgments or their legal expenses, absent a showing of intentional misconduct or bad faith.¹⁹⁰ Moreover, nonprofit organizations are often encouraged to purchase liability insurance for their directors and officers to hedge against the risk of litigation.¹⁹¹ Both statutory and contractual immunity decrease the likelihood that a nonprofit director will be held financially responsible for mismanagement.

4. Summary

As Professor Fallon has persuasively argued, the doctrines of standing, standards, and remedies interact to create a complex allocation of power between courts and organizations.¹⁹² The above discussion demonstrates that they combine to create a hands-off posture for judicial oversight of corporate directors in both

¹⁸⁶ CAL. CORP. CODE § 5239(e)(2) (West 2014); MINN. STAT. § 317A.257(2)(a)(1) (1989) (exempting from scope of immunity “an action or proceeding brought by the attorney general for a breach of a fiduciary duty as a director”).

¹⁸⁷ *Melucci*, 961 N.Y.S.2d 359 (Table).

¹⁸⁸ See, e.g., *Am. Baptist Churches of Metro. N.Y. v. Galloway*, 271 A.D.2d 92 (N.Y. App. Div. 2000); Brody, *supra* note 67, at 657 (“[M]any state nonprofit corporation statutes permit the articles of incorporation to contain a personal monetary ‘liability shield’ for directors who, in good faith, breach the duty of care (but not the duty of loyalty).”).

¹⁸⁹ DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). In some types of for-profit corporations, fiduciary duties can even be eliminated entirely. *Id.* tit. 6, § 18-1101(e); Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123 (2006).

¹⁹⁰ ALI (Draft No. 1), *supra* note 11, at 380.

¹⁹¹ Cherry, *supra* note 128, at 569.

¹⁹² Fallon, *supra* note 110, at 683.

nonprofit and for-profit organizations. Figure 2 sets out the similarities between the for-profit and nonprofit rules discussed above, as well as any departure in the nonprofit context. The similarities are truly striking. Indeed, it appears quite plain that the law of nonprofit organizations continues to develop toward “corporate law parallelism,”¹⁹³ as courts treat nonprofits under a “corporate model.”¹⁹⁴

Figure 2. Summary of For-Profit and Nonprofit Fiduciary Rules

	Summary of For-Profit Rule	Nonprofit Parallelism	Nonprofit Departure
Standing	Treat cause of action as belonging to organization; allow directors and owners only to enforce	Cause of action belongs to organization; limit standing to directors and members, creating standing void for memberless organizations	Occasional “special interest” standing
Duty of Care	Business judgment rule protects reasonable judgment calls	Most jurisdictions apply business judgment rule to board judgment calls	Some jurisdictions have not expressly adopted business judgment rule for nonprofits
Duty of Loyalty	Defer to conflicted transactions when approved by disinterested directors	Modern trend to adopt for-profit standard of review	Some jurisdictions apply higher standard and review all transactions for fairness
Duty of Obedience	Minimally-enforced obligation to maximize profits	Modern trend to allow board to amend mission at will	More specific missions for nonprofits; obligation more closely policed; board decisions scrutinized for compliance with mission
Remedies	Organizations can agree to relax fiduciary standards, indemnify directors, and pay for director insurance	Same default rights and remedies as for-profits	Additional statutory immunity for uncompensated directors; Model Nonprofit Corporation Act does not allow charitable corporations to modify fiduciary obligations

¹⁹³ Katz, *supra* note 151, at 690–91.

¹⁹⁴ Atkinson, *supra* note 152, at 80.

For-profit law's influence on nonprofit governance is easy to observe across all doctrines. Even where nonprofit law imposes a different standard than the for-profit analog, the departures are relatively minor in contrast to the similarities. Further, those instances where nonprofit law does impose a higher standard for directors are counteracted by "stingier" rules of standing at the front end and additional forms of immunity at the back end.¹⁹⁵ The movement towards increasing parallelism means an increase in what nonprofit directors can get away with—latitude that could be used to work against the best interest of the organization.

With the relatively parallel legal treatment of for-profits and nonprofits, the question arises whether that parallelism is warranted. After all, it is plainly not enough to base the nonprofit legal regime on historical quirks or the fact that we call most of them "corporations." Even a casual observer recognizes that there are often dramatic differences between for-profit and nonprofit organizations. Therefore, some scholars argue that for-profit rules of standing, deferential standards, and immunities are ill-suited for nonprofits¹⁹⁶ and observe that nonprofits lack the sort of clear performance metrics, financially-motivated owners, vigorous market-based checks, and sophisticated governance structures that characterize the for-profit arena.¹⁹⁷ Moreover, as donors are often not able to verify product quality before donating, they instead rely on the non-distribution proxy,¹⁹⁸ which, in turn, constrains nonprofit decision-making in a way not experienced by for-profits¹⁹⁹ and causes the missteps of one organization's leaders to reverberate throughout the sector.²⁰⁰ The next part of this Article engages with this debate by

¹⁹⁵ Hazen & Hazen, *supra* note 7, at 363 ("[W]hile the law imposes high standards of responsibility on nonprofit directors, it incongruously includes significant limitations on board accountability for wrongdoing or lack of oversight.").

¹⁹⁶ *Id.*

¹⁹⁷ Boyd, *supra* note 58, at 744; DeMott, *supra* note 10, at 140; Goldschmid, *supra* note 2, at 648; Lee, *supra* note 125, at 950–52; Howard L. Oleck, *Proprietary Mentality and the New Non-Profit Corporation Laws*, 20 CLEV. ST. L. REV. 145 (1971).

¹⁹⁸ Hansmann, *supra* note 26, at 835.

¹⁹⁹ For example, some argue that nonprofits should be more risk-averse than for-profits. See Barry Bozeman & Gordon Kingsley, *Risk Culture in Public and Private Organizations*, 58 PUB. ADMIN. REV. 109 (1998); Keenan Wellar, *Embracing Risk in the Shift from "Program Thinking" to "Social Change Thinking"*, NONPROFIT Q. (July 30, 2012), <https://nonprofitquarterly.org/management/20732-embracing-risk-in-the-shift-from-program-thinking-to-social-change-thinking.html>. When it comes to choosing investments, the default legal rule in most jurisdictions is that trustees are held to a reasonable investor standard, which allows some measure of risk as long as it is consistent with the charitable mission. See FREMONT-SMITH, *supra* note 7, at 212–14.

²⁰⁰ DeMott, *supra* note 10, at 146–47; Mead, *supra* note 9, at 885–86.

proposing five internal accountability metrics and assessing the for-profit firm and the nonprofit corporation against those metrics.

III. APPLYING AN INSTITUTIONAL MODEL FOR JUDICIAL REVIEW

As the above discussion illustrates, there is considerable debate in the nonprofit literature about the propriety and utility of the current judicial regime surrounding nonprofit organizations. This debate spans justiciability doctrines like standing and deference doctrines like the business judgment rule. While the existing literature has yielded potentially profitable ideas, it has not systematically assessed whether the prevailing regime is correctly tailored to the institution and constituents at issue. In this part, we endeavor to fill that gap. First, we set out a set of institutional characteristics that are relevant to this question and then evaluate the nonprofit organization against these metrics, focusing on the different constituencies outlined above. By pinpointing how and for whom the existing mechanisms of judicial review are suited to the nonprofit, we can both offer a more rigorous defense of the status quo with respect to certain constituencies and target for possible reform those constituencies and circumstances most in need of it.

A. *The Institutional Analysis Approach to Judicial Review of Corporate Governance*

How should courts decide *how* to engage in judicial review? Scholars have “almost never treat[ed] deference as a subject in and of itself,”²⁰¹ but this meta-question of how to construct an institutionally or contextually appropriate mechanism of judicial review is in need of attention because, without it, courts all too often permit inertia or historical accident to form the basis of the review they exercise. This is certainly the case in the context of the homeowners’ association,²⁰² and as we have shown here, it is the case in the context of the nonprofit corporation as well.

The solution we offer is to analyze a series of characteristics of the particular institution that speak to its internal mechanisms of accountability, its expertise, and the need for either of those features.²⁰³ After all, on the occasions when courts do consider the bases for judicial review and deference—as in the context of

²⁰¹ Paul Horwitz, *Three Faces of Deference*, 83 NOTRE DAME L. REV. 1061, 1070 (2008).

²⁰² Pollack, *supra* note 14, at 849–52.

²⁰³ *Id.* at 844–46.

legislative, administrative, or for-profit corporate decision-making—they tend to consider these characteristics.²⁰⁴ In other words, judicial rationales for deference tend to turn on judicial conceptions, accurate or not, of the decision-making structure in the institution in question and the relative superiority of that structure compared to that of the courts. Moreover, approaching the question in this accountability or representationally focused manner has a rich basis in the participatory democracy literature.²⁰⁵ As such, assessing how accountable a given governing entity is to its constituents, and determining how much accountability matters in the context of the particular institution, yields conclusions that can form the basis of a considered and tailored approach to judicial review that fits the needs of the institution, its constituents, or, from a court’s perspective, the defendants and the plaintiffs before it.²⁰⁶ These conclusions can either put doctrines that developed through inertia on firmer footing, suggest tweaks to those doctrines, or illustrate a need for a reexamination of the field.

