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# EVOLVING CORPORATE GOVERNANCE STANDARDS FOR HEALTHCARE NONPROFITS: IS BOARD OF DIRECTOR COMPENSATION A BREACH OF FIDUCIARY DUTY?

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This Article reviews the historic, ethical, and legal foundations of fiduciary duty and nonprofit corporate governance. It then addresses the current nonprofit healthcare governance issue of Board compensation. The data collected contrasts the amounts of nonprofit healthcare and for-profit healthcare compensation. This Article argues that nonprofit Board compensation may breach fiduciary duty and compromise public policy. The authors conclude that concerns about nonprofit Board compensation are warranted and propose legislative reform.

Ought the executive department of a great voluntary society, for missions or for any similar enterprise, to be really and formally responsible to anybody? . . .

. . . .

A true responsibility of the executive to some superior or constituent power is a security against mismanagement and the gradual perversion of the trust . . . . Great perversions of trust[] . . . occur. . . for the most part unconsciously, gradually, and with best intentions.<sup>1</sup>

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1. Leonard Bacon, *Responsibility in the Management of Societies*, 5 THE NEW ENGLANDER 28, 29, 32, 33 (1847). Yale professor, Leonard Bacon, studied nonprofit governance and published an article on fiduciary accountability to the public. *Id.* He asserted that Board members, as fiduciaries, are accountable to a higher power of morality and that they must disclose their activities. *Id.* This fiduciary responsibility was thus also an individual responsibility as the manager of others' property. *Id.* This high standard of fiduciary accountability was necessary to prevent public hostility. *Id.*

## INTRODUCTION

Nonprofit organizations exist everywhere in American society.<sup>2</sup> These voluntary associations comprise nearly 10 percent of the U.S. economy and consist of three major categories: health care, education, and human services.<sup>3</sup> Over time, nonprofit governance has evolved, reflecting modifications and conflicts in the interpretation and application of the legal and ethical doctrine of fiduciary duty.<sup>4</sup> These changes have eroded the uniqueness of nonprofit Board of Director (BOD or Board) leadership. In a new era of nonprofit governance, the current permissive practice of nonprofit Director compensation<sup>5</sup> may vitiate volunteerism and breach fiduciary duty.<sup>6</sup> Today, numerous and similar occurrences of malfeasance blur distinctions between nonprofit (e.g., United Way) and for-profit (e.g., Enron) governance.<sup>7</sup> Breach of fiduciary duty has generally triggered corporate wrongdoing; for nonprofits, it has betrayed the public trust.<sup>8</sup>

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2. Alex de Tocqueville, the 19th century French observer of American society, wrote about the uniqueness of democratic American institutions: "Americans of all ages, all stations in life, and all types of dispositions . . . are forever forming associations." 2 ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 129 (ed. Francis Bowen, trans. Henry Reeve, Esq., Cambridge: Sever & Francis 1863) (1840). He asserted that such voluntary associations were necessary for a stable democracy where "all citizens are equally independent and cannot rely on a powerful central government to dictate values or dispense charity." *Id.*; see also AMY S. BLACKWOOD ET AL., *URBAN INST., THE NONPROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING*, 2012, at 2 tbl.1 (2012).

3. See William Byrnes, *A Short History of the Nonprofit Sector*, CALIFORNIA ASS'N OF NONPROFITS, [http://web.archive.org/web/20100813084043/http://www.canonprofits.org/index.php?option=com\\_content&view=article&id=254&Itemid=107](http://web.archive.org/web/20100813084043/http://www.canonprofits.org/index.php?option=com_content&view=article&id=254&Itemid=107) (last visited June 10, 2013); Karla Taylor, *Changing Expectations for Nonprofit Governance*, 57 ASS'N MGMT 64, 64 (2005). The three major nonprofit categories listed above break down as follows: education (18.1 percent); health (13.2 percent); and human services (33.7 percent). PANEL ON THE NONPROFIT SECTOR, *STRENGTHENING TRANSPARENCY, GOVERNANCE, AND ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR* 11 (2005) [hereinafter *STRENGTHENING TRANSPARENCY*]. For example, health care nonprofits include 60 percent of community hospitals, all community health centers, nearly 30 percent of nursing homes, approximately 17 percent of home health care agencies, and 40 percent of all private health insurance enrollees. See Byrnes, *supra*.

4. See REV. MODEL NONPROFIT CORP. ACT (1987) (amended 2008).

5. See, e.g., CAL. LAB. CODE §§ 3351(c), 3363.6(c) (2010).

6. See *infra* notes 72 and 106 and accompanying text; see also REV. MODEL NONPROFIT CORP. ACT; *An Act Regulating Compensation of Board Members of Public Charities: Hearing on H. 3516 Before the J. Comm'n on the Judiciary*, 187th Gen. Ct. (Mass. 2011) [hereinafter *Peregrine Testimony*] (testimony from Michael W. Peregrine, Esq., on behalf of Tufts Health Plan).

7. See generally Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L. Q. 357, 357–69 (2003) (discussing the Enron scandal); Karen Donnelly, Comment, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 UMKC L. REV. 163, 173–74 (2010) (discussing scandals in the independent sector, including United Way, American Red Cross, Nature Conservancy, and American University); Christyne J. Vachon, *Blurring. Not Fading. Looking at the Duties of Care and Loyalty as Nonprofits Move into Commercialism*, 12 TRANSACTIONS: TENN. J. BUS. L. 37, 42–43 (2011) (discussing how

Congress enacted the Sarbanes-Oxley Act in an attempt to regulate fiduciary breaches within for-profit organizations; yet for nonprofits, it has thus far merely initiated a nonprofit dialogue with a review and recommendations in two major reports.<sup>9</sup> The result of these efforts has focused much attention on nonprofit Board accountability, disclosure, and transparency that includes more specific issues of nonprofit ethical responsibility, fiduciary duty, internal financial controls, fraud, and excessive executive compensation.<sup>10</sup> It appears that Congress has generally left nonprofit regulation to the states, and the states are beginning to respond.<sup>11</sup> However, while states may pass statutes to address nonprofit best governance practices and reform, these laws may also contribute to a further blurring of the nonprofit distinction by permitting “reasonable” BOD compensation.<sup>12</sup> Such permissive practice of Board compensation erodes the public trust.<sup>13</sup>

Public trust underscores the historic uniqueness of “a great voluntary society,” and our ubiquitous nonprofit organizations.<sup>14</sup> Yet it also emphasizes the responsibility with which they are managed.<sup>15</sup> These voluntary associations exist pursuant to the U.S. Constitution’s First Amendment Right to Assemble, a hallmark of American democracy.<sup>16</sup> Moreover, they self-govern free from state legislative control and for the public benefit.<sup>17</sup> Thus, the nonprofit governance standard derives from the

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nonprofits and for-profit businesses are becoming similar with regard to corporate governance and corporate malfeasance).

8. See Bacon, *supra* note 1 and accompanying text; see also Mark S. Blodgett and Linda J. Melconian, *Health-care Nonprofits: Enhancing Governance and Public Trust*, BUSINESS AND SOCIETY REVIEW 117:2, 197–219 (2012).

9. See *infra* note 138. Both reports to Congress show not only the urgency of nonprofit issues, but also the lack of congressional action and oversight. *Id.*

10. Board compensation is the major distinguishing factor within the two reports. It appears in the 2007 report but not 2005. See *infra* note 138.

11. See *infra* notes 114 and 104. Among the states, at least Massachusetts and New York appear to be considering ethical reforms. See *id.*; see also *infra* note 114. The Massachusetts AG’s Office has also noted that “compensating Directors is contrary to [a charitable] spirit and diverts resources otherwise focused on achieving the charitable mission of the organization.” See *infra* note 24, at 3.

12. See *infra* note 103.

13. Rachel Penski, Note, *The Case of CEO Richard Grasso and the NYSE: Proposals for Controlling Executive Compensation at Public Nonprofit Corporations*, 58 VAND. L. REV. 339, 340 (2005) (discussing public outcry over the NYSE’s CEO’s excessive compensation package).

14. See Bacon, *supra* note 1, at 29.

15. See *id.*, at 29–30.

16. U.S. CONST. amend. I, § 1. “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances.” *Id.*

17. This process began with the founding of Harvard College (Hall) and culminated in *Dartmouth v. Woodward*. See *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 661 (1819).

application of the highest morality as a “security against mismanagement” first enunciated by Yale scholar Leonard Bacon in 1831.<sup>18</sup>

This Article reviews the governance of nonprofits as it evolved through our constitutional guarantees and case law.<sup>19</sup> It then examines the changing governance standards of fiduciary duty in comparison to for-profit organizations, the more recent emphasis on the fiduciary duty of obedience, and the status of current state regulatory reforms and legislative proposals.<sup>20</sup> Investigation of nonprofit BOD compensation as outlined in Appendix A reveals that, within the three major categories of nonprofit organizations, a number of healthcare nonprofits are currently compensating their Board members at modest levels compared to their for-profit counterparts.

Part A of the analysis argues that nonprofit healthcare BOD compensation may be a breach of fiduciary duty.<sup>21</sup> In particular, the Massachusetts legislative initiative for regulating Board compensation is perhaps to be expected since that State has been in the forefront of the historical evolution of U.S. state nonprofit governance.<sup>22</sup> Part B of the analysis argues that BOD compensation is inefficient and unwarranted within the nonprofit healthcare industry.<sup>23</sup> In Part C, this Article concludes by noting that the blurring of nonprofit and for-profit governance may violate historical and ethical principles of the nonprofit public benefit; therefore, states should establish a presumption that prohibits nonprofit Board compensation and that can be rebutted only with the most rigorous justification as developed by the respective States’ Attorneys General (AGs).<sup>24</sup> The justification should include a measurable connection between the charitable mission of the nonprofit and Board performance.

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18. See Bacon, *supra* note 1, at 32.

19. See Byrnes, *supra* note 3.

20. See Appendix A: Healthcare Nonprofit Board Compensation, *infra* p. 31.

21. There is likely no intention to breach fiduciary duty, but rather a manifestation of Bacon’s admonition about unconscious and gradual perversion of the public trust. See Bacon, *supra* note 1, at 32–33; Peter D. Hall, *A History of Nonprofit Boards in the United States*, BOARDSOURCE 3 (2003), <http://beech.ait.fredonia.edu/nfp/ReadingRoom/PDFs/BoardSource-AHistoryOfNonprofitBoardsInTheUnitedStates.pdf> (last visited June 10, 2013) (describing examples of nonprofits that unintentionally and unintentionally breached their fiduciary duties).

22. See *infra* notes 113–124 and accompanying text.

23. See *infra* notes 172–188 and accompanying text.

24. See Letter from David G. Spackman, Chief of Non-Profit Org./Pub. Charities Div. Mass. Att’y Gen., to Barry L. Shemin, Chair of Bd. of Dir., Harvard Pilgrim Health Care, Davey Scoon, Chair of Bd. of Dir., Tufts Health Plan, David W. Hillis, Chair of Bd. of Dir., Fallon Cmty. Health Plan, and Paul Guzzi, Chair of Bd. of Dir., Blue Cross Blue Shield of MA (Apr. 14, 2011) [hereinafter Spackman Letter], available at [http://www.charitableplanning.com/cpc\\_1821517-1.pdf](http://www.charitableplanning.com/cpc_1821517-1.pdf) (creating a justification for such a presumption based on the compensation practices of the nonprofits discovered by Massachusetts AG Coakley).

