SEARCHING FOR TRUST IN THE NOT-FOR-PROFIT BOARDROOM: LOOKING BEYOND THE DUTY OF OBEDIENCE TO ENSURE ACCOUNTABILITY

Peggy Sasso*

Until recently, little attention has been paid to the law governing not-for-profits, and in particular (1) whether the not-for-profit director should be held to a trust standard, a corporate standard or some other standard in fulfilling his fiduciary duties, and (2) who should have standing to enforce those fiduciary duties. In the 1990s these issues were pushed to the forefront by public scandals at several high profile not-for-profit organizations. These scandals triggered a public outcry that the not-for-profit sector was not being effectively overseen and the public interest was not being adequately protected.

In this Comment, Peggy Sasso concedes that the not-for-profit sector is indeed experiencing a profound crisis, but argues that it is a quiet crisis that has little, if anything, to do with the scandals that have captured the public's attention. Instead, the author suggests that the health and long-term vitality of the sector is fundamentally threatened by increasing institutional homogenization that favors majoritarian concerns at the expense of the nonmajoritarian interests embodied in the organizational mission. Given that this crisis is far more abstract and pervasive than a handful of misdeeds at a few not-for-profits—and is in part informed by our very choice of a democratic government—its resolution is far more complex and less immediately accessible than much of what has been proposed thus far concerning the appropriate standard of fiduciary conduct and who should have standing to enforce those standards.

The not-for-profit director is held to three fiduciary duties: the duty of care, the duty of loyalty and the duty of obedience. While the first two duties exist in for-profit corporate law, the third is unique to the not-for-profit sector and recognizes that, as an institution held in the public trust, the success of the not-for-profit corporation is defined by the efficacy with which it fulfills its mission. Thus, the duty

* Articles Editor, UCLA Law Review, Volume 50. J.D., UCLA School of Law; M.F.A., Yale School of Drama; B.A, University of California, San Diego. The impetus for this Comment was shaped by more than a decade of experience in not-for-profit theater management including work at La Jolla Playhouse, The Guthrie Theater, Hartford Stage Company and Dallas Theater Center. I am grateful to Professor William Klein for his guidance in refining my initial ideas on this topic, and the UCLA Law Review staff, particularly Marc Lewis for his outstanding editorial work. A special thanks to my parents for their ongoing support and encouragement that makes this moment possible. I dedicate this Comment to Professor Peter Arenella whose teaching and friendship inspired me throughout law school and gave me the confidence I needed to succeed.

of obedience provides a standard of legal accountability roughly equivalent to that of enhancing shareholder value in the for-profit sector.

This Comment concludes that while not-for-profit corporate law should play an important aspirational role by substantively defining the duty of obedience as a distinct fiduciary duty, it should play a limited role when it comes to enforcing the duty. Instead of looking to the solution for the crisis solely in terms of corporate law, we must also examine the vital contributions that can be made through further studies of organizational behavior and group processes in the not-for-profit institution. How effective the not-for-profit is at fulfilling its public purposes is ultimately driven by what information is presented in the boardroom and how the directors use that information to strategically position the institution within its operating environment on an ongoing basis.

Effective governance by the board of a not-for-profit organization is a rare and unnatural act. Only the most uncommon of not-for-profit boards functions as it should by harnessing the collective efforts of accomplished individuals to advance the institution's mission and long-term welfare.[1]

INTRODUCTION: THE IMPORTANCE OF TRUST IN THE NOT-FOR-PROFIT BOARDROOM

Preeminent not-for-profit scholar, Lester Salamon, recently observed, the not-for-profit sector is plagued by a "dangerous crisis of confidence"[2] that stems from a financial and economic crisis, as well as a crisis in effectiveness. Together, he concluded, those crises have culminated in a crisis of legitimacy that threatens the long-term viability of the sector as a whole.[3] This Comment explores the contours of that crisis, suggesting its origins and solutions may be substantially found in the not-for-profit boardroom. Accordingly, without minimizing its urgency or severity, it recharacterizes the serious challenge confronting the not-for-profit sector as a crisis in accountability. The Comment then wrestles with two questions: What role can the law play in resolving this crisis, and what role should it play?

The standard of accountability in the not-for-profit sector can be succinctly defined as compliance with the institutional mission. Yet the simplicity of the definition beguiles the profound and inherent complexities that undermine the efficacy of the standard. Broadly analyzed, the problems are twofold: (1) how is the mission to be defined and, more critically, how is institutional performance to be evaluated vis-à-vis the mission? and (2) who should be empowered to evaluate institutional performance and what tools, legal or otherwise, should be available to enforce compliance?

In the for-profit sector, the board and management are the agents of the shareholders (the principals). The principals are authorized to bring derivative lawsuits to ensure that its agents act in the best interest of the corporation. Not-for-profit corporate law, modeled after its for-profit counterpart, holds the director to the same fiduciary duties,[4] but with one critical distinction: There

1. Barbara E. Taylor et al., *The New Work of the Nonprofit Board*, *in* HARVARD BUSINESS REVIEW ON NONPROFITS 54 (1999).

2. Lester M. Salamon, *The Current Crisis*, *in* THE NATURE OF THE NONPROFIT SECTOR 420, 431 (J. Steven Ott ed., 2001).

3. *Id.* at 420–31.

4. In Part V, *infra*, I discuss the specific fiduciary duties of the not-for-profit director. At that time I examine whether the duty of obedience is a fiduciary duty unique to the not-for-profit sector or whether it is more accurately regarded as subsumed by either the duty of care and/or the duty of loyalty. For a discussion of the duty of obedience as a separate duty, see DANIEL KURTZ, BOARD LIABILITY 84–90 (1988).

are no shareholder-equivalent principals to hold the agents accountable. In other words, not-for-profit law, with some exceptions, creates agents without principals.[5] Thus, "because of a lack of classes of private persons with standing to sue, this fiduciary duty is really a legal obligation without a legal sanction."[6]

Should the law redistribute power in the boardroom to rectify this seeming anomaly? Specifically should the class of individuals who have standing to sue for a breach of fiduciary duty be expanded? Would empowering the chief executive officer to sue render the trustee's legal duty to protect and promote the institutional mission (the trustee's duty of obedience) meaningful in a way that it is currently not? And would it facilitate a productive dialogue between the trustee and staff leadership whereby the institutional mission could be strategically evolved to most effectively serve the organization's defining purpose? Part VI of this Comment analyzes the merits of this proposal, while Part VII explores its flaws. This Comment concludes that the law is not the most effective means of promoting fidelity to the institutional mission, and heightening the specter of legal liability might actually accelerate the breakdown in trust between the director and the executive that is vital for optimal institutional performance.

Developing and sustaining trust[7] between the director and the professional staff is one of the most difficult challenges confronting a not-for-profit, yet this trust is essential to formulating and enforcing a standard of accountability that promotes the entity's ongoing relevancy.[8] In the absence of such trust, the organization becomes paralyzed. Not only will there be no consensus defining the criteria against which institutional performance should be measured, a thorough understanding of the relevant performance data depends on the

5. *See* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465 (1996).

6. *Id.* at 466–67 (citations omitted).

7. I am using "trust" to define the behavior whereby one voluntarily makes oneself vulnerable to another who has the capability and capacity to exploit that vulnerability, based on the belief that the trusted person will not choose to exploit that vulnerability. For a discussion of the meaning of trust, see Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1739–40 (2001).

8. Without trust in the board room, the not-for-profit can not hope to be effective over the long-term, and thus deserving of the public's confidence. Donald Langevoort describes the most productive boards as "ones that have enough diversity to encourage the sharing of information and active consideration of alternatives, but enough collegiality to sustain mutual commitment and make consensus-reaching practicable within the tight time frames in which boards must operate." Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 810–11 (2001).

And importantly, as the not-for-profit is perceived to be more effective, the public's confidence in the sector as a whole should subsequently increase. For an analysis of the public's current perception of the not-for-profit sector see Salamon, *supra* note 2, at 428 (reporting the results of a 1994 Gallup survey which found that only one-third of the American population had either a "'great deal'" or "'quite a lot'" of confidence in not-for-profit organizations outside of religion and education).

synergy between the specialized skills and experiences of the lay trustee and the professional staff working together with a shared institutional vision. However, trust cannot be legislated nor can it be fostered through the threat of external sanctions.[9] Trust is a learned behavior informed by each actor's experiences both inside and outside the firm.[10] Consequently, there is no easy fix to restore trust to the not-for-profit boardroom. Instead the internal players within each firm must accumulate enough trustworthy experiences that they learn to rely on each other's diversity of perspectives and experiences instead of being threatened by them. Therefore practices must be enacted within the organization that nurture the fragile trust between the director and the executive.

While Part VIII briefly examines the possible processes and structures that might be implemented to foster internal norms that will promote trust in the not-for-profit boardroom (specifically advocating the need for further exploration of the controversial position that the not-for-profit board needs to be significantly reduced in size while the balance of inside directors to outside directors needs to be increased), it is imperative that theoretical and empirical work on not-for-profit governance begin in earnest to support much needed legal and economic scholarship in this area.[11]

Before turning to an analysis of the efficacy of nonprofit law in ensuring institutional accountability discussed in Parts VI through VIII, it is valuable for the reader to have a comprehensive understanding of the unique tensions that exist in the application of corporate law to the not-for-profit sector. Part II examines the not-for-profit in the context of the for-profit corporation, assessing the relevant similarities and differences that should distinctly inform the application of corporate law in each setting. Part III explores the special role that nonmajoritarian interests play in the not-for-profit sector, which has important ramifications for the structure of the board and the limitations on the effectiveness of law in monitoring institutional accountability. Part IV builds on the implications of Parts II and III, providing both an overview of the functions and responsibilities of the not-for-profit board, as well as specifically examining the inherent tensions between the lay trustee and the professional staff. Part V introduces the reader to the duty of obedience, the fiduciary duty unique to the not-for-profit sector, and contrasts it with the duties of care and loyalty borrowed from its for-profit counterpart.

---

9. *See* Blair & Stout, *supra* note 7, at 1797.

10. *See id.* at 1767; John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2176 (2001).

11. *See* BENJAMIN E. HERMALIN & MICHAEL S. WEISBACH, BOARDS OF DIRECTORS AS AN ENDOGENOUSLY DETERMINED INSTITUTION 3 (Nat'l Bureau of Econ. Research, Working Paper No. 8161, 2001), *available at* http://www.nber.org/papers/w8161.

However, at the outset it is useful for the reader to have an understanding on an institutional level of the crisis in accountability precipitated by a failed dialogue between the board and its executive. Towards that end, this Comment begins with a brief case study of the tumultuous power struggle within the institutional leadership that recently played itself out in the boardroom of the Long Wharf Theatre.[12]

I. THE LONG WHARF THEATRE: A CASE STUDY AND ANALYSIS

In January 1997, after an international six-month search for a new artistic director, the Long Wharf Theatre announced Doug Hughes as its new artistic leader. Hughes, and a yet to be named managing director, were charged with the daunting task of reinvigorating a theater that had previously been led by the same management team for over thirty years, and was now in desperate need of new visionary leadership. If anyone had been groomed for the challenge it seemed to be Hughes. At the time of his appointment, he was a prominent theater artist, and at forty-one, was widely acknowledged within the industry to be ready for a leadership position. Prior to his appointment, he served for twelve years as the associate artistic director at Seattle Repertory Theatre and for one year as director of artistic planning at The Guthrie Theater in Minneapolis. Hughes was a respected artist, highly charismatic, an outstanding speaker, and an excellent artistic ambassador to the community. The trustees of the Long Wharf were thrilled at having secured one of the major rising stars in the field to revitalize their theater and lead it into the next century. In a public show of trust and support, the board president announced that Hughes was to be given "'carte blanche' to run the theater as he sees fit . . . . 'I am looking for a minister for a church . . . . I want a leader who has vision that will make me follow, whether it's controversial or whether it's fun.'"[13] Yet four short years later, the relationship between Hughes and the board of trustees changed dramatically. On June 25, 2001, Hughes's sudden and bitter resignation from the Long Wharf Theatre was front page news in the art section of the *New York Times*.[14]

However, as startling as the announcement was to those outside the company, insiders had been painfully aware of the mounting tensions within the institutional leadership. Although chairwoman Barbara Pearce had led the

12. Long Wharf Theatre is a nationally renowned not-for-profit theater located in New Haven, Connecticut. It was founded in 1965 and currently has an annual operating budget of approximately $6.5 million.

13. Frank Rizzo, *Staging a Revival For Long Wharf, a New Artistic Vision*, THE HARTFORD COURANT, Apr. 13, 1997, at G1.

14. Robin Pogrebin, *Offstage Drama at Long Wharf*, N.Y. TIMES, June 25, 2001, at E1.

search committee that brought Hughes to Long Wharf and Hughes had backed her appointment as board chair, their working relationship was strained almost from the beginning of Hughes's tenure. Hughes felt Pearce micromanaged the theater and interfered with his ability to serve as the institution's visionary leader, while Pearce complained that Hughes was not sufficiently respectful of or attentive to her role as board leader and a key fundraiser.[15] Finally, in a desperate act that would in short order sever his relationship with the theater in which he had been passionately invested for the past four years, Hughes asked the board for Pearce's resignation.[16] In a bold, yet ultimately unproductive and self-defeating move, Hughes was demanding that his employer reorganize its leadership and dismiss its chair in the process. Unsurprisingly, the board backed its chair and Hughes was left with no choice but to submit his own resignation.

After resigning, Hughes professed surprise and seemed genuinely shocked that events turned out as they did. By all accounts his tenure at the theater had been successful, both financially and artistically. He had retired the theater's accumulated deficit, expanded the annual season from five to eight plays, and repositioned Long Wharf as a national player in the field by producing the original production of *Wit* by Margaret Edson,[17] which was moved to New York where it won the Pulitzer Prize and was turned into a critically acclaimed HBO movie starring Emma Thompson. Deeply committed to the institution, Hughes had just signed a new five-year contract with the theater[18] and was well into planning the next season, including contracting actors for the plays he would direct. Hughes claimed "I was in no way trying to run the board . . . [T]his was . . . an attempt by an artistic director, recognizing [that] I am an employee,

15. *Id.* Indeed, Pearce's exceptional skills as a fundraiser have proven invaluable to Long Wharf. During her tenure as board chair, Pearce significantly strengthened the annual fundraising campaign, supporting an increase in the annual operating budget from $5 million to over $6.5 million. In addition, Pearce has taken critical steps to help secure the theater's long-term financial stability by leading several endowment campaigns including a $1.5 million challenge grant from The Doris Duke Charitable Foundation and the Andrew W. Mellon Foundation. Furthermore, she has been a zealous advocate for the theater, effectively leveraging her prominent position in the community in order to maximize the resources and opportunities available to support the theater's work. Most recently she served as Long Wharf's representative for the National Arts Stabilization Project of New Haven, which raised over $5 million for the region's major cultural institutions. Telephone Interview with Michael Stotts, Managing Director, Long Wharf Theatre (June 24, 2003).

16. Pogrebin, *supra* note 14.

17. *Id.*

18. Artistic director employment contracts in the not-for-profit theater are more typically three-year contracts. Therefore, by signing a five-year contract, both Hughes and the Board were recognizing a substantial commitment to each other and to their collaboration as the theater's leadership. The renewed contract indicated a willingness on both sides to work through their differences for the benefit of the organization, thereby rendering the ensuing impenetrable breakdown in communication that much more troublesome.

to seek collaboration on a problem that was making it very difficult to do my job."[19] For her part, Pearce was looking for a different type of collaboration than Hughes had to offer and a different relationship with the artistic director than had been proposed by her predecessor when he announced Hughes's appointment.[20] Pearce was certainly not interested in giving Hughes carte blanche to run the theater as he saw fit, nor was she looking for a minister to give life, meaning, and ultimate direction to the institution through his work as a theater practitioner. As she acknowledged, her relationship with Hughes "ultimately broke down over who called the shots. 'This [was] not a personality conflict. . . . This [was] a philosophical conflict about governance.'"[21] Ultimately, it was a conflict characterized by differing notions about how a not-for-profit board and its CEO should collaborate, precipitating a debilitating breakdown in the requisite trust needed for an effective and productive partnership.

In the end, it was a conflict that produced only losers, both for all the individuals involved, and more importantly, for the not-for-profit organization itself.[22] Hughes is now a freelance theater director and will probably choose never to lead a not-for-profit theater again. He has little incentive to seek another executive position given that he can pursue his passion as a director without assuming the burdens of institutional leadership and the enormous commitment of time and energy necessary to manage board relations. Meanwhile, Long Wharf embarked upon yet another search for an artistic leader, a task made exceptionally difficult given the adverse publicity surrounding

19. Pogrebin, *supra* note 14.

20. Describing her role as Chair of a not-for-profit board, Pearce comments,

> The job of Chair is like the stroke of a crew team. You have to put your oar in first and assume others will follow. There's this tiny period when you have the only oar in the water. The stroke has the strength to take up the weight of the boat when the oar goes in and the confidence that the rest will follow. That's how I see the role of Chair—to take up the work of the institution and by dint of will, move it forward until the other members follow . . . I spent a lot of time at the beginning listening to staff. Now I don't—nor should I. . . . If you have a high degree of energy, vision, and commitment yourself, other people will ramp up their commitment as well, so you can leverage your time.

MANAGEMENT CONSULTANTS FOR THE ARTS, INC., THE CHAIR: MORE THAN JUST A TITLE, *at* http://mcaonline.com/MCA45.html (last visited July 18, 2003). Clearly, Pearce envisions the role of Chair as providing the fundamental leadership and direction for the organization. It is the Chair who promulgates the agenda and it is the role of other institutional players, be they staff or trustees, to step in behind. As will be discussed during the course of this Comment, while this management paradigm may be appropriate in some contexts, it is ill suited to the needs of a not-for-profit organization. The not-for-profit organization is a mission-based institution whose ultimate relevance and viability depends on the *collective leadership* of a *diverse* group of institutional stakeholders to give meaning to the mission over time.

21. Pogrebin, *supra* note 14.

22. *See* MAUREEN K. ROBINSON, NONPROFIT BOARDS THAT WORK 112 (2001) (observing in all power struggles between the board and the professional, "[t]he losers in these boundary disputes are always the executive director and the organization everyone has pledged to serve").

Hughes's departure. Not surprisingly, the theater had to wait over a year before it had a new director at its helm. Also not surprising is the fact that the theater turned to Gordon Edelstein, someone within its own extended family.[23] It is too soon to tell whether Long Wharf will ultimately weather the devastating financial and artistic upheaval it has endured over the last few years.

