



# DIGITAL ACCESS TO SCHOLARSHIP AT HARVARD

## Moral Systems in the Regulation of Nonprofits: How Value Commitments Matter

The Harvard community has made this article openly available. [Please share](#) how this access benefits you. Your story matters.

<b>Citation</b>	Robert C. Clark, Moral Systems in the Regulation of Nonprofits: How Value Commitments Matter (Hauser Ctr. Working Paper No. 33.6, Oct. 2006).
<b>Published Version</b>	<a href="http://www.hks.harvard.edu/hauser/PDF_XLS/workingpapers/workingpaper_33.6.pdf">http://www.hks.harvard.edu/hauser/PDF_XLS/workingpapers/workingpaper_33.6.pdf</a>
<b>Accessed</b>	February 19, 2015 1:17:01 PM EST
<b>Citable Link</b>	<a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:12332534">http://nrs.harvard.edu/urn-3:HUL.InstRepos:12332534</a>
<b>Terms of Use</b>	This article was downloaded from Harvard University's DASH repository, and is made available under the terms and conditions applicable to Other Posted Material, as set forth at <a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#LAA">http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#LAA</a>

*(Article begins on next page)*



**The Hauser Center**  
for Nonprofit Organizations

**Moral Systems in the Regulation of Nonprofits:  
How Value Commitments Matter**

by  
**Robert C. Clark**

*The Hauser Center for Nonprofit Organizations  
Harvard University*

**October 2006  
Working Paper No. 33.6**

## **Abstract**

This essay explores how three behavior-shaping systems - legal, market, and moral - influence the fundamental tasks of both for-profit and nonprofit organizations, including organizational goal-setting; motivation of participants; and deterring and reducing abuse of power. After identifying key features of these normative systems and their characteristic differences, the author argues that the influence of *moral systems* on nonprofit organizations may be underestimated, especially in view of their potentially unifying role with respect to all of the fundamental tasks. He suggests that the prospects for effective reform of nonprofit governance and accountability regimes are improved when the mechanisms and effects of these moral systems are taken into account.

**Moral Systems in the Regulation of Nonprofits:  
How Value Commitments Matter**

By

**Robert C. Clark**

Harvard University Distinguished Service Professor  
Harvard Law School

Paper prepared for Hauser Center symposium on  
October 3 & 4, 2006

This version is a first DRAFT  
and is not intended for broader circulation

September 14, 2006

## Introduction

This essay is an unapologetic thought piece.<sup>1</sup> It offers a framework for thinking about the role of value commitments in nonprofit organizations, and about key differences between nonprofit and for-profit corporations. It also hypothesizes about general tendencies in the differential effectiveness of types of control systems across the nonprofit and for-profit world, and suggests a cautious approach to the development of legal controls on nonprofits.

My starting point is to distinguish among three categories of normative, or behavior-shaping, systems in modern society: legal, market, and moral systems.

I then identify three sorts of tasks that these normative systems may perform or facilitate: determining goals and making them operational; positively motivating organizational participants and stakeholders to contribute effort and resources toward the goals; and deterring and reducing abuse of discretionary power by participants, especially those personnel who have managerial roles (e.g., directors, officers, and trustees) over an organization.

My most general hypotheses are that the three normative systems have characteristically different strategies and techniques for carrying out or facilitating these three tasks; that their strategies and techniques have characteristically different costs and benefits in important recurring settings; and that the roles these normative systems do and ought to play in shaping organizations differ between the for-profit and nonprofit corporations. Somewhat more

---

<sup>1</sup> Thus, it speculates freely and omits citations to the many relevant sources that have influenced me. A later draft will have key citations.

specifically: In paradigmatic nonprofit corporations, the moral systems are often more important and potentially more effective, and the legal system is often less important and less potentially effective, than in the case of for-profit corporations.

These opening statements are very abstract, but will be expanded and illustrated as we proceed.

### **Prelude: On the Nature of Moral Systems**

It is not hard for most scholars to grasp what is meant by “legal systems” or to imagine their role in generating and enforcing norms or rules. Legislators, regulators, and courts make rules and enforceable doctrines or principles. Courts enforce the rules and principles as well as many privately created contractual obligations. Sanctioning violators of rules and principles takes place, if need be, after judicial proceedings that result in state-enforceable sentences, judgments, or settlements. Various state officials such as police and regulators play a role in monitoring compliance and detecting violations, and therefore assist in deterrence.

Similarly, market forces are easily recognized as able to enforce some kinds of norms, such as those created by contracts, both formal and implicit. If a debtor fails to pay, or an employee or agent fails to perform well, the other party may cease to deal with the breaching party, and may release information about the breach to other players in the market, who may then refuse to deal (at least on the same terms) with the defaulting party. In other words, a well-functioning market can sanction norm violators by diminishing their contractual opportunities.

But court-ordered judgments and diminished (or more costly) contracting opportunities are not the only sanctions that can be applied to norm violators. Moral sanctions may also apply.

What does this mean? Because different readers may attach very different intuitive pictures to such concepts as moral systems (or value commitments, etc.), I will attempt a brief portrayal of what is meant in this essay.

Moral sanctions for norm violations come in two forms: social disapproval and guilt.<sup>2</sup> The term “guilt” is meant to suggest a broader concept: self-applied negative feeling that may operate with some force in individuals who have “internalized” a set of values that entail the norm in question. Importantly, the individuals subject to the internalized norms may also have positive, self-reinforcing feelings when they take actions that do conform to the norms. In most people the internalization of value commitments does not result solely or principally from independent individual reflection and reasoning, but from social processes.<sup>3</sup> That is, “moral systems” install values and norms in individuals and reinforce and maintain them.

Moral systems, as I use the term, include coherent social groups, volunteer associations, well-defined professions (clergy, doctors, lawyers, accountants, and the like), and religious groups.

---

<sup>2</sup> Disapproval and guilt may be combined in various degrees, of course.