## I. BACKGROUND

### A. COLONIAL AND STATE HISTORY: SELF-GOVERNANCE FOR THE PUBLIC GOOD

The historic roots of U.S. nonprofits originated in Elizabethan England.<sup>25</sup> The British Parliament first granted the right to assemble to healthcare and education organizations benefitting the public good.<sup>26</sup> This right to form associations also included a tax-exempt status.<sup>27</sup> Many colonial legislatures followed Parliament's common law precedent as nonprofits evolved into a distinctly American practice of institutional governance.<sup>28</sup> The Massachusetts Bay Company's Charter, better known as the Mayflower Compact, is an early colonial framework for nonprofit charters and self-governance.<sup>29</sup>

The founding of Harvard College in colonial Cambridge, Massachusetts triggered the evolution of American nonprofit governance with the chartering of a corporation whose mission was the public good.<sup>30</sup> Its charter, like the Mayflower Compact, did not restrict the Board's powers solely to a grant of property; rather, it further delegated self-governance to the Board and allowed for perpetual succession.<sup>31</sup> While it set precedent for U.S. nonprofit Board independence from government control, it further imposed a duty on the Board to promote the good of both the institution and the public.<sup>32</sup> However, Harvard's managerial autonomy needed further clarification, which it attained with the advent of state rather than colonial legislative and regulatory powers.<sup>33</sup> *Dartmouth v. Woodward* would

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25. See Byrnes, *supra* note 3. The 1597 Charitable Corporations Act exempted hospitals from taxation and was soon followed by the 1601 Statute of Charitable Uses, which expanded the scope of tax exemption. *Id.* It included charities for "maintenance of sick and maimed soldiers, schools of learning, free schools and scholars in universities." *Id.* These Acts sidestepped traditional inheritance law by allowing private and untaxed money to be transferred to the public benefit. *Id.* This included real property that could be transferred to charitable trusts. *See id.*

26. *Id.*

27. *Id.*

28. See Hall, *supra* note 21, at 9–10.

29. *Id.* at 4; see also Carlton Waterhouse, *Avoiding Another Step in a Series of Unfortunate Legal Events: A Consideration of Black Life Under American Law From 1619 to 1972 and a Challenge to Prevailing Notions of Legally Based Reparations*, 26 B.C. THIRD WORLD L.J. 207, 231 n.126 (2006). ("Colonists in Massachusetts established the Mayflower compact and only two colonies did not include self-governance provisions in their formation: New York and Georgia.")

30. See Hall, *supra* note 21, at 5–6. The Massachusetts Colonial legislature established Harvard College in 1636 by granting a formal charter of incorporation making Harvard autonomous and separate from the legislature. *Id.* This autonomy included management of its affairs. *Id.* Its government structure consisted of officers to manage the corporation and the board of public overseers, local ministers, and magistrates, who could veto management decisions. *Id.*

31. *See id.*

32. *Id.* at 5, 18.

33. *Id.* at 5. Two views of nonprofit Board governance still prevail—the Jeffersonian view and the Harvard or common law view. *Id.* at 9–10, 13. The first is subject to the control of state

determine the scope of state authority over nonprofits and BOD independence.<sup>34</sup> In *Dartmouth*, the Marshall Court affirmatively established the principle that private associations for public benefit are expressions of our Constitutional Right to Assemble, free from the “influence of legislative bodies, whose fluctuating policy, and repeated interferences, produced the most perplexing and injurious embarrassments.”<sup>35</sup> Though the *Dartmouth* case appeared to reconcile the legal conflict of nonprofit governance, Board accountability continued to vary among states.<sup>36</sup> Of course, Massachusetts, based on its early history of nonprofit charters, had adopted the common-law/Harvard model of nonprofit governance that was autonomous from the State legislature.<sup>37</sup>

Massachusetts continued to take the early lead in shaping state nonprofit governance.<sup>38</sup> For example, the first standard of nonprofit fiduciary duty was enunciated in 1830 in *Harvard College v. Amory*, in which the Massachusetts Supreme Judicial Court established the Prudent Man Rule: “All that can be required of a trustee to invest, is, . . . to observe how men of prudence, discretion and intelligence manage their own affairs . . . .”<sup>39</sup> It was a strict ethical standard expressly prohibiting any Board self-dealing, or conflict of interest, and it remained the standard for nearly 160 years for nonprofit organizations committed to public benefit.<sup>40</sup> Additionally, nonprofit Board members served as volunteers, another

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legislatures while the second is based upon the constitutional right to assemble and to guard the public’s private rights. *Id.* at 10.

34. *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 518 (1819). In 1817, New Hampshire acquired Dartmouth College and instituted the Jeffersonian view of nonprofit governance by replacing its Board with gubernatorial and legislative appointed overseers. *See id.* at 626.

35. *Id.* at 648. Congressman and Dartmouth alumnus Daniel Webster argued for the Harvard or common law view and the peoples’ right to assemble with Boards serving to protect citizens’ private rights. *See Hall, supra* note 21, at 11–12.

36. *See Hall, supra* note 21, at 13. Virginia followed the Jeffersonian view of state control and oversight. *Id.* at 10, 13. States like Pennsylvania continued to follow the Jeffersonian view by applying a “charitableness test,” established in 1980, by which local authorities could balance tax exemption benefits against the public benefit. *Id.* at 13. New York formed a Board of Regents in 1785 to oversee its nonprofit educational institutions, and in 1990, it replaced the self-dealing trustees of Adelphi University. *Id.*

37. *See id.* at 10.

38. *See generally* *Harvard Coll. v. Amory*, 26 Mass. 446 (1830) (imposing on the trustees of an estate—a nonprofit entity—the “prudent man” rule governing fiduciary duty).

39. *Id.* at 461. In *Amory*, a widow received a \$50,000 estate that diminished to \$30,000 at the time of her death. *Id.* at 447. These monies were then claimed by Massachusetts General Hospital and Harvard. *Id.* at 450. Both of these parties sued the estate alleging mismanagement. *Id.* The court excused the trustees of mismanagement and diminution of the estate consistent with the Prudent Man Investment Rule. *Id.* at 461, 465.

40. *Id.*; *see also* Lynn Foster, G.S. Brant Perkins & Renee Brida, *Investments of Estate Assets*, 4 ARK. PROBATE & ESTATE ADMIN. § 12:5 (2012) (beginning in the 1990s, the “prudent investor” rule began to overtake the 1830s “prudent person rule”).

uniquely distinctive feature of nonprofit organizations serving the public good.<sup>41</sup>

## B. BOARD MEMBER COMPENSATION

For-profit organizations have traditionally viewed Director compensation as an important component of corporate governance within the marketplace and generally consider two primary questions with regard to compensation: does compensation motivate otherwise qualified individuals to serve on corporate Boards and does compensation properly align Directors with shareholders' interests?<sup>42</sup> Several additional factors beyond compensation, however, can motivate Board service at for-profit organizations. For example, Directors are often guided by an altruistic sense that there is an inherent obligation to "do the right thing" for the firm.<sup>43</sup> Also, so long as Directors feel that they have the expertise to contribute, they will serve regardless of compensation.<sup>44</sup> Moreover, the education that Directors receive from serving on Boards and working with peers also plays a strong role in motivating service.<sup>45</sup> Finally, "reputation capital" plays an important role.<sup>46</sup> Directors who serve on the Boards of successful firms are often afforded additional business opportunities and other personal recognition beyond merely an intrinsic sense of accomplishment.<sup>47</sup>

Nonetheless, compensation does motivate Directors to serve at for-profit organizations.<sup>48</sup> The proper form of compensation remains unsettled largely because organizations struggle to maintain an independent Board while simultaneously aligning shareholder and Director interests.<sup>49</sup> For example, the Securities and Exchange Commission (SEC) requires extensive disclosure of BOD compensation to allow the market and

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41. See, e.g., CAL. CORP. CODE § 5239 (2012); see also Robert W. Friz & Elizabeth Virgin, *The Sarbanes Oxley Act—Considerations for Nonprofit Health Care Organizations*, 18 HEALTH LAW, June 2006, at 1, 5 ("Nonprofit organizations have traditionally been governed by Boards of Directors comprised of local unpaid volunteers.").

42. See generally Katherine M. Brown, Note, *New Demands, Better Boards: Rethinking Director Compensation in an Era of Heightened Corporate Governance*, 82 N.Y.U. L. REV. 1102 (2007) (arguing that cash and equity should form the basis of Director compensation).

43. *Id.* at 1114 (comparing Directors to politicians).

44. *Id.* at 1114–15 (noting that "[t]he strongest incentive for directors to 'do the right thing.' . . . is not so much independence as it is their expertise, diligence, and inherent curiosity" (quoting Michael Barrier, *The Compensation Balance*, INTERNAL AUDITOR, June 2002, at 47)).

45. *Id.* at 1115 (noting one Director who commented that Board members should pay for their service because of the education received).

46. *Id.* at 1116.

47. See *id.*

48. *Id.* at 1115–16. While perhaps not the driving force to serve, financial compensation may impact the manner in which Directors serve. *Id.* at 1116. Compensation may further provide a psychological link to the organization. See *id.*

49. See *id.* at 1117.

shareholders to monitor and react to an organization's policy.<sup>50</sup> Shareholders react to whether or not Directors are fulfilling their agency roles while the market monitors whether the firm is maximizing its value.<sup>51</sup> Consequently, corporate Board compensation is efficiently captured within the marketplace.

There are two primary means of compensating Directors and each one has its shortcomings.<sup>52</sup> First, firms may pay Directors directly in cash.<sup>53</sup> This practice maintains the Board's independence from shareholders and managers and reduces conflicts of interest, as Directors are less likely to consider the financial impact of their decisions on the company.<sup>54</sup> Second, firms often alternatively offer Directors equity either through direct shares of stock or through stock options.<sup>55</sup> Equity compensation theoretically reduces agency costs as the interests of Directors are aligned with shareholders.<sup>56</sup> Those aligned interests, however, can result in too "cozy" of a relationship that could lead to earnings management and other ethical breaches.<sup>57</sup> Additionally, a third alternative method of compensating Directors ties compensation to performance.<sup>58</sup> However, as Directors set their own performance goals, potential conflicts of interest are readily apparent.<sup>59</sup> Further, the practice of Directors sharing identical performance goals as managers or officers of the corporation reduces the independence of the Board.<sup>60</sup>

Charitable volunteer associations throughout the colonial and early state period generally did not compensate Board members, a traditional practice

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50. *Id.*

51. *Id.* at 1118.

52. *Id.* at 1121–26.

53. *See id.* at 1121–22.