While it seems clear that the recent events at Long Wharf were unfortunate for both Hughes and the theater, why should this matter to anyone outside the small world of the not-for-profit theater? Certainly the board had every right to dismiss Hughes when the relationship proved unworkable. There is nothing unique in either the not-for-profit or for-profit sector about conflicts between CEOs and boards of directors that end in the termination of the CEO. Just like a for-profit business, a not-for-profit manages a diversity of institutional stakeholders, ranging from trustees to staff to donors to customers to suppliers, and their expectations of the organization are often at odds.[24] Even when all parties involved have the best intentions, there are times when conflicts regarding

23. Gordon Edelstein assumed the position of artistic director for the Long Wharf Theatre on July 1, 2002. He had previously been affiliated with the theater from 1990 to 1997 as both the associate artistic director and an associate director.

24. *See* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 467 (1996). David Hammack suggests that the institutional donor is the principal actor equivalent to the shareholder in the for-profit context. *See* David C. Hammack, *Accountability and Nonprofit Organizations: A Historical Perspective*, 6 NONPROFIT MGMT. & LEADERSHIP 127, 132 (1995). But John Carver finds this analysis too cynical, arguing that "it is important that the grantor *not be* seen as owner. Ownership is not merely paying the bills, although this may be a factor." JOHN CARVER, BOARDS THAT MAKE A DIFFERENCE: A NEW DESIGN FOR LEADERSHIP IN NONPROFIT AND PUBLIC ORGANIZATIONS 122 (1997) (emphasis added). However, as Hammack responds, most not-for-profits focus a significant amount of attention on making sure the needs of their major donors are being met at all times. Hammack, *supra*, at 132–33. And Hammack's observation is correct as far as it goes for there is little dispute that major donors play a critical role in shaping the not-for-profit. *See* Christopher Reynolds, *The Board Game: Ante Up Enough Time and Money and You Can Be a Player on L.A.'s Cultural Scene*, L.A. TIMES, Apr. 27, 2003, at A2 ("[T]he more directly [board members] contribute to the resources of the institution, the more they dictate the direction of the institution.") (quoting Andrea Rich, President and Director of the Los Angeles County Museum of Art).

Nevertheless, it would be a mistake to argue that the donor substitutes for the equity holder in the for-profit corporation as the appropriate monitor of institutional accountability. *See* Brody, *supra*, at 470. The mature not-for-profit is funded by a multitude of donors numbering in the thousands and higher, so attempting to determine the "donor's will" as if there was one monolithic super donor intent seems absurd. In reality the interests of the different donors will conflict and must be reconciled—just like the conflicts between and within other stakeholder classes. Furthermore, relying on the donor to ensure institutional accountability to the mission is hardly the most effective solution. As Brody argues, donor control usually "lead[s] to inefficient overproduction of what a particular donor wants to support" regardless of what is in the best interests of the not-for-profit organization. *Id.* Finally, it is not clear why one would entrust supervision of the not-for-profit to the institutional donor when, as a sector, private giving from all sources constitutes only nine percent of not-for-profit income. Clearly other stakeholders have a stronger claim on the not-for-profit institution than the private donor. *See* Lester M. Salamon, *Scope and Structure: The Anatomy of America's Nonprofit Sector*, *in* THE NATURE OF THE NONPROFIT SECTOR, *supra* note 2, at 23, 33.

strategic positioning of the institution become insurmountable, forcing the parties in conflict to go their separate ways. However, it is one thing when the conflict evolves out of a dialogue between two or more parties, and quite another when the conflict is precipitated by a fundamental lack of trust that precludes any dialogue from happening. The situation at Long Wharf is arguably representative of the latter dynamic. From the beginning, the parties involved were so concerned with who was attending what meeting behind whose back, that there was no opportunity to productively discuss substantive issues, including their aspirations for the institution and their roles within it. In the end both parties ended up hurting the institution that they were both so fervently fighting to protect.

Unfortunately, the debilitating lack of trust between the board and the professional staff that characterized the situation at Long Wharf is a serious problem that occurs with alarming frequency throughout the not-for-profit sector. Arguably the only unusual aspect of the Hughes situation is that the tumultuous offstage drama was reported in vivid detail by the national press. As Peter Dobkin Hall notes, outside major newspapers,

> hardly a week passes without a feature on the resignation of a nonprofit executive director or a key staffer. These articles follow a curiously reliable format. They tell of the wonderful jobs by these managers . . . . The articles speak of missions successfully accomplished and managers going on to new and more exciting challenges. Taken at face value, everything seems rosy. The educated eye can discern unmistakable signs of conflict between the smooth phrases of these barely edited press releases.[25]

A certain amount of conflict reflects healthy engagement between institutional stakeholders with a rich diversity in perspectives and experiences. But this is not the type of conflict to which Hall refers; instead, he describes a conflict that stems from a failed dialogue—or no dialogue at all—between key institutional decisionmakers. And as the financial pressures confronting the entire not-for-profit sector continue to increase, the debilitating power struggle

---

25. PETER DOBKIN HALL, INVENTING THE NONPROFIT SECTOR AND OTHER ESSAYS ON PHILANTHROPY, VOLUNTARISM, AND NONPROFIT ORGANIZATIONS 210 (1992). For a recent example of such an article, see Celestine Bohlen, *San Francisco Museum Director Resigns Suddenly*, N.Y. TIMES, Aug. 18, 2001, at B7. Describing the revolving door of executive leadership in the not-for-profit theater, theater historian Norris Houghton observes that many leaders

> seem to be at a perpetual Alice-in-Wonderland tea-party whereas the directors are always moving one place on. After a period of from two to five years, the director at Kalamazoo moves to Dallas; the director at Dallas moves to Charleston; the director at Indianapolis moves to Pittsburgh; the man in Omaha moves to Indianapolis; the man in Duluth moves to Shreveport; his predecessor there moves to Memphis; and so it goes, round and round in a circle.

NORRIS HOUGHTON, ADVANCE FROM BROADWAY: 19,000 MILES OF AMERICAN THEATRE 80 (1941).

between the board and the executive staff for control of the institution threatens to paralyze the leadership of these institutions and thereby undermine the efficacy of this vital economic sector.[26]

II. THE NOT-FOR-PROFIT SECTOR IN THE CONTEXT OF ITS FOR-PROFIT COUNTERPART

Despite the dearth of studies on not-for-profit governance, scholarship on the for-profit corporation and the law's role in codifying the corporate board and imposing fiduciary duties provides an important analytical framework. The normative hypothesis of law and economics scholarship posits that corporate law ought to be efficient: Corporate law should promote wealth optimization by minimizing transaction costs.[27] Behavioral law and economics identifies these costs as stemming from uncertainty (the difficulty of predicting future events), opportunism (the inevitability that the parties involved will be tempted to pursue their own self-interest), complexity (long-term contractual relationships give rise to a myriad of contingencies) and bounded rationality (humans have a limited cognitive capacity that will inhibit their ability to process the requisite information ensuring that all contracts will be incomplete).[28] By organizing economic activity into a firm, transaction costs resulting from incomplete contracts and subsequent opportunism can be minimized. Within the firm, contracts (both express and implicit) can be rewritten and supplemented on an ongoing basis, and most importantly the terms can be imposed by employer fiat. Recognizing the inherent advantage in allocating resources by authoritative direction, as opposed to the pricing system of the general market, was one of Ronald Coase's greatest contributions to the scholarship of corporate governance. Consistent with this scholarship, the law recognizes that the organizational structure of the corporation derives its value from the role that its authority-based structure plays in minimizing transaction costs across stakeholders that have different access to information as well as different interests. Accordingly, the law vests the locus of this authoritative direction in the board of directors.[29]

---

26. George Thorn, *On Board Mythology*, J. ARTS MGMT. & L., Summer 1990, 51, 56–57; *see also* Reynolds, *supra* note 24 (observing "this generation of . . . board members is more inclined to challenge institutional tradition and, perhaps because more of theirs is on the table, more worried about money").

27. *See* STEPHEN M. BAINBRIDGE, CORPORATIONS LAW AND ECONOMICS 20–23 (2002) (analyzing the normative principle of wealth maximization in the for-profit sector).

28. *Id.* (discussing the impact that conditions of uncertainty and complexity have on the concept of bounded rationality).

29. "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any

Assuming that maximum efficiency is achieved when all of the corporation's constituents specialize in a particular function, locating decisionmaking authority in the board of directors should minimize transaction costs across diverse corporate constituencies. However, even assuming the validity of the predicate assumption, this analysis can only be taken so far because the board is not a monolithic body; instead it is comprised of individuals with unique interests and agendas.[30] So while Stephen Bainbridge is correct in observing that at the apex of the hierarchical corporate structure is an entity that functions mainly by consensus,[31] the substantive analysis demands an investigation into how that consensus is achieved and at what costs. Even conceding that the disparate group of individuals who sits on the board has identical access to information, each member will have differing abilities to process that information given his skill sets and past experiences. And notwithstanding the fact that all members may share a common goal for the institution (as was the case with the Long Wharf), each will have his own motivations and interests that will inform how he approaches the task of corporate governance. Therefore a study of the process through which consensus is achieved at the board level goes to the heart of corporate governance, and helps inform issues such as who should sit on the board of directors and how large the board should be.

Any such inquiry logically begins with an analysis of the corporate board's role. Of course, the board has the power of fiat and thereby minimizes transaction costs. But what does this power really mean in terms of defining the role(s) the board should play on a month-to-month basis?[32] Conventional wisdom dictates that the board is a governance mechanism intended to reduce agency costs arising from the separation of ownership and control.[33] However,

---

limitation set forth in the articles of incorporation. . . ." MODEL BUS. CORP. ACT § 8.01(b) (1984); "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided . . . in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (2002).

30. *See* HERMALIN & WEISBACH, *supra* note 11, at 32–33 (observing that boards are comprised of unique individuals with each individual director valuing "issues of emotions, fairness, and norm adherence more than economics tells us that they should"); G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 894 (2000) (coining the metaphor "connected contracts" as recognition of the "complex interaction among all of the participants in an economic venture").

31. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 3 (2002).

32. *See generally* HERMALIN & WEISBACH, *supra* note 11, at 31–34 (surveying empirical studies of board performance in the for-profit sector).

33. *See id.* at 1; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248 (1999); Gulati et al., *supra* note 30, at 945. *See generally* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1 (1996). Agency costs are traditionally defined as the structuring, monitoring, and bonding costs of a set of contracts between individuals with conflicting interests plus the value of any output lost given that the costs of full enforcement of the contracts will exceed the benefits. *See* Michael C. Jensen & William H.

framing the discussion in terms of ownership of the corporation is problematic. While it is debatable who, if anyone, actually owns the for-profit corporation, the issue becomes even more clouded in the not-for-profit context where—by definition—there can be no alienable claims to institutional profits.[34] Thus the notion of ownership is ultimately a distraction. Instead, it is more helpful to recognize that agency costs arise in the corporate organizational form principally because the institutional decisionmakers are not the significant risk bearer of the consequences of their decisions (putting aside the close corporation and situations where board members are controlling shareholders).[35] Therefore, it follows that the board has an important monitoring function to ensure management does not shirk its responsibilities or otherwise exploit the situation. Recognizing that the ramifications of management's decisions will be paid for primarily by corporate stakeholders other than management (typically described as the residual claimant) the board checks management's power to implement or veto actions.[36]

However, while monitoring is certainly a function of the corporate board, its role has a tendency to be overplayed.[37] It is a distorting oversimplification to argue that management does not have something at stake in the overall performance of the corporation. While management may not have a significant financial investment, it will have some, if not all of the following investments in the firm: reputational capital, firm-specific capital, client-specific capital, and intellectual capital.[38] Accordingly, management will generally have made both a significant investment of human capital that is not readily transferable to another corporation, as well as reputational capital with tangible financial ramifications. Consequently, it is not entirely clear what incentives a board of directors has to provide superior monitoring performance over that provided by management with its tremendous personal investment in the corporation.[39] This is especially true because board members frequently sit on more than one board and are generally paid an insignificant amount given their other streams of income (and are not paid at all in the not-for-profit sector).

Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

34. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 342 (1983).

35. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) [hereinafter *Ownership and Control*].

36. *See generally* Gulati et al., *supra* note 30, at 920–21 (discussing examples of positive versus negative control within the corporation).

37. *See* Dallas, *supra* note 33, at 2.

38. *See* Gulati et al., *supra* note 30, at 923.

39. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 951 (1999); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 275 (1997).

In addition to its monitoring role, the corporate board is also generally recognized as having management responsibilities. Over the last thirty years these responsibilities have been given short shrift by scholars and policymakers who have focused their attention instead on the board's monitoring functions.[40] However, as adept as the monitoring board may be at dealing with institutional crises[41] and arbitrating disagreements among corporate constituents,[42] it is the managing board that provides for the ongoing success and viability of the corporation by counseling the CEO, engaging in strategic planning, and assessing the merits of significant corporate transactions.[43] This managerial function has also been referred to as the "relational function" of the board.[44] By virtue of the prominent social stature of its members, as a body, the board can cultivate and nurture relationships within the corporation and with critical players across the broad social, cultural, political, and economic environments in which the corporation operates. Accordingly, the board facilitates the exchange of information, capitalizes on needed resources, and promotes the corporation's status among essential communities.[45] These vital managerial functions have important implications for the composition of any board. For even if one accepts the somewhat problematic assumption that the monitoring functions of the board are best performed by independent outside directors,[46] it is highly unlikely that a board comprised exclusively of independent outside directors will perform its managerial functions effectively or efficiently. Vital tasks like advising the CEO, selecting a new CEO, and engaging in long-term strategic planning require detailed knowledge of the corporation's operations as well as the complex intricacies of the industry in which it operates.[47] Recognizing this inherent tension between the board's monitoring and managing responsibilities, several scholars of for-profit governance have recently suggested that the optimal board may be a mix of inside, independent, and gray (or affiliated)

40. For example during the past few decades, poor board performance has almost exclusively been attributed to a breakdown in monitoring procedures, with the solution being the addition of ever more outside directors. Notably, the Business Roundtable, an organization comprised of CEOs from large corporations, recommended that boards be composed primarily of independent directors. *See* Business Roundtable, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241, 249 (1990). Also noteworthy is the American Law Institute's 1982 proposal for a law requiring boards to have a majority of independent directors, although this was later changed to a mere recommendation. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03(a) (Tentative Draft No. 1, 1982).

41. *See* Fisch, *supra* note 39, at 282.

42. *See Ownership and Control*, *supra* note 35, at 315.

43. *See* Fisch, *supra* note 39, at 272, 282.

44. *See* Dallas, *supra* note 33, at 3.

45. *See id.*; Bainbridge, *supra* note 31, at 8.

46. *See* HERMALIN & WEISBACH, *supra* note 11, at 32 (concluding from their extensive empirical study that the number of independent directors is not dispositive of board performance).

47. *See* Bhagat & Black, *supra* note 39, at 940; Dallas, *supra* note 33, at 22.

directors.[48] While that proposition is considered controversial in the for-profit sector, it is generally thought to be untenable in the not-for-profit context. To understand why that has historically been the case I turn now to a discussion of the not-for-profit sector. While there are obvious differences between the two sectors, the organizational needs served by corporate governance in either, and hence the role of corporate law in both, are fundamentally similar. Among other things, this confluence has critical implications for the composition of the not-for-profit board.

One of the most salient differences between the for-profit entity and its not-for-profit counterpart is how the two organizations measure institutional success. Under corporate case law it is well established that the for-profit corporation's primary objective, and thus the focus of corporate governance, must be to maximize wealth for the corporate shareholders.[49] By contrast, the focus of not-for-profit governance is decidedly less clear. Namely, the not-for-profit sector lacks any universal, readily accessible, or objective measure of accountability. Consequently, effective corporate governance demands that at the institutional level the organization rigorously establish its individual criteria for success and reach consensus about how it should be measured. The criteria and evaluative procedures must then be explicitly communicated to the institutional stakeholders and their buy-in obtained. And finally, those entrusted with the governance of the not-for-profit must formulate effective strategies to maximize success.[50]

The starting point for any such strategic analysis must be the institutional mission. However, interpreting the mission is rarely a straightforward process, and it is further complicated by the fact that the not-for-profit often serves a richly diverse constituency.[51] Given the intangibility of the product

48. *See* Bhagat & Black, *supra* note 39, at 950–51; Langevoort, *supra* note 8, at 800.

49. *E.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders."). *Dodge* has been cited over four hundred times for this proposition from the Supreme Court down to the state trial level.

50. *See* HERMALIN & WEISBACH, *supra* note 11, at 30; ABA, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 10 (George W. Overton ed., 1993) [hereinafter GUIDEBOOK] ("It has been said that all organizations exist to maximize *something* for *somebody*; the not-for-profit corporation is no exception. Defining the *something* and the *somebody* is the duty of every nonprofit board and every director.") (emphasis added).

51. While most service organizations may have a relatively objectively defined mission (such as providing food, shelter or medical care to a particular demographic), the typical cultural organization will often have as part of its mission a commitment to producing art of the highest quality and to achieve national recognition for doing so. As the mission becomes less quantifiable (using the arts as a salient example), it becomes increasingly important who is at the table assessing whether the institution is indeed producing work of the highest national or international quality in furtherance of its mission. The following provides a representative sampling of the mission statements of some of the major not-for-profit theaters.

offered by many not-for-profits, such as the arts, the multitude of institutional stakeholders are likely to define organizational success and effectiveness differently.[52] To whom is the not-for-profit to be accountable when the interests

"The Dallas Theater Center will produce classic, contemporary and new plays *of the highest quality*. We will create communal experiences that inspire new ways of thinking and living. Our work will nurture and help shape *the future of the American theater*." Dallas Theater Center mission statement, *available at* http://www.dallastheatercenter.org/mission.html (emphasis added) (last visited July 18, 2003).

> The Guthrie Theater serves as a vital artistic resource for the people of Minnesota and the region. Its primary task is to celebrate, through theatrical performances, the common humanity binding us all together. The Theater is devoted to the traditional classical repertoire that has sustained us since our foundation and to the exploration of new works from diverse cultures and traditions. The Guthrie *aspires to the highest levels of artistic achievement* and to reaching the widest possible audience with our work. The Guthrie Theater sees itself as *a leader in American Theater with both a national and international reputation*.

Guthrie Theater mission statement, *available at* http://www.guthrietheater.org/act_ii/mission.htm (emphasis added) (last visited July 18, 2003).