<sup>3</sup> These social processes may build on evolutionarily evolved dispositions that many people have – for example, the tendency to engage in spiteful retribution and impose punishment on non-reciprocators or on those who grab more than an equal share of collective benefits, even when punishment is on balance costly to the person imposing it. In recent years, such tendencies have been much studied by game theorists in experimental settings, and evolutionary biologists have developed theories about them. For my purposes, it is crucial to go further and recognize that social systems often augment, direct, and specify such tendencies in important ways.

Congregations within the world religions (Judaism, Christianity, Islam, Hinduism, Buddhism) provide the clearest and starkest examples of moral systems, so I will focus briefly on them. These social groups have elaborate processes that lead to and maintain the internalization of norms. At least five distinctive and practically important strategies have been identified and studied.

- (1) *Big myth strategy*. Religions ground norms in elaborate world views that themselves satisfy psychological needs. They link norms to views about the origin and destiny of the universe (including, perhaps, a divine creator), the origin and destiny of humans (including, perhaps, an afterlife dependent on current norm compliance), and the like. Linking norms to a much larger, explanatory mental framework makes them stronger and harder to change.
- (2) *Little myth strategy*. Religions often teach norms via sacred and vivid stories, histories, parables, and the like. The basic texts of all of the world religions illustrate this interesting phenomenon. Their stories – unlike, say, the judicial opinions in legal cases – are actually consumed by many group members (not just professionals) and they take advantage of cognitive-psychological phenomena like the vividness and availability heuristics to get themselves embedded in individual psyches.
- (3) *Rituals*. Religions rehearse norms and values in various and oft-repeated collective rituals and mass gatherings – synagogue meetings, masses, calls to prayer,



pilgrimages, weddings and funerals, etc. Religions never just announce and publish a rule and assume it will stick. Their repetitive rituals take advantage of social facilitation processes now studied seriously by psychologists (who, to be sure, are often most interested in advertising and marketing applications).

(4) *Devotions*. Religions also encourage focused and repeated reflection on values and norms. Such focused repetition enhances commitment.

(5) *Sacralization*. Religions typically declare certain texts, times, places, and persons to be holy or sacred, thereby putting them beyond the permitted realm of individual second-guessing and attempted criticism. When successful, the technique helps control the disintegrating erosion of norm enforcement by individual reasoning (which is often self-serving) about appropriate norms and their proper application to individual cases.

Other social systems like social clubs, voluntary associations devoted to public-interest causes, and the professional groups often have analogs to, or echoes of, the five strategies. For this and other reasons, coherent non-religious social groups can often cause effective value internalization and thereby lower the marginal costs of deterring and sanctioning norm violations. Their chances of success may be lower than in the case of strongly established religious groups, but are far from trivial.

(Notice that even liberal legal systems have analogs to the value internalization techniques sketched above. Judges wear robes, for example, and many lawyers and law professors tend to view the U.S. Constitution as a kind of sacred text. Put another way, real-world normative systems are often hybrids of the ideal-type systems I am describing. But I would insist that there is a vast difference in the extent to which the various real-world normative systems effectively use norm-internalization techniques. For example, legal systems probably tend to achieve less internalization than religious systems.)

Moral systems often encourage members to contribute to the provision of public goods or to enhance overall group welfare by altering the distribution of wealth (e.g., by charitable giving). In light of this tendency, it is no accident that the historically most salient, or classic, nonprofit organizations – universities, hospitals, and charities providing goods and services to the poor<sup>4</sup> – tend to have been created by religious groups, which were often the most strongly developed exemplars of moral systems. In modern, more nearly secular societies, the relative role of other social groups with significant moral systems – for example, the teaching and medical professions and voluntary associations committed to public-interest-regarding ideological causes -- has increased in importance.

With great reluctance I will refrain from analyzing the characteristic costs and benefits of moral systems versus legal systems. Doing that would require a very long book. Perhaps it will suffice here to note two tendencies. (1) Moral systems often have major marginal cost advantages over legal and market systems in deterring, and detecting and sanctioning,

---

<sup>4</sup> One might also mention churches themselves, insofar as they are associations that provide individual and group benefits.

violations of certain kinds of norms, such as those forbidding fraud and theft. This advantage results from the fact that, when norms are internalized, individuals will monitor and deter or sanction themselves. Similarly, acting on “gossip,” or reports about other actors who don’t respect group norms, and applying social sanctions such as disapproval and exclusion, are often cheaper and quicker than using legal processes. (2) On the other side of the balance sheet, moral systems often have huge installation-and-maintenance costs, as well as serious negative side effects. Religions, in particular, must pay not only for specialized professionals (rabbis, priests, imams, monks) as does the legal system (lawmakers, regulators, judges, lawyers, police), but also for the cost of repeated mass rituals and educational efforts. Moreover, their emphasis on sacralizing texts and authority figures may retard scientific and rational thought and impair flexibility in developing and adjusting norms. At the same time, religious involvement may generate positive externalities (e.g., health benefits and crime reduction) to individuals and groups.

As these comments suggest, overall assessment of normative systems is extraordinarily difficult. For purposes of this essay, the essential point is simply that moral systems may have genuine norm-enforcement advantages over legal and market systems in some contexts.

### **Some Paradigmatic Examples for Analysis**

In order to focus analysis somewhat, consider some hypothetical but prototypical examples.

Mouse Catcher Studios, Inc. is a Delaware-incorporated for-profit corporation that produces movies and television shows for the mass market. It reports to the SEC, its stock is listed on the New York Stock Exchange and traded by tens of thousands of investors, and it has a \$30 billion market capitalization.

Mind Grower College is an old Massachusetts nonprofit corporation. It has about 1500 students, all enrolled in a B.A. program; 100 faculty, half of whom are tenured; 300 staff; and an \$800 million endowment. Among other things, the latter funds a considerable amount of faculty research in the arts, humanities, and social sciences.