54. Brown, *supra* note 42, at 1121–22. In a riskier marketplace, Directors often prefer the security of cash compensation. *Id.*

55. *Id.* at 1122–23; *see* Tom Johansmeyer, *Board of Directors are Doing More to Earn Their Keep*, DAILY FIN., (Dec. 18, 2009), <http://www.dailyfinance.com/2009/12/18/boards-of-directors-are-doing-more-to-earn-their-keep/>.

56. *See* Brown, *supra* note 42, at 1124.

57. Caroline A. Antonacci, Note, *SAB 99: Combating Earnings Management with a Qualitative Standard of Materiality*, 35 SUFFOLK U. L. REV. 75, 76 (2001). Earnings management arises when "[e]xecutives, accountants, and auditors contribut[e] to the wide-spread use of creative accounting gimmicks [that] are motivated by inflated earnings targets, judicial and legislative pronouncements retracting accountants' liability, and executive compensation plans triggered by upward momentum in stock price." *Id.*

58. Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. L. 227, 228 n.3 (1999) ("Although having a significant portion of an executive's pay take the form of contingent compensation is a relatively recent phenomenon, pay for performance is not a new idea. Some say that the philosophy of linking pay to performance dates back to the Protestant Reformation of the sixteenth and seventeenth centuries.").

59. *See* Brown, *supra* note 42, at 1131.

60. *Id.*

that prevailed well into the late twentieth century.<sup>61</sup> In particular, health care nonprofits have traditionally relied upon volunteer community and business leaders to serve as Directors; yet, during the last twenty-five years, the permissive practice of compensating Directors has ushered in a new era.<sup>62</sup> The justification for this permissive practice largely stems from the complex nature of the healthcare industry and the perceived competition for qualified Directors.<sup>63</sup> The mission of all healthcare organizations is to finance and deliver healthcare services; however, the distinction between for-profit and nonprofit healthcare organizations is less clear because both offer similar services with an identical mission of caring for patients.<sup>64</sup>

Appendix A illustrates 2010 Director compensation data for the top ten organizations by assets within four categories: all industry nonprofits, all industry for-profits, healthcare nonprofits, and healthcare for-profits.<sup>65</sup> In the top ten nonprofit healthcare industry classification, seven out of ten organizations compensated their Boards while only forty-one out of 229 individual Directors within that classification received compensation. Furthermore, within the top ten healthcare nonprofits, the average salary paid per Director who received compensation was \$79,799, and \$14,287 per Director inclusive of Directors who received no compensation. In the all industry nonprofit class, twenty-three out of 160 Directors received compensation with an average of \$147,276 paid per Director who received compensation, and \$12,170.90 per Director inclusive of Directors who received no compensation. In comparison, for-profit healthcare Directors received an average of \$259,556 annually.

### C. FIDUCIARY DUTY

A nonprofit Board's fiduciary duties and ethical governance obligations ultimately run to those segments of the public for whose benefit the

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61. See *supra* notes 30 (founding of Harvard), 31 (describing the Mayflower compact), 34 (providing judicial clarification in the Dartmouth case), 38 (showing the changes brought about by the Amory case) and accompanying text.

62. Compare Nicole Huberfeld, *Tackling the "Evils" of Interlocking Directorates in Healthcare Nonprofits*, 85 NEB. L. REV. 681, 687 (2007) with REV. MODEL NONPROFIT CORP. ACT § 8.12 (1987) (permitting nonprofit Director compensation).

63. Peregrine Testimony, *supra* note 6.

64. *Id.*

65. See Appendix A, *infra* pp. 28–32. Further, studies suggest that the healthcare nonprofit industry operates more efficiently than the for-profit industry. See Steffie Woolhandler & David U. Himmelstein, *When Money Is the Mission – The High Costs of Investor-Owned Care*, 341 NEW ENG. J. MED. 444, 445–46 (1999); Pauline V. Rosenau & Stephen H. Linder, *Two Decades of Research Comparing For-Profit and Nonprofit Health Provider Performance in the United States*, 84 SOC. SCI. Q. 219, 219, 224 (2003). In the healthcare industry, the distinction between for-profit organizations and their nonprofit counterparts is less clear because both offer similar services with the identical mission of caring for patients. William C. Kellough, *Affiliations, Sales, and Conversion Involving Non-Profit and For-Profit Healthcare Organizations in Oklahoma*, 33 TULSA L.J. 521, 522–23 (1997).

organization's charitable purpose was created.<sup>66</sup> Nonprofit Directors fulfill these duties by governing with due care, loyalty, and obedience.<sup>67</sup> Furthermore, the Board must execute its leadership role in a way that strengthens the nonprofit mission and financial integrity throughout all levels of the organization.<sup>68</sup> The states' power to police BOD fiduciary responsibilities generally rests with the Office of the State AG, most often through its public charities or consumer protection divisions.<sup>69</sup> Hence, due to this minimal oversight, the BOD's responsibility to set the appropriate fiduciary tone at the top of the nonprofit organization and to govern in a manner that preserves the public trust are of paramount importance.<sup>70</sup>

Nonprofit BOD's fiduciary duties support the public trust by placing the public's interest first and foremost.<sup>71</sup> Unlike for-profit Directors, nonprofit Directors' fiduciary duty directly encompasses multiple stakeholders' interests rather than focusing on the narrower interests of shareholders, since the nonprofit organization's goal is not to maximize profits for shareholders.<sup>72</sup> Rather, the purpose of nonprofit BOD fiduciary

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66. Lesley Rosenthal, *Nonprofit Corporate Governance: The Board's Role*, THE HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 15, 2012), <http://blogs.law.harvard.edu/corpgov/2012/04/15/nonprofit-corporate-governance-the-boards-role/#more-27827>; see also Tracy G. Landauer & Harry J. Friedman, *How to Be a Responsible Nonprofit Director: Do's and Don'ts—Avoiding Punishment for Good Deeds*, GREENBERG TRAURIG ALERT 1–4 (Nov. 2005), <http://www2.gtlaw.com/pub/alerts/2005/1102.pdf>.

67. See Gary R. Pannone, *Board Governance and the Non-Profit Organization*, PANNONE LOPES DEVEREAUX & WEST LLC, <http://www.pldw.com/Knowledge-and-Resource-Center/PLDW-Board-Governance.pdf> (last visited April 21, 2013) (defining the duties, responsibilities and management structure of the nonprofit board); R.I. GEN. LAWS § 7-6-22 (2012) (outlining the duties of the board of directors); see also *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575 (Sup. Ct. 1999).

68. See generally Pamela C. Smith, Kerry McTier & Kelly R. Pope, *Nonprofit Employees' Machiavellian Propensities*, 25 FIN. ACCOUNTABILITY & MGMT 335 (2009) (arguing that nonprofit organizations need to take steps at all levels in order to preserve its charitable mission, specifically focusing on public information, fiscal control, management, disclosure, and the public good).

69. See, e.g., *The Non-Profit Organizations/Public Charities Division*, ATT'Y GEN. OF MASS., <http://www.mass.gov/ago/bureaus/business-and-labor/the-non-profit-organizations-public-charities-division/> (last visited Feb. 11, 2013) [hereinafter *Public Charities*]; *Charities*, ATT'Y GEN. OF CAL., <http://oag.ca.gov/charities> (last visited Feb. 11, 2013); *About the Charities Bureau*, ATT'Y GEN. OF N.Y., [http://www.charitiesnys.com/about\\_new.jsp](http://www.charitiesnys.com/about_new.jsp) (last visited Feb. 11, 2013).

70. See generally Mark S. Schwartz, Thomas W. Dunfee & Michael J. Kline, *Tone at the Top: An Ethics Code for Directors?*, 58 J. BUS. ETHICS 79 (2005) (arguing that Directors play a critical ethical role, requiring them to set the tone for their organization's overall ethics and corporate governance programs).

71. LARUE TONE HOSMER, THE ETHICS OF MANAGEMENT 116–17 (7th ed., McGraw-Hill 2011). A fiduciary is defined as “[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship.” BLACK’S LAW DICTIONARY 702 (9th ed. 2009).

72. Gary Kirk & Shabnam B. Nolan, *Nonprofit Mission Statement Focus and Financial Performance*, 20 NONPROFIT MGMT. & LEADERSHIP 473, 477 (2010); see also Woolhandler & Himmelstein, *supra* note 65, at 446.

duty is solely to fulfill the organization's charitable mission—a stakeholder-based purpose to benefit the public.<sup>73</sup>

Potentially weakening the connection between nonprofit BOD governance policy and the public benefit, the 1987 Revised Model Nonprofit Corporation Act (RMNCA) provides states the opportunity to modify fiduciary duties as defined in the RMNCA, and specifically, permits the practice of Board compensation.<sup>74</sup> The RMNCA accomplishes this by relaxing the standard applied to conflicts of interest and self-dealing as established in *Amory's Prudent Man Rule*,<sup>75</sup> moving the Rule closer to today's for-profit Business Judgment rule<sup>76</sup> applicable to for-profit Boards.<sup>77</sup> Yet, while allowing the practice of nonprofit BOD compensation arguably alters the tradition of volunteerism,<sup>78</sup> the Official Comments to the RMNCA provide that BOD compensation must be consistent with the fiduciary standards of due care and loyalty.<sup>79</sup> Nevertheless, the Model Act ushered in a new era of nonprofit governance.<sup>80</sup>

The 1987 RMNCA, its subsequent revisions, and most state statutes further erode nonprofit BOD's accountability to the public by failing to account for the fiduciary duty of obedience.<sup>81</sup> The nonprofit BOD duty of obedience may be distinguished from the duties of care and loyalty as it

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73. See Kirk & Nolan, *supra* note 72. Missions are the revered essence of nonprofits. *Id.* at 474.

74. See REV. MODEL NONPROFIT CORP. ACT §§ 1.02, 8.12, 8.30–8.33 (1987) (amended 2008). The Revised Model Nonprofit Corporation Act is an ABA-sponsored model statute for uniform nonprofit governance that states may adopt. See *id.* §§ 1.01, 1.02.

75. See *supra* notes 38–40 and accompanying text.

76. Margaret E. McLean, Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPS by Corporate Officers and Directors to Avert Hostile Takeovers, 10 PEPP. L. REV. 731, 761 (1983) (“The prudent man requirement is likened to the sound business judgment rule applicable to directors of a corporation.”). Under both the nonprofit Best Judgment and for-profit Business Judgment Rule, self-serving transactions and conflicts of interest may be “permissible as long as the board” is “fully informed” and acts are not “demonstrably contrary to the [organization’s] best interest.” See Hall, *supra* note 21, at 22.

77. Hall, *supra* note 21, at 22.

78. See *supra* note 62 and accompanying text.

79. See REV. MODEL NONPROFIT CORP. ACT § 8.12 cmt. (1987) (noting Board must comply with sections 8.30 through 8.33, which includes duty of care and loyalty in determining Board compensation).

80. Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1685 (2009) (“To combat the potential for, and effect of, nonprofit governance abuse, an increasing number of states have adopted the Revised Model Nonprofit Corporation Act.”).

81. Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 IOWA J. CORP. L. 631 (1998) (addressing duty of care and loyalty but not mentioning duty of obedience); see also Huberfeld, *supra* note 62, at 703–04, 712 (discussing the fact that only a handful of courts have acknowledged the duty of obedience, and that the RMNCA does not address the duty of obedience); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 897 (2007).

does not emanate from the nonprofit organization as an organization; rather, it arises from the organization's charitable purpose or mission as described in its articles of incorporation and bylaws.<sup>82</sup> Commentators have suggested that limiting enforceable fiduciary duties to only care and loyalty will not sustain the public trust.<sup>83</sup> This might be especially so considering the heightened scrutiny afforded financial fiduciaries in today's environment and may work to empower the Board to all but ignore the nonprofit's charitable goals.<sup>84</sup> Consequently, the duty of obedience's absence directly undermines Bacon's admonition that the Board's true responsibility is obedience to the public good to secure against mismanagement and the perversion of the public trust.<sup>85</sup>

Moreover, the duty of obedience plays a critical and different role from the duty of care and loyalty since those duties are closely aligned with market efficiencies.<sup>86</sup> The duty of obedience maintains that Directors are unbound by market forces in making strategic organizational decisions.<sup>87</sup> Instead, the societal concerns of the organization's founders as outlined in the charitable mission contained in its articles of incorporation and bylaws guide the decision making of Directors.<sup>88</sup> For example, in *Manhattan Eye, Ear & Throat Hospital v. Spitzer*, the court considered whether the sale of a

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82. Douglas Y. Park, *To Whom Does the Nonprofit Board of Directors Owe Fiduciary Duties?*, DYP ADVISORS (Feb. 12, 2013), [www.dypadvisors.com/2012/04/16/to-whom-does-nonprofit-board-of-directors-owe-fiduciary-duties/](http://www.dypadvisors.com/2012/04/16/to-whom-does-nonprofit-board-of-directors-owe-fiduciary-duties/). Directors' fiduciary duties within nonprofits extend to both the corporation and to the public. Huberfeld, *supra* note 62, at 699. However, it is the duty of obedience that fixes the public benefit as articulated by the nonprofit's charitable mission. *Id.* The duty of obedience originated in the law of trusts, which requires the trustee to administer trust assets according to the express wishes of both the creator and donors. *See* Sugin, *supra* note 81, at 898. For nonprofit charities, Board members must make every decision in order "to advance the nonprofit's purpose" as articulated in the nonprofit's mission. Danné L. Johnson, *Seeking Meaningful Nonprofit Reform in a Post Sarbanes-Oxley World*, 54 ST. LOUIS U. L.J. 187, 200 (2009) (citation omitted). Courts analyze the duty of obedience under one of two approaches: first, a narrow approach via an *ultra vires* interpretation questioning whether or not the Board acted outside the scope of the organization's purpose; and second, a more flexible approach via an internal interpretation of how the Directors managed the scope of the organization's mission. *See* Sugin, *supra* note 81, at 900–02.

83. *See* Sugin, *supra* note 81, at 894. Some states do apply the duty of obedience even though those states fail to codify it. *Id.* at 899. This is well illustrated by the recent increase in restricted gifts resulting from "charities' drifting from their . . . purpose or mission." Benjamin, *supra* note 80, at 1677–78. Restricted gifts create a trust, and therefore, their use is even narrower than the charitable purpose. *Id.* at 1680.

84. *See* Sugin, *supra* note 81, at 894; Benjamin, *supra* note 80, at 1679–80.

85. *Compare* REV. MODEL NONPROFIT CORP. ACT (1987) (failing to discuss the duty of obedience) *with* Bacon, *supra* note 1, at 32–33 (arguing that the BOD's true responsibility is to obey the public good).

86. Benjamin, *supra* note 80, at 1681.

87. *Id.* at 1682 (observing that, under the duty of obedience, "nonprofits are foremost concerned with their mission, which they find inherently valuable and to be considered before economics").

88. *See id.*

troubled New York nonprofit hospital violated the Board's duty of obedience.<sup>89</sup> The court conceded that eliminating the nonprofit's mission via a dissolution of its assets and establishing a new mission might be appropriate to solve financial difficulties;<sup>90</sup> however, it cautioned that the duty of obedience requires a consideration of whether "[e]mbarkation upon a course of conduct which turns it away from the charity's central and well-understood mission should be a carefully chosen option of last resort."<sup>91</sup>

Though the nature and scope of nonprofit BOD fiduciary duties have been at the forefront of recent discussions of nonprofit reform proposals and financial concerns,<sup>92</sup> the RMNCA does not impose substantial regulations on nonprofits to ensure financial accountability.<sup>93</sup> This starkly contrasts with laws governing for-profit organizations, which must follow the financial accountability requirements of the Sarbanes-Oxley Act.<sup>94</sup> Furthermore, little concerted effort to effect regulatory change has been proposed for nonprofits,<sup>95</sup> while similar action can be observed in other sectors. For example, the SEC, the President, and various industry groups and leaders have endorsed modifying Broker-Dealer laws to include fiduciary duties.<sup>96</sup> Yet, in regard to nonprofits, Congress has initiated merely two panel reports that express concerns for nonprofit governance, fiduciary duty, and other ethical issues such as BOD compensation.<sup>97</sup> Congress has instead relegated to the states the authority to propose legislative reforms in these areas to strengthen fiduciary duty for nonprofit governance.<sup>98</sup>

#### D. STATE AND FEDERAL REFORMS

The states exercise primary jurisdiction and regulatory authority over nonprofits by governing their legal formation, providing oversight of their

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

90. *Id.* at 595.

91. *Id.*

92. See *supra* note 82 and accompanying text.

93. See REV. MODEL NONPROFIT CORP. ACT (1987) (amended 2008).

94. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, pmb., 116 Stat. 745, 745 (codified at 15 U.S.C. § 7201) (enacting Sarbanes-Oxley Act "[t]o protect investors by improving the accuracy and reliability of corporate disclosures").

95. Doug Donovan, *Nonprofits Need a Strong, Unified Voice to Lobby Government*, *Report Says*, CHRON. OF PHILANTHROPY (Sept. 19, 2012), <http://philanthropy.com/article/Nonprofits-Need-a-Strong/134540/>.

96. See generally STAFF OF THE SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011) (recommending the implementation of, among others, duties of care and loyalty to broker-dealers). In fact, one commentator suggests working toward a "fiduciary society," where those entrusted with other's money must abide by fiduciary duties imposed by federal statute. John Bogle, *A Crisis of Ethic Proportions*, WALL ST. J., Apr. 21, 2009, at A19.

97. See *infra* note 138 and accompanying text.

98. See *infra* notes 114, 69, 104, and accompanying text.

operations, and enforcing their fiduciary duties.<sup>99</sup> State statutes require nonprofits to file articles of incorporation and bylaws which must include statements of charitable purpose and mission.<sup>100</sup> State AGs, representing the interests of the public trust, are the public face of nonprofit accountability, transparency, and disclosure.<sup>101</sup> They provide oversight of nonprofit fiduciary duty, mission, and purpose and enforce state nonprofit law.<sup>102</sup>

California spearheads State efforts to adopt Sarbanes-Oxley-like requirements of financial integrity for nonprofit organizations<sup>103</sup> To wit, the California Nonprofit Integrity Act imposes on nonprofit Boards a responsibility to exercise heightened oversight over its financial matters.<sup>104</sup> However, while a step in the right direction, the California law has many weaknesses. First, California hospitals are exempt from mandatory audit and accompanying disclosure requirements.<sup>105</sup> Also, while the California legislation sets a standard of reasonableness for Board approval of CEO and CFO compensation as well as Board compensation, it provides little guidance by way of criteria to follow in applying the standard.<sup>106</sup> Third, while California law prohibits and penalizes nonprofit breaches of the duty of loyalty through self-dealing, these restrictions do not apply to compensation of Board members who participate in the decision to pay as long as the compensation is just and reasonable.<sup>107</sup> Finally, even though California defines a volunteer Board member as one who is not

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99. See, e.g., CAL. CORP. CODE §§ 5000–10841(2012) (governing nonprofit corporation law); see also MASS. GEN. LAWS, ch. 180 §§ 1–29 (2010) (governing corporations for charitable uses). Many states have passed “sunshine laws” that require nonprofits to disclose financial information, including revenue and expenditures. Donnelly, *supra* note 7, at 164 n.8 (citation omitted).

100. See, e.g., CAL. CORP. CODE §§ 5130–5134 (2012).

101. See CAL. CORP. CODE § 5250 (2012); MASS. GEN. LAWS, ch. 12, § 8 (2010).

102. See *supra* note 69.

103. Donnelly, *supra* note 7, at 176–77 (noting that California was the first state to legislate state-imposed reforms on nonprofit governance); see also CAL. GOV’T CODE § 12586(e) (2005) (requiring financial reporting and audits for nonprofits with gross revenues of \$2 million or more).

104. See David Tate, *Nonprofit Board Standard of Care, Risk Management, and Audit Committee Responsibility*, DAVIDTATE.US, 4 (May 19, 2011), [http://davidtate.us/files/Nonprofit\\_Board\\_Standard\\_of\\_Care\\_Risk\\_Management\\_and\\_Audit\\_Committee\\_Responsibilities\\_David\\_Tate\\_Esq\\_051920113.pdf](http://davidtate.us/files/Nonprofit_Board_Standard_of_Care_Risk_Management_and_Audit_Committee_Responsibilities_David_Tate_Esq_051920113.pdf) (noting that, while the entire BOD is responsible for overseeing nonprofit’s financial statements and accounting system, the BOD *may* delegate that responsibility to an audit committee and, if it receives more than \$2 million in gross revenues, *must* have their annual financial statements audited by an independent certified public accountant). *But cf.* NYS Legislative Session, NPCCNY.ORG (Aug. 2005), [http://www.npccny.org/info/gov\\_rel\\_080105b.htm](http://www.npccny.org/info/gov_rel_080105b.htm) (proposing, unsuccessfully, the “Nonprofits Accountability Bill,” which would have imposed Sarbanes-Oxley-like financial controls requirements on nonprofit BODs).

105. CAL. GOV’T CODE § 12583 (2005); see also Rosemary E. Fei, *California’s Nonprofit Integrity Act of 2004*, ALDER & COLVIN, 5 (Spring 2006), [http://www.adlercolvin.com/pdf/nonprofit\\_governance/AC%20Web%20Resource%20--%20CA%20NIA%20of%202004%20\(00171023\).PDF](http://www.adlercolvin.com/pdf/nonprofit_governance/AC%20Web%20Resource%20--%20CA%20NIA%20of%202004%20(00171023).PDF).