> La Jolla Playhouse *advances theatre* as an art form and as a vital social, moral and political platform by providing unfettered creative opportunities for the leading artists of today and tomorrow. With our youthful spirit and eclectic, *artist-driven approach* we will continue to *cultivate a local and national following* with an insatiable appetite for audacious and diverse work. In the future, San Diego's La Jolla Playhouse will be considered singularly *indispensable to the worldwide theatre landscape*, as we become a *permanent safe harbor for the unsafe and surprising*.

La Jolla Playhouse mission statement, *available at* http://www.lajollaplayhouse.com/mission.htm (emphasis added) (last visited July 18, 2003).

> Berkeley Repertory Theatre seeks to set a *national standard* for ambitious programming, engagement with its audiences, and *leadership within the community in which it resides*. We endeavor to create a diverse body of work that expresses a *rigorous, embracing aesthetic* and reflects the *highest artistic standards*, and seek to maintain an environment in which talented artists can do their best work. We strive to engage our audiences in an ongoing dialogue of ideas, and encourage lifelong learning as a core community value. Through productions, outreach and education, Berkeley Rep aspires to use theatre as a means to challenge, *thrill and galvanize what is best in the human spirit*.

Berkeley Repertory Theatre mission statement, *available at* http://www.berkeleyrep.org/HTML/AboutTheRep/mission.html (emphasis added) (last visited July 18, 2003).

"The mission of The Shakespeare Theatre is to become the *nation's leading force in producing and preserving the highest quality of classical theatre*. The theatre endeavors to strengthen the tradition of classical theatre in America through productions that reflect its current world." The Shakespeare Theatre, Washington, D.C. mission statement, *available at* http://www.shakespearetheatre.org/tinfo.html (emphasis added) (last visited July 18, 2003).

52. *See* Daniel P. Forbes, *Measuring the Unmeasurable: Empirical Studies of Nonprofit Organization Effectiveness From 1977 to 1997*, 27 NONPROFIT & VOLUNTARY SECTOR Q. 183, 183 (1998) (observing that the very concept of evaluating organizational effectiveness in the not-for-profit sector is problematic because "it can mean different things to different people and there exist many alternative ways of measuring organizational effectiveness") (citations omitted); WILLIAM G. BOWEN, INSIDE THE BOARDROOM 148 (1994) (acknowledging that the not-for-profit's mission is often so "difficult to define with precision and subject to intense debate" it is not surprising that it typically is interpreted differently by key groups of institutional stakeholders); Ronald E. Fry, *Accountability in Organizational Life: Problem or Opportunity for Nonprofits?*, 6 NONPROFIT MGMT. & LEADERSHIP 181, 192 (1995) (predicting that not-for-profits in the future will be challenged by stakeholders pulling the organization in different directions through fundamental disagreements about institutional expectations and how they should be measured); *see also* Robert D. Herman & David O. Renz, *Multiple Constituencies and the Social Construction of Nonprofit Organization Effectiveness*, 26 NONPROFIT & VOLUNTARY SECTOR Q. 185,

of those parties conflict within and between themselves?[53] Whose claim on the institution has priority? Does this evolve over time? Does it change with different circumstances? As with any successful corporation, a not-for-profit must know who its primary stakeholders are at any given moment, but it must also be able to evaluate how much and what kind of power each stakeholder has.[54] Failure to do so will ultimately render the not-for-profit irrelevant. No organization can be all things to all people, and attempting to be so undermines the institution's core competencies and threatens its long-term viability.[55]

As financial pressures in the not-for-profit sector continue to mount and the field's leaders are confronted with increasingly difficult decisions impacting the strategic allocation of their limited resources,[56] it is critical for the not-for-profit board to be clear on its institutional mission and how to measure success against it so as to be able to evaluate the relevance of the demands being placed upon it within a specific context. However, given that the institutional mission will not likely translate into a readily quantifiable standard against which accountability can be measured, and given the diversity of stakeholders with no clear residual claimant: Who should be empowered to assess institutional performance vis-à-vis the mission? Specifically, who should sit on the not-for-profit corporate board? And what role, if any, should nonprofit corporate law play in ensuring accountability to the institutional mission?

Once formulated, the institutional mission should be fluid, and be continually evaluated against the organization's defining sense of purpose and its unique internal and external operating environments.[57] The continual strategic

---

196 (1997) (presenting empirical data that the perception of an individual organization's effectiveness can differ significantly across institutional stakeholders; specifically finding that staff judgments of effectiveness correlated with the institutional funders' assessments 27 percent of the time and with the board's assessment only 6 percent of the time).

53. Discussing this dilemma in the context of the conversion of a not-for-profit hospital into a for-profit entity, James J. Fishman observed that "[t]here is a philosophical question . . . [of] whom do the boards represent: patients, the doctors, a part of the public and which sector, or the community as a whole? It is unclear whether board members know." James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701, 737 (1998).

54. Robert P. Lawry, *Accountability and Nonprofit Organizations: An Ethical Perspective*, 6 NONPROFIT MGMT. & LEADERSHIP 171, 175 (1995) (observing that "what is needed [by any not-for-profit] is a precise taxonomy of those to whom some answerability is required and of the legitimate standards or expectations that each of these persons or groups may have").

55. *See* MICHAEL E. PORTER, COMPETITIVE ADVANTAGE: CREATING AND SUSTAINING PERFORMANCE 12 (1985) ("Being 'all things to people' is a recipe for strategic mediocrity and below-average performance because it often means that the firm has no competitive advantage at all.").

56. For a discussion of the financial crisis in the not-for-profit sector see Salamon, *supra* note 2, at 420–24.

57. The institution's mission is its organizational blue print. It should clearly communicate what the organization does, how it does it, and why it does it. For a discussion of how to formulate a

repositioning of the not-for-profit institution in what is an increasingly competitive environment (whether it be competition for donations, earned income, labor, or materials), requires the specialized skills, competencies, and perspectives of the lay trustee and the professional executive staff working together. The lay trustee and the staff are generally the critical resources of any not-for-profit, providing skills, experience, finances, and reputation. Consequently, the not-for-profit board and its executive staff must nurture an environment of trust that enables them to agree on critical performance indicators[58] and effectively deploy their limited human resources in monitoring the institution's performance against those indicators on an ongoing basis. A paralyzing lack of trust and subsequently failed dialogue between the not-for-profit board and its management team, as exemplified by the situation at Long Wharf Theatre, is a serious liability for the not-for-profit. As a result of a sustained lack of agreement regarding the organization's key performance indicators and how they should be measured, the not-for-profit is likely to lose its identity as well as any competitive advantage it may have had, and over time it can become increasingly difficult to articulate exactly what public purpose it is serving that justifies its tax exempt status. Arguably, an increasing number of not-for-profits are experiencing such a debilitating breakdown in trust between board members and the executive staff, and a subsequent crisis in accountability.[59] One of the foremost issues in not-for-profit governance must be the restoration of trust and respect between the lay trustee and the professional staff. But rebuilding this trust is easier said then done. Part III of this Comment discusses the inherent contradictions that define the not-for-profit sector, and helps explain why trust is often glaringly absent from the not-for-profit boardroom.

III. THE ROLE OF NONMAJORITARIAN INTERESTS AND THE PARADOX OF THE NOT-FOR-PROFIT SECTOR

On the one hand, the not-for-profit sector is celebrated in our democratic society as a means through which a diversity of interests can be served that do

---

mission statement, see MICHAEL ALLISON & JUDE KAYE, STRATEGIC PLANNING FOR NONPROFIT ORGANIZATIONS: A PRACTICAL GUIDE AND WORKBOOK 68–69 (1997).

58. *See* Taylor et al., *supra* note 1, at 61 (observing that not-for-profits often lack performance indicators "largely because the trustees and the staff have never determined what matters most"); CARVER, *supra* note 24, at 6 (noting that one of the profound differences between not-for-profit and for-profit sectors "is that most nonprofit[s] . . . lack a behavioral process to aggregate the many individual evaluations of product and cost. The organization is missing the foundation that would enable it to define success and failure, to know what is worth doing, and, in the largest sense, even to recognize good performance.").

59. *See* Salamon, *supra* note 2, at 431 (discussing the convergence of crises in the not-for-profit sector that have culminated in a crisis of accountability). *See generally* Nello McDaniel, *The Not-For-Profit Arts Experiment*, J. ARTS MGMT. & L., Summer 1990, at 41, 47.

not have the support and/or interest of the majority. John Gardner described the not-for-profit sector as

> the natural home of nonmajoritarian impulses, movements, and values . . . Institutions of the nonprofit sector are in a position to serve as the guardians of intellectual and artistic freedom. Both the commercial and political marketplaces are subject to leveling forces that may threaten standards of excellence. In the nonprofit sector, the fiercest champions of excellence may have their say.[60]

These organizations, formed to serve nonmajoritarian needs according to nonmajoritarian standards, are accorded legal legitimacy through incorporation. Furthermore, assuming the organization meets the requirements of Internal Revenue Service Code section 170(c), it receives an indirect subsidy for its activities because its donors receive tax deductions for their contributions.[61] Thus, our society formally embraces the diversity of initiatives that lead to the formation of the not-for-profit, recognizing that by serving the needs of a discrete minority, the not-for-profit is in turn promoting public welfare.

However, on the other hand, because the organization is receiving a federal subsidy in a democratic society (both indirectly through the tax system and often directly in the form of government grants), it is by definition subject to strong majoritarian pressures. The lay trustees represent the majoritarian interests, safeguarding the investment of the tax-paying public who indirectly subsidizes the not-for-profit sector through the payment of higher taxes to fund governmental subsidies in the form of tax exempt status to the institution, tax deductions to the donors, and direct grants to the institution.[62] Not surprisingly, as the law governing not-for-profit charitable corporations has evolved, particularly over the past fifty years, it has empowered the lay trustee with the right to protect majoritarian concerns through recourse to the legal system. Specifically, the courts have granted trustees standing to sue their not-for-profit organization (and/or their fellow trustees) for a perceived failure of the institution to continue to serve the public interest(s) for which it was chartered.[63] The trustee is generally the only person who has standing to bring such a suit independently of the state attorney general, who is officially charged with monitoring the not-for-profit sector in the interests of the public.[64]

---

60. John W. Gardner, *The Independent Sector, Foreword* to AMERICA'S VOLUNTARY SPIRIT ix, xiv (Brian O'Connell ed., 1983).

61. 26 U.S.C. § 170 (2000).

62. *See* James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 678 (1985) (arguing that "[n]onprofits may be exempt from taxation, but they should not be exempt from the responsibilities that go with such benefits").

63. *See* Holt v. Coll. of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964).

64. *See* BOWEN, *supra* note 52, at 12–13.

While it is entirely appropriate in a democratic society for the legal system to strongly protect the majoritarian interests when national government funding is involved, as it is with the 501(c)(3) organization,[65] society must also vigilantly protect the nonmajoritarian impulse that served as the genesis of the institution if the not-for-profit sector is to retain its legitimacy. The not-for-profit structure is the organizational means through which "Americans put into action their First Amendment rights to freedom of speech, freedom of religion, and freedom of assembly."[66] Yet, majoritarian pressures tend to silence those defining characteristics of an organization that are unique, diverse, and subsequently less readily accessible to the majority[67] and may promote institutional isomorphism as well as homogenization both within and between fields in the not-for-profit sector.[68] Limiting regulation of the not-for-profit sector exclusively

65. Defined by the Internal Revenue Code as "[C]orporations . . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals." 26 U.S.C. § 501(c)(3) (2000).

66. Hammack, *supra* note 24, at 131.

67. Discussing the impact of anti-elitism sentiments on the quality of American arts, Agnes de Milles commented that the

> American conscience became so imbued with the idea that what was not useful was no good. If it had no practical, utilitarian purpose, if you couldn't mend the roof with it, or stuff a chink with it, or patch a boot, or wear it on your back, or put it in the stew pot, or manure your fields, or physic your child with it, what use was it? It was effeminate; it was trivial; it was un-American.

Agnes de Milles, Remarks at the Conference on the Economic Impact of the Arts, Graduate School of Business and Public Administration, Cornell University (May 28, 1981); *see also* Michael Kimmelman, *Museums in a Quandary: Where Are the Ideals?*, N.Y. TIMES, Aug. 26, 2001, at §2, 1. Lamenting the current identity crisis which many museums are experiencing today, and attributing in part to an undue emphasis on majoritarian concerns at the expense of the professional, he comments:

> Museums are at a crossroads and need to decide which way they are going . . . . [B]eyond leisure and entertainment, our perception of a museum, and its moral value, still has to do with our desire for sacred space, even if we are reluctant to put it that way . . . . Otherwise, museums are just fancy storage facilities and gift shops . . . . It entails less equivocation, less democracy, less blurring of the line between commerce and content, and a reassertion of authority on the part of museums, which must restate their convictions about esoteric beauty, the ethical import of aesthetics and the special, if intangible, power of the things they possess.

Id.

68. *See* Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147 (1983) (discussing the general pressures towards institutional isomorphism within an organizational field). Such homogenization of product was already apparent in the not-for-profit theater industry in the 1960s when the field was less than a decade old. At the time, theater historian Julius Novick commented that "these theaters are becoming 'supermarketized;' they are too much alike; they tend to peddle standard merchandise in which they have no personal stake." JULIUS NOVICK, BEYOND BROADWAY: THE QUEST FOR PERMANENT THEATRES 21 (1968). See also ARTHUR BARTOW, THE DIRECTOR'S VOICE 284 (1988), quoting theater director Peter Sellers as saying:

> [T]he main shock is that the American people have gotten so used to predigested culture and to being told that there is one solution and one point of view for everything. We produce theatre that's based on not letting anyone disagree. The whole objective is to

to those who represent majoritarian interests (namely the attorneys general, the lay trustee and the mass media), "leads to demands that *every single* non-profit espouse values acceptable to the majority."[69]

At its core, the not-for-profit corporation is a business just like its for-profit counterpart. To be viable over the long-term, a corporation must establish a

---

make everyone in the entire audience laugh or cry at the same moment. That is professional theatre in America. It is a science.

Id. Following up on Sellers's theme, theater director John Hirsch argued that the not-for-profit theater is governed by "working atmospheres more suitable for turning out painting by numbers than theatre of the highest excellence." *Id.* at 172.

69. Hammack, *supra* note 24, at 136. Although not specifically referring to the not-for-profit sector, when de Tocqueville visited the United States in the nineteenth century, he recognized the profound sociological and aesthetic implications of a society governed by the majority. Accordingly, he asked,

> What do you expect from society and its government? . . . Do you wish to raise mankind to an elevated and generous view of the things of this world? . . . Do you hope to engender deep convictions and prepare the way for acts of profound devotion? Are you concerned with refining mores, elevating manners, and causing the arts to blossom? . . . If in your view that should be the main object of men in society, do not support democratic government; it surely will not lead you to that goal. But if . . . your object is not to create heroic virtues but rather tranquil habits . . . if in place of a brilliant society you are content to live in one that is prosperous . . . then it is good to make conditions equal and to establish a democratic government.

ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 226 (George Lawrence trans., J.P. Mayer & Max Lerner eds., 1966).

In the not-for-profit theater the notion of the "balanced season" as that term is commonly understood in the industry is a direct attempt to respond to perceived majoritarian interests. In the most basic terms, the balanced season is aimed at providing a little something for everyone in the seasonal slate of plays. However, as theater director and producer Tyrone Guthrie explained, "plays are chosen for production from all sorts of categories, because . . . they are 'good of their kind' . . . New plays of promise are 'balanced' by old plays of repute; nobody . . . know[s] what they are trying to achieve, nor what the hell is the score." TYRONE GUTHRIE, A NEW THEATRE 38 (1963). In trying to become everything to everyone, the theater becomes nothing at all. It loses its relevance and reason for existence in the first place. *See* NELLO MCDANIEL & GEORGE THORN, THE WORKPAPERS: A SPECIAL REPORT—THE QUIET CRISIS IN THE ARTS 12–25 (1991) (discussing the inherent fallacy in not-for-profit theaters attempting to chase majoritarian concerns); ROBERT BRUSTEIN, REIMAGINING AMERICAN THEATRE 265 (1991) (quoting McNeil Lowry, former head of the Ford Foundation, issuing a warning to the not-for-profit arts in 1976 that "[i]t is easier to popularize the arts away than to repress them"). Recognizing the central role that the professional must play in leading the not-for-profit arts institution in order for the not-for-profit to continue to produce work of integrity in service of its mission, Lincoln Kirstein, co-founder of the New York City Ballet, commented, that in the arts:

> Elite is a word to be fought for . . . . [T]he term 'esoteric' once meant what was known only to a select and worthy few, unavailable to the commonality. Most specialists deal in esoterics—neurologists, astronauts, mining engineers, astronomers. Their specialties deal in fact rather than fancy or fantasy, and constitute them as an elite. But the esoterics of the artist are no less special, apart, difficult, and demanding of legitimacy.

Lincoln Kirstein, *The Performing Arts and Our Egregious Elite*, *in* THE PERFORMING ARTS AND AMERICAN SOCIETY 196 (W. McNeil Lowry ed., 1978). Lamenting the popularization of the arts at the expense of the professional and the ensuing lack of distinctive visions and purpose in not-for-profit theaters across the country, theater director Adrian Hall commented, "we are the American theater now . . . [b]ut what we failed to do entirely was impress on anybody that we [the artists] belong at the artistic center." Hilary de Vries, *New Paths for Regional Theaters*, N.Y. TIMES, Sept. 3, 1989, at §2, 1.

competitive advantage either through cost leadership or product differentiation.[70] Most not-for-profits must secure their competitive advantage through differentiation. As Professor Henry Hansmann argues, the not-for-profit corporate form, theoretically, should only be the organizational structure of choice when there is a severe contract or market failure that can best be addressed through the nondistribution constraint of the charitable organization.[71] For example, the not-for-profit organizational structure can be attractive to a business that has consumers willing to pay higher prices for quality service, but who refuse to do so in a for-profit setting, fearing that the higher prices will not significantly increase the quality of the service but instead enrich the shareholders. Such customers should theoretically be willing to pay the higher price in a not-for-profit setting where profits are required by law to be reinvested in the organization.[72] It follows then that the not-for-profit's competitive advantage generally does not lie in the production of inexpensive goods and services that outbid those offered by the for-profit sector, but rather in the production of

70. *See generally* PORTER, *supra* note 55, at 11–12.