First, we assess the opportunities for exit from the organization. Drawing on Albert Hirschman’s insights, this concept of exit is a central way in which constituents can communicate dissatisfaction to the institution.²⁰⁷ Whether it is

²⁰⁴ See, e.g., *Chevron v. Nat’l Res. Def. Council*, 467 U.S. 837, 865–66 (1984) (discussing agencies’ superior accountability and expertise relative to courts); Bainbridge, *supra* note 129, at 117–24 (noting that the case for deference would be weaker “if judicial decision making could flawlessly sort out sound decisions with unfortunate outcomes from poor decisions, and directors were confident that there was no risk of hindsight-based liability,” but that this is not the case because “judges are not business experts”); Clayton P. Gillette, *Courts, Covenants, and Communities*, 61 U. CHI. L. REV. 1375, 1426 (1994) (noting that deference is “predicated on an assumption that those who make decisions that bind associations, typically the board of directors, are representative of the association’s members,” and “[t]o the extent that this is not true, the relationship between the parties provides little reason for the court to [defer]”).

²⁰⁵ See Neil K. Komisar, *A Job for Judges: The Judiciary and the Constitution in a Massive and Complex Society*, 86 MICH. L. REV. 657, 667–68, 677–78, 690 (1988) (explaining that assumption of judicial deference to political processes may be overcome where processes malfunction in terms of failures of representation); see generally JOHN HART ELY, *DEMOCRACY AND DISTRUST* (1980); NEIL K. KOMESAR, *IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY* (1994). More recent efforts by scholars of administrative law and of nonprofit corporations have taken a similar path. See, e.g., Evelyn Brody, *Entrance, Voice and Exit: The Constitutional Bounds of the Right of Association*, 35 U.C. DAVIS L. REV. 821, 856–65 (2002); Lisa Schultz Bressman, *Procedures as Politics in Administrative Law*, 107 COLUM. L. REV. 1749 (2007) (analyzing features of administrative agencies and arguing that the Court develops administrative law doctrines with attention to agencies’ real, operational characteristics and with the goal of developing procedural rules that improve decisional legitimacy).

²⁰⁶ Brody, *supra* note 205, at 900–01; Pollack, *supra* note 14, at 853 (discussing why “accountability is the place to start”).

²⁰⁷ ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 21 (1970); Pollack, *supra* note 14, at 853–54.

selling shares, voting for another candidate, or patronizing a different brand, exit works best as an accountability device when it is easy and fast: easy, because it eliminates other variables or reasons to stay and thus increases the salience of the signal; and fast, because it ensures a more apparent causal linkage.²⁰⁸

Second, we look at the opportunities for voice within the organization. If exit is difficult or slow, the ability to work within the institution to change it offers a satisfying accountability substitute. However, just as salience is important for exit to be a useful form of accountability, voice must not only be effective, but perceived *ex ante* by constituents to be an endeavor that is likely to be effective or at least taken seriously. Absent that likelihood, few rational constituents would invest the resources necessary to be heard.²⁰⁹

The availability of exit and voice depends not only on the cost of exercising these options, but also on the cost of monitoring. It is not enough to decide to leave or to speak, but one must also gain enough information to form an opinion. As we unpack below, these information costs are relatively high in several scenarios familiar to the nonprofit universe. Indeed, Hansmann's trust theory—the dominant economic theory of the nonprofit form—places enormous weight on the high monitoring costs accompanying much of what nonprofits do.²¹⁰

Third, in the absence of either of these levers of internal accountability, we examine whether a court is well-situated to address the institution's lack of accountability. An institution's relevant expertise compared to that of the courts is widely understood to be a central consideration in the question of deference, and it is at this point in the analysis that it comes into play.²¹¹

The final two characteristics answer the question whether a lack of accountability may be acceptable in light of the nature of the relationship between the institution and its constituents. If the answer is yes, a form of deference or a doctrine of nonjusticiability may remain warranted even in the absence of internal

²⁰⁸ HIRSCHMAN, *supra* note 207, at 24.

²⁰⁹ *Id.* at 39.

²¹⁰ *See generally* Hansmann, *supra* note 26.

²¹¹ *See, e.g.*, *Chevron v. Nat'l Res. Def. Council*, 467 U.S. 837, 865–66 (1984); Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L.J. 833, 866 (2001) (noting that *Chevron* deference is rooted in large part in the Court's observation that "agencies typically have greater expertise about technical and specialized subjects than do courts"); Lisa Schultz Bressman, *Chevron's Mistake*, 58 DUKE L.J. 549, 556 (2009) (same).

accountability or relative expertise because the costs of enforcing the issue are outweighed by the costs of judicial review.²¹² The likely impact range of an institutional decision is a metric that captures the set of rights or expectations that one enters into the institution with and that may hang in the balance in an institutional decision.²¹³ When these are low or relatively unimportant, the set of cases likely to arise out of the particular institution will rank low on the set of demands made on courts, and a rule of deference may be justified.²¹⁴ Similarly, the more that the interests of those who run an institution align with the interests of affected constituencies, and the more the constituencies' interests are themselves homogeneous, the less need there is for judicial intervention.²¹⁵

These characteristics are not evaluated in a strict equation *per se*, but rather guide an inquiry into the functioning of a particular institution. The first two—exit and voice—are where the analysis begins, and they are of paramount importance because they reflect the degree to which the institution may be responsive to or beholden to its constituents. The third, expertise, is nearly as central because it is widely viewed as an acceptable substitute for the accountability provided by exit and voice. The final two may be viewed as a set of brakes, checking our response to an institution's lack of accountability or expertise in those contexts additional oversight may be too costly or ill-advised.

B. *Evaluating Nonprofit and For-Profit Corporations*

Because the law uses for-profit law as the baseline for nonprofit rules, we use the institutional characteristics of for-profit firms as the comparator for nonprofit organizations in this section. We then draw on available empirical evidence and theoretical literature to carry out the analysis, using the constituent typology developed in Part I.

1. Exit

In the for-profit context, constituent exit is easy for both the shareholder and customer constituents. The shareholder who is dissatisfied with the board's decision-making can simply sell his shares on the market, where both buyers and alternative investments abound. Such divestment, which can be accomplished with

²¹² Pollack, *supra* note 14, at 855–56.

²¹³ *Id.*

²¹⁴ *Id.* at 856.

²¹⁵ *Id.* at 856–57.

low transaction costs, accomplishes a complete disassociation from the institution. If a decision causes enough shareholders to disassociate in such a fashion, the consequences can be dramatic, and the threat of such action thus imposes *ex ante* constraints on board decision-making.²¹⁶

The same ease of exit often holds true for the customer constituent. If the board makes a decision that either degrades the quality of the product or that simply is inconsistent with customers' social or policy preferences the customer can generally vote with his feet in the same way that the shareholder can by patronizing a competitor. Of course, we recognize that there are some caveats. For one, this assumes that the customer has relevant information about the product or policy, and most consumers have incentives to invest only minimal time in learning about most of the companies with which they interact. It also is made more complicated by the prospect of a monopoly or even a business that functions as a local monopoly in practice—say, the only car dealership in town. Moreover, consumer product preferences, including price, may drown out governing preferences, as when a consumer prefers shoes made from a particular shoemaker, regardless of the environmental or labor policies employed in the shoe's manufacturing. In such a circumstance, customer behavior will be less responsive to the corporate action. Still, these nuances can be carried through the analysis without calling into question the ultimate conclusion that the for-profit corporation performs highly on the exit metric of accountability, certainly for shareholders and, with some issues of degree at the margins, for customers as well.

In the nonprofit context, constituent exit functions similarly as an accountability tool at the donor/member level analogous to that of the for-profit shareholder—but somewhat less well at the customer level, and strikingly less well at the beneficiary level. However, there are nuances worth unpacking, so we begin with donor exit. Donors are highly mobile: those who are dissatisfied with the decisions of a nonprofit board can, like the shareholder, vote with their feet by simply ceasing to donate to that organization. For example, when Susan G. Komen for the Cure, a well-known breast cancer research nonprofit, made the widely publicized decision to stop giving grants to Planned Parenthood for breast cancer screenings, it saw its donations drop by a staggering 22%. Participation in the organization's Races for the Cure, and the accompanying race fees and

²¹⁶ *Id.* at 857–59.

contributions, also dropped off precipitously.²¹⁷ The speed and volume of the reaction reflects the ease with which donor constituents can exit the organization. Indeed, the fact that, within months, the organization reversed its decision perhaps illustrates the effectiveness of that exit.²¹⁸ Of course, the decision was met with a firestorm of criticism and public relations consequences separate and apart from the drop in contributions, so it would be an overstatement to say that the donor reaction was the cause of the policy reversal. However, this analysis does not require that a specific exercise of exit *in fact* caused a specific policy change, but rather that there is an easy structural mechanism for constituents to exit. The *availability* and use of this lever of accountability is what ultimately matters, and a donor can exit an organization as easily as putting down the checkbook and either finding one of many rival organizations to take the money,²¹⁹ or, worse, cutting back on the amount given to charity entirely.²²⁰ In short, having already parted with his initial donation, the donor has no further link holding himself to that particular organization.