Consider more briefly another pair of examples, both of which involve receiving money from some participants and supplying food to another group. Harriet & Davis Fruit Co. is a for-profit corporation that takes orders by phone or Internet to send gifts of fruit and nuts to persons designated by the customers. Mother Teresa Food Bank is a nonprofit corporation that is staffed by some nuns and many religiously committed volunteers; it receives modest donations from many individuals and gives food to poor and low-income people around the world.

Admittedly, these hypotheticals are “loaded” in the sense that reflection about them may lead to different intuitions than would arise if one imagined other entities – for example, on the nonprofit side, a private family-controlled foundation, a donor advised fund, or a secular social services agency that receives most of its funding from the federal government. Nevertheless, the examples all represent classic or prototypical organizations that are worth analysis.

I will refer to the examples as we consider the three “tasks” that each normative system might carry out or facilitate.

### **Task One: Determine Goals**

Law’s role as to the for-profit. In the case of a publicly held for-profit corporation like Mouse Catcher Studios, the law makes a modest though important contribution to the explicit determination of its goals and output.

Although the law’s actual and ideal stance is not free from academic debate,<sup>5</sup> and varies across jurisdictions in response to lobbying by special interests, and is surprisingly mushy on specifics, the traditional norm – embodied, say, in the judicial heritage of Delaware, where more than half of publicly traded for-profit corporations are incorporated – reflects a *shareholder primacy view* that greatly facilitates the operation of both legal and market controls over managerial conduct.

The law’s traditional view may be restated more fully as follows:

1. It is not usually helpful to speak of a *corporation’s* “purpose.” Policymakers should consider the total impact of corporations on social welfare, and in doing so should

---

<sup>5</sup> There is a surprisingly recurrent academic literature debating the validity and merits of a shareholder primacy view versus a stakeholder model of the publicly held for-profit corporation. In corporate boardrooms, however, the issue rarely arises, and shareholder primacy rules.

consider their effects on all affected constituencies. But they should consider directors' duties as a separate issue.

2. In general, elected legislators (not corporate boards) are the actors who should attempt to structure laws so as to optimize the total impact of corporations on human welfare. Doing so will involve many guesses and many kinds of laws.
3. A for-profit corporation's directors have a fiduciary duty to maximize shareholder value, subject to several important constraints (items a, b, and c below) and important caveats (items d and e):
  - a. Directors may and should cause their corporation to obey the law, even when the risk of detection and punishment seems low.
  - b. Directors may and should cause their corporation to meet all of its legal obligations to non-shareholder constituencies, such as creditors, employees, suppliers, customers, taxing authorities, and so forth.<sup>6</sup>
  - c. Directors should cause their corporation to respond to market, social, and normative forces in such a way as to keep non-shareholder constituencies optimally involved in the corporation's business.<sup>7</sup>

---

<sup>6</sup> Since legal obligations may be created in a staggering variety of ways -- by contracts, common law, statutes, regulations, rulings, case law interpretations, and so forth -- the scope and impact of this often unstated caveat to the shareholder primacy viewpoint are enormous.

- d. Directors may cause their corporation to engage in charitable giving (which is authorized by statute in all states).
  
- e. Directors may cause their corporation to cease participating in clearly and seriously unethical actions (e.g., genocide, apartheid), even when continuing them is profit maximizing and not clearly illegal under applicable law.<sup>8</sup>

In summary, as the legal system shapes the entire regime of laws and regulations applicable to corporations, it does consider the for-profit corporation's total impact on all affected stakeholders and on society more generally. As a result, such corporations are governed by a vast array of rules aimed at protecting customers, employees, suppliers, creditors, the local community, the environment, and so on. However, the residual or open-ended goal and duty of the corporation's controlling body, the board of directors, and of its top officers (CEO, COO, CFO, etc.), as specified by corporation law, is to **maximize value for shareholders** (the residual claimants or "owners"), subject to various constraints and caveats.<sup>9</sup>

---

<sup>7</sup> For example, directors may properly consider the problem of protecting the firm from loss of "specific investments," and such considerations may lead them to grant conditions and benefits to employees that go beyond those legally required, so long as they judge that such actions are likely to enhance shareholder value. Similar considerations may properly lead them to cause the corporation to act as a "good citizen" when anticipating or responding to community groups. Since such decisions are genuinely matters of judgment rather than decisions to fulfill reasonably clear and fixed legal obligations, directors are protected by the business judgment rule when making them.

<sup>8</sup> This caveat may be called the "matters of conscience" exception. Perhaps not all traditionalists would agree with including it, since it is hard to define and risks being over-expanded, but they should.

<sup>9</sup> Another caveat: The corporation statutes of many states now have provisions saying that boards "may" consider the interests of non-shareholder constituencies in the context of hostile takeover attempts, or perhaps more generally.

Thus, at the end of the day, and even in the twilight of all the constraints and caveats, the directors and officers of Mouse Catcher Studios must strive to maximize only one set of stakeholder interests, those of the shareholders. And although the operational meaning of this objective can itself be debated – Are we talking about long-term or short-term shareholder value? Do we accept market price as the key indicator of shareholder value? How treat shareholder subgroups with different time horizons and risk preferences? – the goal, as compared to the goals of other organizations (e.g., a legislature or a university) and their managers or fiduciaries, is remarkably unitary, definite, and subject to genuine external monitoring.

We will consider the law's role, or relative lack of a role, in getting people to adopt the shareholder wealth-maximization goal and be positively motivated to contribute to it, in the next section of the paper. For now, it is worth noting that it takes little external effort or special institutional design to get the relevant people to embrace this goal. Investors in shares naturally like the idea that directors and officers have a duty to enhance shareholder wealth. They also like the unitary and objective nature of the goal, since both of these characteristics promote monitoring and facilitate the application of legal and market sanctions against underperforming managers. For their part, managers (meaning both the officers and the board of directors) don't mind having to pursue the shareholder-value goal as their scorecard objective, so to speak, especially if, as is usually the case in public corporations, their pay consists partly and substantially of stock and options. And other stakeholders like employees and customers may not like the managers' unitary residual focus, but will usually accept if they can pursue their own

---

In practice, these special provisions are used as managerial shields, and are not accepted as primary managerial goals by either the investing community or unthreatened managers.



objectives vis-à-vis the corporation by contracting, or otherwise exerting market power; or if they benefit from, and perhaps even influence the provision of, laws, doctrines, and institutions that are aimed at protection of their interests.