71. *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 504–09 (1981) (discussing the unique functions served by the not-for-profit organizational structure); *see also Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1584–85 (1992) (stressing that the not-for-profit structure is nothing more than a "private organizational structure" that will be selected as the business form of choice only when the unique functions served by the not-for-profit structure as identified by Hansmann are strategically advantageous to the particular business). However, it is important to recognize that while Hansmann's theories might be theoretically persuasive, in reality the not-for-profit form may be chosen less out of economic considerations and more because of an idealized notion about what the not-for-profit sector represents in our society. For example, the not-for-profit theater movement, which had its origins in the 1950s and early 1960s, adopted the not-for-profit organizational structure largely as a statement about the central role that arts must play in society, namely art produced for art's sake, not dictated by market concerns. The choice was made to incorporate as a not-for-profit not because of some perceived long-term economic advantage (the founders were living in the moment, unsure whether their theaters would even survive short-term), but out of a naïve assumption that the not-for-profit form would somehow shield the artists and their theaters from business concerns altogether. The not-for-profit structure was embraced as a way of signaling "that theater should stop serving the function of making money and be restored as a form of art." William MacDougall & Ron Scherer, *Staging a Revolution in American Theater*, U.S. NEWS & WORLD REP., June 11, 1984, at 74 (quoting Zelda Fichandler, one of the leaders of the regional theater movement and founder of Arena Stage in Washington D.C., explaining why the not-for-profit structure was adopted by the fledgling theater movement); *see also* Fishman, *supra* note 62, at 667 (arguing that for many, the choice of the not-for-profit corporate form runs no deeper than a desire to solicit charitable contributions and a recognition that the not-for-profit corporate structure is the organization that is likely to best facilitate that process).

72. For an analysis of how the theory of voluntary price discrimination can be applied to the not-for-profit performing arts, see Henry Hansmann, *Nonprofit Enterprise in the Performing Arts*, 12 BELL J. ECON. 341, 343–45 (1981). Hansmann argues that the not-for-profit performing arts industry is able to remain financially viable in part because of its ability to "charge" prices higher than the market will bear by soliciting additional funds from its wealthier patrons to supplement the actual ticket price the patron pays to attend the performance. *See also* Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393, 399–400 (discussing the performing arts as an example of a collective good).

products that serve the unique needs of a discrete, often nonmajoritarian segment of the population.

Therefore, the long-term viability of any not-for-profit organization depends on the recognition of a competitive advantage that results from a strategic blending of both majoritarian and nonmajoritarian influences. The vitality of the not-for-profit sector would thus seem to largely depend upon a dialogue in the boardroom based upon mutual respect between the lay trustee and the professional staff to successfully integrate the majoritarian and nonmajoritarian interests at the center of any not-for-profit organization. Yet nonprofit corporate law, which currently limits standing to enforce a breach of fiduciary duties to majoritarian representatives, ignores one of the parties necessary for that dialogue, thereby fostering institutional isomorphism and the homogenization of services that undermines the not-for-profit's competitive advantage and ultimately renders it irrelevant.[73] Furthermore, there are distinct skill sets, perspectives, and procedures involved in effectively monitoring each of the three distinct fiduciary duties[74] recognized by not-for-profit corporate law. And yet, the courts have taken a cookie-cutter approach to the oversight and enforcement of each of these duties. The long-term health of the not-for-profit sector demands a more nuanced approach to fiduciary oversight, and ultimately, nonprofit law may prove unsuccessful in achieving this critical objective.

In Part V this Comment examines the not-for-profit trustee's fiduciary duties, and in Part VI it explores who currently has, and who possibly should have, standing to enforce them. It concludes that instead of being eliminated or collapsed under the umbrella of the duty of care, the duty of obedience should be more clearly delineated as one of the three fiduciary duties to which the not-for-profit corporate board is held, thereby sending an important message to the sector that fidelity to the institutional mission is critical. However, as analyzed in Part VII, it would ultimately be counterproductive to expand standing to sue the corporation for breach of the duty of obedience to the not-for-profit executive, although the argument is initially appealing as a means of redistributing power in the boardroom.[75] Clearly the executive, as both the professional and holder of inside performance information, is singularly positioned to assess institutional compliance with the mission. But empowering the executive to sue in his unique capacity as an executive would

73. *See generally* PORTER, *supra* note 55, at 12.

74. The not-for-profit director is held to three different fiduciary duties. First, the duty of care requires a certain level of diligence regarding institutional activities and decisionmaking; second, the duty of loyalty sets parameters on self-dealing; and third, the duty of obedience mandates compliance with the institutional mission. *See* KURTZ, *supra* note 4, at 22–90.

75. *See generally* Gulati et al., *supra* note 30, at 897 (discussing the allocation of power as a fundamental element in any business endeavor).

undermine trust in the boardroom that is essential to promote effective and meaningful communication between the institutional leaders and to facilitate a strategic and delicate interweaving of both the majoritarian and nonmajoritarian concerns upon which the success of the not-for-profit industry depends.[76] Consequently, as will be discussed in Part VIII, internal behavioral norms must be fostered within the boardroom in order to bridge the gap created by recognizing a legal duty of obedience without a significant corresponding legal sanction.

IV. THE FUNCTIONS AND RESPONSIBILITIES OF THE NOT-FOR-PROFIT BOARD AND THE TANGO BETWEEN THE LAY TRUSTEE AND THE EXECUTIVE

Before examining the board's fiduciary duties, it is important to understand who the lay trustee is, how the board's functions have been traditionally conceived, and what the ultimate purpose(s) of the not-for-profit board are in a democratic society. As noted arts management consultant Nello McDaniel opines, "while few arts professionals have ever seen a truly successful board, everyone knows what one looks like."[77] A flourishing industry has arisen, fueled by the efforts of consultants, practioners, and academics, providing "how-to" advice on not-for-profit governance. Countless books and articles have been written over the past twenty years on the ideal size, composition, committee structure, and function of the perfect board, and yet board performance often continues to fall "far below the promise."[78] The source of this problem is not the tremendous diversity of approaches endorsed as the means of achieving a "successful" board because any attempt at uniformity would be doomed to fail in such an eclectic sector of the economy.[79] However, disagreements over the *function* of the not-for-profit board must be examined more carefully; if it is not clear what purpose(s) the board is serving, there is no basis for trust between the institutional players, nor can an accurate assessment be made with regard to board composition. Is the board's primary responsibility to determine policy? To implement policy? To monitor management and ensure that the public's resources are protected from lazy and/or self-interested managers? Or is it there primarily to lay claim to the funding resources necessary to fulfill the functions of

76. In reformulating the principles of nonprofit accountability, we must "reconcile [the] diversity and freedom of belief [at the core of the not-for-profit sector] with some form of majority rule." Hammack, *supra* note 24, at 137; *see also* ROBINSON, *supra* note 22, at 9 (noting that "[t]here is a delicate balance to achieve between the legitimacy conferred through legal mechanisms . . . and the freedom to pursue an independent agenda that inspires public support and trust").

77. McDaniel, *supra* note 59, at 41.

78. *Id.*

79. As Nello McDaniel warns, "[a]nything that seems as simple as the not-for-profit board but that is surrounded by so much debate must, in fact, be very complex." *Id.* at 42.

the not-for-profit? Arguably, it is some combination of all of these,[80] which raises interesting questions regarding the presence of inside directors on the board to complement the lay trustee.[81] For now, I turn to less controversial subjects and outline the generally accepted functions of the traditional not-for-profit board.

The responsibilities of the board include the following ten monitoring and managerial functions:

1. establishing and overseeing the organization's policies and ensuring effective organizational planning;
2. monitoring the conduct of the staff to ensure that the business is being properly managed;
3. reviewing the organization's finances, including approving the annual budget and monitoring financial projections throughout the year, and implementing fiscal controls to ensure that organizational resources are expended only to further organizational activities;
4. defining, modifying, and communicating the organization's mission, and monitoring and evaluating organizational programs to determine which are most consistent with the mission on an ongoing basis;
5. hiring and firing the chief executive(s) and establishing appropriate compensation for the executive leadership;
6. securing the resources necessary to enable the organization to fulfill its mission;
7. serving as an advocate for the organization in the larger community;
8. ensuring compliance with any rules or standards prescribed by law, required by an independent accreditation agency, or assigned by the organization's bylaws and articles of incorporation;
9. recruiting new board members and evaluating the performance of their fellow trustees on an ongoing basis; and
10. establishing procedures to ensure that each board member understands and complies with his duties as a board member.[82]

---

80. The board-staff relationship is often summarized in the following two slogans: (1) The board governs and the staff manages; and (2) the board makes policy and the staff administers it. *See* ROBINSON, *supra* note 22, at 112. As simple as these slogans are, they are powerful normative standards that inform the dialogue in not-for-profit boardrooms across the country. Unfortunately, this conception of the board-staff relationship is dangerously disconnected from the realities of managing these complex entities, crippling the leadership's efficacy in continually and strategically repositioning the institution to ensure its long-term viability. Accordingly, Brian O'Connell comments that "[t]he worst illusion ever perpetrated in the nonprofit field is that the board of directors makes policy and the staff carries it out." BRIAN O' CONNELL, THE BOARD MEMBER'S BOOK: MAKING A DIFFERENCE IN VOLUNTARY ORGANIZATIONS 44 (1985).

81. *See* discussion *infra* Part VIII.

82. Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for the Conduct of Not-for-Profit Directors*, 33 J. HEALTH L. 455, 458 (2000); NAT'L CTR. FOR NONPROFIT BOARDS, WHAT ARE THE BASIC RESPONSIBILITIES OF NONPROFIT BOARDS?, http://www.ncnb.org/fullanswer.asp?id=102; *see* BOWEN, *supra* note 52, at 18–20.

Effectively fulfilling any one of these responsibilities can be extremely difficult when the board, despite the best intentions of its members, is not equipped with the requisite tools for success.[83] Historically, it was easier to mask or at least overlook the failings of the lay board. Boards generally invested the majority of their energies in raising funds, and as long as the organizations continued to grow and budgets balanced, few questions were asked and even fewer demands were placed on the board.[84] As funding became tighter in the 1980s, the relationship between the board and the executives began to change.[85] Agency costs, and thus, the monitoring functions of the board, assumed increasing importance in not-for-profit governance, paralleling a similar trend in the for-profit sector.[86] As discussed above, the primary tasks of the monitoring board consist of executive staffing issues and the oversight of financial reporting, auditing, and disclosure to ensure that the executive is performing effectively and in the best interests of the organization.[87] In the not-for-profit context, the monitoring function is generally vested in the lay trustee who is charged with safeguarding the community's investment in the organization. As Nello McDaniel argues, the not-for-profit board thus serves an important role in addressing the deeply held American belief that while supporting organizations that enhance the quality of life is a good thing, "no individual is trustworthy enough to separate personal ambition and economic motive . . . sufficiently enough to be worthy of that support."[88]

However, such a simplistic conceptualization conflicts with the complex and highly competitive environment in which the mature not-for-profit generally operates. A board focused aggressively on its monitoring functions fosters a dichotomous "them and us" mentality and undermines the board's

83. For the purposes of this discussion, I am focusing only on those board members who are actively engaged with the organization and its mission and are serving on the board primarily to advance the interests of the not-for-profit. Many boards, however, have at least some trustees that do not live up to this standard. As Brann Wry notes, "[t]oo often, voluntary governance work is viewed as a nonbusiness activity, a spare-time pursuit that does not come to the level of gravity or immediacy attributed to one's livelihood activity." Brann J. Wry, *The Trustee: The Ultimate Volunteer*, J. ARTS MGMT. & L., Summer 1990, at 11, 14. David Shenk echoes this observation, opining "[w]hile real jobs are generally doled out one-per-customer, nonprofit board seats are coveted honorifics snapped up by the half dozen . . . . It's fascinating to note how some of the most inspiring and reputable leaders by day in this country turn out to be world-class lemmings during nonprofit play time." David Shenk, *Board Stiffs: How William Gates and Paul Tagliabue Helped William Aramony Bilk America*, WASH. MONTHLY, May 1992, at 9, 11–12.

84. *See* McDaniel, *supra* note 59, at 48 (discussing the willingness of the founding artists of the not-for-profit theater movement to give "authority and control of their organizations to community volunteers in order to obtain the financial and human resources necessary to do their work").

85. *Id.* at 49.

86. *See* discussion *supra* Part V.

87. *See* Langevoort, *supra* note 8, at 802.

88. McDaniel, *supra* note 59, at 46. For a discussion of how the board's monitoring function, taken to an extreme, contributes to a unproductive board mythology, see Thorn, *supra* note 26, at 55.

effectiveness not only in performing its vital managerial functions, but paradoxically diminishes its monitoring capabilities as well. Professor Donald Langevoort posits that rigorous independence can unintentionally reduce the level of trust in the boardroom, chilling communication between the director and the staff; subsequently leading to the staff withholding critical information from the board and thus ultimately "interfer[ing] with the board as a productive team in all its capacities, including monitoring."[89] Clearly, if they are to most effectively support the institutional mission to which they are both committed, the lay trustee and executive must be partners with the work of one informing the work of the other.[90] This is even more true today as "[t]he specialized nature of the services provided by nonprofits, as well as intensified competition for funding, contracts, and clientage[ ] has raised the level of expertise [and sophistication] needed by trustees."[91] The lay trustee is increasingly dependent on the professional for information and evaluation of institutional performance, while the staff is increasingly reliant on the lay trustee to perform as a strategic advocate for the organization.

Notwithstanding the fact that the organization's ability to successfully fulfill its mission over the long-term depends on the synergy between the lay trustee and the staff, "[t]he relationship between the executive director and the board is one of the most complex and perplexing relationships in the nonprofit sector."[92] Questions of "[w]ho is in charge? Who does what? Who gets to lead and who gets to follow?"[93] can quickly degenerate into a debilitating power struggle for institutional control despite the best intentions of the parties involved, as exemplified by the situation at Long Wharf, culminating in an unproductive struggle for "the power to determine how inputs are used in the organization and what objectives are pursued."[94] As William Bowen observes,

---

89. Langevoort, *supra* note 8, at 800.

90. The interdependence between the professional and the lay trustee is readily apparent in the not-for-profit theater sector. On the one hand the lay trustee "commits himself to keeping the mission of the endeavor alive and relevant to current societal needs . . . [and yet the] embodiment of [the] mission is . . . in the artistic work of the organization." Wry, *supra* note 83, at 12–14.

91. HALL, *supra* note 25, at 137.

92. ROBINSON, *supra* note 22, at 111.

93. *Id.* Reflecting the uncertainty of roles in the not-for-profit sector, John Dillon wondered about his role as the incoming artistic director (CEO) versus that of the board with regards to defining the work of the institution:

> What, in short, are the inheritors inheriting? Do we inherit a corporate name, an empty building, a group of artists, a tradition? Are we being asked to remodel or just rearrange the furniture? And if we take too long trying to figure out if the new sofa should go by the window or the door, will we find ourselves out on the street?

John Dillon, *How a Theatre Means*, *in* 7 THEATRE PROFILES 49 (Laura Ross & John Istel eds., 1986).

94. Ben-Ner & Hoomissen, *supra* note 72, at 395 (arguing that the right of control is the paramount right of ownership); *see also* HALL, *supra* note 25, at 96, observing that the definitive

"even some of those most intimately involved with . . . nonprofit organizations have only a dim sense of where power resides, how it is distributed and exercised, and how it is limited and controlled."[95]

While the tensions between the lay trustee and the executive staff have become increasingly strained with the rapid rise in the professionalization of the not-for-profit sector over the past twenty years,[96] the struggle for control of the not-for-profit between the professional and the lay trustee dates back to the origins of the not-for-profit corporation in this country. One of the key turning points in determining the character of nonprofit corporate governance occurred in the 1860s during the struggle for control over Yale University between the business community (alumni), the professionals who taught at Yale, and the ministers who had previously led the institution.[97] At issue were critical questions: Who should control the not-for-profit charitable corporation, who could demand a voice in its governance, who was the public they served, and how did that public express itself? Political economist Thorstein Veblen was an outspoken participant in the debate. He argued vigorously against the empowerment of the lay trustee in nonprofit governance at the expense of the professional. Veblen was deeply concerned by the implications of a lay board assuming fiduciary responsibility for institutional budgets, realizing that by controlling the purse strings the lay board could define the work of the not-for-profit organization without regard to the professionals who were the experts in the field. Accordingly, he commented that boards comprised of businessmen "are of no material use in any connection; their sole effectual function

---

transforming event in terms of institutional development is generally the introduction of the professional manager and the ensuing power struggle with the board for the control over

> the definition and implementation of organizational goals . . . [with] the prevalence of such conflicts suggest[ing] a significant and largely unnoticed struggle for institutional control, which in terms of the debate over diversity in the nonprofit sector, may be of considerable significance . . . [Prior to the introduction of the professional] [t]he activities of the organization, whether of good, bad, or middling quality, were really of concern to no one else [but the board of directors]. The addition of professional management greatly increased the complexity of the organization.

Id.

95. BOWEN, *supra* note 52, at x.

96. The mounting tensions have primarily been driven by increased competition for limited funds as well as heightened management accountability standards demanded by government and other institutional funders. *See* J. Steven Ott, *Economic and Political Theories of the Nonprofit Sector*, *in* THE NATURE OF THE NONPROFIT SECTOR, *supra* note 2, at 179, 180 (discussing how shifts in funding experienced by many not-for-profits in the 1980s and 1990s led them to aggressively pursue alternative entrepreneurial revenue streams); DIANE J. DUCA, NONPROFIT BOARDS: ROLES, RESPONSIBILITIES, AND PERFORMANCE 138–39 (1996) (examining the rise of professionalism in the not-for-profit sector and its impact).

97. *See* PETER DOBKIN HALL, A HISTORY OF NONPROFIT BOARDS IN THE UNITED STATES 12–14 (1997) for an overview of the power struggle at Yale University in the 1860s that laid the foundation for the modern structure of lay governance in the not-for-profit sector.

being to interfere with the academic management in matters that are not of the nature of business, and that lie outside their competence and outside the range of their habitual interest . . . ."[98]

Notwithstanding Veblen's concerns, the lay model of governance won the battle at Yale and became the paradigm of nonprofit governance in this country.[99] Its advocates argued that it removed control from elitist guilds of professionals out of touch with the general public and placed authority instead with the disinterested layperson.[100] As Hall observes, the transformation in governance that took place at Yale in the mid 1800s "can be seen as an effort to create a new kind of public accountability—accountability not to the public as represented by government or by professional authority, but to the public as represented by the most economically successful."[101] Yet the concerns that Veblen raised have yet to be adequately addressed, with the unresolved tension between the lay trustee and the professional threatening to undermine the relevance of the not-for-profit sector just as Veblen predicted.