106. CAL. GOV’T CODE § 12586(g).

107. Blodgett & Melconian, *supra* note 8, at 197–219.

compensated, it permits Director reimbursement by the nonprofit for expenses incurred.<sup>108</sup>

In terms of nonprofit BOD compensation, Illinois, California, Texas, and Virginia explicitly authorize modest compensation of nonprofit Boards in their statutory codes.<sup>109</sup> Illinois, for example, has increased the amount of nonprofit compensation a Director can receive without losing statutory limited liability protection from \$5,000 to \$25,000.<sup>110</sup> However, none of the statutory provisions of these four states describe standards of reasonable compensation for Board members, and none of them provide criteria by which to determine the overall justification for BOD compensation.<sup>111</sup>

This lack of concrete statutory guidance, and perhaps fueled by the 1987 RNMCA's failure to align the nonprofit BOD duty of obedience with its respective mission, has led to increased attorney general activism,<sup>112</sup> especially with regard to nonprofit BOD compensation. The Massachusetts AG, Martha Coakley (AG Coakley), has been front and center in attempts to regulate Massachusetts nonprofits.<sup>113</sup> In 2009, AG Coakley undertook a study aimed at reviewing nonprofits' compensation practices with regard to independent Directors and focused specifically on the compensation practices of four Massachusetts charitable health insurance providers.<sup>114</sup> In 2011, perhaps at least partially in response to AG Coakley's study, two of the four Massachusetts health insurance providers suspended Director compensation indefinitely,<sup>115</sup> while the other two voted to continue the

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108. See CAL. LAB. CODE § 3352(i) (2010); CAL LAB. CODE § 3363.6(c) (2010); Peregrine Testimony, *supra* note 6.

109. Peregrine Testimony, *supra* note 6.

110. *Id.*

111. *Id.*

112. See *id.* at 7 (noting the Massachusetts AG's "vigorous oversight of the nonprofit sector"); see also Alice M. Maples, *State Attorney General Oversight of Nonprofit Healthcare Corporations: Have We Reached an Ideological Impasse?*, 37 CUMB. L. REV. 235, 240–41 (2007). Oversight by State AGs has increased over the last few years. See Patrick Coffey et al., *The "Charitable Trust" Controversy Confronting Banner Health and Other Nonprofit Healthcare Systems*, 16 HEALTH LAW. 1, 1 (2003). The various AGs argue that nonprofit corporate assets are held in trust for the benefit of the community that a particular nonprofit serves. *Id.* The competing arguments balance a lack of resources and an otherwise lack of regulation. Maples, *supra*, at 240.

113. See Christine McConville, *Pols Aim to Ban Money for Nonprofit Boards*, BOSTON HERALD, May 23, 2011, at 5.

114. Press Release, Mass. Att'y Gen. Office, Massachusetts Attorney General Martha Coakley Announces Enhanced Oversight of Non-Profit Executive and Board Compensation (Sept. 2, 2009), available at <http://www.mass.gov/ago/news-and-updates/press-releases/2009/ag-coakley-announces-enhanced-oversight-of.html>.

115. Massachusetts Blue Cross Blue Shield, although voting to end its practice of Director compensation in 2011, subsequently reinstated this practice in 2013. See Robert Weisman, *Blue Cross to Pay Board Again, Though at Reduced Level*, THE BOSTON GLOBE, Mar. 1, 2013, <http://www.bostonglobe.com/business/2013/03/01/blue-cross-blue-shield-massachusetts-reinstate-board-fees-though-reduced-level/SuPw27Pjg84r1bQ93GWu4M/story.html>. Fallon Community Health Plan, the other health insurer that suspended its BOD compensation, also reinstated its Director compensation practices. *Id.*

practice.<sup>116</sup> Shortly after, AG Coakley released a critical and strongly negative report on the compensation practices of the two health insurance providers that elected to continue compensating their independent Directors.<sup>117</sup>

In her report, AG Coakley noted that “Compensating [D]irectors is contrary to [charitable] spirit and diverts resources otherwise focused on achieving the charitable mission of the organization.”<sup>118</sup> The report further pointed out that an inherent conflict of interest exists with the Board’s self-determination of compensation.<sup>119</sup> Ultimately, as a result of its findings, the report submitted two Massachusetts AG initiatives: (1) public disclosure of independent Director compensation levels, as well as the basis and rationale for such compensation; and (2) specific legislation authorizing AG-determination of justifiable compensation.<sup>120</sup>

In May 2011, AG Coakley filed legislation aimed at prohibiting the continued practice of compensating independent Directors of public charities.<sup>121</sup> The Bill proposes that “[n]o Massachusetts based public charity . . . shall provide compensation to any independent officer, [D]irector or trustee for service . . . except with the approval of the Director [of the AG’s public charities division]. . . . Any such public charity intending to provide [such] compensation . . . shall file an application . . . requesting the approval of the Director.”<sup>122</sup> The Bill further permits the AG to develop criteria for granting its approval through rules and regulations.<sup>123</sup> The legislation, however, remained in committee at the end of the formal 2012 legislative session and its future passage is uncertain.<sup>124</sup>

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116. See Spackman Letter, *supra* note 24, at 1; see also Robert Weisman, *Insurer’s Board Suspends Own Pay*, BOSTON.COM (Mar. 9, 2011), [http://www.boston.com/business/healthcare/articles/2011/03/09/blue\\_cross\\_board\\_suspends\\_its\\_own\\_pay/](http://www.boston.com/business/healthcare/articles/2011/03/09/blue_cross_board_suspends_its_own_pay/).

117. See generally Spackman Letter, *supra* note 24 (criticizing the compensation practices of Tufts Health Plan and Harvard Pilgrim Health Care).

118. *Id.* at 2.

119. *Id.* at 2–3.

120. *Id.* at 5–6.

121. *Bill H. 3516*, COMMONWEALTH OF MASS., <http://www.malegislature.gov/Bills/187/House/H3516> (last visited Feb. 17, 2013) [hereinafter *Bill H. 3516*].

122. H.B. 3516, 187th Leg. (Mass. 2011).

123. *Id.* § 1, sec. 8F½(b). The AG has developed regulations in which the office has established a rebuttable presumption standard. See also HOSMER, *supra* note 71.

124. See H.R. 3515, 2011 Leg., 187th Sess. (Mass. 2011), available at <http://www.malegislature.gov/Bills/187/House/H3516>. AG Coakley’s report and legislative proposal invited critical comments and strong opposition. See, e.g., *Attorney General Coakley’s Latest Proposal Could Drive Foundations and Their Money Out of Massachusetts*, CHARITY GOVERNANCE CONSULTING (Apr. 18, 2011), [http://www.charitygovernance.com/charity\\_governance/2011/04/attorney-general-coakleys-latest-proposal-could-drive-foundations-and-their-money-out-of-massachusetts.html#more](http://www.charitygovernance.com/charity_governance/2011/04/attorney-general-coakleys-latest-proposal-could-drive-foundations-and-their-money-out-of-massachusetts.html#more) [hereinafter CHARITY GOVERNANCE CONSULTING]. For example, some argued that the legislation is merely a political reaction to a problem that does not exist. *Id.* Furthermore, the article pointed out a potential constitutional challenge under the freedom of association. *Id.* Critics also noted several potential unintended results including the potential that

In addition to state government, the Internal Revenue Service (IRS) also exercises oversight over nonprofits.<sup>125</sup> Recent revisions in IRS Forms 990 and 1023, the forms with which all nonprofit corporations must comply to secure their tax-exempt status,<sup>126</sup> require more reporting transparency and disclosures.<sup>127</sup> The IRS proposes nine principles of good governance for nonprofits, including Principal 8, which governs payment of reasonable Board and executive compensation.<sup>128</sup> Principle 8 cautions that charities should refrain from compensating Directors, but nonetheless allows Director compensation “when determined appropriate by a committee composed of persons who are not compensated by the charity and have no financial interest in the determination.”<sup>129</sup> Principle 8 also directs readers to various parts of the Internal Revenue Code and Treasury Regulations, but fails to identify little additional criteria apart to those mentioned in the Code and Regulations that are unique to Board member compensation.<sup>130</sup> Furthermore, these nine principles include “satisfaction” requirements for

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nonprofits would move out of Massachusetts and an increased number of side deals for talent would occur as former board members became paid consultants. *Id.*

125. Blodgett & Melconian, *supra* note 8, at 197–219. This special tax-exempt status is granted because nonprofits commit their net earnings to public purpose and benefit. See Pamela C. Smith & Kelly A. Richmond, *Call for Greater Accountability Within the U.S. Nonprofit Sector*, 11 ACAD. ACCT. & FIN. STUD. J. 75, 76–77 (2007). Additionally, they must adhere to the language of the 1969 Tax Reform Act, which provides “rigorous registration, reporting, and accountability requirements.” See Hall, *supra* note 21, at 21.

126. Nicole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831, 852 (2007) (stating that Form 990 must be filed in order to preserve tax-exempt status); C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL’Y 399, 442 (1995) (stating that Form 1023 must be filed to preserve tax-exempt status).

127. Press Release, Internal Revenue Serv., IRS Releases Discussion Draft of Redesignated Form 990 for Tax-Exempt Organizations (June 14, 2007), available at <http://www.irs.gov/uac/IRS-Releases-Discussion-Draft-of-Redesignated-Form-990-for-Tax-Exempt-Organizations>. Steuerle & Sullivan, *supra* note 126. *But see* Donnelly, *supra* note 7, at 180, 188 (noting that the IRS lacks legislative authority from Congress to regulate nonprofit governance).

128. The nine principles of good governance for nonprofits proposed by the IRS are

- (1) Adoption of a Mission Statement, (2) Adoption of a Code of Ethics and Whistleblower policies, (3) Satisfaction of the Duty of Care/Director Diligence, (4) Satisfaction of the Duty of Loyalty/effective conflicts of interest oversight, (5) Constituent transparency, (6) Oversight of fund-raising activity, (7) Stewardship of financial affairs, (8) Payment of reasonable compensation; and (9) Adoption of a document retention policy.

*IRS Releases Suggested Governance Guidelines for Tax-Exempt Organizations*, MCDERMOTT WILL & EMERY (Feb. 5, 2007), <http://www.mwe.com/publications/uniEntity.aspx?xpST=PublicationDetail&pub=6137>; INTERNAL REVENUE SERV., GOOD GOVERNANCE PRACTICES FOR 501(C)(3) ORGANIZATIONS [hereinafter GOOD GOVERNANCE], available at <http://www.mwe.com/info/news/IRS0207.pdf>.

129. GOOD GOVERNANCE, *supra* note 128, at 4.

130. *Id.*; 26 C.F.R. § 53.4958-6 (2002). *But see* Treas Reg. § 53.4958-6 (noting factors and examples supporting rebuttable presumption of the reasonableness of compensation).

evaluation of Board performance of fiduciary duties of care and loyalty; yet they are silent on the fiduciary duty of obedience.<sup>131</sup>

Prior to the annual filing of Form 990, nonprofits must file an initial Form 1023 in order to receive a federal tax exemption under § 501(c)(3).<sup>132</sup> In 2004, the IRS amended Form 1023 and developed a new list of questions as a result of its survey of perceived executive and Board abuses.<sup>133</sup> These questions address BOD pay and other compensation issues.<sup>134</sup> Others have noted that,

[w]hile the Form 1023 prior to the current version asked questions regarding organization structure and governance, it principally focused on the charitable activities of the organization. In contrast, the 2004 . . . version places an increased emphasis on an organization's governance by

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131. GOOD GOVERNANCE, *supra* note 128, at 4.