Law's role as to the nonprofit. Turn now to Mind Grower College. The law's role in determining its goals is extremely limited. A nonprofit corporation may have whatever charitable or similar ultimate purposes its founders select, and the actual meaning or operational content of these goals is frequently reshaped, as the organization evolves, free of interference by the legal system.

It is not hard to see why. If one of Mind Grower's key goals is "to advance fundamental knowledge" and it attempts to achieve it by supporting "top-quality research," there is room for virtually endless argument about what fundamental knowledge is and what really counts as top-quality research. One can foresee internal and external debate about, and continually evolving and changing views about, various suggested measures of fundamental knowledge and excellent research. Should we judge achievement of the goal by what faculty at other colleges think of the research done at Mind Grower College? If so, how do we determine and weight their views? (Survey results? Actual attempts to lure Mind Grower faculty to other institutions? Success by MGC in recruiting faculty from other colleges?) Should we measure excellence by citation frequency? By Nobel and Pulitzer Prizes awarded to the MGC faculty? Should we defer to the evaluations and rankings done by independent, field-focused groups of outside experts, or by the views of academic associations that also engage in accrediting the college? What about the

rankings created by news media? What about the opinions of foundations or people in industry and the practicing professions?

More generally, the underlying ultimate goal of the trustees of Mind Grower College is farther away from objectivity and ease of monitoring than the goal of Mouse Catcher's directors. And the law's statements about mission do not give much help to the process of goal determination and operationalization. Moreover, the law seems to have no easy way of encouraging managers to adopt Mind Grower's "real" ultimate goal.

Finally, a similar, if not so extreme, set of observations could be made about Mind Grower College's other large-scale goal of "providing a superb liberal arts education" to its graduates. The meaning of this goal, and even more so the measures of its achievement, are highly contestable by well-meaning participants and observers.

And yet... Private nonprofit liberal arts colleges exist and often thrive. Their goals get chosen and made operational. How?

The role of market forces in goal determination? One could attempt to alleviate the question just posed about Mind Grower College by resort to a market-forces analysis. For whatever reasons, the analyst says, potential participants and stakeholders – potential donors, faculty, students, and firms that hire graduates – "have" preferences for superb liberal arts education and top-quality basic research that advances fundamental knowledge. Because these potential participants have market power over the college – they can refuse to donate, be hired,

apply or enroll, or hire graduates – the managers, because they have a self-interest in the college’s continuation and prosperity (officers want their jobs and pay, trustees want their power and prestige), will strive to make the goals operational and achieve them. In doing so, the specific outputs will tend to reflect the interpretations and preferences of the participants in accord with their relative market power.

In this analysis, so far, the legal system supplies a modest but practically important goal specification to the for-profit corporation but does very little in the case of the nonprofit corporation. The market, by contrast, provides strong assistance in both cases, by making managers responsive to the existing or legally dictated preferences of potential participants.

The role of moral systems in goal specification. But it would be odd and unrealistic, I assert, to view Mind Grower College as simply “implementing” the externally found or exogenously “given” preferences of potential participants. If MGC is like other established colleges, it contains a powerful professional class, its tenured faculty, who continually reinforce, amplify, reshape, and define the operational meaning of, the commitment of college participants toward achieving the goals of superb liberal arts education and good research that advances fundamental knowledge. This group engages in a pattern of social processes and rituals that build, sustain, and change commitments to the goals. The social processes are real and ongoing, even if hard to identify and measure. They provide the goal specifications that the legal system is basically helpless to supply, and that the market system simply accepts as exogenously given.

The example of Mother Teresa Food Bank illustrates similar points, perhaps even more starkly. That organization's goal of providing free food to the poor is directly mandated or urged by an identifiable moral system, and the staff and volunteers who carry it out continually reinforce the goal, and define it more concretely, by their ongoing work. If functioning as intended, the whole organization is a moral system in action.

### **Task Two: Motivate Participants**

The analysis is similar, though interestingly different in important ways, when one turns to the role of the three control systems in requiring or facilitating positive commitment to the organization's goals. How are the participants and stakeholders incentivized and motivated, and what roles do the normative systems play in the process?

Motivation at for-profits: no problem? In the for-profit case of Mouse Catcher Studios, market forces can operate as vigorously as they do because most participants already have a natural or given impulse to maximize their wealth. As before, the market's primary role is simply to run with what is given.<sup>10</sup>

---

<sup>10</sup> This characterization is not entirely true, of course. Market participants may devote substantial conscious effort toward augmenting, shaping, and even changing preferences. There is, after all, a vast and successful advertising and marketing industry. More interestingly, constant participation in market transactions may increase or otherwise affect positive motivation. For example, it is not unrealistic to conjecture that, by engaging repeatedly in the practice of preparing for, performing, and/or attending quarterly earnings calls, the participating corporate officers and investors reinforce and even enhance their level of greed and strong focus on maximizing profits and share prices. It may be more informative to analyze a preference-shaping process of this sort in psychological and sociological terms, by reference to classic notions of a regular "ritual" with real "functions" or by resort to more trendy concepts in behavioral economics. Either way, the exercise supports the framework developed in this essay.

Nor is there much apparent role in motivation at Mouse Catcher for the moral systems, if it is true that people are biologically predisposed to want, or to learn to want, more and more wealth (and power and prestige). (True, one might alter this judgment if one could credibly argue for the relevance, validity, and significance of an updated version of a thesis similar to Max Weber's theory of the Protestant Ethic and the rise of capitalism. I do not mean to rule out the existence and importance of such background influences of the moral systems.)