As Peter Hall correctly identifies, the palpable tension between the board and the professional is ultimately "the question of who is best fit to act as steward for the public interest—and, indeed, what the public interest (or the public) is."[102] Yet over the past several decades as not-for-profits have developed into complex, sophisticated businesses, often operating alongside for-profit institutions, neither the lay trustee nor the professional staff can do without the other. The breadth of knowledge and specialized skills needed in the boardroom to make informed strategic business decisions on an ongoing basis demands a careful blending of their unique competencies and perspectives to most effectively serve the institution.

The lay trustee, likely lacking a sophisticated understanding of the particular business, will tend to have a generalist approach that may miss important nuances inherent to operating in highly structured, technical and/or esoteric fields. Without the requisite skill sets for comprehensive qualitative assessment, the lay trustee is likely to focus on quantitative evaluation measures that will be

98. THORSTEIN VEBLEN, THE HIGHER LEARNING IN AMERICA 48 (Transaction Pub. 1993) (1918).

99. *See* HALL, *supra* note 97, at 13–14. From 1860 to 1900, the presence of businessmen, bankers, and lawyers on university boards increased from 49 percent to 65 percent while the presence of academics increased from only 5 percent to 8 percent. *Id.* at 14. Furthermore, not only did they dominate the boards of the major not-for-profits by the turn of the century, but by establishing grantmaking foundations, the business community also "had created powerful instruments for shaping the priorities and policies of a wide range of cultural institutions." *Id.*

100. *Id.*

101. *Id.*

102. HALL, *supra* note 24, at 139. Hall explains that boards and professionals often clash in their interpretation of organizational mission and how best to serve it, and this divide is often accentuated by differences in social background and professional training. *See id.* at 210.

familiar from the for-profit sector.[103] Quantifiable data provides a sense of security and reassurance, albeit false, in a sector where the criteria for success can seem amorphous and unknowable, shifting from moment to moment and from stakeholder to stakeholder.[104] Not surprisingly, the not-for-profit board often becomes mired in micromanaging the minutia of budgetary detail, demanding that every dollar spent has a return on investment in terms of increased sales and/or contributions.[105] The temptation of board members to engage in nickel and dime analysis of multimillion dollar budgets and to get lost in the fine points of marketing campaigns is understandable given that these are areas that speak to their experience and where they know they can successfully deploy their talents. Yet by so doing, the board can create a governance vacuum.[106] Ultimately all the data in the world is useless to a board's attempt to measure institutional effectiveness if it does not know the right questions to ask and is not equipped with the requisite skills to understand the answers.[107] As

103. Donald Langevoort argues that this tendency of outside directors to rely on "heuristic forms of thought tied to readily observable data" is problematic in the for-profit boardroom as well when the outside directors "lack detailed knowledge of the firm's inner workings." Langevoort, *supra* note 8, at 807.

104. *See* Brody, *supra* note 24, at 443 (arguing that with the quest to quantify goals and results, or "scientific philanthropy," the inquiry into organizational effectiveness becomes strictly objective, thereby transforming the measures by which the not-for-profit evaluates its success). Laura Chisholm warns of the danger in applying a purely objective standard to evaluations of the not-for-profit's performance. Accordingly, she comments that "[a]s more is quantified and reported, it is tempting to rely on the hard data, on what *can* easily be quantified, as the basis of rules and standards, without testing whether such an approach oversimplifies or has solid theoretical or policy underpinnings." Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 NONPROFIT MGMT. & LEADERSHIP 141, 154 (1995). For a discussion of the impact that this quest for purely objective performance indicators has had on the not-for-profit theater, see BRADLEY MORRISON & JULIE GORDON DALGLEISH, WAITING IN THE WINGS: A LARGER AUDIENCE FOR THE ARTS AND HOW TO DEVELOP IT (1987). Documenting the transformation of the not-for-profit theater movement from one that was artist driven to one that was defined primarily by its ability to perform objective public service outreach goals, Morrison and Dalgleish comment that now,

> [b]efore checks could be issued, the new patrons needed reason and logic, facts and figures, and strong proof of practical results. They asked that magic be described in proposals, that dreams be fit into boxes on forms. Visions had to be Xeroxable . . . The arts were being politicized through a process by which the new bureaucrat-patron sensitized the artists . . . to the needs and demands of a broader, less personal and more pragmatic constituency.

Id. at 16.

105. *See* DUCA, *supra* note 96, at 12–13 (discussing the phenomenon of not-for-profit boards acting more like managers than trustees).

106. *See id.* at 13 (discussing both the vacuum in governance and the inherent tension between the board and the executive when the board attempts to operate as managers); *see also* Bernard Holland, *How to Kill Orchestras*, N.Y. TIMES, June 29, 2003, at §2, 1 (observing not-for-profit "[s]ymphony boards tend toward successful business people admirably devoted to keeping orchestras fiscally afloat but who, with little knowledge of music or real interest in it, have no capacity to fix a purpose or a path").

107. *See* Nancy R. Axelrod, *Board Leadership and Board Development*, *in* THE JOSSEY-BASS HANDBOOK OF NONPROFIT LEADERSHIP AND MANAGEMENT 123 (Robert D. Herman ed., 1994) (discussing general questions the board should ask to assess institutional performance).

Ronald Fry warns, as data becomes increasingly quantifiable given advances in technology:

> [T]he ability to access, manipulate, and analyze information will far out distance our ability to make sense of that information in ways that can guide or sustain collective effort . . . [and] without truly shared understandings of what information means among those who are accountable for an organization's promises, the likelihood of success is small.[108]

Line items are being carefully scrutinized, but the public purpose for which the institution was founded may be lost. Certainly zero-based budgeting, rigorous financial controls, and bottom line analysis must play a critical role in not-for-profit management.[109] But, if the not-for-profit's institutional mission is deemed satisfied solely by the pursuit of sound financial objectives, the mission becomes reduced to one of survival and nothing more. The end game becomes survival at all costs.[110] And the most significant cost of all is often the sacrifice of the public purpose for which the institution was initially founded.

---

108. Fry, *supra* note 52, at 192–93.

109. Zero-based budgeting is an important management tool in the not-for-profit sector to the extent that all budgetary assumptions should be reviewed and challenged when creating the annual budget, if for no other reason than that the not-for-profit is generally underfinanced and must therefore account for every dollar it is spending somewhere at the expense of something else. Zero-based budgeting does not mean, however, that each budget line item should be evaluated strictly in terms of potential financial return on expenditures, as measured either through sales or grant income. In other words, the inquiry cannot simply be an objective one, but must ultimately be informed by the institutional mission.

110. The survival instinct of the not-for-profit corporation is often exasperated by the construct of the self-perpetuating board of directors, an institutional reality of most not-for-profit corporations. *See* BOWEN, *supra* note 52, at 13. Bowen has argued that this survival instinct might become so powerful and pervasive that it could have a debilitating and corrupting effect on the entire not-for-profit industry. *Id.* at 148. Accordingly, Bowen considers the issue of when and how to dissolve a not-for-profit that has ceased to serve its public purpose a policy issue of "great significance." *Id.* at 15. The failure of the first not-for-profit theater movement of the twentieth century provides a salient illustration of the devastating impact that the survival instinct can have on the not-for-profit. Confronted by a theater movement comprised of theaters that no longer were producing relevant work that resonated with their institutional missions, theater historian Oliver Sayler wrote, "Whereas the original Little Theatres were little not simply because funds were scant but rather from a deliberate restriction of auditorium for the sake of intimacy and aloofness, the Little Theatres of today are little simply because they are not yet big." OLIVER M. SAYLER, OUR AMERICAN THEATRE 118 (1923). The theaters became more concerned with survival, as equated with growth, than with fulfilling their institutional missions. Less than ten years after Sayler's comments, most of the Little Theaters had become irrelevant to their communities, and, no longer viable, were forced to shut their doors. BEN BLAKE, THE AWAKENING OF THE AMERICAN THEATRE 7 (1935). Arguably, if the dynamics by which a not-for-profit's mission was defined and monitored were altered so that institutional competence could not be so readily reduced to terms of financial performance, specifically by legally recognizing the role of the professional in institutional assessment, the institutional inertia within the not-for-profit sector that Bowen is seeking to address could be minimized.

By contrast, not-for-profit executives have often spent years of training in the field achieving "a special authority [within the institution] that arises from their professionalism. In such cases, they are schooled and experienced in the use of complex bodies of knowledge that give them a competence possessed only by those who have had a similar kind of preparation."[111] In addition, they are part of a larger community with the requisite perspective to measure institutional success in terms of the national benchmarks that may be part of the institutional mission.[112] However, too much of a good thing can quickly become a liability.[113] The rise of professionalism has certainly not been without its problems for the not-for-profit. Professionals can become so myopically focused on producing certain services and programs that they wholly disregard matters of efficiency and effectiveness critical for the institution's long-term survival.[114] As a result of their special expertise and training they can develop a "tenacious attachment to what they know—they are less likely to want to 'put on the corporate hat' or even to look to the interests of the community that they serve, [or] set[ ] aside their personal interests . . . than their predecessors might have been."[115] Despite their best intentions, professionals who fail to recognize the community's perspective risk hijacking the not-for-profit to serve the needs of a highly insular group of specialists—thereby undermining the base of community support necessary for its ultimate survival.[116] Furthermore, by defining and measuring success in

111. CYRIL O. HOULE, GOVERNING BOARDS: THEIR NATURE AND NURTURE 10 (1989); *cf. Ownership and Control*, *supra* note 35, at 314 (noting that in the context of for-profit governance, "it is natural that [the board's] most influential members are internal managers since they have valuable specific information about the organization's activities").

112. *See* BOWEN, *supra* note 52, at 112; HALL, *supra* note 25, at 96; *see also* sources cited *supra* note 51, for some examples of not-for-profit mission statements. Each of these theaters defines its mission on a broader scale than simply serving the immediate community in which they are located, instead they look to national and international indicators as benchmarks for success.

113. For a brief overview of the critique against the professionalism of the not-for-profit sector since the Great Society, see Salamon, *supra* note 2, at 427. *See also* BOWEN, *supra* note 52, at 140 (observing that "the professional staff may be so conscious of the unique qualities of their institution, and so sensitive to their own obligations to be the guardians of its uniqueness, that . . . they will patronize or even dismiss the 'unwashed' executive"). For a critique of the impact that the professional has had on the American university see MARTIN ANDERSON, IMPOSTORS IN THE TEMPLE (1992).

114. *See* DUCA, *supra* note 96, at 139 (discussing the negative impact that professionalism has had on the not-for-profit).

115. HALL, *supra* note 25, at 265.

116. A fascinating case study in the tension between a local versus a national outlook and the importance of maintaining a balance between the two is the Actor's Workshop in San Francisco, which closed its doors in 1966 after only fourteen years (as compared with many of its contemporaries which continue to operate today). The Workshop neglected its local community and focused exclusively on building a national reputation. In its short life, the Workshop earned a prominent place in American theater history, playing a critical role in shaping the future of the American theater. However, despite its national and international success, the Workshop was ultimately dependent on the local community,

terms of comparisons to similar institutions, the professional can also contribute to institutional isomorphism and homogenization of product, ironically resulting in the same end game as an overemphasis on majoritarian concerns. For, by losing sight of the unique needs of its immediate community, the not-for-profit's ability to distinguish itself on a national level will likely be diminished accordingly.[117]

Consequently, "[l]ike the tango, the relationship between the executive director and the board requires a strong sense of balance, a high degree of trust, a willingness to follow as well as lead, and an ability to communicate clearly, sometimes subtly, throughout the course of the dance."[118] But, the problem of how to appropriately distribute power between the professional and the lay board so that they tango effectively has yet to be resolved.[119] Certainly the board must retain ultimate power,[120] including the prerogative to dismiss the executive as it sees fit. That being said, the professional must be empowered to play a strong leadership role in defining what the institution

---

which it had aggressively shunned, for its funding. At the end of the day, that community did not feel the Workshop belonged to them and thus were not willing to give it the financial support it needed in order to survive. And so one of the few theaters in this country to achieve international renown folded due to the neglect of the key constituents in its own backyard. For a brief history of the Actor's Workshop see NOVICK, *supra* note 68, at 84–90.

117. *See* DiMaggio & Powell, *supra* note 68, at 148–52.

> Once disparate organizations in the same line of business are structured into an actual field . . . powerful forces emerge that lead them to become more similar to one another. . . . Two aspects of professionalization are important sources of isomorphism. . . . Universities and professional training institutions are important centers for the development of organizational norms among professional managers and their staff. Professional and tra[d]e associations are another vehicle for the definition and promulgation of normative rules about organizational and professional behavior. Such mechanisms create a pool of almost interchangeable individuals who occupy similar positions across a range of organizations and possess a similarity of orientation and disposition that may override variations in tradition and control that might otherwise shape organizational behavior.

Id. (citation omitted). For example, in the not-for-profit theater industry, the formation of the national service organization Theatre Communications Group (TCG) in 1961 has, at least to some extent, had a profound effect on structuring the organizational field and encouraging institutional isomorphism. One of TCG's first acts was to hire marketing guru Danny Newman to visit all of the fledgling theaters and implement a unified subscription marketing campaign at each. Clearly TCG was providing a valuable information service to the young field, but it came at a high price: the potential loss of individual organizational identity as each theater redefined success in terms of how well it measured up to national organizational norms, which in this case were defined by the size of a theater's subscription base—regardless of what size base might actually be appropriate given the theater's individual mission.

118. ROBINSON, *supra* note 22, at 111.

119. *See generally* McDaniel, *supra* note 59, at 50 (acknowledging that the not-for-profit theater continues to struggle with forging a "true partnership of artists, audience, and community" in a way that "satisf[ies] society's need for artists and the artists' needs for creative expression without threatening basic values, beliefs, and societal stability.").

120. *See* HOULE, *supra* note 111, at 11 (arguing that at all times the board must retain ultimate power while the executive has to retain immediate power).

is and can be, drawing on his wealth of experience within the field. Should the law have a role to play in distributing power between these institutional leaders in the not-for-profit boardroom? Specifically, by strengthening the fiduciary duties and demanding greater accountability from the not-for-profit director, can the law productively animate the dynamic relationship between the lay trustee and the professional staff?

V. LEGAL ACCOUNTABILITY: THE NOT-FOR-PROFIT DIRECTOR'S FIDUCIARY DUTIES

During the last decade it has become highly fashionable, both in the popular media as well as in academic circles, to lament the crisis of accountability in the not-for-profit sector. Part of this increased attention has been spurred by the sector's impressive growth in the last thirty years. Since 1970, it has grown at a rate of four times the rest of the economy[121] and currently employs approximately 10.5 percent of the employed population.[122] Prior to this development, little attention had been paid to the law governing not-for-profits, and in particular (1) whether the not-for-profit corporate trustee should be held to a trust standard, a corporate standard, or some other standard in fulfilling his fiduciary duties, and (2) who should have standing to sue the not-for-profit to enforce those fiduciary duties. In the 1990s these issues were pushed to the forefront by several public scandals at renowned not-for-profit organizations.[123] These scandals triggered a

121. GILBERT M. GAUL & NEILL A. BOROWSKI, FREE RIDE 2–3 (1993).

122. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 14 (1995). The rapid growth of the not-for-profit sector was at least partially driven by efforts in the 1980s under the Reagan and Bush administrations to privatize public services, including contracting them out to not-for-profits. *See* HALL, *supra* note 25, at 80. While the sector has grown significantly during the latter part of the twentieth century in terms of numbers of organizations, it is important to realize that from the inception of the United States, the not-for-profit organization has played a vital role in providing public goods. Notably, the American government has consistently defined a public good much more narrowly than its European counterparts, relying in part on not-for-profit organizations to pick up where the government leaves off. *See* Hammack, *supra* note 24, at 128–29 (noting that U.S. federal expenditures have remained below 30 percent of gross national product compared with 50 percent or greater in much of Western Europe).

123. Some of the more notorious not-for-profit scandals of the 1990s include: (1) The United Cancer Council's use of a professional fundraising company to conduct a sweepstakes campaign that resulted in the fundraising company pocketing 93 percent of the over $18 million raised; (2) the indictment and eventual criminal conviction of Bill Aramony, former president of the United Way, on charges of conspiracy, mail and wire fraud, filing false income tax returns and dealing in stolen property all while president of the United Way; (3) the Points of Light Foundation's alleged expenditure of approximately 90 percent of its government-funded budget on administration and promotion, leaving very little to fund direct programming costs; and (4) the Foundation for New Era Philanthropy's Ponzi scheme through which dozens of not-for-profits, as well as many major philanthropists, contributed funds to the organization with the promise of a significant return on their investment. In their shocking naiveté, the charities and philanthropists involved lost tens

public outcry that the not-for-profit sector was not being effectively overseen and the public interest was not being adequately protected.[124] Public trust in the not-for-profit began to erode with not-for-profits increasingly viewed as little more than competitors of like businesses in the for-profit sector, but with the unfair advantage of government subsidies and little to no accountability. This general unease with the not-for-profit sector is reflected by Professor Harvey Goldschmid's observation that "only our highly restrictive standing rules . . . and the forbearance and egregious understaffing of our state charity regulators stand between nonprofit directors of large institutions and an unfortunate morass of expensive and embarrassing litigation."[125] Echoing Goldschmid's concerns, plaintiff's lawyers, consumer advocates, and academics have recently begun demanding clarity in the standard of conduct for the not-for-profit director and advocating an expansion of who has standing to sue the not-for-profit corporation.[126]

Yet, extrapolating from a few outrageous scandals to conclude that there is a pervasive problem plaguing the entire not-for-profit industry is a misguided leap in logic. While a few spectacular scandals exposing greed, corruption, and sheer incompetence at some of the largest not-for-profits makes for tantalizing reading and compelling litigation, these problems are not what threaten the long-term viability of the not-for-profit sector. Indeed, the crisis in the not-for-profit sector is a quiet crisis that lacks the lurid details of illicit sex, embezzlement, and unauthorized trips on the Concorde to propel it to the front pages of public discourse. Instead, this quiet crisis is characterized by the homogenization of the sector primarily in response to majoritarian concerns at the expense of the nonmajoritarian interests that were the original inspiration behind forming the not-for-profit corporation.[127] In other words, it is a problem within the

---

(perhaps hundreds) of millions of dollars. For an overview of this scandal and others see Chisolm, *supra* note 104, at 142. For detailed discussion of the United Way scandal, see JOHN S. GLASER, THE UNITED WAY SCANDAL: AN INSIDER'S ACCOUNT OF WHAT WENT WRONG AND WHY (1994).