The availability of donor exit is not limited to such dramatic policy changes or public relations disasters. Indeed, donors may exit due to real or perceived changes in the quality of the organization's effectiveness or priorities.²²¹ Most nonprofits publicize reports of their spending, and websites like Charity Navigator are devoted to comparing and evaluating the effectiveness of charities based on metrics like financial efficiency—program expenses versus administrative expenses versus fundraising expenses—and reporting transparency.²²² Donors who do not approve of, say, the spending habits of the organization or the ratio of program expenses to administrative expenses or salaries, are free to take their

²¹⁷ Associated Press, *Komen Sees Big Drop in Contributions After Dispute*, POLITICO (Jan. 4, 2014, 7:32 AM), <http://www.politico.com/story/2014/01/susan-g-komen-contributions-after-dispute-101743.html>.

²¹⁸ Pam Belluck et al., *Cancer Group Backs Down on Cutting off Planned Parenthood*, N.Y. TIMES, Feb. 3, 2012, <http://www.nytimes.com/2012/02/04/health/policy/komen-breast-cancer-group-reverses-decision-that-cut-off-planned-parenthood.html?pagewanted=all>.

²¹⁹ Carol Chetkovich & Peter Frumkin, *Balancing Margin and Mission: Nonprofit Competition in Charitable Versus Fee-Based Programs*, 35 ADMIN. & SOC'Y 564 (2003).

²²⁰ *Id.* at 584, 586.

²²¹ Margaret F. Sloan, *The Effects of Nonprofit Accountability Ratings on Donor Behavior*, 38 NONPROFIT & VOLUNTARY SECTOR Q. 220–36 (2009).

²²² *How Do We Rate Charities?*, CHARITY NAVIGATOR, www.charitynavigator.org/index.cfm?bay=content.view&cpid=1284#.V13-vYQdJFI (last visited Dec. 1, 2015).

money elsewhere—either to another charity serving the same goals, another charity entirely, or no charity at all. Indeed, there are an increasing number of organizations pursuing a stagnant pot of money.²²³ Knowing this, and eager to tout the approval of evaluators like Charity Navigator, charitable nonprofits are disciplined by donors *ex ante*, in the form of the prospect of exit, as well as *ex post*, much like for-profits are by shareholders.

However, the strength of this discipline in practice is open to some debate.²²⁴ Scholars have observed that, in spite of these avenues for information and donor exit, nonprofits “are widely regarded as much less well-governed and subject to much less oversight than the average public company” and that these information-providing resources “pale in comparison with the investors, analysts, watchdogs, and government agencies monitoring every move made by large[] for-profit firms.”²²⁵ The information costs to donors of verifying where donations go are high, which is part of the reason for the nonprofit form in the first place,²²⁶ and absent actual knowledge, the emotional benefit and tax advantage to the donor is equal whether the donation is squandered or life-changing. Moreover, although the IRS releases tax filings from tax-exempt nonprofit organizations, this provides a very basic insight into the organization’s functioning, compared to the lengthy and highly detailed information that must be provided by publicly-traded firms.²²⁷ Although nonprofits are encouraged to provide additional information as a matter of good governance, this remains entirely a matter of discretion, which allows nonprofits to provide positive information and keep hidden the negative.²²⁸ Still, despite the information costs, the nonprofit is an institution in which the act of exit is generally an easy, available, and low-cost discipline tool for donors.

²²³ Brice S. McKeever & Sarah L. Pettijohn, *The Nonprofit Sector in Brief 2014*, URBAN INST. 2 (Oct. 2014), available at <http://www.urban.org/UploadedPDF/413277-Nonprofit-Sector-in-Brief-2014.pdf>.

²²⁴ YOUNG, *supra* note 44, at 111 (“One important source of relief, and hence discretion, for nonprofit entrepreneurs is that few constituents will have direct knowledge of performance, much time for monitoring, or precise criteria for judgment.”).

²²⁵ M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 599–600 (2009); Manne, *supra* note 92 (discussing difficulties of donor oversight in practice).

²²⁶ See generally Hansmann, *supra* note 26.

²²⁷ Elizabeth K. Keating & Peter Frumkin, *Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation*, 63 PUB. ADMIN. REV. 3, 9–10 (2003).

²²⁸ *Id.* at 7.

Dissatisfied members may also resort to generally easy avenues of exit. As discussed above, membership in these organizations is usually voluntary, so, like the donor, the member often faces no structural constraints on his or her exit. Moreover, effecting the exit is a decidedly low-transaction cost maneuver: simply stop paying dues, ignore junk mail, or send an email asking to be removed from a mailing list. Of course, this is not to say that member exit is always free in every sense. For example, the Boy Scout brand is well-known and the organization is pervasive, so parents who wish a scout-like experience for their children may have limited alternative options. There is a cost attendant to identifying a new organization with the desired mission, practices, and quality. It may be costlier for a member who has built a reputation or assumed a leadership position within an organization, or who has established friendships with other members, as might happen when one's children befriend fellow scout, to exit the organization. Moreover, there is not always abundant competition, and the existing organization may have a wealth of resources—consider a lodge or a church—that cannot be met elsewhere, or that would be difficult to create from scratch.²²⁹ While the economic costs of exit are very low, the emotional costs of exit may be a factor in this context in a way that it is not present in that of the corporate shareholder.

Still, it is rare for a single nonprofit to dominate a sector like the Boy Scouts do. For most members, the ease of exit is facilitated by a large amount of competition for members and a relative ease of creating a competing organization where there is not one already.²³⁰ A conservation-minded individual has numerous environmental groups from which to choose, depending on preferences about tactics, areas of emphasis, and so forth.²³¹ Moreover, the number of available organizations continues to grow each year²³²—to say nothing of less formal associational options provided by social media.²³³ Starting a rival business might

²²⁹ David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 257 (2009).

²³⁰ *Austin v. Mich. Chamber of Commerce*, 494 U.S. 652, 710 (1990) (Kennedy, J., dissenting) (“One need not become a member of the Michigan Chamber of Commerce or the Sierra Club in order to earn a living. To the extent that members disagree with a nonprofit corporation’s policies, they can seek change from within, withhold financial support, cease to associate with the group, or form a rival group of their own.”).

²³¹ Paul R. Armsworth et al., *The Size, Concentration, and Growth of Biodiversity-Conservation Nonprofits*, 62 BIOSCIENCE 271 (2012).

²³² *Quick Facts About Nonprofits*, *supra* note 47.

²³³ See generally Javier Sajuria et al., *Tweeting Alone? An Analysis of Bridging and Bonding Social Capital in Online Networks*, 43 AM. POL. RES. 708 (2015).

require lots of capital, but starting a membership organization has very low start-up costs, allowing a plethora of associations to multiply to cater to every preference. For example, exploiting political divisions from the passage of the Affordable Care Act, the Association of Mature American Citizens positioned itself as a conservative version of the American Association of Retired Persons (“AARP”).²³⁴

However, where membership is not entirely voluntary—in the sense that it is tied to some other interest, making it what we call an “interest-linked membership”—exit is not so simple. For example, membership in a homeowners’ association and payment of dues are almost always required when one purchases property in the community.²³⁵ Membership in a labor union, or, at least, payment of dues, may also be required to maintain certain employment.²³⁶ In these situations, exiting the membership organization means exiting the entire relationship and forfeiting other interests. For this reason, the homeowners’ association is an institution from which exit is not a generally available form of accountability.²³⁷ Similarly, although exit from labor unions is a complex subject that merits further study,²³⁸ it is certainly a far more difficult notion in that context—which explains why federal law strictly oversees labor union elections to ensure fairness.²³⁹

At the donor/member level, we conclude that exit is a generally easy and available lever of institutional accountability, at least roughly on par with that of the for-profit corporation. However, certain member organizations in which membership is required by virtue of some other important interest are exceptions to this rule.

At the customer level, exit is almost as easy as it is for the for-profit’s customer, but not exactly. Both can choose to switch to a competitor, or, failing competition, forgo receiving the service altogether.²⁴⁰ Additionally, the customer has fairly little skin in the game, beyond the cost of whatever product being

²³⁴ *About Us*, ASS’N MATURE AM. CITIZENS, <http://amac.us/about-us> (last visited Dec. 1, 2015).

²³⁵ Barbara McCabe & Jill Tao, *Private Governments and Private Services: Homeowners Associations in the City and Behind the Gate*, 23 REV. POL’Y RES. 1143, 1144 (2006).

²³⁶ 29 U.S.C. § 158(a)(3) (2012).

²³⁷ Pollack, *supra* note 14, at 859–60.

²³⁸ *Harris v. Quinn*, 134 S. Ct. 2618 (2014).

²³⁹ 29 U.S.C. §§ 401–531.

²⁴⁰ Justin Pulford et al., *Unilateral Treatment Exit: A Failure of Retention or a Failure of Treatment Fit?*, 41 SUBSTANCE USE & MISUSE 1901 (2006).

purchased. So long as the customer receives the goods or services for which he bargained, he has little basis to complain about other activities of the organization. That said, the nature of some relationships between customer and nonprofit may be relatively less fluid. For example, it may be moderately difficult for a student to transfer credits from one university to another.²⁴¹ Still, the difficulty does not depend on the ownership character of the university. In fact, the customer may not even know the nonprofit/for-profit status of the supplier.²⁴² In other words, it is not the institution itself, but rather the nature of the service provided, that could make exit moderately more difficult in the nonprofit context. After all, nonprofit organizations generally settle in less profitable markets and provide less profitable goods and services due to the inability of nonprofit insiders to personally profit from the organization's activities. When they do, they fill an important niche.²⁴³ Accordingly, we predict that, in the aggregate, the nonprofit customer may be somewhat more limited in his ability to choose a competitor than a for-profit customer, although the differences are probably minimal.