The legal system also takes motivation toward wealth-maximization as basically given, but it also facilitates the establishment of incentives to align managerial efforts with shareholder wealth by its creation of mandatory disclosure systems like the securities laws. The increased transparency and visibility of corporate performance helps shareholders to exercise, in the market and in legal forums, such disciplinary powers as they have over their supposed fiduciaries. Similarly, the law plays an important role by structuring the institutional arrangements that give shareholders rights to vote, to sue, and to sell – all of which can result in significant discipline over managers who might be tempted to depart from their goal of trying to maximize shareholder wealth.

Motivation at nonprofits: a mystery? When we turn to the nonprofit context, the picture changes dramatically.

In the case of Mind Grower College, for example, the career-long commitments of faculty members to basic research and liberal arts education are undoubtedly not a mere function of initial preferences, but are reinforced, sustained, amplified, and shaped by social processes

that keep the faculty together and connected to the rest of the higher-education teaching profession. Effort is a function not only of resulting pay, but also of resulting status and compliance with internalized norms. The motivating process is advanced by social/moral systems that assign greater prestige and status to those who sign on to, and vigorously pursue, the values of academia. Not only do diligent faculty gain higher praise and status, but they also come to internalize academic values and pursue them more seriously as ends in themselves. Even the pay setters' metrics come to be shaped in line with the faculty's academic values.

In other words, the moral systems are vitally important to sustaining and enhancing motivation in nonprofits. The point is perhaps illustrated even more forcefully and vividly by religious nonprofits. The staff and volunteers who work at Mother Teresa Food Bank are presumably driven in significant part by a different, but strong, set of motivations than the simple income-earning goals that motivate the employees at Harriet & Davis Fruit Co. The volunteers' active participation in MTFB work itself undoubtedly reinforces and strengthens their motivation.

In the United States, of course, the legal system also plays an important role in motivation at nonprofits. But unlike the moral systems' modes of shaping preferences and positively increasing individual motivation, the legal system's role is often simply facilitative. (That is, it gets out of the way.) The tax deductibility of contributions to nonprofits lowers the economic cost of giving, though it neither eliminates that cost nor originates the impulse to give. The nondistribution constraint – that is, the absence of a shareholder class, which has rightfully been identified as a key defining feature of the nonprofit form (cf. Hansmann) – removes a major

pressure to take advantage of the imperfect knowledge or bargaining power of consumers of or contributors to the nonprofit (e.g., students at MGC or small donors to MTFB). More generally, the legal system may facilitate nonprofits by not regulating them heavily. For some types of nonprofits, though, government, which is the legal system's institutional creator, may provide major funding that operates as an independent positive motivator of activity. Nevertheless, it is hard to imagine the nonprofit sector continuing with any degree of vibrancy apart from the positive motivations that are shaped and enhanced by moral systems.

### **Task Three: Control Abuse**

In every sizable organization, whether for-profit or nonprofit, a major set of problems arises as an inevitable byproduct of the fundamentally desirable location of decision making power in directors or trustees, officers, and employees or volunteers. These participants are supposed to use their power to advance organizational goals, but they may sometimes use it to extract improper private benefits of control. In less detached terminology, they may engage in theft, fraud, unfair self-dealing, and many forms of slack.

Here, at last, it appears that the legal system has a major role to play in both the nonprofit and the for-profit world. But, as I shall explain, a broad overview of patterns of abuse suggests what might be called “**the puzzle of nonprofit governance,**” and the likelihood that it can be partly answered by consideration of the moral systems' special role in controlling self-dealing and the like in nonprofits.

Law and the for-profit. Turn first to the legal system's regulation of fiduciary abuse in the for-profit world in which Mouse Catcher Studios operates. The legally generated norms and enforcement apparatus are extraordinarily elaborate, complex, expensive, and at first blush severe. They may usefully be grouped under six categories.

1. There are many statutes, regulations, and doctrines prohibiting fraud. Those involving fraud in financial accounting, reporting, and auditing matters are especially numerous and complex.
2. There are, mostly at the state level, elaborately developed and frequently applied judicial doctrines spelling out fiduciary duties to refrain from unfair self-dealing, deflection of corporate opportunities, unfair competition with one's corporation, unfair action toward public or minority stockholders in change-of-control situations, and so on.
3. Corporate law as implemented generally gives residual claimants, the shareholders, the right to vote. Most notably, shareholders can vote in, or vote out, the board of directors, which in most matters is the ultimate decision making authority over corporate affairs. In exercising this right, shareholders may be motivated by hopes of better business performance with a different managerial team, but they may also vote in accord with their perceptions of managerial extraction of excessive private benefits, and may thereby sanction wrongdoers. The right to vote leads to some of



the most dramatic and salient corporate-world events – proxy fights and takeover contests.

4. Corporate law and the federal securities laws create elaborately developed and frequently used rights to sue corporate directors and officers. Importantly, these rights reside in shareholders as well as in various public officials such as the Department of Justice and the Securities and Exchange Commission. In the United States, litigation against for-profit corporations and their officers and directors is a major industry, as indicated by the large numbers and huge settlement amounts of federal securities class actions, state law-based stockholder derivative suits, and actions by the DOJ and SEC.
  
5. Shareholders have the right to sell their shares – which conveniently embody their whole bundle of economic rights and governance rights – and can frequently do so on organized and efficient markets. Importantly for our purposes, the right to sell can act as a meaningful sanction against perceived abuses by corporate fiduciaries. Widespread selling can depress stock price, make financing and business plans harder for managers to achieve, and hurt officers and directors whose own compensation consists (as it often does) in significant part of stock, stock units, and the like. It might also pave the way for hostile takeover bids that could also act as severe sanctions on the fiduciaries.

6. The federal securities laws provide elaborate mandatory disclosure rules that facilitate the operation of the sanctioning mechanisms identified in items 3, 4, and 5 (rights to vote, sue, and sell), and thereby greatly enhance the importance and value of those mechanisms.