124. David Shenk's article in the Washington Monthly, *supra* note 83, illustrates the general public's distrust of not-for-profits as a result of several high profile scandals. Expressing his concerns, Shenk comments that "[u]nfortunately, in the nonprofit world, the buck often doesn't stop anywhere. Instead, it drifts around aimlessly until it's buried in a basement filing cabinet or shredded á la Aramony. . . . [Nonprofit corporate directors are] over-extended executives and status-seeking lawyers or financiers who have neither time for, nor interest in, real oversight." Shenk, *supra* note 83, at 10.

125. Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 640 (1998).

126. *See* ROBINSON, *supra* note 22, at 31; Thomas J. Billitteri, *Rethinking Who Can Sue a Charity*, CHRON. PHILANTHROPY, Mar. 12, 1998, at 1; *Developments in the Law—Nonprofit Corporations*, *supra* note 71, at 1591.

127. For an overview of the crisis of legitimacy that threatens the not-for-profit sector, see *supra* notes 2–6.

infrastructure of the not-for-profit corporation itself, and not between the not-for-profit and society at large. Arguably, then, this crisis of legitimacy runs far deeper than a few scandals, and it is unlikely that changing standing rules or increasing staffing at the state attorney general's office will alleviate the real problem. At best this homogeneity, and corresponding lack of competitive advantage, fosters inefficiency with regards to mission fulfillment.[128] At worst it leads to a wholesale corruption of the public purpose for which the corporation was first chartered.[129] Given that this crisis is far more abstract and pervasive than a handful of misdeeds at a few not-for-profits, and is fundamentally informed by our very choice of a democratic government, its resolution is far more complex and less immediately accessible than much of what has been proposed thus far concerning appropriate standards of fiduciary conduct and who should have standing to sue to enforce those standards. However, it would be a mistake to summarily dismiss the law as too blunt an instrument to have any role in ameliorating the quiet crisis. In order to assess the role the law might play, this Comment next re-examines the substantive assumptions underlying the basic fiduciary duties and how these assumptions inform the procedural enforcement of those duties.

The not-for-profit director is held to three fiduciary duties: the duty of care, the duty of loyalty, and the duty of obedience.[130] The first two duties exist in for-profit corporate law while the third is unique to the not-for-profit sector. Some states adopt nonprofit corporate statutes unique to the sector, while other states simply rely on existing for-profit statutes.[131] Yet, whether the fiduciary duty is drawn from a nonprofit statute or a for-profit one, the appropriate standard of conduct to which the trustee should be held must still be determined. Specifically, the question is whether a trust standard or a corporate standard should apply,[132] for while the not-for-profit corporation

128. *See* Salamon, *supra* note 2, at 426–28 (discussing the perception of inefficiency in the not-for-profit sector).

129. *See* discussion *supra* Part IV.

130. For a thorough overview of each of these three duties in the not-for-profit context see KURTZ, *supra* note 4, at 22–90.

131. See FISHMAN & SCHWARZ, *supra* note 122, at 58. Marilyn Phelan notes that some states adopted the first draft of the Model Nonprofit Corporation Act promulgated in 1951 including Wisconsin, Alabama, North Carolina, Virginia, Nebraska, North Dakota, Oregon, Texas, and the District of Columbia. Some states adopted the Revised Model Nonprofit Corporation Act promulgated in 1987 including Oregon and Tennessee. Other states, such as California and New York, have separate not-for-profit corporate statutes but differ significantly from the original Model Nonprofit Act. And a few states, such as Delaware, have one general corporation act that governs both not-for-profit and for-profit corporations. *See* MARILYN E. PHELAN, NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS §§ 1:12–1:63 (2001) (providing an overview of the status of each state's legal treatment of the not-for-profit corporation).

132. *See* Fishman, *supra* note 62, at 677 (arguing that the distinction between a corporate and a trust standard is not simply "a theoretical question with . . . little practical import").

shares characteristics with both the for-profit corporation and the charitable trust, it is a distinct legal entity.[133] In establishing the standard of conduct applicable to each of these duties and identifying who has standing to enforce them, public policy demands a careful balancing between encouraging voluntary, unpaid board service while at the same time holding the director ultimately accountable for ensuring the not-for-profit continues to serve its public purpose.[134] Determining what standard to apply to best serve these public policy objectives has been problematic for the sector and remains unresolved.[135]

The trustee is held to a higher standard of conduct than the corporate director.[136] While the trustee is liable for ordinary negligence and is strictly prohibited from self-dealing, the corporate director is generally only liable for gross negligence and is permitted to engage in self-dealing with the corporation within specified limits. Certainly a strong argument can be made that the law of trust should be applied to the not-for-profit corporate director, for the director and the trustee are "solely responsible for administering the trust assets, and in both cases they are fiduciaries in performing their trust duties."[137] It seems disingenuous to suggest that simply by a fortuity of organizational structure that the not-for-profit director and the trustee should be held to different standards.[138] After all, "fiducia" is the Latin word for trust,[139] and without the public trust the not-for-profit sector would cease to be viable.[140] However, the competing policy concern

133. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) ("The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust.").

134. *See* FISHMAN & SCHWARZ, *supra* note 122, at 161; KURTZ, *supra* note 4, at 30; *see also* REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 1 [hereinafter RMNCA] (1987) (noting that courts will take into consideration that not-for-profit corporate directors are serving without compensation in an effort to promote the public good when assessing liability).

135. *See* PHELAN, *supra* note 131, at § 4.02 (observing that while the not-for-profit corporation shares characteristics with the for-profit corporation and the charitable trust, it is its own legal entity, and courts have yet to build a robust body of case law establishing applicable legal standards in determining the roles and responsibilities of the not-for-profit corporate director).

136. *See Stern*, 381 F. Supp. at 1013; Mann v. Commonwealth Bond Corp., 27 F. Supp 315, 320 (S.D.N.Y. 1938); *see also* FISHMAN & SCHWARZ, *supra* note 122, at 150; KURTZ, *supra* note 4, at 22; PHELAN, *supra* note 131, at § 4:02.

137. Holt v. Coll. of Osteopathic Physicians & Surgeons, 394 P.2d 932, 937 (Cal. 1964) (citation omitted).

138. *See* PHELAN, *supra* note 131, at § 4:09; *see also* Brody, *supra* note 24, at 462–63 (noting that the various constructs of corporation, government agency and charity are nothing but "legal fictions" with indeterminate boundaries); *Development in the Law—Nonprofit Corporations*, *supra* note 71, at 1584 (explaining that the not-for-profit corporate form is just one type of "private organizational structure selected from a menu of business forms" that will be adopted when it makes strategic business sense to do so).

139. OXFORD LATIN DICTIONARY 699 (P.G.W. Glare ed., 1983); *see* FISHMAN & SCHWARZ, *supra* note 122, at 159.

140. *See* ROBINSON, *supra* note 22, at 9.

of encouraging board service has led many states to instead adopt the more lenient corporate standard with regard to the not-for-profit director.[141] Furthermore, the functions performed by the not-for-profit and for-profit directors in governing an ongoing business concern are very similar on an organizational level.[142] Therefore, bringing the statutory treatment of the not-for-profit corporation in line with its for-profit counterpart makes administrative sense. Notably, the ABA's Revised Model Nonprofit Corporate Act (RMNCA),[143] promulgated in 1987, specifically adopted the corporate standard rather than the more restrictive trust standard with regard to the duty of care and the duty of loyalty.[144]

The RMNCA does not recognize the duty of obedience,[145] and even if it did, there is no equivalent corporate duty or standard to adopt. The fact that the RMNCA does not include the duty of obedience is a serious omission and will be discussed below. Suffice it to say that through the omission, the RMNCA carries its theme of creating symmetry between nonprofit and for-profit corporate law to an illogical extreme. The two entities measure accountability by very different standards, with the for-profit corporation relying on market indicators to assess performance, while the not-for-profit corporation derives its standard of accountability from legal and social norms. Presumably the RMNCA assumed the duty of obedience was adequately addressed through duties of care and loyalty.[146] While this is a proposition that I find lacking, a brief review of these two duties as they are commonly understood in the not-for-profit sector is in order before turning to a more critical analysis of the duty of obedience.

---

141. Approximately twenty states apply the corporate standard of conduct to the not-for-profit director.

142. The *Stern* court observed that it is "the modern trend . . . to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their 'pure' corporate counterparts." *Stern*, 381 F. Supp. at 1013.

143. The first Model Nonprofit Corporation Act was drafted in 1951. In 1987 it was significantly revised, strongly influenced by California's Nonprofit Corporation Law (NCL) that had been effective in California since 1980. Michael Hone served as the author of California's NCL as well as the reporter on the RMNCA.

144. RMNCA, *supra* note 134, at § 8.30(e); *see also* HALL, *supra* note 97, at 17 (arguing that both the original Model Nonprofit Corporation Act and its revision were primarily attempts "to bring the statutory treatment of nonprofits into line with the main body of corporate law"); PHELAN, *supra* note 131, at § 4:02.

145. *See id.*

146. For arguments in favor of collapsing the duty of obedience into the duties of care and loyalty, see Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 692 (1998); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1406 n.30 (1998).

A. The Duty of Care and the Business Judgment Rule

The duty of care mandates that the board discharge its directorial functions with a certain level of diligence and competence.[147] The RMNCA states the duty as follows:

> A director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person *in a like position* would exercise *under similar circumstances*; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.[148]

While the duty contains both substantive and procedural components,[149] as reflected by the official comments to the RMNCA, the duty is predominantly concerned with procedural issues.[150] The comments begin by observing that the duty of care for the not-for-profit director is very similar to its for-profit counterpart in that not-for-profit directors must "exercise their judgment with due regard to the nature, operations, finances, and objectives of their organization."[151] While this could be seen as a substantive inquiry into the quality of the board's decisions as they impact the organization's core operations, the comments clarify that the inquiry does not address the substantive nature of the oversight provided, but is instead focused on the *procedural*

147. *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000), Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). For a general overview of the duty of care in the not-for-profit sector, see FISHMAN & SCHWARZ, *supra* note 122, at 160–200; KURTZ, *supra* note 4, at 22–48; PHELAN, *supra* note 131, at § 4:08; GUIDEBOOK, *supra* note 50, at 21–27; *see also* DUCA, *supra* note 96, at 22–23 (observing that the general public has a right to expect not-for-profit "board members to behave competently and with diligence"); Chisolm *supra* note 104, at 145 (arguing that while the duty of care has no precise meaning, it is "generally understood . . . to require diligence and attentiveness to the affairs of the organization"). However, as Professor Harvey Goldschmid argues, it is one thing to require that not-for-profit boards act competently and diligently, but competently and diligently as to what? *See* Goldschmid, *supra* note 125, at 639. He points to RMNCA section 8.01 which simply states that all corporate powers shall be vested with the board and that the corporation shall be managed under its direction, without specifying the particular functions to be performed by the board. *Id.* Accordingly, he concludes that the generality of section 8.01 and similar statutory provisions leave alarmingly unclear "what nonprofit boards are actually supposed to do." *Id.*

148. RMNCA, *supra* note 134, at § 8.30(a) (emphasis added).

149. *See* FISHMAN & SCHWARZ, *supra* note 122, at 161.

150. The emphasis on the decisionmaking process as opposed to the substance of the decision is consistent with for-profit duty of care jurisprudence. *See* Eisner, 746 A.2d, at 264 ("Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only."); *see also* Shlensky v. Wrigley 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) ("[W]e do not mean to say that we have decided that the decision of the directors was a correct one. . . . [N]evertheless we feel that unless the conduct of the defendants at least borders on one of the elements, the courts should not interfere.").

151. RMNCA, *supra* note 134, § 8.30, cmt. 2.

quality of the supervisory and decisionmaking processes employed.[152] The board's assessment of an issue or situation can be fundamentally flawed, but it will have likely satisfied its duty of care so long as it acts with common sense and informed judgment.[153] Informed judgment requires that the board be "reasonably acquainted with matters demanding its attention"[154] which can generally be satisfied by attending board meetings, consulting experts as needed, and carefully reviewing the financial and other materials submitted to the board.[155] Furthermore, the interpretations of "in a like position" and "under similar circumstances" are strongly influenced by the public policy desire to encourage volunteer board service in the not-for-profit sector and recognize that board members "are attempting to promote the public good."[156] Both of these phrases incorporate each not-for-profit's unique position regarding goals and resources. Furthermore, this language seems to acknowledge that the degree of information available on which to base institutional decisions will vary by situation, and will depend largely upon the urgency with which the decision must be made.[157] And finally, the language indicates that the board member is not expected to bring any special skill set or expertise to the decisionmaking process.[158] Thus, if a director acts in good faith and in the best interests of the not-for-profit corporation, he will generally be protected from liability "even if the [decision] proves disastrous to the organization."[159]

---

152. *See also* Everett v. Phillips, 43 N.E.2d 18, 19–20 (N.Y. 1942).

> [H]owever high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. That is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs.

Id.

153. *See id.*; *see also* FISHMAN & SCHWARZ, *supra* note 122, at 184–85.

154. RMNCA, *supra* note 134, § 8.30 cmt. 2.

155. *See id.*; *see also* FISHMAN & SCHWARZ, *supra* note 122, at 184; GUIDEBOOK, *supra* note 50, at 21–22.

156. RMNCA, *supra* note 134, § 8.30 cmt. 2; *see* FISHMAN & SCHWARZ, *supra* note 122, at 184. However, it can also be argued that "in a like position" and "under similar circumstances" can undermine public policy by enabling not-for-profit directors to "find shelter behind their lack of experience and lack of capacity for their positions." BARRY R. FURROW ET AL., HEALTH LAW 195 (1995).

157. *See* KURTZ, *supra* note 4, at 27; FISHMAN & SCHWARZ, *supra* note 122, at 184.

158. *See* RMNCA, *supra* note 134, § 8.30 cmt. 2 ("No special skill or expertise should be expected...."); FISHMAN & SCHWARZ, *supra* note 122, at 184; KURTZ, *supra* note 4, at 25–26. While no special skills or expertise are required of board members, if a director possesses relevant specialized knowledge he is legally compelled to use it in the decisionmaking process. *See* RMNCA, *supra* note 134, § 8.30 cmt. 2; KURTZ, *supra* note 4, at 48.

159. FISHMAN & SCHWARZ, *supra* note 122, at 161; *see* Everett v. Phillips, 43 N.E.2d 18, 19–20 (N.Y. 1942); DUCA, *supra* note 96, at 22.

Many courts will protect the not-for-profit corporate director even further by applying a gross negligence standard of review as opposed to the reasonably prudent person standard typically codified by statute.[160] The business judgment rule, sometimes referred to as the best judgment rule in the not-for-profit sector,[161] is a judicial doctrine of abstention designed to protect honest, informed business judgments made by a corporate board of directors.[162] The rule originated in the for-profit sector to promote and facilitate creative, innovative, strategic, and entrepreneurial thinking in the corporate boardroom.[163] Clearly, there is a need for such thinking in the not-for-profit as well if it is going to successfully compete with other businesses,[164] so it is not surprising that many courts have mitigated the duty of care with the business judgment rule in the not-for-profit sector.[165] The comments to the RMNCA state that not only is the use of the business judgment rule in the not-for-profit sector consistent with the duty of care as codified in the RMNCA, but that the rule should be extended in the not-for-profit context to "discretionary matters voted upon by the board of directors and not just those that can be

160. *See* Beard v. Achenbach Mem'l Hosp., 170 F.2d 859 (10th Cir. 1948); Yarnall Warehouse & Transfer, Inc. v. Three Ivory Bros. Moving Co., 226 So. 2d 887 (Fla. Dist. Ct. App. 1969). *See generally* Blair & Stout, *supra* note 7, at 1792–93 (discussing the divergence between the standard of conduct codified by statute versus the standard of review employed by courts in enforcing the duty of care in the for-profit sector).

161. *See* FISHMAN & SCHWARZ, *supra* note 122, at 161.

162. *See* KURTZ, *supra* note 4, at 49; FISHMAN & SCHWARZ, *supra* note 122, at 161; Goldschmid, *supra* note 125, at 643–45.

163. *See* KURTZ, *supra* note 4, at 49; BOWEN, *supra* note 52, at 21.

164. Based on his study of the sociology of the performing arts, Joseph Bensman concludes that the act of risk taking is vital to the long-term health of the field. He observes:

> [T]he very act of innovation inevitably invites a high rate of failure; but the risk of failure is the only avenue by which continual creativity in the arts is assured. Certainly, playing for short-term success and to established audience tastes is a form of failure itself. It leads to stagnation.

Joseph Bensman, *The Phenomenology and Sociology of the Performing Arts, Introduction* to JACK B. KAMERMAN & ROSANNE MARTORELLA, PERFORMERS & PERFORMANCES: THE SOCIAL ORGANIZATION OF ARTISTIC WORK 36–37 (1983).

165. Kurtz argues that the applicability of the business judgment rule in the not-for-profit sector is not without its problems. He acknowledges that risk taking by directors can indeed be important to secure and stabilize vital income streams for the not-for-profit. However, Kurtz questions whether risk-taking behavior can be reconciled with the caution generally employed to protect a not-for-profit's resources. KURTZ, *supra* note 4, at 50–51. But Kurtz's analysis is not particularly compelling. While a not-for-profit business must balance the level of risk employed and the level of caution exercised, a *for-profit* corporation must also establish a balance between caution and risk. The reasonable balance will likely differ between the two sectors and between fields within sectors, but the fact that the balance changes has no bearing on the application of the business judgment rule. The business judgment rule asks, given the reasonable applicable balance between risk and caution, has the director acted with gross negligence or engaged in willful misconduct? For an additional critique of the business judgment rule as applied in the not-for-profit context see FURROW ET AL., *supra* note 156, at 208–09, opining that in the absence of other means of holding the director accountable, such as market controls, the "blanket protection" afforded by the business judgment rule may not be appropriate.

characterized as 'business' decisions."[166] The net result is that when the board makes an informed decision in good faith, no matter how unfortunate the decision is for the not-for-profit, it is highly improbable that the board will be subject to judicial inquiry or liability.[167]

B. The Duty of Loyalty and Its Relationship to the Duty of Care

At first glance it may appear that the duty of loyalty imposes a more substantive duty on the not-for-profit director.[168] In accordance with the duty of loyalty, the director must pursue the interests of the not-for-profit rather than his own or those of another person or organization.[169] This duty as it is applied in the for-profit sector is specifically concerned with self-dealing.[170] While this duty is substantive to the extent that it analyzes the substance of financial transactions made by individual board members, it does not address the larger issue of institutional purpose.