Like customers, nonprofit staff members typically enjoy roughly the same opportunities of exit as in the for-profit sector. In either sector, finding a new job is not always easy. Yet nonprofits compete for talent not only on salary, but also by providing an opportunity to fulfill important non-monetary goals.²⁴⁴ A nonprofit that stops fulfilling its mission will often find it hard to compete with for-profits on financial incentives alone, risking a loss of top talent to the competition.

By contrast, exit is almost always difficult for the beneficiary.²⁴⁵ Whereas the customer comes with dollars and can go elsewhere, the beneficiary of the nonprofit

²⁴¹ Sara R. Kusiak, Comment, *The Case for A.U. (Accountable Universities): Enforcing University Administrator Fiduciary Duties Through Student Derivative Suits*, 56 AM. U. L. REV. 129, 173 & n.280 (2006).

²⁴² See generally Florian Dreves et al., *Do Patient Perceptions Vary with Ownership Status? A Study of Nonprofit, For-Profit, and Public Hospital Patients*, 43 NONPROFIT & VOLUNTARY SECTOR Q. 164 (2014); Femida Handy et al., *The Discerning Consumer: Is Nonprofit Status a Factor?*, 39 NONPROFIT & VOLUNTARY SECTOR Q. 866 (2010).

²⁴³ See generally Jill Horwitz, *Making Profits and Providing Care: Comparing Nonprofit, For-Profit, and Government Hospitals*, 24 HEALTH AFF. 790 (2005).

²⁴⁴ See generally Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LITERATURE 701 (1996).

²⁴⁵ Aseem Prakash & Mary Kay Gugerty, *Trust but Verify? Voluntary Regulation Programs in the Nonprofit Sector*, 4 REG. & GOVERNANCE 22, 26 (2010) ("These beneficiaries typically cannot vote with their feet (or dollars), or even voice their disapproval. For them, nonprofits are often the monopoly providers of essential products and services.").

is often not in a position to be “choosy.” Beneficiaries rely on nonprofit organizations for food, medical services, housing, and other life-sustaining services. Accordingly, recipients of, say, a food bank’s food are unable to express disapproval with the decisions of the food bank by rejecting the food, both for structural reasons—the absence of a channel for that feedback, as discussed below—and for practical ones—the organization does not rely on the beneficiaries for resources. A beneficiary may thus have little choice but to accept charity on the terms that the organization offers.²⁴⁶ Moreover, when a charity chooses to exclude a potential beneficiary, the beneficiary cannot further exit an organization when already placed on the outside. For example, the families who face eviction from homeless shelters into the bitterness of a New York winter have exit forced upon them; there is no way to signal disapproval to the agency by exiting twice.²⁴⁷ As a result, at the beneficiary level, neither exit nor the prospect of exit are effective levers of accountability, meaning that “nonprofits have a greater power advantage relative to the people they serve than for-profit businesses have relative to their customers—or than politicians, arguably, have vis-à-vis constituents.”²⁴⁸

2. Voice

Shareholders of for-profit corporations have a formal vote regarding who serves on the board, yet they have few opportunities for effective voice beyond the ballot. Indeed, a shareholder’s voice is largely limited to his vote in director elections and on any proposal for which a shareholder vote is required.²⁴⁹ All of the other corporate decisions are, by design, made by the directors and managers on their own.²⁵⁰ In this way, the opportunities for voice are roughly equivalent to those in our representative democracy, with one important qualification: whereas every

²⁴⁶ Susan A. Ostrander, *The Growth of Donor Control: Revisiting the Social Relations of Philanthropy*, 36 *NONPROFIT & VOLUNTARY SECTOR Q.* 356, 357 (2007).

²⁴⁷ See Julie Bosman, *Homeless Families Could Face Eviction Over Rules*, N.Y. TIMES, July 27, 2009, http://www.nytimes.com/2009/07/28/nyregion/28homeless.html?_r=0.

²⁴⁸ Woods Bowman, *Nonprofit Accountability and Ethics: Rotting from the Head Down*, *NONPROFIT Q.* (Oct. 26, 2012), <https://nonprofitquarterly.org/management/21259-nonprofit-accountability-and-ethics-rotting-from-the-head-down.html>.

²⁴⁹ See, e.g., WILLIAM A. KLEIN ET AL., *BUSINESS ASSOCIATIONS* 521 (7th ed. 2009). Even that voting power is of questionable impact. See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 *VA. L. REV.* 675, 732 (2007) (“The shareholder franchise is largely a myth.”).

²⁵⁰ See generally Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *NW. U. L. REV.* 547 (2003).

citizen gets one vote in our political system,²⁵¹ every *share*, not every *shareholder*, gets one vote in the corporation.²⁵²

The same is true for customers, who have no formal mechanism to make themselves heard within the corporation's functioning. However, "voice, while always valuable, is most important when exit is difficult."²⁵³ Because exit, as discussed above, is a low-cost, high-impact form of accountability in the for-profit corporation for both the shareholder and the customer, these limitations on voice are less worrisome than they would otherwise be in that context.

In the nonprofit context, we again divide the analysis by constituency. For donors, like for-profit shareholders, the opportunities for voice are limited. In fact, they are even more limited because donors do not even have the ability to cast a vote for leadership or on any policy questions. Whereas shareholders at least have the theoretical ability to influence the direction of the corporation or the decisions the board makes, nonprofit donors lack even that. For example, it is certainly not as if the American Red Cross ("Red Cross"), sends donors a proxy card along with the free return-address labels.

Some have argued that, "[i]n the charitable sector, one voice can uniquely trump all others: the donor's."²⁵⁴ However, this concept of "voice" does not generally reflect the structural paths for voice on which we focus. Rather, *ad hoc* public relations crises or the real and perceived need to keep donors happy is best understood, not as a form of voice, but as a salient *ex ante* form of exit discipline, as noted above.²⁵⁵ In other words, charities certainly recognize the need to keep the donors happy as a class. Reliant on their beneficence, charities often cater to donors' whims.²⁵⁶ This was highlighted by the controversy over the Red Cross' use

²⁵¹ *Reynolds v. Sims*, 377 U.S. 533, 558, 568 (1964) (quoting *Gray v. Sanders*, 372 U.S. 368, 379–80 (1963)) (requiring apportionment of seats in state legislature to be done on a population basis and repeating the familiar "one person, one vote" formulation).

²⁵² Pollack, *supra* note 14, at 861.

²⁵³ *Id.* at 860.

²⁵⁴ Brody, *supra* note 205, at 860.

²⁵⁵ Scholars have argued that competition for donor dollars leads to excessive investments in fundraising. Susan Rose-Ackerman, *Charitable Giving and "Excessive" Fundraising*, 97 Q. J. ECON. 193 (1982); Inkyung Cha & William Neilson, *Is Competition Among Charities Bad?* 1 (Tex. A&M Univ., Working Paper Series No. 0116, 2001), available at <http://web.utk.edu/~wneilson/Charity-competition.pdf>.

²⁵⁶ Cass Brewer, *Gift Horses, Choosy Beggars, and Other Reflections on the Role and Utility of Social Enterprise Law*, ENTREPRENEURSHIP.ORG 4 (2014), www.entrepreneurship.org/entrepreneurship-law/

of donations following the terrorist attacks of September 11, 2001.²⁵⁷ After an enormous outpouring of generosity that exceeded the amount needed to address post-tragedy needs, the Red Cross announced that it would use some of the donated funds to bolster infrastructure for future emergencies.²⁵⁸ Somewhat irrationally, donors were upset that the donations were not being used to directly aid the victims of this particular disaster.²⁵⁹ To satisfy donors, the Red Cross departed from its longstanding policy, and rather than prepare for the next disaster, the organization began to fritter away the gigantic endowment by offering large cash payments to New York residents merely inconvenienced by the attacks.²⁶⁰ For our purposes, though, this was not a form of donor voice because it did not use a channel of institutional access. Rather, it was a form of *ex ante* disciplining by the prospect of donor exit: the Red Cross recognized that it needed to keep donors happy in order to continue to receive donations. Absent that consideration, there was nothing—no vote needed—to prevent the Red Cross from sticking to its policy.

Although exit continues to be the donor's biggest stick, it is not as if donors have no means of vocalizing in the organization. Even though courts were once reluctant to allow donors to enforce restrictions written into gifts,²⁶¹ and even though tax law discouraged undue donor control over gifts once they pass to a charity,²⁶² sophisticated donors can structure their gifts to impose legally

gift-horses-choosy-beggars-and-other-reflections-on-the-role-and-utility-of-social-enterprise-law.aspx (select "Download" hyperlink). The power that donors possess over the organization means that they are sometimes described as a charitable organization's "owners." Judith L. Miller, *The Board as a Monitor of Organizational Activity*, 12 NONPROFIT MGMT. & LEADERSHIP 429, 432–33 (2002) (noting but criticizing this perspective); Gerhard Speckbacher, *Nonprofit Versus Corporate Governance: An Economic Approach*, 18 NONPROFIT MGMT. & LEADERSHIP 295, 307 (2008).

²⁵⁷ See Robert A. Katz, *Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief*, 36 IND. L. REV. 251, 300–01 (2003).