132. See INTERNAL REVENUE SERV., FORM 1023 (rev. 2006) [hereinafter 2006 FORM 1023]; INTERNAL REVENUE SERV., FORM 990 (2012). Treasury regulations provide that nonprofits must make their Form 990 and Form 1023, along with the IRS determination letter readily available for public inspection by request or by posting on the Internet. See 26 C.F.R. §§ 301.6104(d)-1(a), 301.6104(d)-2(a), (b)(2) (2012). However, only the IRS has standing to bring an action against the nonprofit for failure to comply with the disclosure requirement. 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, 1129 n.223 (2001). Commentators have suggested that regulation should require nonprofits to post these forms on the nonprofit's webpage. Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701, 776 (2008).

133. See Press Release, Internal Revenue Serv., IRS Revises Application Form for Charitable Organizations (Nov. 1, 2004), available at <http://www.irs.gov/uac/IRS-Revises-Application-Form-for-Charitable-Organizations>; Friz & Virgin, *supra* note 41, at 7.

134. INTERNAL REVENUE SERV., FORM 1023, at 3 (rev. 2004) [hereinafter 2004 FORM 1023]. Part V of the revised Form 1023 asks

[1] Do you or will the individuals that approve compensation arrangements follow a conflict of interest policy? [2] Do you or will you approve compensation arrangements in advance of paying compensation? [3] Do you or will you document in writing the date and terms of approved compensation arrangements? [4] Do you or will you record in writing the decision made by each individual who decided or voted on compensation arrangements? [5] Do you or will you approve compensation arrangements based on information about compensation paid by **similarly situated** taxable or tax-exempt organizations for similar services, current compensation surveys compiled by independent firms, or actual written offers from similarly situated organizations? . . . [6] Do you or will you record in writing both the information on which you relied to base your decision and its source? . . . [7] [Has your organization] adopted a **conflicts of interest policy** consistent with the [IRS] sample conflict of interest policy . . . ? . . . [8] What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you for setting their own compensation? [9] What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you regarding business deals with themselves?

*Id.* at 3–4 (emphasis in original).

focusing on [B]oard and management relationships (independence) as well as compensation and other potential opportunities for inurement.<sup>135</sup>

This proactive shift has made it more difficult for nonprofits to submit fraudulent responses because of the specificity of the questions.<sup>136</sup> For example, in order to address the BOD's fiduciary duty as it pertains to compensation, question 5b of Part V of the 2004 Form 1023 poses, "What procedures will you follow to assure that persons who have a conflict of interest will not have influence over you for setting their own compensation?"<sup>137</sup>

In two separate reports, the Panel on the Nonprofit Sector (the Panel)—a panel convened in 2004 at the encouragement of the Senate Finance Committee for the purpose of preparing recommendations to Congress and the IRS to improve the oversight and governance of charitable and nonprofit organizations—urged nonprofit Board leadership to strengthen its governance and ethics principles with more disclosure, accountability, and transparency, and developed hundreds of recommendations for Congress and the IRS to improve its laws, education efforts, and enforcement.<sup>138</sup> Particularly, the Panel's 2007 Report identified a number of nonprofit best practices.<sup>139</sup> Among the items, it included Principle 20, which states the presumption that "Board members are generally expected to serve without compensation," noting that in most cases compensation may not be appropriate.<sup>140</sup> However, despite this general presumption, it explicitly acknowledges that nonprofit charitable organizations may pay reasonable Board compensation when "appropriate" to do so.<sup>141</sup>

While Principle 20 discusses a mechanism for determining reasonable compensation and suggests that Board compensation may be consistent with governance best practices in certain instances, it fails to identify those instances and proposes no criteria for determining what constitutes an appropriate justification for compensating Directors.<sup>142</sup> Rather, Principle 20 allows for Director compensation so long as it is "reasonable and necessary

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135. Evelyn Brody, *Sunshine and Shadows on Charity Governance: Public Disclosure as a Regulatory Tool*, 12 FLA. TAX REV. 183, 207–08 (2012).

136. *See id.* at 208 (citation omitted). Further, the proactive approach permits the IRS to rely less heavily on audit procedures. *Id.* (citation omitted).

137. 2004 FORM 1023, *supra* note 134, at 4.

138. *See* STRENGTHENING TRANSPARENCY, *supra* note 3, at preface, 4–8; PANEL ON THE NONPROFIT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS, preface, 5 (2007) [hereinafter PRINCIPLES]; *About the Panel on the Nonprofit Sector*, NONPROFITPANEL.ORG, <http://www.nonprofitpanel.org/about/Index.html> (last visited May 26, 2013).

139. *See* PRINCIPLES, *supra* note 138, at 8–27.

140. *Id.* at 19; *see also* Peregrine Testimony, *supra* note 6.

141. PRINCIPLES, *supra* note 138, at 19.

142. *Id.*; *see also* Peregrine Testimony, *supra* note 6.

to support the performance of the organization in its exempt function.”<sup>143</sup> Consequently, nonprofits should rely on state nonprofit corporation statutes, expressing clear legislative intent, that authorize payment of Board compensation without State oversight.<sup>144</sup> These statutes leave it up to the nonprofit Board to act in the best interests of the organization.<sup>145</sup> Unlike for-profit Boards in which the owners, stockholders, and investors of the organization provide oversight of Board actions, nonprofit Boards are not subject to organizational stakeholder oversight of Board decisions to compensate themselves.<sup>146</sup> Thus, only the State AGs, who represent the public interest, have oversight, albeit limited, to police nonprofit Board actions.

## II. ANALYSIS

### A. NONPROFIT DIRECTOR COMPENSATION MAY BE UNETHICAL AND MAY VIOLATE FIDUCIARY DUTIES

Nonprofit BOD compensation raises issues of conflict of interest and may compromise the fiduciary duties of due care, loyalty, and obedience.<sup>147</sup> State AGs supervise nonprofit Boards’ management and may bring enforcement actions for breaches of fiduciary duties of care and loyalty.<sup>148</sup> For healthcare nonprofits especially, the Board must be loyal to the nonprofit and obedient to the healthcare’s mission to finance and deliver healthcare services.<sup>149</sup> Directors can satisfy the duty of loyalty to advance the best interests of the organization by avoiding conflicts of interest and self-dealing.<sup>150</sup> Moreover, they can meet their fiduciary duty of obedience by advancing and fulfilling the nonprofit’s mission within the scope of the organization’s public purpose—not by responding to competitive market pressures—as developed in *Manhattan Eye, Ear & Throat Hospital*.<sup>151</sup> These duties encompass the preservation of a “great voluntary society” benefitting the public good.<sup>152</sup>

However, autonomous Board compensation promotes, at the very least, the appearance of a conflict of interest and provides a Board the opportunity to advance its own self interests to the detriment of the nonprofit’s

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143. PRINCIPLES, *supra* note 138, at 19.

144. Peregrine Testimony, *supra* note 6, at 2–3 (discussing Illinois and California law).

145. *Id.*

146. *Id.*

147. See *supra* note 67 and accompanying text.

148. See *supra* note 69 and accompanying text.

149. See Huberfeld, *supra* note 62, at 701–04.

150. See *id.* at 701–02.

151. *Id.* at 703–04, 706–08; see also *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 597 (Sup. Ct.1999).

152. See Bacon, *supra* note 1 and accompanying text.

mission.<sup>153</sup> “[D]irectors of a large charity may be more likely to consider the advantages to themselves of doing business with the charity than to view self-dealing transactions as a way to help the charity.”<sup>154</sup> Self-interest violates the Baconian ethical requirement to obey the charitable mission and fulfill the public benefit, which in turn compromises the public trust.<sup>155</sup> Furthermore, Board compensation without obedience to its mission weakens the purpose of the nonprofit’s existence.<sup>156</sup> A Board that engages in Board compensation may not be acting within the highest moral and ethical standards even though it meets legal standards of reasonableness and the appropriate level of due care.<sup>157</sup> Consequently, this permissive practice undermines, as Bacon pointed out, the ethical “security against mismanagement and [promotes] the gradual perversion of the trust. . . . Great perversions of trusts . . . occur . . . for the most part unconsciously, gradually, and with the best intentions.”<sup>158</sup>

Today’s relaxation of nonprofit fiduciary standards appears to pull nonprofit Boards in two opposing directions: (1) meeting lofty public expectations tied to Bacon’s historical high moral standards and perceptions; and (2) being legally required to meet only a Best Judgment Rule, a fiduciary standard that is analogous to the for-profit standard of business judgment.<sup>159</sup> This modified standard does not secure against mismanagement; it fails to prevent self-dealing and conflicts of interest. It creates the slippery slope Bacon warned would lead to a perversion of the public trust. Tightening nonprofit fiduciary duty to an outright prohibition of any self-dealing or conflicts of interest would help to differentiate it from the for-profit Business Judgment Rule and restore the more rigorous standards of the past.<sup>160</sup>

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153. See Spackman Letter, *supra* note 24, at 2–3.

154. Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 637 (1999).

155. See Bacon, *supra* note 1, at 32–33.

156. See Kirk & Nolan, *supra* note 72.

157. See Bacon, *supra* note 1, at 32–33; REV. MODEL NONPROFIT CORP. ACT (1987); Kirk & Nolan, *supra* note 72, at 473–90.

158. Bacon, *supra* note 1, at 32–33; see also PRINCIPLES, *supra* note 138, at 19.

159. Benjamin, *supra* note 80, at 1694 (discussing the similarities between the for-profit and nonprofit best judgment rule); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 n.10 (Del. 1981) (describing the modern for-profit “business judgment” rule).

160. See Benjamin, *supra* note 80, at 1694; *Maldonado*, 430 A.2d at 784 n.10; REV. MODEL NONPROFIT CORP. ACT § 8.30 cmt. (1987) (amended 2008). The 1987 RMNCA abandoned the strict trust standard of the “prudent man” for the more flexible and lenient corporate standard of “business judgment.” REV. MODEL NONPROFIT CORP. ACT § 8.30 cmt. Under the trust standard, board self-dealing and conflicts of interest are “strictly prohibited”; under the corporate standard, such Director transactions are “permissible as long as the board [is] fully informed” and the members are not “demonstrably contrary to the nonprofit’s best interest[s].” Hall, *supra* note 21, at 22.

Perhaps the Massachusetts AG Final Report to the public discussed in Part I-D reflects Bacon's moral admonition to nonprofit Boards to avoid perversion of the public trust.<sup>161</sup> It's finding that Director compensation at the nonprofits under investigation "fail[ed] to meet the standard of good governance that [the Massachusetts AG's office] believe[d] should be expected of a public charity" while still permitting nonprofits to compensate Directors if they have a "clear and convincing rationale" for doing so certainly corroborates the observation that the permissive practice of Board compensation may adhere to Directors' fiduciary duties under limited circumstances.<sup>162</sup> However, it further suggests that BOD compensation may exacerbate the ethical tension that pulls nonprofit Boards in opposing directions. The recent legislative proposal submitted by the Massachusetts AG partially addresses such ethical tension.<sup>163</sup> It grants authority to the Massachusetts AG to determine the merits of Board compensation under a "clear and convincing" standard.<sup>164</sup> However, it does not provide specific criteria to determine justifiable compensation.<sup>165</sup>

Any proposal to determine nonprofit Board compensation should consider adherence to the charitable mission as the litmus test for today's nonprofit regulatory reforms. Ethical traditions of rigorous individual Board responsibility, volunteerism, and adherence to mission serve the public and the fiduciary duties of due care, loyalty, and obedience.<sup>166</sup> As such, those duties may preclude BOD compensation if the practice of BOD compensation subverts its commitment to its charitable mission or otherwise results from a conflict of interest.