(An aside on market forces.) Note that many of the legal system's impositions, such as the elegant structural rules that make the shareholder's right to sell shares so tidy and efficient, may be characterized as ways of facilitating market sanctions against violations of implied contracts and fiduciary duties. The legal and market systems work hand in hand, and both seem on their face to be very powerful.<sup>11</sup>

Law and the nonprofit. Consider now the law's role in controlling abuse by fiduciaries in nonprofits. The principles and enforcement mechanisms in this context are also multiple and complex (cf. Fremont-Smith 2004), but they differ in some fundamental ways.

1. There are statutes and doctrines against fraud by such fiduciaries, although they are not as elaborately spelled out as in the case of for-profit corporations.
2. Both nonprofit corporation law and trust law (which applies to some nonprofits) impose well-developed fiduciary duties on the trustees and officers of nonprofits.

These duties are similar in scope and coverage to those applied to directors and

---

<sup>11</sup> A related point is that some market participants, such as shareholders, are directly hurt by fiduciary misconduct and have a natural incentive to administer sanctions, so long as they can do so at acceptable cost and can expect a recovery, or avoid additional loss, or achieve some other end. But the market left to itself may not supply sufficient knowledge about violations or tools for administering sanctions; both the legal and moral systems can step in on these fronts.

officers of for-profits. In some respects they may be stricter, and they cover some additional problems. But the case law developing their concrete meanings and applications, and litigation involving them, are much less voluminous than in the for-profit world, in part because of the differences pointed out in the next several items.

3. Rights to vote on the identity of trustees are less prevalent, more limited, and significantly less important than in the for-profit world. There is no single class of residual claimants who have both the right to vote and a strong incentive to use it wisely. Intended beneficiaries usually don't have the voting power. At Mind Grower College, for example, neither the students nor the general (much less future) public that is supposed to benefit (eventually) from the research that advances fundamental knowledge, vote on the election of trustees. Nor do the tenured faculty, which is otherwise the de facto ruling class. Alumni and alumnae, who may include significant donors, might have such a right, but incentives to participate are weak, and in some of the classic and best nonprofit institutions (e.g., Harvard), even they may be formally excluded, because the ultimate governing body (the board – called “the Corporation” at Harvard) is formally self-perpetuating – it has the right to elect its own successors. Needless to say, the severely stunted voting rights given to participants in nonprofits like Mind Grower College means that there is less room for analogs of the for-profit world's proxy contests and takeover battles. The voting sanction over nonprofit fiduciaries seems vastly weaker than in the for-profit world.

4. Similarly, rights to sue are significantly less prevalent and more limited than in the for-profit world. State attorneys general can sue, but their resources and interest in doing so are significantly smaller than those available to the DOJ and the SEC (which watch over for-profits but historically have had much smaller roles in policing nonprofits). The Internal Revenue Service has regulatory power and may act to remove the tax exemptions of charities violating prohibitions against private benefit and private inurement, or to impose intermediate sanctions (excise taxes) on designated power-wielding participants who receive or willfully approve “excess benefits” from charities. But most importantly for our comparative analysis, intended beneficiaries have no ability to bring the equivalent of shareholder derivative suits and securities class actions. (This pattern may be about to change somewhat, of course.) Even the rights of donors are relatively limited, to enforcement of their particular arrangements with the nonprofit. Consequently, in the nonprofit world there is nothing like the sub-sector of plaintiff law firms that sustain the giant litigation industry focused on publicly held for-profit corporations.
  
5. Rights to sell residual interests in nonprofits simply do not exist. Granted, various participants may choose to exit: good students can stop enrolling at Mind Grower College, donors can stop giving, and so on. These possibilities can discipline managers. But the exiting participants do not sell others rights that permit the equivalent of a hostile takeover.

6. There are mandatory disclosure rules applicable to nonprofit corporations, but they are limited and cannot begin to compare in coverage, specificity, and consequence to the regime applicable to for-profit corporations. (To test the point, see if you can find, on a governmentally funded website similar to the SEC's Edgar system, the equivalent for Mind Grower College of the annual 10-Ks, the quarterly 10-Qs, and the numerous 8-Ks filed, and available to anyone on earth with web access, for Mouse Catcher Studios.) Nor are auditing standards and internal control requirements, such as those now governed by the infamous section 404 of the Sarbanes-Oxley Act, so highly developed as in the case of for-profits. The same may be said for explicit statutory requirements and statutes criminalizing specific conduct involving presentation of financial results. They are more elaborately developed in the for-profit world.

To summarize: Although general legal principles constraining fraud and self-dealing by fiduciaries are similar and roughly comparable in the for-profit and nonprofit worlds, there is a dramatic difference in the availability and potency of legally shaped sanctioning mechanisms -- that is, the rights of participants and others to vote, to sue, and to sell or exit in a way that has punishing consequences -- and in the development of mandatory disclosure regimes that might enable and facilitate sanctioning efforts. In the nonprofit world, the sanctioning mechanisms and disclosure regimes seem much weaker.

Note also that market forces are unlikely to "make up the difference." Quite the opposite is true: Precisely because the goals and achievements of nonprofits like Mind Grower

College are more contestable, elusive, complex, and shifting than the relatively unitary, objective, and readily monitored goal of a for-profit corporation like Mouse Catcher Studios, market forces seem less likely to detect and sanction fiduciary misconduct. This point seems especially valid when the question is ability to detect and sanction organizational slack -- since slack in nonprofits can often be portrayed by the relevant professional class as “really” being an indicator of quality (consider, for example, low student-faculty ratios in a college) -- but it even extends, I would argue, to other forms of self-dealing and extraction of private benefits.

The puzzle of nonprofit governance. In light of the points made about legal and market controls in the prior two sections, one might expect the relative prevalence and severity of fiduciary misconduct to be vastly greater in nonprofit corporations than in for-profit corporations.