²⁵⁸ *Id.* at 302–03.

²⁵⁹ *Id.* at 303.

²⁶⁰ Nick Paumgarten, *Trumperty Below Canal*, NEW YORKER (Feb. 18, 2002), http://www.newyorker.com/archive/2002/02/18/020218ta_talk_paumgarten (describing Red Cross volunteers offering six figure cash payments to condo owners "inconvenienced" by the terrorist attacks).

²⁶¹ Iris J. Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093, 1094 (2005) ("The cat is out of the bag: Donors are fast discovering what was once a well-kept secret in the philanthropic sector—that a gift to public charity donated for a specific purpose and restricted to that purpose is often used by the charity for its general operations or applied to other uses not intended by the donor.").

²⁶² See I.R.C. § 4966 (2012).

enforceable obligations on the nonprofit organization.²⁶³ Moreover, scholars have documented an increasing trend among the wealthiest donors to retain greater amounts of formal control over large donations.²⁶⁴ Further, given the importance of donors to many nonprofits' models, certain donors may be afforded a place of honor within the organization. For example, major donors are commonly invited to serve on the board of directors. In that capacity, they are no longer simply "donor" constituents, but decision-makers. The organization may treat them not simply as major donors, but as representatives of donor interests, articulating at the highest levels of the organization the attributed perspective of the donor class.

However, for members, structural opportunities for voice are stronger than for donors as a group, and perhaps even stronger than for shareholders in the for-profit context. Formal membership comes with voting rights by definition, so there is an institutional structure in place for the exercise of member voice that is not present for the exercise of donor voice. This distinction is especially important in light of the exit conclusion reached above. Recall that, while exit is generally easy in the context of the membership organization, it may be less so when membership is tied to some other interest like employment or home ownership. In those situations, these interest-linked members may have the ability to resort to stronger avenues of voice.

We say "may" because the promise of member voice is often illusory in practice. "[M]any elections in membership organizations are characterized by low turnout rate and lack of democracy, and members may be marginalized in relation to board members and management."²⁶⁵ Specifically, the opportunities for voice in the context of the homeowners' association appear promising, but still prove to be largely unavailing due to a range of structural factors.²⁶⁶ Labor unions and other nonprofits of this type merit further study, precisely because exit from them is difficult.

Voice tends to be stronger for nonprofit staff, paid and unpaid, as compared with for-profit staff. Nonprofit scholars have noted that the actual functioning of

²⁶³ David L. Wilkinson, *Donor Intent and the Failure of the Honor System*, UTAH B.J., July/Aug. 2012, at 12, 16.

²⁶⁴ Ostrander, *supra* note 246, at 369.

²⁶⁵ Chao Guo & Juliet A. Musso, *Representation in Nonprofit and Voluntary Organizations: A Conceptual Framework*, 36 NONPROFIT & VOLUNTARY SECTOR Q. 308–26, 314 (2007) (citations omitted).

²⁶⁶ Pollack, *supra* note 14, at 861–66.

nonprofits looks more like an inverted hierarchy, where nonprofit “executives typically have greater information, more expertise, and a greater stake in and identification with the organization,” leading to considerable power for the nonprofit senior management.²⁶⁷ True, many businesses have strong executives as well, but, as will be discussed in greater detail below, board monitoring and oversight is typically more meaningful in the for-profit realm. The tendency to devolve power leads to nonprofit staff in a position of greater power compared to the business employee, at least at the level of senior management.

Finally, we turn to the customer and beneficiary level. For both, voice is weak. There are often no formal institutional structures to give customers or beneficiaries the opportunity to shape the direction of the organization or to control its priorities. They do not get a vote, and there are no other points of formal access to vocalize within the institution. They are left to lobby for their priorities and complain of deficiencies, but nothing compels the organization to listen.²⁶⁸

Recognizing this problem, some of the nonprofit literature calls for greater empowerment or participatory governance, but these have largely not come to pass.²⁶⁹ Further, even these would still fail to offer a formal mechanism of voice within the organization. For example, organizations might place a token beneficiary or customer on the board of directors, perhaps believing that the interests of beneficiaries can be expressed through that assigned representative.²⁷⁰ Use of an unelected representative is something, but it is not the same as the formal vote given to for-profit shareholders. Perhaps some organizations choose to take meetings or provide groups of potential beneficiaries with the opportunity to make their pitches,²⁷¹ but these sorts of voluntary listening tours are markedly different

²⁶⁷ THE JOSSEY-BASS HANDBOOK ON NONPROFIT LEADERSHIP AND MANAGEMENT 155–56 (Robert D. Herman & Assocs. eds., Jossey-Bass 2d ed. 2005). See Judith L. Miller-Millesen, *Understanding the Behavior of Nonprofit Boards of Directors: A Theory-Based Approach*, 32 NONPROFIT & VOLUNTARY SECTOR Q. 521, 531–32 (2003).

²⁶⁸ Ebrahim, *supra* note 17, at 203 (“[I]f clients find the services inadequate or of low priority, their options are generally limited to refusing the service (exit) or complaining about it (voice).”).

²⁶⁹ See Gregory D. Saxton, *The Participatory Revolution in Nonprofit Management*, NONPROFIT Q. (Aug. 2, 2012), <https://nonprofitquarterly.org/management/20769-the-participatory-revolution-in-nonprofit-management.html>; Ostrander, *supra* note 243.

²⁷⁰ Kelly LeRoux, *Paternalistic or Participatory Governance? Examining Opportunities for Client Participation in Nonprofit Social Service Organizations*, 69 PUB. ADMIN. REV. 504, 510 (2009) (reporting that 49% of surveyed organizations have a client on the board).

²⁷¹ Saxton, *supra* note 269.

from the sorts of institutional central lines to decision-makers that are generally considered avenues for voice. Such discretionary access stands in sharp contrast to the mandate on federal administrative agencies to consider the viewpoints of interested parties, which include both regulated entities and “beneficiaries” of the regulation—industry groups and environmental groups in the context of the EPA, to use a blunt example—during regulatory processes.²⁷² Tracing formal “points of institutional access” that are not granted at the discretion of the institution,²⁷³ the customer and beneficiary both plainly lack the access that the member of a membership nonprofit theoretically has.

Beginning to put the pieces together, we see that from the perspectives of the donor and customer, exit is relatively easy and is thus an effective means of accountability. By contrast, voice is very limited. Accountability from the donor’s perspective thus relies almost entirely on exit. From the perspective of the member of a nonprofit without any connected interests, exit is also easy, but at least some opportunities for voice are also an available mechanism for accountability. This puts members ahead of donors in terms of access to levers of accountability and on similar footing with for-profit shareholders. However, when membership is linked to other interests, exit is much harder. The opportunity for voice might balance the accountability inquiry, but the promise of that opportunity may be more theoretical than real. In contrast, the employee enjoys significant voice within the nonprofit in light of the hands-off nature of most boards and the staff’s greater involvement and identification with the organization’s activities. Lastly, from the perspective of the beneficiary, neither exit nor voice is an effective means of accountability. As we move into the final three characteristics, all of which have to do with substitutes for these mechanisms of institutional accountability, we will have to pay closest attention to the cases of the interest-linked member and the beneficiary. These represent the sharpest departures from the for-profit corporation’s mechanisms for exit and voice, since the donor and the non-interest-linked member perform similarly well on those scores.

3. Expertise

When exit and voice are poor mechanisms of institutional accountability, we must look elsewhere for a justification for judicial deference or applications of

²⁷² 5 U.S.C. § 553 (2012); *Pub. Citizen, Inc. v. FAA*, 988 F.2d 186, 197 (D.C. Cir. 1993) (explaining that an agency must “respond to ‘relevant’ and ‘significant’ public comments” (internal citation omitted)).

²⁷³ Pollack, *supra* note 14, at 854.

doctrines of nonjusticiability. For instance, in the contexts of administrative law, foreign affairs law, and others, courts generally and primarily look to the government's relative expertise as a basis for granting deference.²⁷⁴

In for-profit organizations, directors are picked because they have, or are presumed to have, a business acumen that is respected by corporate law.²⁷⁵ Thus, as one court put it: "Not only do businessmen know more about business than judges do, but competition in the product and labor markets and in the market for corporate control provides sufficient punishment for businessmen who commit more than their share of business mistakes."²⁷⁶

By contrast, for nonprofit boards, there are relatively weak external motivations to obtain expert board members, at least when one conceives of expertise in the sense of business acumen. Nonprofit organizations lack shareholders, and their boards are often self-perpetuating such that existing board members elect new directors.²⁷⁷ Moreover, nonprofit board members commonly serve without compensation,²⁷⁸ which at times leads to difficulty attracting qualified personnel.²⁷⁹ On the other hand, for-profit directors are generally well-compensated for their service. According to a 2013 survey, for-profit directors generally receive more than \$100,000 per year for their part-time service on a

²⁷⁴ *Holder v. Humanitarian Law Proj.*, 130 S. Ct. 2705, 2711 (2010) ("[R]espect for the Government's factual conclusions is appropriate in light of the courts' lack of expertise with respect to national security and foreign affairs . . ."); *Chevron v. Nat'l Res. Def. Council*, 467 U.S. 837, 865 (1984) (highlighting comparative agency expertise as basis for deferring to reasonable agency interpretations of ambiguous statutes).