An inherent conflict of interest exists when a Board determines its own compensation.<sup>167</sup> In the for-profit context, transparency and disclosure reduce the conflict because shareholders react by replacing Board members, filing derivative lawsuits, or developing shareholder proposals.<sup>168</sup> For example, dissatisfied shareholders may propose that Directors be compensated with stock options in lieu of other monetary compensation in order to align otherwise divergent interests.<sup>169</sup> Further, the marketplace reacts to for-profit Board decisions, thereby serving as a "backbone" to such

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161. Spackman Letter, *supra* note 24; see Bacon, *supra* note 1, at 32.

162. Spackman Letter, *supra* note 24, at 5, 6; see also REV. MODEL NONPROFIT CORP. ACT § 8.12 (1987) (allowing Director compensation).

163. See H.R. 3515, 2011 Leg., 187th Sess. (Mass. 2011), available at <http://www.malegislature.gov/Bills/187/House/H3516>.

164. See *id.*

165. Compare *id.* with 2004 FORM 1023, *supra* note 134.

166. See *supra* notes 62 and 68 and accompanying text.

167. Johansmeyer, *supra* note 55.

168. *Id.* (noting a derivative lawsuit by Goldman Sachs shareholders for excessive board compensation).

169. *Id.*

decisions. On the other hand, as discussed above in Part I.C, state regulation has failed to expand standing beyond the AGs' Office so that, in most instances, donors are not able to regulate nonprofits.<sup>170</sup> Considering this diminished stakeholder oversight in the nonprofit context, and after applying the fiduciary duties of due care and loyalty, Board-determined BOD compensation may not be justifiable. The practice of permitting Director compensation may also violate the fiduciary duty of obedience to advance the nonprofit mission.<sup>171</sup>

#### **B. BOARD COMPENSATION: BLURRING OF FOR-PROFIT AND NONPROFIT HEALTHCARE SECTORS**

The practice of compensating nonprofit Boards may be unethical and potentially violative of fiduciary duties, but it also appears to be impractical.<sup>172</sup> This can be seen through analyzing the critiques levied against AG Coakley's proposed legislation discussed above in Part I-D. In addition to the critics' legal challenges and claims of unintended results, critics also asserted familiar free market concerns.<sup>173</sup> They noted that healthcare is an evolving and highly regulated industry requiring highly skilled and compensated Directors.<sup>174</sup> They further contended that competition with public companies for qualified Board members compels healthcare nonprofits to actively compete for Directors, thereby permitting the market to drive compensation levels.<sup>175</sup> Finally, they claimed that Directors' exorbitant time commitments justify compensation.<sup>176</sup> However, all of these arguments resonate with for-profit rationales for compensation rather than with nonprofit volunteerism and mission.

AG Coakley responded to these criticisms by noting that there are equally complex charitable hospitals that do not pay their Boards.<sup>177</sup>

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170. See *supra* notes 69 and 70; see also Gilkeson, *supra* note 127, at 852–53.

171. Gilkeson, *supra* note 127, at 853; see also Bacon, *supra* note 1, at 32–33.

172. See *supra* note 124.

173. See CHARITY GOVERNANCE CONSULTING, *supra* note 124.

174. See Jeffrey A. Alexander & Shou-Yih D. Lee, *Does Governance Matter? Board Configuration and Performance in Not-for-Profit Hospitals*, 84 MILBANK Q. 733, 749 (2006); *Commentary for Nonprofit Health Care Board Members: The Right Path or a Minefield*, 49 INQUIRY 9, 10 (2012) [hereinafter *Commentary*] (commentary by Bill Kreykes).

175. See Alexander & Lee, *supra* note 174; *Commentary*, *supra* note 174.

176. See Alexander & Lee, *supra* note 174; *Commentary*, *supra* note 174; see also Peregrine Testimony, *supra* note 6. *But see Best Practices: Nonprofit Corporate Governance*, MCDERMOTT, WILL & EMORY (June 2004), <http://www.mwe.com/publications/uniEntity.aspx?xpST=PublicationDetail&pub=4545> (providing Best Practices guideline for Nonprofit Corporate Governance but failing to mention Director compensation).

177. See *supra* note 118 and accompanying text; *Enabling Massachusetts Attorney General Martha Coakley's and Senator Mark Montigny's Efforts to Dictate to Private Nonprofit Entities*, CHARITY GOVERNANCE CONSULTING (May 25, 2011), [http://www.charitygovernance.com/charity\\_governance/2011/05/enabling-massachusetts-attorney-general-martha-coakleys-and-](http://www.charitygovernance.com/charity_governance/2011/05/enabling-massachusetts-attorney-general-martha-coakleys-and-)

Furthermore, the Massachusetts AG's Office noted that there was no evidence that those Boards do not volunteer a proportionate amount of time.<sup>178</sup> The data in Appendix A below reveals an additional and perhaps more nuanced consideration.<sup>179</sup> For-profit healthcare organizations do not appear to be in direct competition with their nonprofit counterparts for Board members because of the dramatic difference in compensation levels.<sup>180</sup> More importantly, compensation levels, or lack thereof, should not form the basis of competition for qualified Board members in a nonprofit setting.

Director compensation and competitive market forces would suggest that Directors choose to serve based upon the level of compensation. A brief review of the data, however, suggests otherwise.<sup>181</sup> Appendix A illustrates that nonprofit healthcare Board members are compensated an average of \$14,287.25 annually, while for-profit Board members within the same industry are compensated an average of \$259,556.31 annually.<sup>182</sup> This disparity in compensation demonstrates that Board service between a nonprofit healthcare Board and a for-profit healthcare Board is not in direct competition; thus, the rationale for increasing compensation as a means of securing qualified Board members has little merit.<sup>183</sup>

Free market proponents would argue that nonprofit healthcare Director compensation is necessary to attract better-qualified Directors.<sup>184</sup> Similar to the duty of obedience as described in *Manhattan Eye, Ear & Throat Hospital*, better quality healthcare also appears to be immune to competitive market pressures.<sup>185</sup> For example, several studies reveal that nonprofit health providers offer more effective care as compared to for-profit providers.<sup>186</sup> Obedience to the charitable mission of the nonprofit should drive Directors' decision making, not profit maximization.<sup>187</sup> Further, enticing Directors with compensation as the driving force may result in a

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senator-mark-montignys-efforts-to-dictat.html [hereinafter CHARITY GOVERNANCE CONSULTING 2].

178. See Spackman Letter, *supra* note 24, at 3.

179. See Appendix A: Healthcare nonprofit board compensation.

180. *Id.*

181. *Id.*

182. See *id.*; see also text accompanying notes 65–67. Those in the nonprofit healthcare industry are willing to receive lower wages than their for-profit counterparts in exchange for job satisfaction. See Amy Butler, *Wages in the Nonprofit Sector: Healthcare, Personal Care, and Social Service Occupations*, BUREAU OF LABOR STATISTICS (Apr. 15, 2009), <http://bls.gov/opub/cwc/cm20090123ar01p1.htm>.

183. See Appendix A: Healthcare nonprofit and healthcare for profit board.

184. See CHARITY GOVERNANCE CONSULTING 2, *supra* note 177.

185. See generally *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575 (Sup. Ct. 1999) (discussing the duty of obedience and its effect on a healthcare nonprofit); Woolhandler & Himmelstein, *supra* note 65, at 445–46.

186. Rosenau, *supra* note 65, at 228.

187. See *supra* note 72 and accompanying text.

profit-oriented mindset contrary to the nonprofit's charitable mission and a volunteer society.<sup>188</sup>

### C. RECOMMENDED REGULATORY APPROACH: PERFORMANCE AND MISSION

Compensating nonprofit healthcare Directors may violate long-held nonprofit fiduciary principles and blur distinctions between nonprofit and for-profit governance.<sup>189</sup> As a general practice, therefore, the nonprofit healthcare industry should avoid compensating Directors. Instead, nonprofit healthcare organizations should consider enhancing and promoting other rationales or benefits that motivate individuals to serve on nonprofit Boards. After nearly twenty-five years of the permissive practice of Board compensation, only 2 percent of nonprofit Board members receive annual compensation.<sup>190</sup> This minimal participation further suggests that nonprofit Board service is not driven by compensation. Clearly, then, it is still the charitable mission of the nonprofit that attracts the service of Board volunteers.<sup>191</sup> One way to attract Directors in the absence of compensation is to draft a comprehensive organizational mission that incorporates branding of organizational purpose and promotes community prestige.<sup>192</sup> Nonprofits could further promote their respective Directors and place them in positions of high visibility. This would make BOD membership a highly coveted and privileged experience.<sup>193</sup> Such branding and prestige enhances organizational mission and avoids conflicts of interest that arise when Directors are compensated.<sup>194</sup>

This recommendation, however, is undermined as a “best practice” when nonprofits elect to compensate their Boards.<sup>195</sup> As previously noted, there is a vacuum of accountability within the traditional nonprofit fiduciary relationship because nonprofits do not have shareholders to enforce fiduciary principles.<sup>196</sup> The dynamic of this lack of agency control begs the question: what is the proper regulatory approach to address nonprofit Board compensation in the healthcare industry?

The federal government has made some progress in establishing benchmarks and addressing the myriad of governance abuses within the

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188. Kirk & Nolan, *supra* note 72, at 473–90; Woolhandler & Himmelstein, *supra* note 65, at 444 (1999).

189. Johnson, *supra* note 82, at 195–96.

190. *Id.* at 205.

191. *See id.* at 230–31.