But precisely the opposite appears to be the case. The long history of media accounts suggests that nonprofit enterprises seem to be much less afflicted with scandals stemming from managerial misconduct than is the case with respect to for-profit business enterprises. This impression appears to hold even when one adjusts for the relative sizes of the two sectors. There are some good media surveys of nonprofits that do indicate troubling instances of fiduciary misconduct in some nonprofit organizations. (Gibelman & Gelman 2001; cf. ALI Discussion Draft 2006, *passim*.) But the scale and frequency of misconduct they reveal seem to pale in comparison to the recurring reports of scandals erupting in the for-profit world -- for example, the arresting instances of financial manipulation and blatant self-dealing that came to light in scandals involving Enron, Worldcom, Tyco, Royal Dutch Shell, Parmalat, and numerous other

companies during the stock market downturn at the beginning of this decade. Similarly, there is occasional outrage at the excessive pay obtained by a few university presidents or other leaders of nonprofits, but the amounts and their prevalence seem almost pathetic when put against the data underlying the ongoing and intense, but so far ineffective, criticism of CEO pay packages at publicly held for-profit corporations.

To accentuate the riddle a bit, consider an additional perspective and impression. Looking at the long sweep of history, it appears that larger nonprofits tend to have a longer life span than large for-profit corporations. Try, for example, to name some large for-profit corporations that have lasted as long as Harvard College or the Massachusetts General Hospital. The longevity might suggest that such nonprofits have survival-promoting structural characteristics (“good corporate genes”). How can this be true, in view of the pathetic weakness of legally shaped sanctioning mechanisms that might control managerial misconduct in the nonprofits?

Some approaches to the puzzle. There are a variety of obvious approaches to attempting resolution of the puzzle just presented, and each may have some merit. My interest here is in proposing that efficacious moral systems should be considered a strong explanatory factor.

One approach to the puzzle is to simply question impressions, ask for good data, and hold on to the possibility that there is every bit as much (or even more) fiduciary misconduct in nonprofits as in for-profits. A variation on this approach might be called the hidden evil hypothesis: precisely because the law imposes less severe disclosure requirements and fewer

easily invoked sanctioning mechanisms, less of the managerial misconduct in nonprofits comes to light. My guess is that there is some merit to this approach, but that it would not begin to fully resolve the puzzle. Even in the absence of easily invoked legal sanctioning mechanisms, there are many individuals – journalists, investigators, busybodies, internal whistle blowers, aggrieved former employees, etc. – whose lives give them access to scandalous information about managerial conduct in nonprofits and who could get personal satisfaction from revealing it to the media and others. It is hard to imagine a vast pattern of high-level scandalous conduct going undiscovered for decades.

A second approach to resolution of the puzzle is to critique and discredit the particular design and effectiveness of the legally shaped control mechanisms that are available in the for-profit world. The application to the puzzle would be to then suggest that there is therefore no good reason to suppose that the apparently more powerful legal controls over for-profit managers will make a real difference in their self-seeking behavior.

For example, various legal scholars claim that shareholder voting power results only rarely in displacement of entrenched and suboptimal boards, and there are identifiable (and potentially remediable) reasons why this is so (Bebchuk); that shareholder derivative actions are afflicted with their own agency problems and have no proven relationship with shareholder value (Romano); that hostile takeovers have declined in significance since the 1980s, in part, it seems, because of identifiable and measurable structural obstacles allowed by law (Coates, Bebchuk, & Subramanian; others); and so on.



On first reflection, though, one can grant enormous weight to such reform-oriented critiques and the supporting empirical studies, yet still be incredulous of the proposition that, in the aggregate, the legal and market controls do not have very significant force in reducing managerial misconduct in the for-profit world. That is, the legal and market controls may be materially suboptimal, but they seem very far from trivial. So an attempted solution to the puzzle that is solely along this path is likely to be incomplete. (Moreover, an effort to fully discredit legal controls would require a very long journey, with a nontrivial risk of getting lost in a methodological wilderness.)

Moreover, even if the inefficacy in practice of apparently useful legal controls could explain a lack of difference in fiduciary misconduct rates between for-profits and nonprofits, it would not explain why the rate appears to be lower in the nonprofits.

One could also attack the puzzle of nonprofit governance by identifying mechanisms and forces that lead to reduction of managerial misconduct in nonprofits, but which are different in type than those that scholars and policymakers usually think about in the for-profit setting. This thought leads to what might be called the third way: recognizing the real-world importance of moral systems.

Consider, for example the role of reputation and social sanctions. It may well be that board members of nonprofits are much more interested in how others in their relevant social set will perceive them as board members than in any pecuniary or “junket-type” benefits of service, that information about board service gets around, and that social sanctions for

excessive slack (not to mention extraction of personal economic benefits) are relatively real and effective.

But perhaps the more promising avenue is to investigate the force of internalized moral commitments on the behavior of those who tend to devote themselves to leadership of nonprofits (or to volunteer efforts, or to higher-level and professional staff positions in nonprofits). As suggested in the prelude of this essay, “moral” commitments may stem from a variety of socially facilitated sources. These include (a) religious beliefs, such as those held by the founders and operators of early-era nonprofit hospitals and redistribution-oriented charities like the Salvation Army, (b) “public interest” world views, such as the save-our-endangered-environment views espoused by active leaders of environmentally oriented nonprofits, or the “knowledge for its own sake” or “knowledge for the greater long-range good” ideologies of many academics, and (c) commitments based on sympathy, compassion, and socially amplified altruistic impulses, such as those that animate foundations which support medical research for vividly unfortunate medical conditions. It may be, then, that the key to the puzzle is to expand reasoning about human nature beyond economic reasoning in its narrower manifestations. Ideology and internalized control mechanisms (“conscience”) are important factors in human behavior, and policy makers should seek to study and understand when they are and are not present and how they are channeled, strengthened, and weakened by the operation of particular psychological and social variables. Research into such matters should be central to the work of scholars concerned about nonprofit governance and accountability.

### *Some Obvious Questions*

The hypothesis that moral systems can be forcefully operative in certain organizations raises at least three further questions that require comment.