²⁷⁵ Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket After Disney IV?*, 83 DENV. U. L. REV. 531, 544 (2005) ("A core principle of Delaware corporate law, the business judgment rule exemplifies the judiciary's extreme deference to directors' business decisions and Delaware's value on the social utility of treating directors as experts in evaluating corporate risk.").

²⁷⁶ *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1262 (Conn. 1994) (quoting *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986)).

²⁷⁷ Reiser, *supra* note 39, at 829.

²⁷⁸ Hazen & Hazen, *supra* note 7, at 393–94. There are some exceptions to the norm of uncompensated directors in some large foundations and in many commercial nonprofit organizations, such as health plans. *Id.*

²⁷⁹ NAT'L SURVEY OF NONPROFIT & VOLUNTARY ORGS., RECRUITMENT AND RETENTION OF VOLUNTEERS 1–2 (2006), available at http://www.imaginecanada.ca/sites/default/files/www/en/nsnvo/l_recruiting_retaining_volunteers_factsheet.pdf.

board.²⁸⁰ Even beyond compensation, a board member of a business commonly owns shares that rise and fall with the organization's performance; a nonprofit board member often benefits simply by being on a board, regardless of how the organization performs.²⁸¹

The criteria used for selecting directors also differ between the sectors. While the for-profit sector values the effective businessperson, the nonprofit sector primarily values the willingness to donate large sums of money to the organization, a commitment to the organization's mission, or political or social connections that may prove useful to the organization.²⁸² Even worse, nonprofit boards rarely resemble the population the nonprofit is designed to serve.²⁸³ This is not the case of every nonprofit board. Indeed, some nonprofits or some conditions of government funding explicitly require that a certain fraction of board members represent the population that the nonprofit serves.²⁸⁴ However, the problem of board representation can lead to what Lester M. Salamon has termed "philanthropic paternalism," where the organization adopts the perspective of its donors rather than its clients, focusing on the problems and solutions favored by the wealthy and powerful in society rather than the intended beneficiaries.²⁸⁵ In certain contexts, particularly those having to do with rights or interests of beneficiaries, this bias not only fails to overcome a general lack of expertise, but may compound it.

In addition to the compositions of the boards, the tasks undertaken by the boards differ in important ways. In the for-profit context, the business judgment rule is thought to discourage a judge from second-guessing a complicated business deal.²⁸⁶ It is also designed to incentivize innovation and risk-taking, both of which

²⁸⁰ Rachel Chiu, 2013 DIRECTOR COMPENSATION REPORT: NON-EMPLOYEE DIRECTOR COMPENSATION ACROSS INDUSTRIES AND SIZE 1 (2013), available at http://www.fwcook.com/alert_letters/The_2013_Directors_Compensation_Report.pdf.

²⁸¹ See generally Robert D. Herman, *Are Public Service Nonprofit Boards Meeting Their Responsibilities?*, 69 PUB. ADMIN. REV. 387 (2009).

²⁸² See Chris Cornforth & Charles Edwards, *Board Roles in the Strategic Management of Non-Profit Organisations: Theory and Practice*, 7 CORP. GOV. 346, 360–61 (1999).

²⁸³ See Guo & Musso, *supra* note 265, at 314–15.

²⁸⁴ LeRoux, *supra* note 270, at 512.

²⁸⁵ Lester M. Salamon, *Of Market Failure, Voluntary Failure, and Third-Party Government: Toward a Theory of Government-Nonprofit Relations in the Modern Welfare State*, 16 NONPROFIT & VOLUNTARY SECTOR Q. 29, 41–42 (1987).

²⁸⁶ See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("Absent an abuse of discretion, [a board's] presumptively informed and honest judgment will be respected by the courts."); *Liebman v. Auto Strop*

the shareholder has signed on for: after all, that is where gains come from.²⁸⁷ Moreover, a director's job is largely limited to oversight from the boardroom.²⁸⁸

Things are much different on the average nonprofit board. Nonprofit directors go well beyond the boardroom and are often called to wear many hats, functioning as unpaid staff, as fundraisers, as lobbyists, as well as governors.²⁸⁹ There is also a common expectation that nonprofit directors contribute financially to their organization—quite the opposite of the custom in the for-profit board.²⁹⁰ Insofar as nonprofit board members are asked to wear other hats, their oversight obligations tend to be de-emphasized.²⁹¹ At the same time, when nonprofit boards make decisions on simple matters that call for less specialized business knowledge, the argument for comparative expertise relative to judges is at its lowest.²⁹²

To conclude, nonprofit directors are expected to do more for the organization than simply govern. They are not compensated (and are actually expected to donate their own resources to the organization's cause), they are selected by existing board members for reasons other than governing prowess, and they lack clearly-defined principals or market discipline. These structural pressures do not push nonprofit boards toward good governance, and indeed many scholars are skeptical of

Co., 150 N.E. 505, 506 (N.Y. 1926) (“Courts will not interfere with [board discretion] unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose.”).

²⁸⁷ *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (“The [business judgment] rule could rationally be no different. . . . Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.”); see also, e.g., Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 455–58 (2005) (discussing same).

²⁸⁸ Katherine O'Regan & Sharon M. Oster, *Does the Structure and Composition of the Board Matter? The Case of Nonprofit Organizations*, 21 J.L. ECON. & ORG. 205, 207 (2005).

²⁸⁹ *Id.* at 212.

²⁹⁰ BOARDSOURCE, NONPROFIT GOVERNANCE INDEX 2012: DATA REPORT I CEO SURVEY OF BOARDSOURCE MEMBERS 16 (2012), available at <http://www.thenonprofitpartnership.org/files/board-source-governance-2012.pdf>.

²⁹¹ Bradley E. Wright & Judith L. Millesen, *Nonprofit Board Role Ambiguity: Investigating Its Prevalence, Antecedents, and Consequences*, 38 AM. REV. PUB. ADMIN. 322, 334 (2008).

²⁹² Lee, *supra* note 125, at 953–54.

nonprofit board performance.²⁹³ Although quantifying board performance is no easy task, nonprofit boards are often thought to fail to live up to even basic “good governance” recommendations, such as having board members who attend meetings²⁹⁴ or having audit committees with financial experts to ensure the organization’s financial integrity.²⁹⁵ As the ALI recently observed:

[S]ound practices of board constitution and operation in the nonprofit sector might be even less prevalent than in the business sector. Indeed, it has long been customary in the nonprofit world—in large as well as in small charities—for board members to be asked and agree to serve out of friendship with senior executives or other board members or out of belief in the charity’s cause, with little appreciation of a board member’s role and obligations. Many donation-dependent organizations have emphasized fundraising above oversight. It has seemed acceptable for charities to be governed casually, if not ceremonially, by their boards, allowing too much reign to management, particularly when the charity’s founder is the chief executive.²⁹⁶

Application of the business judgment rule when a board lacks business judgment is, put simply, a bit of a contradiction in terms.

²⁹³ Carter G. Bishop, *Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701, 702 (2008) (“Unfortunately, abdication and dereliction are far more common on volunteer nonprofit charitable boards.”); DeMott, *supra* note 10, at 139 (“There is ample reason to believe that the overall quality of directors’ performance in the nonprofit sector is less than in publicly-traded, for-profit business corporations.”); George W. Dent, Jr., *Corporate Governance Without Shareholders: A Cautionary Lesson from Non-Profit Organizations*, 39 DEL. J. CORP. L. 93, 99 (2014); Goldschmid, *supra* note 2, at 632 (“[A]lmost all evidence suggests that nonprofit directors provide less oversight, less effective participation in decision-making, and in general, less effective governance than their peers in comparable for-profit corporations.”); Barbara E. Taylor et al., *The New Work of the Nonprofit Board*, HARV. BUS. REV., Sept./Oct. 1996, at 4 (“Effective governance by the board of a nonprofit organization is a rare and unnatural act.”).

²⁹⁴ Boyd, *supra* note 58, at 744; Lee, *supra* note 125, at 950. Of course, this is not to say that every single nonprofit is plagued by the problem of recruiting experts. Our point is simply that, given the prevailing practices of board member recruitment, particularly in donative organizations, the deck is stacked against nonprofit board expertise.

²⁹⁵ CTR. ON PHILANTHROPY AT IND. UNIV., FINANCIAL LITERACY AND KNOWLEDGE IN THE NONPROFIT SECTOR 31–32 (Feb. 2012), available at <http://www.philanthropy.iupui.edu/files/research/2012/financialliteracy.pdf>.

²⁹⁶ ALI (Draft No. 1), *supra* note 11, at Part II.3, Introduction, Reporter’s Note (a).

The nonprofit's claim to the same kind of expertise that for-profits have is thus often significantly weaker, but this is not the only form of expertise that matters. As noted above, nonprofit boards also owe duties of obedience to their missions.²⁹⁷ Selecting board members who have a heart, if not a head, for the mission likely leads the typical nonprofit board to have more mission expertise than good judgment.²⁹⁸ Even here, we remain troubled by the common lack of beneficiary influence on the board, leading to boards with strong views on missions but less than ideal knowledge about how to best implement them. Moreover, fiduciary law operates curiously contrary to this expertise dynamic. As noted earlier, the business judgment rule extends deference to duty of care claims, where nonprofit boards struggle, while more closely reviewing duty of obedience claims, where nonprofit boards have a stronger claim to authority.²⁹⁹

4. Impact Range

Although the board's expertise is measured at the organizational rather than the constituent level, the board's failings can fall unevenly on different constituencies. This reality is reflected in the impact range characteristic, which measures the potential loss of each type of constituent.