192. *Id.*

193. *See id.*

194. *Id.*

195. *See supra* notes 116–118 and accompanying text. Two Massachusetts nonprofits elected to compensate their Boards despite AG Coakley's recommendation. *Id.*

196. *See Gilkeson, supra* note 127, at 840–41.

nonprofit sector.<sup>197</sup> For example, both Form 990 and Form 1023 have included disclosure requirements for organizations to receive tax-exempt status.<sup>198</sup> However, Form 1023 is deficient because it does not elicit specific responses regarding substance and procedure to the majority of its questions.<sup>199</sup> For example, nearly every question on the Form 1023 queries a “yes” or “no” answer.<sup>200</sup> Question 4(d) in the section related to Director compensation illustrates this point: “Do you or will you record in writing the decision made by each individual who decided or voted on compensation arrangements?”<sup>201</sup> This lack of qualitative data is not sufficient to ferret out improper Board compensation.<sup>202</sup>

The enforcement of fiduciary principles of nonprofit governance is left to the respective State AGs.<sup>203</sup> Moreover, state legislatures should follow Massachusetts and enact legislation that establishes a rebuttable presumption that Board compensation<sup>204</sup> is improper and grants to the AG rule-making authority to develop rigid criteria for overcoming that presumption. Such proactive state legislative response, closely mirroring the proposed Massachusetts legislation, may add sufficient rigor into Form 1023 and Principle 20 of the 2007 Panel on the Nonprofit Sector’s Report.<sup>205</sup>

Criteria for overcoming the presumption must focus on the mission in relation to Director performance.<sup>206</sup> This would directly connect Board compensation to its performance in the advancement and fulfillment of the nonprofit’s purpose. Further, the level of concern regarding nonprofit Board independence should be different from the for-profit healthcare industry. Independence in the for-profit sector from meeting financial benchmarks for compensation could be problematic because management and Directors could manipulate earnings, whereas adhering to the nonprofit’s mission does not lend itself to such manipulation. For example, instead of permitting nonprofits to compensate Directors on an annual basis at a fixed sum, the AG regulations could require nonprofits to present their mission along with a metric for achieving that mission. Any permissible Director compensation should be directly conditioned upon successfully satisfying the metric, thereby properly aligning compensation with the nonprofit’s charitable mission.

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197. Compare 2004 FORM 1023, *supra* note 134, with 2006 FORM 1023, *supra* note 131.

198. Gilkeson, *supra* note 127, at 852 (noting donors monitor nonprofit finances via Form 990).

199. See generally 2006 FORM 1023, *supra* note 127.

200. *Id.*

201. *Id.* at 4.

202. See generally *id.*

203. See, e.g., *supra* note 69.

204. See H.B. 3516, 187th Leg. § 1, sec. 8F½(b) (Mass. 2011).

205. See *id.*

206. Kirk & Nolan, *supra* note 72, at 473–90.

**CONCLUSION**

This Article has traced the ethical and legal history of nonprofit governance in the United States, demonstrating a strong ethical foundation for what should be today's measure of nonprofit fiduciary duty. The nonprofit Best Judgment Rule is merely analogous to the for-profit Business Judgment Rule, thereby allowing virtually no ethical differentiation between nonprofit and for-profit governance. In adopting the 1987 RMNCA Best Judgment Rule, state statutes have failed to alleviate this blurring of nonprofit and for-profit fiduciary duty; rather, they have contributed to it.

Today, nonprofit healthcare organizations, as revealed in the data contained in Appendix A, compensate their Boards to attract talent, albeit on a smaller scale compared to their for-profit counterparts. The current permissive practice of Board compensation in the nonprofit healthcare industry may be a violation of this duty. Further, justifications for nonprofit BOD compensation that rely on the competitive landscape for Directors mistakenly analogize nonprofit with for-profit competitive pressures for Directorship. This Article concludes by suggesting that nonprofit Board compensation should be presumptively prohibited and should only be rebutted with a rigorous showing, as determined by the State AG, of how such compensation is consistent with Director performance in achieving the charitable mission and purpose of the nonprofit organization.

## APPENDIX A

## ALL INDUSTRY DATA:

2010 Director Compensation: Top 10 All Industry Nonprofits							
	# of Directors	Directors Paid	Sum of Salary	Average of Salary	Max Salary	Min Salary	Average Hours per Week
<b>Education</b>	<b>126</b>	<b>1</b>	<b>\$789,000.00</b>	<b>\$6,261.90</b>	<b>\$789,000.00</b>	<b>\$</b>	<b>4.23</b>
Massachusetts Institute of Technology (MA)	8	0	\$	\$	\$	\$	5.00
President and Fellows of Harvard College (MA)	5	0	\$	\$	\$	\$	5.00
Stanford University Board of Trustees of the Leland Stanford Ju (CA)	31	0	\$	\$	\$	\$	2.00
Trustees of Columbia University in the City of New York (NY)	24	1	\$789,000.00	\$32,875.00	\$789,000.00	\$	3.00
Trustees of Princeton University (NJ)	40	0	\$	\$	\$	\$	6.23
Yale University (CT)	18	0	\$	\$	\$	\$	4.72
<b>Health</b>	<b>34</b>	<b>22</b>	<b>\$2,598,345.00</b>	<b>\$76,421.91</b>	<b>\$232,123.00</b>	<b>\$</b>	<b>2.66</b>
Howard Hughes Medical Institute (MD)	10	10	\$439,582.00	\$ 43,958.20	\$60,000.00	\$30,832.00	3.20
Kaiser Foundation Health Plan Inc. (CA)	12	12	\$2,158,763.00	\$179,896.92	\$232,123.00	\$122,865.00	2.43
Kaiser Foundation Hospitals (CA)	12	0	\$	\$	\$	\$	2.43

<b>Economic Development</b>	<b>0</b>	<b>0</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>0.00</b>
Southwest Louisiana Business Development Center (LA)	0	0	\$	\$	\$	\$	0.00
<b>Grand Total</b>	<b>160</b>	<b>23</b>	<b>\$3,387,345.00</b>	<b>\$21,039.41</b>	<b>\$789,000.00</b>	<b>\$</b>	<b>3.87</b>

Note. Kaiser Hospitals and Kaiser Health Plan have the same board members; only show compensation for Kaiser Health Plan on Form 990.

<b>2010 Director Compensation: Top 10 All Industry For-Profits</b>						
	<b># of Directors</b>	<b>Directors Paid</b>	<b>Sum of Salary</b>	<b>Average of Salary</b>	<b>Max of Salary</b>	<b>Min of Salary</b>
<b>Banking</b>	<b>55</b>	<b>55</b>	<b>\$15,061,610.00</b>	<b>\$273,847.45</b>	<b>\$646,229.00</b>	<b>\$18,750.00</b>
Bank of America	12	12	\$3,693,762.00	\$307,813.50	\$646,229.00	\$240,000.00
Citigroup	17	17	\$4,232,500.00	\$248,970.59	\$612,500.00	\$18,750.00
JPMorgan Chase	10	10	\$2,555,185.00	\$255,518.50	\$270,185.00	\$245,000.00
Wells Fargo	16	16	\$4,580,163.00	\$286,260.19	\$377,217.00	\$41,000.00
<b>Conglomerates</b>	<b>16</b>	<b>16</b>	<b>\$4,741,353.00</b>	<b>\$296,334.56</b>	<b>\$357,251.00</b>	<b>\$151,650.00</b>
General Electric	16	16	\$4,741,353.00	\$296,334.56	\$357,251.00	\$151,650.00
<b>Diversified Financials</b>	<b>40</b>	<b>40</b>	<b>\$10,907,347.00</b>	<b>\$272,683.68</b>	<b>\$503,287.00</b>	<b>\$34,348.00</b>
Fannie Mae	9	9	\$1,685,000.00	\$187,222.22	\$300,000.00	\$160,000.00
Freddie Mac	11	11	\$1,791,348.00	\$162,849.82	\$300,000.00	\$34,348.00
Goldman Sachs Group	11	11	\$4,627,249.00	\$420,659.00	\$503,287.00	\$199,335.00
Morgan Stanley	9	9	\$2,803,750.00	\$311,527.78	\$322,917.00	\$299,583.00
<b>Insurance</b>	<b>13</b>	<b>13</b>	<b>\$3,071,659.00</b>	<b>\$236,281.46</b>	<b>\$521,220.00</b>	<b>\$23,750.00</b>
American Intl Group	13	13	\$3,071,659.00	\$236,281.46	\$521,220.00	\$23,750.00
<b>Grand Total</b>	<b>124</b>	<b>124</b>	<b>\$33,781,969.00</b>	<b>\$272,435.23</b>	<b>\$646,229.00</b>	<b>\$18,750.00</b>

**Healthcare Data:**

<b>2010 Director Compensation: Top 10 Healthcare Nonprofits</b>							
	<b># of Directors</b>	<b>Directors Paid</b>	<b>Sum of Salary</b>	<b>Average of Salary</b>	<b>Max Salary</b>	<b>Min Salary</b>	<b>Average Hours per week</b>
Adventist Health System Sunbelt Inc (FL)	22	1	\$3,091.00	\$140.50	\$3,091.00	\$	2.77
Banner Health (AZ)	12	2	\$432,000.00	\$36,000.00	\$45,000.00	\$27,000.00	4.00
Catholic Healthcare West (AZ)	15	1	\$43,804.00	\$2,920.27	\$43,804.00	\$	3.53
Cleveland Clinic Foundation (OH)	92		\$	\$	\$	\$	2.80
Howard Hughes Medical Institute (MD)	10	1	\$439,582.00	\$43,958.20	\$60,000.00	\$30,832.00	3.20
Kaiser Foundation Health Plan Inc (CA)	12	2	\$2,158,763.00	\$179,896.92	\$232,123.00	\$122,865.00	2.43
Kaiser Foundation Hospitals (CA)	12	0	\$	\$	\$	\$	2.43
Memorial Sloan-Kettering Cancer Center (NY)	31	0	\$	\$	\$	\$	1.42
Shriners Hospitals for Children (FL)	12	1	\$111,540.00	\$9,295.00	\$111,540.00	\$	6.25
Trinity Health Corporation (MI)	11	4	\$83,000.00	\$7,545.45	\$25,000.00	\$	2.00
<b>Grand Total</b>	<b>229</b>	<b>41</b>	<b>\$3,271,780.00</b>	<b>\$14,287.25</b>	<b>\$232,123.00</b>	<b>\$</b>	<b>2.84</b>

Note. Kaiser Hospitals and Kaiser Health Plan have the same board members; only show compensation for Kaiser Health Plan on Form 990.

<b>2010 Director Compensation: Top 10 Health For-profits</b>						
	<b># of Directors</b>	<b>Dire-ctors Paid</b>	<b>Sum of Salary</b>	<b>Average of Salary</b>	<b>Max of Salary</b>	<b>Min of Salary</b>
Baxter International	12	12	\$2,552,377.00	\$212,698.08	\$227,228.00	\$203,228.00
Becton, Dickinson	13	13	\$2,847,982.00	\$219,075.54	\$241,920.00	\$91,942.00
Boston Scientific	13	13	\$2,985,182.00	\$229,629.38	\$633,650.00	\$27,382.00
Cigna	11	11	\$4,959,691.00	\$450,881.00	\$2,398,849.00	\$240,208.00
Community Health Systems	7	7	\$1,375,042.00	\$196,434.57	\$235,007.00	\$20,000.00
Express Scripts	11	11	\$2,833,000.00	\$257,545.45	\$277,000.00	\$244,000.00
Humana	10	10	\$2,793,982.00	\$279,398.20	\$562,340.00	\$212,516.00
Medco Health	8	8	\$2,213,312.00	\$276,664.00	\$297,789.00	\$257,789.00
Stryker	8	8	\$2,228,293.00	\$278,536.63	\$308,721.00	\$222,246.00
Thermo Fisher	12	12	\$2,464,552.00	\$205,379.33	\$385,023.00	\$4,889.00
<b>Grand Total</b>	<b>105</b>	<b>105</b>	<b>\$27,253,413.00</b>	<b>\$259,556.31</b>	<b>\$2,398,849.00</b>	<b>\$4,889.00</b>