(1) Don't moral systems operate in for-profits too? First, supposing that moral systems can be importantly effective in controlling fiduciary misconduct in some corporations, why would there be a difference between nonprofit and for-profit corporations in the frequency and power of their influence? Can't moral systems operate in for-profits too?

The answer is that they can and do operate in for-profits, but are not as likely to be salient and additively effective amid legal and market controls. Why? In part because, as explained above, in nonprofits the moral systems are heavily involved in the organization's essential processes of determining goals and motivating key employees to work harder and better. Moral control of potential misconduct is intertwined with, indeed part of, existing important social processes in the organization. The moral system operates in an integrated fashion to pursue all three key tasks. It is thus more likely that norms about promoting organizational welfare become internalized and partially self-enforcing. In any event, such norms may be more likely to be enforced by social sanctions inside nonprofit organizations. (We might call the argument in this paragraph **the integration thesis**.)

By contrast, in for-profits the goal (shareholder value maximization) is externally set and not one promoted heavily by moral systems. (Ken Lay of Enron went to church services, but it is

unlikely that his minister preached the sublime virtues of maximizing shareholder value.) Motivation to work toward the profit-maximizing goal is provided by pay arrangements and market forces. Moral systems external to the corporation may train participants to feel that fraud and theft against people or entities toward which one is in a position of trust are wrong, but these injunctions are not thereby rehearsed, specified, drilled in, facilitated by group processes, bolstered by social sanctions, or linked to an overarching world view, in the social processes of the corporation itself. As a consequence, truly moral individuals may continue to be so when acting as corporate fiduciaries, and may properly translate their general moral self-constraints into correct specific principles of action inside the corporation (instead of, say, rationalizing selfish actions, which can happen easily in some contexts, such as diversion of corporate opportunities or trading on inside information). But there is likely to be some slippage because the morality-reinforcing processes are not so institutionally embedded in the organization as they are in many classic nonprofits. In the for-profit corporation, there is a lack of integration of the three tasks of specifying goals, motivating participants, and controlling abuse, and this non-integration suggests an absence of mutual reinforcement of the three tasks.<sup>12</sup>

(2) Can law enhance morals? Assuming that moral systems are especially strong and effective in some nonprofits, it seems clear, as an empirical matter, that this is not always true and that their effectiveness varies greatly across nonprofit organizations. One is then tempted to wonder whether the legal system can effectively require, enhance, facilitate, or at least reward and select for, nonprofit corporations that have well-functioning moral systems.

---

<sup>12</sup> A related obvious question, both here and throughout my analysis, is whether the empirical evidence indicates that value commitments matter more in nonprofits. Empirical work on the behavior and performance of nonprofits as compared to for-profits is very incomplete, imperfect, and difficult to interpret in the aggregate, but it does at least appear to be consistent with an altruistic model of nonprofits. (Malani, Philipson, & David 2003)

It would be socially good if such strategies were feasible, but this author is not aware of tested tactics that would actually work and be cost-effective. This skepticism is reinforced by certain scholars in the behavioral law and economics movement who embrace and document the reality and power of social norms but who also analyze the multiple difficulties faced by lawmakers who might want to leverage or make use of social norm-making and norm-enforcing processes. (E.g., Rachlinski, Scott, various others.)

(3) Shouldn't legal controls over nonprofits be strengthened anyway? Assume the existence and importance in some (or many) nonprofits of effective moral systems that work to control abuse by fiduciaries. Does that fact provide any reason not to toughen or enhance legal controls over fiduciary misconduct in ways currently being proposed and considered (e.g., by the American Law Institute)? Wouldn't more be better? And isn't tougher legal regulation called for by the twin facts that fiduciary misconduct does occur in the nonprofit world and that many nonprofits (and, indeed, some subcategories of nonprofits) appear not to have effectively functioning embedded systems of moral control?

Perhaps surprisingly, there are at least two general reasons for caution. One is that tougher legal regulation may create more costs than benefits. This risk seems especially worth study and analysis when proposed new rules are being transplanted from the for-profit world but are already seriously criticized as cost-ineffective there. Two vivid examples are the strict corporate governance arrangements mandated by the Sarbanes-Oxley Act and the shareholder derivative suit. Numerous empirically oriented scholars have raised severe doubts about the

cost-effectiveness of these arrangements, and although there are opposing voices too, it seems risky to transplant such arrangements to the nonprofit world, where monitoring is intrinsically more difficult and incentives to invoke sanctioning mechanism are intrinsically more diffuse and not necessarily granted to the right persons.

A more subtle reason for caution is the possibility that explicit legal rules and sanctioning mechanisms may tend to “crowd out” and displace moral norms and sanctions, making them less effective. Some legal scholars writing about social norms (e.g., Dan Kahan) have developed this theme in more general law-enforcement contexts like tax collection and prevention of littering. They may have a valid point, and it might be applicable in the context of the nonprofit corporation. (I myself have no firm view about the prevalence or seriousness of such crowding out risks. I do believe the problem should be studied and debated in the nonprofit context.)

## **Conclusion**

This essay has suggested a model of key differences between prototypical nonprofit and for-profit corporations.

As to the for-profit corporation, moral systems may contribute to task three, that of controlling abuse of discretionary power by fiduciaries, by supplying participants who are less disposed to engage in fraud, self-dealing, or other modes of extracting improper personal benefits. But the moral systems play relatively little role in the two tasks of goal determination

and positive motivation. Those tasks are advanced by individuals' natural desires for wealth and facilitated by institutional arrangements (which laws and markets shape).

In the classic nonprofit corporation, by contrast, moral systems play an essential and integrated role in all three tasks: determining goals, motivating participants, and controlling abuse. This integration of functions, it is postulated, may contribute to the effectiveness with which the tasks are carried out. It may help to explain the legal system's somewhat reduced role in the regulation of nonprofits as opposed to for-profits. And although the difference certainly does not imply that legal regulation should be abandoned, or that efforts to improve the legal regulation of nonprofits should not be pursued earnestly and thoughtfully (cf. Fremont-Smith 2006), it does suggest caution.