For the for-profit shareholder, the impact range is decidedly low. Thanks to limited liability provisions, a shareholder has no exposure, financial or otherwise, beyond the value of his investment.³⁰⁰ Similarly, in most cases, the customer's only exposure or impact is in receiving an unsatisfactory product or service, or in seeing a favored product or service discontinued. At best, this is a job for consumer

²⁹⁷ See ALI (Draft No. 1), *supra* note 11, at Part II.B.2.c.

²⁹⁸ See generally BOARDSOURCE, LEADING WITH INTENT: A NATIONAL INDEX OF NONPROFIT BOARD PRACTICES (2015), available at <http://leadingwithintent.org/wp-content/uploads/2015/01/LWI-Report-2.pdf>.

²⁹⁹ See ALI (Draft No. 1), *supra* note 11, at Part II.B. One important exception is that, when required by First Amendment concerns, courts have extended great deference to their leaders' implementation of missions. *Boy Scouts of Am. v. Dale*, 530 U.S. 640, 651 (2000) (discussing "expressive association"); *Serbian E. Orthodox Diocese v. Milivojevich*, 426 U.S. 696, 709 (1976) (discussing religious organizations).

³⁰⁰ See FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 91 (1991). This might not have always been precisely true, particularly for closely-held family corporations where shareholders have emotional investments as well as financial. Joseph H. Astrachan & Peter Jaskiewicz, *Emotional Returns and Emotional Costs in Privately Held Family Businesses: Advancing Traditional Business Valuation*, 21 FAM. BUS. REV. 139, 142 (2008).

protection law, and in the broad run of situations, it amounts merely to an annoyance.

Nonprofit donors face a low impact range similar to that of the for-profit shareholder. In financial terms, the only real “loss” they can experience is the knowledge that their donation was ill-used—assuming, somewhat implausibly for most donors, that they take the time to gain actual knowledge on how their donation was spent. In contrast to the for-profit shareholder, the donor has no expectation of any personal return on his “investment”—the donation. The same reasoning holds true for most members, who have invested a membership fee or other contribution, but face no additional financial loss. However, with that said, the donor and the member very well may feel more loyalty or emotional investment in the cause of the particular nonprofit to which he donates than he would upon investing in a for-profit corporation. The possible sense of betrayal if a nonprofit misuses funds thus should not be disregarded as a constituent impact.³⁰¹

Still, anger and disillusion are relatively minor impacts, particularly when compared to the impact range faced by interest-linked members. Members of homeowners’ associations face the loss of their homes, the forced spending of additional money, or the limitations on the use of their private properties.³⁰² Members of labor unions have the terms of their employment, or even the fact of their employment, negotiated and set by the union.³⁰³ In both cases, the members presumably may derive some benefit from these restrictions—a more pleasant neighborhood or a more humane employment contract—but the important point is not that the relationship can be a positive one. Of course it can be. It is that the relationship has bound up in it so many important rights and interests that an institutional failure—the time when it is not a positive relationship—can have devastating consequences.³⁰⁴

Nonprofit staff stand in a similar situation to interest-linked members. Economic dependency on a salary places workers at risk of considerable harm if

³⁰¹ The harm is particularly great if the jilted donor spurns charitable giving at large, punishing not just the culprit organization but also the sector as a whole.

³⁰² Pollack, *supra* note 14, at 869–72.

³⁰³ 29 U.S.C. § 159(a) (2012).

³⁰⁴ Though in the homeowners’ association context, most homeowners’ association residents did not seek out the homeowners’ association. Pollack, *supra* note 14, at 869–70. In some states or industries, employees do not have much of a choice when it comes to union membership, either. See *Harris v. Quinn*, 134 S. Ct. 2618 (2014).

the salary is discontinued or if working conditions deteriorate due to ineffective leadership.

Finally, we turn to the impact range for customers and beneficiaries. On the customer side for both for-profits and nonprofits, the impacts are generally small. As discussed in the context of exit, the nonprofit customer may be somewhat more limited in his ability to choose a competitor, and so somewhat more impacted by mismanagement on the part of the nonprofit, but we continue to treat this as a negligible difference.³⁰⁵ However, on the beneficiary side, the impact range can be more dramatic. For hungry beneficiaries in need of food and shelter in order to survive, the relationship between a nonprofit charity and its beneficiary is almost entirely one of reliance.³⁰⁶ Mismanagement or financial misfeasance on the part of a nonprofit can result in the intended beneficiaries not receiving the benefits—to the same extent, of the same quality, or at all—that are the very purpose of the institution and the institutional relationship.³⁰⁷ The potentially large impact on nonprofit beneficiaries stands in stark contrast to the impact on many of the other stakeholders in the nonprofit's enterprise.

5. Homogeneity

Finally, we examine the homogeneity of the interests of the constituents of the institution. As explained above, greater homogeneity diminishes the concerns we might have about collective action problems and weak mechanisms of voice because it means that “minority interests are less likely to arise.”³⁰⁸ By contrast, an institution in which a range of heterogeneous interests must be mediated by the leadership is an institution in need of strong mechanisms of accountability to both prevent and expose capture or majority domination of minority interests. Put another way, we might overlook a non-expert board overseeing a constituency with minimal sway in the organization if another constituency can represent their

³⁰⁵ See ALI (Draft No. 1), *supra* note 11, at Part III.B.1.

³⁰⁶ See Bob Jones, *Canton Homeless Shelter Forced to Close Down Due to Lack of Funding, 27 Residents Must Be Relocated*, NEWSNET5 (Jan. 29, 2015, 11:16 AM), <http://www.newsnet5.com/news/local-news/oh-stark/canton-homeless-shelter-forced-to-close-down-due-to-lack-of-funding-27-residents-must-be-relocated>.

³⁰⁷ See Edward Ericson Jr., *How Corruption, Waste, and Mismanagement Killed the 143-Year-Old Nonprofit and Left Dozens of Baltimoreans Homeless*, BOSTON CITY PAPER (Dec. 26, 2012), <http://www.citypaper.com/bcp-cms-1-1421115-migrated-story-cp-20121226-featu-20121226,0,4820571.story>.

³⁰⁸ Gillette, *supra* note 204, at 1413.

interests by proxy. To be clear, because it involves a comparison across constituents and not only an analysis of the relationship between a given constituent and the institution, this characteristic must be examined at the level of the institution, not at the level of each constituent. In this way, it is like the expertise metric we have already discussed.

In the for-profit corporation, the interests of the shareholders are essentially unified around maximizing profit. Some shareholders may certainly have preferences about how the corporation should be run that go beyond profit, but it is a fair generalization that the primary motivation for the average shareholder is the return on investment that he hopes to achieve.³⁰⁹ We recognize that the common interest of shareholders may not always be shared by customers or employees, who naturally may desire to get more from the company and to contribute less, and that this divergence may lead to tension between shareholders, customers, and employees about how company resources should be allocated. To the extent that the for-profit may not be fully homogeneous across all of its constituents, this particular metric plays a relatively small role because the for-profit corporation scores well on other metrics of accountability.

The story for nonprofits is similar. At a certain level of generality, everyone involved wants the nonprofit to succeed, but there may be differences of perspective on how best to achieve success. However, it gets worse because, in the context of the nonprofit, there may even be differences of opinion about what success entails.³¹⁰ Recalling the broader mission of nonprofits, the very fact of goals unrelated to profit opens the door to these kinds of heterogeneous perspectives. Donors are often looked to as a stand-in for beneficiaries within the organization, and while donors and beneficiaries want the organization to spend its resources both wisely and effectively, potential differences quickly emerge between and among donors and beneficiaries.³¹¹

To begin, as noted in the prior section, the actual harm faced by a donor is nowhere near as deep or concrete as the threat to the beneficiary. This means that the donor lacks a strong incentive to monitor and uncover mismanagement. Even if the donor were so inclined, effective monitoring is costly because the harms are

³⁰⁹ Pollack, *supra* note 14, at 872.

³¹⁰ See generally John C. Sawhill & David Williamson, *Mission Impossible? Measuring Success in Nonprofit Organizations*, 11 *NONPROFIT MGMT. & LEADERSHIP* 371 (2001).

³¹¹ Ebrahim, *supra* note 17, at 198.

experienced more by someone unconnected to the donor.³¹² By contrast, whereas a donor may not care all that much about exactly how the nonprofit goes about achieving the ends for which the donor donated, and whereas a donor may be indifferent about the kinds of tradeoffs that may need to be made in the course of providing services or benefits, a beneficiary may have substantial preferences and may feel the costs of a “wrong” choice far more acutely than would a donor. However, beyond diverging incentives and information lies a more fundamental incongruence of perspectives between donor and beneficiary. Donors often come from a much different place than the clients served, and as a result may have little understanding of what beneficiaries truly need.³¹³ Employees come closest to representing the beneficiary—their relatively close interactions with the beneficiary give them the best insight—but employees have incentives for better salaries, offices, and working conditions that regularly put their interests in conflict with those of the clients.³¹⁴

Given the significant problems with beneficiaries’ access to the other levers of accountability discussed here, we would want to see a very clear signal of interest homogeneity before accepting a weak judicial role—one that we do not have.