Therefore, by simply looking at the duty of care and the duty of loyalty, we end up in the situation that many not-for-profits find themselves today. When all that we ask of the not-for-profit board is that it govern in

166. RMNCA, *supra* note 134, § 8.30 cmt. 3; *see also* KURTZ, *supra* note 4, at 51; *Developments in the Law—Nonprofit Corporations*, *supra* note 71, at 1601.

167. *See* FISHMAN & SCHWARZ, *supra* note 122, at 185; GUIDEBOOK, *supra* note 50, at 27. In *Joy v. North*, Judge Winter recognized that applying the business judgment rule means that the corporate director is rarely held to the reasonable person standard of care:

> While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. . . . [L]iability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.

Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (citations omitted). It is important to recognize, however, that while the business judgment rule makes the requisite standard of care very low, it does not provide a safe harbor for breaches of the duty that involve bad faith, criminal activity, fraud, or willful misconduct. *See* FISHMAN & SCHWARZ, *supra* note 122, at 185–86.

168. For a general discussion of the duty of loyalty as applied in the not-for-profit sector, see FISHMAN & SCHWARZ, *supra* note 122, at 200–27; KURTZ, *supra* note 4, at 59–84; PHELAN, *supra* note 131, at § 4:05; GUIDEBOOK, *supra* note 50, at 28–32.

169. However, consistent with for-profit duty of loyalty jurisprudence, the RMNCA permits the director to use his connections to secure inexpensive goods and services for the not-for-profit even if the director stands to gain as a result of the transaction. *See* RMNCA, *supra* note 134, § 8.30 cmt. 4. Section 8.31(b) specifies the particular standard for public benefit corporations.

170. *See* Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. Spec. Term 1944).

> [T]o discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the "business judgment rule" . . . it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest. The "business judgment rule," however, yields to the rule of undivided loyalty . . . to avoid the possibility of fraud and to avoid the temptation of self-interest.

Id. (citations omitted).

good faith, refrain from self-dealing at the expense of the corporation, and make informed decisions, we are in danger of losing sight of the bigger picture. Indeed, the institution's very purpose for existing becomes subordinate to procedural concerns. Although these procedural concerns are critical to ensuring the integrity of the not-for-profit sector and securing the public trust, alone they are insufficient to protect the ongoing relevance of any given not-for-profit. We are potentially left with institutional trappings without the soul of the institution.[171] As Hall argues, with the promulgation of the RMNCA and its adoption by many states, the not-for-profit board was "[f]reed . . . [from] the need to consider community benefit in any broad sense and with minimal formal accountability to beneficiaries, trustees had only to consider the financial prospects of organizations on whose boards they sat."[172] Safeguards were in place to promote sound financial management, which, while critical to the long-term survival of the not-for-profit, are secondary to the consideration of whether the institution continues to fulfill the public purpose for which it was founded.[173] Even a flawless financial management strategy cannot ensure a not-for-profit's ongoing relevance to the community; hence the importance of the third not-for-profit fiduciary duty, the duty of obedience.

C. The Duty of Obedience

Unlike the for-profit corporation, the not-for-profit does not answer to the stockholder who ultimately measures institutional performance based on a single, well understood objective: financial return on investment.[174] Certainly it is inaccurate to imply that the long-term health of a for-profit institution is solely based on quantifiable financial ratios without regard to qualitative indicators, such as quality of product and customer satisfaction,[175] yet even these

171. A pioneer of the regional theater movement in the 1950s, Zelda Fichandler challenged the field forty years later, arguing that the regional theater no longer measured its success by artistic excellence, and thus the institutions they had nurtured into existence were in danger of becoming irrelevant. She asked:

> Is it possible for the body of work to go, only a faint pulse remain, only the Cheshire Cat smile of the work, and the institution still be regarded as alive? . . . As we transform backward, will we simply get thinner and thinner as artistic standards bleed from our veins, and end up down the drain? How small can the vision get before it's some other vision or no vision at all?

Zelda Fichandler, *On Growing Small*, AM. THEATRE, May 1992, at 20, 22.

172. HALL, *supra* note 97, at 19.

173. Safeguarding the mission does not mean a rigid, formalistic adherence to specific activities that have outlived their useful purpose. The mission is a living document that must be continually updated for it to remain a relevant reflection of the general purpose for which the organization was formed.

174. *See* BOWEN, *supra* note 52, at 20; FISHMAN & SCHWARZ, *supra* note 122, at 152.

175. *See* BOWEN, *supra* note 52, at 118–19 (recognizing the limits of using financial benchmarks as the exclusive indicator of institutional health in the for-profit sector).

seemingly intangible measures are eventually translated into quantifiable performance realities. Not-for-profit effectiveness, however, often cannot ultimately be reduced to a concept as tangible and relatively objective as enhancing shareholder value.[176] While the not-for-profit is ultimately responsible to the bottom line in terms of its very survival, merely surviving as a business does not guarantee that the public purpose for which it was founded is being satisfied.[177] Often there are no readily accessible measures to determine if the not-for-profit is indeed fulfilling its public purpose. This has led commentators to argue that not-for-profit corporations are held to less stringent accountability standards than their for-profit counterparts. However, while it is true that the not-for-profit has "greater freedom to pursue [its] objectives without the concern that the decisions will be criticized or revised by market forces,"[178] it does not then follow that the not-for-profit corporation is by definition inevitably held to a lower standard of accountability than a for-profit corporation. Both the for-profit and the not-for-profit must answer to and serve the needs of their immediate constituencies in order to remain relevant and viable as ongoing businesses. They simply have a different means of measuring their institutional success.

Instead of answering only to a financial bottom line, the not-for-profit must also answer to its mission. Given that the not-for-profit is held in the public trust for the benefit of society,[179] it follows that mission fulfillment[180] is roughly equivalent to enhancing shareholder value in the for-profit sector. And it is this standard of accountability that is given legal meaning in nonprofit corporate law as the duty of obedience.[181] The

176. *See id.* at 116–17; Vic Murray & Bill Tassie, *Evaluating the Effectiveness of Nonprofit Organizations*, *in* THE JOSSEY-BASS HANDBOOK, *supra* note 107, at 310 (arguing that unlike the for-profit sector which is ultimately held accountable to the bottom line, the criteria for measuring a not-for-profit's success are often "many, varied and mutually contradictory" and are based on "subjective indicators not clearly understood or agreed to").

177. *See* Rosabeth Moss Kanter & David V. Summers, *Doing Well While Doing Good: Dilemmas of Performance Measurement in Nonprofit Organizations and the Need for a Multiple-Constituency Approach*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 154, 158 (Walter W. Powell ed., 1987) (arguing that a primary goal of survival can cause not-for-profits to "lose sight of other purposes, including their reasons for existing in the first place").

178. FISHMAN & SCHWARZ, *supra* note 122, at 243; *see also* BOWEN, *supra* note 52, at 9.

179. *See* Dennis R. Young, Editor's Notes, 6 NONPROFIT MGMT. & LEADERSHIP 121, 124 (1995).

180. The think tank on nonprofit accountability defines mission fulfillment as twofold: (1) consistently doing what the organization promises it will do; and (2) maintaining long-term relevance by meeting the needs of its constituents in a changing environment. *Id.*

181. The codification of the means by which the not-for-profit is held accountable into a specific fiduciary duty is significant. While the for-profit sector has the external mechanism of the market against which institutional effectiveness can be measured, one of the primary external mechanisms by which the not-for-profit is ultimately held accountable is the law governing the sector. *See* KURTZ, *supra* note 4, at 49–50 (arguing that instead of measuring their accountability in terms of market indicators like their for-profit counterparts, the not-for-profit director is held accountable primarily

duty of obedience[182] is a legacy of trust law that does not square with the RMNCA's attempt to line up not-for-profit fiduciary duties with those of its for-profit counterpart.[183] While the few courts that have heard duty of obedience cases have held the board to somewhat different standards,[184] at issue in all the cases is whether the board exceeded its discretion in interpreting and applying the broad nature of the not-for-profit's public purposes, usually involving ultra vires activity.[185] Thus, the duty of obedience resembles the trustee's duty to administer in compliance with the founding purpose.[186] In the not-for-profit corporate sector this translates into two specific subduties: a duty to ensure that the institution obeys the laws that govern and regulate it[187] and a duty to make sure that the institution continues to operate for the purpose for which it was formed.[188]

---

through the legal codification and enforcement of specific fiduciary duties); Ben-Ner & Hoomissen, *supra* note 72, at 406 (observing that law and public policy "constitute the main external support mechanisms" in the not-for-profit sector in lieu of market control); *see also* Chisolm, *supra* note 104, at 142–46 (reviewing the legal rules that set the standards of accountability in the not-for-profit sector); Lawry, *supra* note 54, at 175 (discussing the appropriateness of using law as a means of establishing accountability in the not-for-profit sector).

182. For a general discussion of the duty of obedience as applied in the context of the not-for-profit corporation see FISHMAN & SCHWARZ, *supra* note 122, at 227–29; KURTZ, *supra* note 4, at 84–90.

183. PHELAN, *supra* note 131, at § 4:02, at 4-2 (recognizing the limitations inherent in the current legal standards of accountability). Specifically, while the not-for-profit director clearly has a legal duty to ensure that the assets of the not-for-profit corporation are used for the public purposes for which they were entrusted, "there is no clear-cut body of law establishing the legal standards to be applied in determining the roles and responsibilities of directors." *Id.*

184. Some courts have enforced a strict duty of obedience on directors. *See* Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999) (holding that the duty of obedience "mandates that a Board, in the first instance, seek to preserve its original mission. Embarkation 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"); Queen of Angels Hosp. v. Younger, 136 Cal. Rptr. 36 (Ct. App. 1977) (holding that a not-for-profit that used funds to operate medical clinics instead of a hospital had breached the duty of obedience). Other courts have applied the "substantial departure" test, which provides the not-for-profit with more flexibility in adapting to changing conditions. *See* Taylor v. Baldwin, 247 S.W.2d 741 (Mo. 1952); City of Paterson v. Paterson Gen. Hosp. 235 A.2d 487 (N.J. Super. Ct. Ch. Div. 1967).

185. Ultra vires actions are unauthorized as beyond the scope of power permitted by the corporate charter. *See generally* Peregrine & Schwartz, *supra* note 82, at 466.

186. FISHMAN & SCHWARZ, *supra* note 122, at 227.

187. For example, filing annual reports with state and federal government and complying with relevant labor laws.

188. *See Manhattan Eye, Ear & Throat Hosp.*, 715 N.Y.S.2d at 593, stating that the duty of obedience "requires the director of a not-for-profit corporation to be faithful to the purposes and goals of the organization," since "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'être of the organization."

Id. (quoting V. BJORKLAND ET AL., NEW YORK NONPROFIT LAW AND PRACTICE § 11-4[a], at 414) (emphasis omitted); *see also* KURTZ, *supra* note 4, at 21; ROBINSON, *supra* note 22, at 33.

While the duty itself is easy to state, its substantive meaning is defined and informed by both the standard of review applied by the courts and by who is legally empowered to enforce the duty. Some commentators have argued that directors should be held to the same standards of conduct under the duty of obedience as they are under the duty of care.[189] However, the logic of this position seems tenuous at best. The duty of care in the not-for-profit and the for-profit sectors serve similar purposes, namely to ensure that certain procedures are adhered to in the decisionmaking process. Because they are aimed at achieving the same goals, it follows that a similar standard of conduct should be applied in both sectors. The duty of obedience, on the other hand, does not have a for-profit counterpart. A for-profit standard of conduct should not be applied to a uniquely not-for-profit duty. As the duty of obedience can be traced back to trust law, it makes far more sense for the not-for-profit corporate director to be held to a higher standard regarding the duty of obedience akin to the higher standards of trust law.

VI. STANDING TO ENFORCE THE NOT-FOR-PROFIT DIRECTOR'S FIDUCIARY DUTIES

Accordingly, an argument can be made for heightening the specter of the duty of obedience by increasing enforcement. Potentially that could be accomplished by expanding standing to sue under the duty of obedience to the senior executive[190] who has unique qualifications and access to performance data that are particularly relevant in assessing compliance with and relevancy of the institutional mission. For as a legal duty, the duty of obedience means little without a corresponding threat of legal sanction,[191] which under the current status of nonprofit law appears extremely unlikely when the law does not empower the individuals who are uniquely qualified to monitor and enforce this particular duty. In the for-profit sector, the shareholder enforces fiduciary duties through derivative and third party actions,[192] and are often encouraged to do so by "entrepreneurial attorneys" aggressively seeking causes of action.[193] However, as discussed previously, the not-for-profit does not have readily identifiable equity holders equivalent to the for-profit shareholder. Consequently, the question of who should have standing to enforce a

189. *See* Goldschmid, *supra* note 125, at 641.

190. The question of who has standing is essentially the question of who has a legally recognized right to assert a claim against the organization in a specific context. *But see* Atkinson, *supra* note 146, at 658 (arguing that the nature of the claim often has some bearing on who is granted standing).

191. The law's ability to motivate behavior is most effective when the probability of sanction is high. *See* Langevoort, *supra* note 8, at 828.

192. *See Developments in the Law—Nonprofit Corporations*, *supra* note 71, at 1594.

193. *See id.* at 1599.

particular not-for-profit fiduciary duty is a complex issue,[194] "turn[ing] very much on what sort of charity we as society want to have."[195] Potential plaintiffs include the state attorney general, board members, donors and those with a special relationship to the organization such as specified beneficiaries,[196] or perhaps, the chief executive officer.

A. Current Status of the Law

Modeled on English charitable laws, initially the state attorney general was exclusively empowered as the enforcer of not-for-profit fiduciary duties.[197] The attorneys general were placed in the role of *parens patriae* to speak on behalf of the beneficiaries of the not-for-profit[198] on the theory that (1) centralized enforcement was critical for the survival of the not-for-profit, which would otherwise be unable to withstand an endless morass of litigation instigated by countless parties,[199] and (2) that while the not-for-profit's immediate focus may be addressed to serve the needs of particular individuals and/or purposes, by doing this work, the not-for-profit benefits society as a whole and thus, the appropriate enforcer of fiduciary duties is a representative of the general population.[200] However, the attorneys general are extremely limited in their ability to provide oversight to the not-for-profit sector. Not only does the attorney general potentially have political motives that might conflict with the nonmajoritarian impulses of the not-for-profit,[201] but attorneys general simply do not have the

194. *See* Brody, *supra* note 146, at 1429 (arguing that not only is there no clear principal enforcer of charitable fiduciary duties that naturally emerges from organizational structure, but the way the law addresses the issue "makes enforcement of charity fiduciary duties difficult").

195. Atkinson, *supra* note 146, at 658.

196. *See Developments in the Law—Nonprofit Corporations*, *supra* note 71, at 1594–95.

197. *See* GUIDEBOOK, *supra* note 50, at 13.

198. *Id.*

199. *See* Chisolm, *supra* note 104, at 151–52 (discussing the advantage of limiting enforcement powers to the attorney general and the Internal Revenue Service).

200. *See* Holt v. Coll. of Osteopathic Physicians & Surgeons, 394 P.2d 932, 935 (Cal. 1964) ("Since there is usually no one . . . who could properly represent the interests of the trust or the public, the Attorney General has been empowered to oversee charities as the representative of the public. . . ."); Chisolm, *supra* note 104, at 147 (noting that it is consistent with the purposes of the not-for-profit sector as a whole that beneficiaries of a specific not-for-profit are generally not granted standing to demand accountability at law because the not-for-profit's service of its beneficiaries' needs are "but the vehicle by which the charity delivers a social good to society at large"); *see also* Atkinson, *supra* note 146, at 693–94 (arguing that a legal framework granting permissive standing to private individuals to enforce fiduciary duties could be easily corrupted by economic self-interest).

201. *See* Atkinson, *supra* note 146, at 694 (noting that the attorney general likely has political motives which can affect the quality of oversight over the not-for-profit sector).

necessary resources to invest in oversight.[202] Indeed, given the limited resources available to monitor the thousands of not-for-profit corporations, the charitable organization, is for all practical purposes, self-regulating.[203]

Acknowledging this reality, the court in *Holt v. College of Osteopathic Physicians and Surgeons*[204] extended standing to enforce fiduciary duties to the individual directors of the organization. The court recognized that the purpose "of enforcement is to bring to light conduct detrimental to a charitable trust so that remedial action may be taken."[205] While the court accepted the central oversight role played by the attorney general, it argued that "the need for adequate enforcement is not wholly fulfilled by the authority given him."[206] The court reasoned that the attorney general is likely to be consumed by seemingly more pressing needs than not-for-profit oversight, and even with more resources, the attorney general could not possibly be sufficiently involved in the affairs of each not-for-profit to fully appreciate the impact of a board's every decision.[207] The court determined that the not-for-profit corporation could only benefit from more diligent oversight supplementing that provided by the attorney general's office.[208] Relying heavily on the scholarship of Professor Ken Karst,[209] the court recognized the value of the individual board member as an enforcer.[210] It reasoned that the "co-trustee is . . . in the best position to learn about

202. According to the National Association of Attorneys General, in 1998 twenty-five states had no person in the attorney general's office assigned to monitor not-for-profits. Billitteri, *supra* note 126. Only eleven states had two or more people dedicated to full time oversight. *Id.*

203. *See* Axelrod, *supra* note 107, at 119; Fishman, *supra* note 62, at 669. Atkinson argues that instead of bemoaning the fact that the not-for-profit corporation is essentially self-regulating, nonprofit corporate law should embrace this reality and recognize the not-for-profit corporation as the primary enforcer of its fiduciary duties. He refers to this proposal as the "sectarian model." Atkinson, *supra* note 146, at 686–94. Under the sectarian model, the attorney general has no say in how a not-for-profit uses its resources as long as the corporation does not grossly violate the permissive standards of conduct embodied in the duties of care and loyalty. *Id.* at 687. Up to this point, Atkinson's sectarian model is little more than a statement of the current reality. However, he then reasons that the duty of obedience should be abolished and the attorney general should be the only individual granted standing to enforce the remaining two duties. *Id.* By so doing, Atkinson eliminates the fundamental means of ensuring substantive accountability in the not-for-profit sector—compliance with the institutional mission—and simultaneously invests exclusive enforcement authority in an individual whom he admits is so understaffed that his ability to monitor the sector will be superficial at best. A self-regulating model makes sense only if those charged with regulating the not-for-profit, the board and the chief operating officer, are legally empowered to do so.