C. Summary

This analysis reveals that, when it comes to accountability factors relevant to a system of judicial review, nonprofit organizations share many similarities with for-profit organizations. This suggests that the relatively unthinking, yet nearly wholesale, adoption by nonprofit law of for-profit law’s fiduciary doctrines actually can be justified based on the sort of institutional analysis we have set out here. However, while it is encouraging that nonprofit law is largely on the right track by using for-profit corporate law as its baseline, there are a few notable departures in the nonprofit realm that warrant closer examination.

³¹² Manne, *supra* note 92, at 257–58.

³¹³ Indeed, those who control the purse strings may overestimate their knowledge, creating an additional barrier to the needs of those they serve. Cf. Dennis R. Young, *The Influence of Business on Nonprofit Organizations and the Complexity of Nonprofit Accountability: Looking Inside as Well as Outside*, 32 AM. REV. PUB. ADMIN. 3, 5 (2002) (noting that board members can “bring strong ideas but limited understanding of the organization’s societal mission or purpose or how that purpose can be effectively achieved”).

³¹⁴ No doubt, many employees will be able to suppress their own incentives for the good of those of the organization. However, this possibility does not change the fact that the conflicting interests make them a poor stand-in for beneficiaries.

First, while many constituencies of nonprofit organizations can, for the most part, keep the organization on the right track (from their perspective, at least) through available means of voice and exit, there is considerable variation between the different constituencies in their ability to provide internal accountability. Figure 3, below, illustrates how nonprofit and for-profit constituencies tend to compare in terms of exit and voice, as well as the potential impact range. For-profit shareholders and nonprofit members enjoy the most exit and voice, but nonprofit donors have ample opportunities for exit that also work to keep the nonprofit organization in check. Of course, these internal mechanisms of accountability are not perfect. For example, the incentives for closely monitoring nonprofit behavior are generally thought to be lower in the nonprofit world than in business enterprises, as the financial motive of reaping maximum profits leads to greater oversight.³¹⁵ However, for the most part, exit and voice provide powerful forms of institutional accountability for most constituencies in both the for-profit and nonprofit realms.

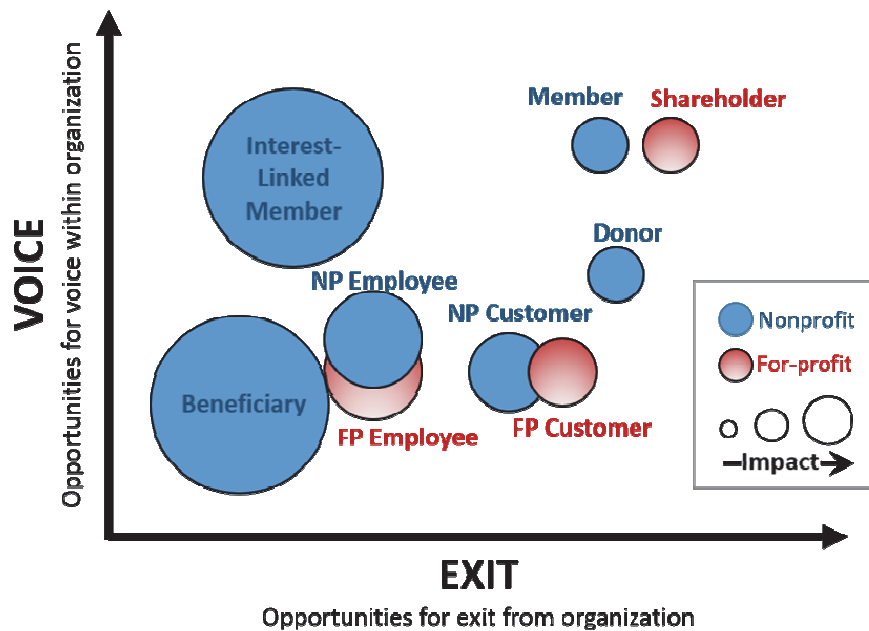
The general utility of exit and voice is a good thing for defenders of the judicial treatment of nonprofits because nonprofits are not generally characterized by well-functioning governing boards with considerable expertise. As noted, the commentary on nonprofit boards is sharply critical. Recall that board expertise is a primary justification for keeping government and courts in a relatively hands-off posture of organizational decision-making, but on this metric, nonprofits perform quite poorly as a general rule.

But what about those constituents for whom exit and voice are less clearly effective? Because of the failure of expertise at the institutional level, we are troubled by the fact that the points with the least exit and voice—beneficiaries and interest-linked members—are also the largest. These constituents face the biggest impact ranges, whereas the points with the most exit and voice are also the smallest. Interest-linked members are in a relatively better position than beneficiaries, but that is only because of the promise of voice. Where voice is effective, a deferential judicial posture is well-justified, but if it is not or cannot be made effective, courts should be prepared to “fill the breach.” However, for beneficiaries, neither exit nor voice has much promise. Beneficiaries of the nonprofit tend to have little sway within the organization, both compared to other nonprofit constituencies and compared to all for-profit constituencies. Moreover, our institutional analysis reveals a striking disparity between beneficiary influence

³¹⁵ Manne, *supra* note 92, at 257–58.

on the organization and impact on the beneficiary. Since beneficiaries often depend on nonprofits for food, housing, and medical care, they have a tremendous amount at stake when a nonprofit loses its way. Neither the board nor any other constituency faces this loss in quite the same way as the beneficiary, leaving the beneficiary class at the greatest risk of harm from governing errors.

Figure 3. Results of Institutional Analysis



CONCLUSION

As is too often the case, the current legal regime in which nonprofits operate and make decisions arose out of inertia and analogies that do not, at first glance, go beyond the surface. By looking carefully at the mechanisms of accountability that operate within the for-profit and the nonprofit, and by examining the strength of the claims to those mechanisms possessed by those institutions' various constituencies, we have tested the validity of these analogies and concluded that, in fact, the nonprofit and the for-profit are generally similar in this regard. For most of the relevant constituencies, the corporate law analogy is one that is far more justified than has previously been recognized.

However, we caution that the analogy—and the legal regime it entails—comes up short when we consider interest-linked members and beneficiaries. Whereas extralegal mechanisms of accountability keep the organization's leaders on track with respect to many constituencies, institutional characteristics conspire

with legal rules to place these groups in a relatively powerless posture. Thus, there is a real risk of disconnect between those who run charitable organizations and those who should be benefiting from them. Hoping for good behavior from those in charge is not enough. Even if nonprofit governors mean well, they may not be *doing* well—at least not as well as they could. By prioritizing deference to nonprofit directors over the needs of the vulnerable, fiduciary law substitutes motive for duty and good intentions for good acts.

At a minimum, this finding warrants further examination. Generic calls for sector accountability through increased federal or state regulation³¹⁶ or vesting fiduciary enforcement in specially incentivized third parties³¹⁷ might address some issues facing the sector, but they still leave the beneficiary voiceless and the interest-linked member immobile. Given that the blind spot with respect to these constituencies is largely a product of failings of voice and exit, we see potential in reforms specifically targeted at increasing their voice. Although one approach might be to increase standing³¹⁸ or to decrease the legal rights of those with greater economic sway,³¹⁹ a promising option with respect to beneficiaries could be to provide them with a formal voice outside of litigation. For example, charities might be required, perhaps as a condition of receiving federal or state tax exempt status, to have a certain percentage of the board composed of beneficiary representatives.³²⁰ Many government funding programs already require the served population to have representation on the board.³²¹ Alternatively, nonprofits could be required to grant beneficiaries a vote on at least some director candidates and major organizational decisions, such as modification to the articles of

³¹⁶ See Mead, *supra* note 9; Boyd, *supra* note 58.

³¹⁷ See James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 272–87 (2003) (proposing a charity commission); Fishman, *supra* note 64, at 671–74 (proposing increased use of relators); Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1, 68–81 (2009) (proposing a federal oversight board); Manne, *supra* note 92 (proposing for-profit monitoring companies).

³¹⁸ Goldschmid, *supra* note 2, at 670; Nix, *supra* note 8, at 188.

³¹⁹ Given the greater influence of donors compared to beneficiaries within the organization, we should be wary about extending additional legal rights to donors, such as granting them standing or allowing them to enforce restrictions on gifts.

³²⁰ Obviously, some nonprofits' beneficiaries, e.g., young children, will be unable to serve as board members, creating the need for a representative closely aligned with their interest, e.g., parents.

³²¹ LeRoux, *supra* note 270, at 512.

incorporation, thus creating a class of beneficiary members.³²² If election mandates are viewed as too blunt, courts could instead tailor the level of deference extended to a decision to the level of input the organization received from beneficiaries before acting. Solutions that focus on the level of deference courts extend, and the preconditions for that deference, could also be worthwhile in the context of interest-linked members for whom formal avenues for voice may fail to live up to their promise.³²³

Holding the leaders of donative organizations to their charitable goals is not something that the law can do alone. Nonprofits should take seriously their obligations to all their constituencies, not just in marketing materials, but also by including them in the organization's decision-making.

³²² Reiser, *supra* note 39, at 850–52. These election rights could come with more complex director election rules that allow a mix of elected and appointed directors on a single board, or different classes of membership with different voting rights, much as we might find with different stock classes.

³²³ *See generally* Pollack, *supra* note 14.