204. 394 P.2d 932 (1964).

205. *Id.* at 935.

206. *Id.* at 936.

207. *Id.* at 935.

208. *Id.* at 936.

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

210. *Holt*, 394 P.2d at 936.

breaches of trust and to bring the relevant facts to a court's attention,"[211] and found that, as the trustee is intimately involved with the affairs of the specific not-for-profit, he is generally in a more advantageous position than the attorney general to evaluate the board's compliance with its fiduciary duties. And while the court recognized the importance of protecting the not-for-profit from "harassing litigation" for public policy reasons, it did not consider extending standing to the individual board member to be unduly burdensome to the organization as the board members are "both few in number and charged with the duty of managing the charity's affairs."[212]

B. Expanding Standing to Sue to the Chief Executive Officer

In expanding standing to include the individual board member in the not-for-profit corporation, the court looked to the Second Restatement of Trusts.[213] Section 391 provides that a "suit can be maintained for the enforcement of a charitable trust by the Attorney General or other public officer, or by a co-trustee, or by a person who has a *special interest* in the enforcement of the charitable trust . . . ."[214] Thus the move the court made in *Holt* was relatively straightforward because the co-trustee was already recognized as having standing in the context of the charitable trust. But *Holt* leaves unanswered who falls under the category of "special interests" in the context of the not-for-profit corporation? The answer to this question need not be the same with respect to enforcement of each fiduciary duty; the focus here will be on the duty of obedience.[215] Recognizing the complexity of the business in which today's not-for-profits are often engaged, a compelling yet superficial argument can be made that standing to enforce the duty of obedience should be expanded to include the CEO.[216] As discussed earlier, lay trustees often lack the requisite sophisticated understanding of the business in which their not-for-profit is

211. *Id.* (citing Karst, *supra* note 209, at 444).

212. *Id.* at 936 (quoting Karst, *supra* note 209, at 444–45).

213. *Id.* at 934.

214. RESTATEMENT (SECOND) OF TRUSTS § 391 (1959) (emphasis added).

215. *See* Atkinson, *supra* note 146, at 662 (commenting that "it is conceivable that the law would place the enforcement of different duties in different hands. Similarly, the law could be relatively generous in granting standing to enforce some duties, but relatively chary as to others . . . .").

216. It is important to note that the CEO is specifically excluded from the category of "special interests" in the commentary to the Second Restatement of Trusts so it does not logically follow that *Holt* extends standing to the chief executive officer. The official commentary to the Second Restatement of Trusts states: "A person who is employed by the trustees to render services in the administration of the trust has no such special interest as to entitle him to maintain a suit for the enforcement of the trust." RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. d. However, in California the class of private persons with standing to sue has been expanded by statute to include any executive who holds an officer position. CAL. CORP. CODE § 5239(d) (West 1990).

engaged to effectively monitor compliance with the mission in a meaningful qualitative manner. A nuanced understanding of the institutional mission and how the choices before the organization impact that mission is often only possessed—in any meaningful degree—by the professional charged with leading the not-for-profit.[217] Therefore, legally empowering the professional to monitor institutional compliance with the mission seems to address Hall's concern that because historically "neither donors, their descendants, nor potential beneficiaries have [had] legal standing to challenge the use of charitable funds—and attorneys general have been less than willing to take positions on these questions—'mission' has become a less-than-meaningful constraint on the actions of trustees."[218] Following the logic of *Holt*, it is the professional CEO who is uniquely positioned to provide effective oversight of this fiduciary duty, and by taking advantage of this increased diligence, the not-for-profit, and by extrapolation the public welfare, benefits. Furthermore, expanding standing as proposed should not result in the not-for-profit sector being inundated with debilitating levels of litigation.[219]

---

217. *See* BOWEN, *supra* note 52, at 140 (observing that typically board members are outsiders to the particular field of business in which the not-for-profit is engaged and are removed from the daily operations of the not-for-profit. Therefore, they are confronted with the inherently difficult proposition of "address[ing] normative questions that depend on a nuanced understanding of the mission of the institution and the choices before it."). Yet notwithstanding this lack of preparedness and a potentially unsophisticated understanding of the issues informing the institutional mission, nonprofit corporate law largely entrusts the safeguarding of the mission exclusively to the lay board. But there is one important exception: the religious institution. The religious community itself is given the power to define and interpret the institutional mission. As Atkinson notes:

> [A]t every point along this high-church/low-church spectrum, there is radical autonomy from external control by either the private sector or the state on matters of core mission . . . [T]he attorney general can question whether a religious body is sufficiently careful with its funds, but not whether it is sufficiently Catholic, Quaker, or otherwise orthodox.

Atkinson, *supra* note 146, at 688. Certainly there are factors that distinguish the religious organization from other organizations in the not-for-profit sector, such as Constitutional guarantees concerning the freedom of religion, as well as notions about the higher ethical norms that inform standards of conduct in the religious institution. *See* Fishman, *supra* note 62, at 677 n.302. Yet, at the end of the day, are these factors really the source of deference to the professional that we see in the religious institution? Perhaps the heightened role afforded to the religious practitioner to define and interpret the institutional mission is an implicit recognition that the layperson is unqualified to make such substantive decisions regarding organizational vision. If this is true, why should the result be different at other not-for-profits that are engaged in business wholly outside the expertise of its lay board members? After all, when he appointed Doug Hughes as the new artistic director of Long Wharf, the board chairman announced that he was looking for Hughes to be "a minister to a church." Rizzo, *supra* note 13. However, in Hughes's church, the lay board were not expected to defer to the minister in establishing institutional vision and priorities, nor did they. When Hughes did not conform to their agenda, he lost his job. *Id.*

218. HALL, *supra* note 97, at 21.

219. If the *Holt* court found that expanding standing to entire boards of directors to enforce all fiduciary duties would be insignificant in terms of the amount of subsequent litigation that would be generated, then expanding standing to one additional person (the CEO), to enforce only one duty (the duty of obedience), would not place undue burdens on not-for-profits in terms of potential litigation.

Admittedly, there would be little immediate perceptible impact from officially granting the CEO legal standing to sue under the duty of obedience,[220] but there could be profound long-term implications resulting from such a redistribution of power between majoritarian and nonmajoritarian interests, and between the lay board and the professional staff. Legal standards can play an important role in shaping social norms and establishing guidelines for future conduct,[221] because they shape the corporate discourse and provide a framework for the dialogue.[222] Accordingly, nonprofit fiduciary law might be more productively viewed as less about imposing sanctions[223] and more about communicating appropriate forms of behavior to those actors,[224] namely the executive and the lay trustee "who are beyond the reach of the firm's normal systems of social control."[225] In other words, with regard to corporate law, judges play a role more akin to preacher than policeman.[226] "Courts preach . . . not to enlist the

220. On its surface, the proposal that the "special interests" doctrine be expanded to recognize the right of the CEO to sue his employer for breach of obedience appears to be an insignificant and purely academic contribution to the problem as identified. First, breach of obedience is a fiduciary duty that is rarely litigated, imperfectly understood, and generally treated as inferior to the corporate duties of care and loyalty in the legal literature. Second, given that the CEO likely has limited resources to fund such litigation, and might have legitimate concerns about future employment at his current institution and elsewhere, he probably will not bring such a lawsuit. Accordingly it is highly improbable that the courts would see much action resulting from expanding the legal standing to sue as proposed.

221. *See* Blair & Stout, *supra* note 7, at 1793–99; Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1654 (2001); *see also* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999).

222. *See* Blair & Stout, *supra* note 7, at 1796.

223. *See id.* at 1793–94.

224. *See* Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

> [T]he law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable . . . But they are not required by the corporation law and do not define standards of liability.

Id. Compare MODEL BUS. CORP. ACT § 8.30 (1999) (articulating an aspirational negligence standard of conduct for directors), *with id.* § 8.31 (establishing the gross negligence standard of liability to which directors will be held).

225. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1013 (1997); *see also* Blair & Stout, *supra* note 7, at 1794–96.

226. *See* Rock, *supra* note 225, at 1016. Professors Blair and Stout's analysis of the duty of care in corporate case law supports the proposition that legal norms, specifically in the context of corporate fiduciary duties, play a profound role in shaping conduct irrespective of the degree to which those legal norms are actually enforced through the legal system. They observe that despite the fact that the business judgment rule in practice protects the corporate trustee in many situations from complying with the negligence standard required under the duty of care, courts "have continued to insist that a duty to use reasonable care exists" in practice. Blair & Stout, *supra* note 7, at 1791–92. Despite the fact that "a negligent director is more likely to be hit by lightning after leaving her board meeting than she is to pay damages," *id.* at 1791, the corporate director's willingness to adhere to a higher standard of conduct than is required by the courts represents the power of the legal norm itself to frame behavioral expectations and motivate conduct accordingly. *Id.* at 1794.

aid of third-party 'norm enforcers,' but primarily to influence corporate participants' behavior more directly by fleshing out the social context of their relationships."[227]

Therefore, by granting the CEO standing to sue it can be argued that the law would communicate to the leadership of the not-for-profit corporation that the professional has an important role in the boardroom defining, monitoring, and enforcing an institution's mission. Thus, it would be unnecessary for professionals to exercise their newfound standing status en masse for the effects to be felt in the boardroom. Notably, few lawsuits are brought against the not-for-profit corporate trustee for breach of any fiduciary duty under the current status of the law.[228] However, we do not need a robust case law to recognize that the threat of litigation might be a significant behavioral motivator given that the lay director almost always serves without financial compensation, making the fear of costly litigation, regardless of sanctions, a real concern.[229] Furthermore, board membership is an important means of communicating social status,[230] and a lawsuit for violation of a fiduciary duty could have a devastating impact on the board member's social standing in the community. Therefore, for both social and economic reasons, the mere possibility of liability—even if it is remote—might be a powerful behavioral motivator for the lay trustee.

VII. THE DUTY OF OBEDIENCE AND THE SERIOUS LIMITATIONS OF CORPORATE LAW IN THE NOT-FOR-PROFIT SECTOR

But relying solely on the law to promote a dialogue of trust in the not-for-profit boardroom is, at best, an ineffective means of achieving the end result, and such reliance would likely produce unintended, counterproductive

227. Blair & Stout, *supra* note 7, at 1796–97; *see also* Rock, *supra* note 225, at 1097 (arguing that "fiduciary duty law evolves primarily at the level of norms rather than the level of rules").

228. There are several conclusions that one can draw here. It could be argued that the lack of litigation in this area is symptomatic of a gross under enforcement of the fiduciary duties. *See* Goldschmid, *supra* note 125, at 640. However, it is more likely that disagreements over fiduciary conduct are not being glossed over but instead are being settled outside of the courtroom. As Brody argues, private settlements are often the most effective means of balancing the regulator's two main objectives: (1) ensuring that the not-for-profit is managed for the benefit of the public welfare; and (2) maintaining public confidence in the not-for-profit that could easily be destroyed by a more public means of resolving the dispute. Brody, *supra* note 146, at 1410. *See* Fishman, *supra* note 62, at 671 (noting that the "[p]ublicity generated by the mere filing of the suit may dry up sources of funds. The reputation of the organization may never recover."); *see also* Peregrine & Schwarz, *supra* note 82, at 476. Unfortunately these private closing agreements create a "secret body of law" that make it virtually impossible to assess the effectiveness of regulation which can lead to a public perception that not enough is being done to ensure the accountability of today's not-for-profits. *See* FISHMAN & SCHWARZ, *supra* note 122, at 160; Brody, *supra* note 146, at 1410–11.

229. *See* Wry, *supra* note 83, at 19; KURTZ, *supra* note 4, at 95.

230. See discussion of reasons why people join not-for-profit boards *infra* note 272.

consequences.[231] First, even though the director is uncompensated, the miniscule threat of liability is unlikely to be a significant behavioral motivator.[232] Expanding the class of individuals with standing to enforce those duties to someone who not only has little incentive to bring suit if they want to continue working in their chosen profession, but is also unlikely to have the financial resources to litigate such an action, would do little to raise the specter of liability. Not only would the actual threat be minimal, the board might conceivably perceive the possibility of the threat as even less than it actually is given that not-for-profit directors tend to be successful individuals with a proclivity for "overestimat[ing] their ability to control their environment and avoid harm . . . [and] significantly . . . underestimat[ing] the likelihood of their own negligence, for that tends to threaten their sense of identity."[233] In other words, if the lay trustees collectively do not trust the executive to be part of the leadership team, the law cannot manufacture that trust.[234] Any attempt to do so would likely be perceived as illegitimate by the very class of people the law would be attempting to influence. Furthermore, because the threat of sanction would also be low, it seems likely that attempting to legislate trust in the boardroom would have no impact on the players involved, and might actually "generate an aversion to the demand and a devaluation of the law's legitimacy in this area."[235] Framing the situation in terms of a "low probability/low sanction threat causes people to think simply in economic terms, which may readily lead to noncompliance simply because the threat of sanction is so visibly remote."[236]

Therefore, a well-intentioned attempt to induce cooperation through the imposition of external motivators is likely to backfire by "undermining corporate participants' *internal* motivations,"[237] and thus actually curtailing the desired behavior. Not only will the participants be encouraged to perform a cost benefit analysis with regard to compliance, but it is problematic to argue that

231. *See generally* Bainbridge, *supra* note 31, at 50 ("[T]eams have within them a network of social sanctions that shape incentives. Judicial review is not an appropriate vehicle for fostering the sort of social norms on which internal team governance relies.").

232. As has already been discussed, courts rarely impose sanctions for breaches of fiduciary duties except in situations of gross negligence. *See* Rock & Wachter, *supra* note 221, at 1623 (noting that the "duty of care, despite *looking* like a typical legally enforceable standard of care, actually is best understood as an NLERS [nonlegally enforcing rules and standards], with the business judgment rule assuring that enforcement is almost entirely nonlegal").

233. Langevoort, *supra* note 8, at 825.

234. *Id.* at 28 (noting that the director will assess the legitimacy of the legal standard along with his perception of the standard's legitimacy as "socially constructed by peer groups" before deciding whether to comply with it or not).

235. *Id.* at 31.

236. *Id.* at 29.

237. Blair & Stout, *supra* note 7, at 1809.

by making it "easier for corporate participants to 'litigate trust,'"[238] the participants will develop more trustworthy behavior towards each other. Encouraging the lay trustee and the professional to become legal adversaries hardly seems the best route to nurture an ongoing and productive dialogue between them. Thus if the law becomes too aggressive, it risks undermining any real basis for trust in the not-for-profit boardroom; and yet if the law does not act aggressively, it "accomplishes little in terms of direct behavioral impact and risks undercutting the norms that do operate."[239] Consequently, while nonprofit corporate law has a role to play in establishing the framework in which "nonlegally enforcing rules and standards"[240] can operate, namely by recognizing the importance of fidelity to the institutional mission through the codification of an independent legal duty of obedience, the law is not the best means through which to enforce this duty.[241] Far more efficacious in the effort to develop trust in the not-for-profit boardroom is for the actual participants, namely the lay trustee and the professional, to confront the stereotypes that may be impeding productive dialogue and together develop an organizational structure and internal norms[242] that will encourage a working trust between them.[243]

238. *Id.* at 1797.

239. Langevoort, *supra* note 8, at 830.

240. The term nonlegally enforceable rules and standards (NLERS) was coined by Rock & Wachter to refer to internal norms. *See* Rock & Wachter, *supra* note 221, at 1623. They argue that in order to be truly effective, internal norms must not have a legal sanction for noncompliance available to the parties as a safety net, for a "judicial safety net" undermines the parties' motivation to fully address the issue themselves. *See* Edward B. Rock & Michael L. Wachter, *Symposium Norms & Corporate Law: Introduction*, 149 U. PA. L. REV. 1607, 1617 (2001).

241. While Blair, Stout, Rock and Wachter, among others, have made compelling arguments that one of the primary purposes of corporate law as implemented by the courts is to communicate acceptable and appropriate standards of behavior through sermons rather than sanctions, there is currently little scholarship on *how*, if at all, corporate law actually influences corporate norms. Clearly, in order for corporate law to impact corporate norms, the sermons must not only seem legitimate to the players they are attempting to influence, they must also be effectively *communicated* to the players. *See* Langevoort, *supra* note 8, at 823–25. And with the scholarship in such an embryonic state, as Rock argues, "it is still unclear how (and whether) the parables make their way to their audience." Rock, *supra* note 225, at 1106. Where are the corporate actors getting their information about corporate law? From business newspapers like *The Wall Street Journal*? Their own legal council? And how distorted by the deliverer's own self-interested agenda is the information being transmitted? *See* Langevoort, *supra* note 8, at 823–25.

242. Internal norms are rules of behavior that are punished by social sanctions rather than legal penalties. To be an effective sanctioning mechanism, the participants must have repeat interactions thereby enabling future punishment, group norms must be internalized, and the participants must have the requisite level of self-esteem that motivates them to avoid behavior that would precipitate sanctioning by the group.

243. Not only would it be more efficacious, it also avoids exasperating what Brody refers to the "circularity problem" that was raised by the dissent in *Holt v. College of Osteopathic Physicians & Surgeons*, 394 P.2d 932, 939–40 (Cal. 1964) (McComb, J., dissenting). The circularity problem arises when a minority of the institutional leadership can bring suit against the majority, thereby undermining the

VIII. RESTRUCTURING THE NOT-FOR-PROFIT BOARD TO FACILITATE TRUST IN THE BOARDROOM: FULFILLING THE DUTY OF OBEDIENCE THROUGH NONLEGALLY ENFORCING INTERNAL NORMS

This Comment, then, proposes that the structure of the typical not-for-profit board be re-examined and specifically, that the number of inside directors[244] on the board be increased in relation to the number of outside directors. It is not uncommon for the not-for-profit board to be comprised entirely of lay trustees, and if the board does include insiders, it is extremely rare for there to be more than one.[245] Placing the CEO as the sole insider on the board as a means of encouraging dialogue between the lay trustee and the professional is a simplistic solution that has largely proven ineffective for many of the same reasons that expanding standing to sue would be ineffective. As the sole insider voice on a board of fifty or more, simply putting one professional on the board has had little to no impact on the quality of the dialogue in the not-for-profit boardroom.[246] However, if the number of insiders on the not-for-profit board were increased so that they formed a critical mass, say one third of the board,[247] then the potential strategic advantage of having insiders on the board (to build trust in the boardroom and facilitate the exchange of information for the benefit of the

---

general principle that the corporation is to be governed by the majority of the board. For a discussion of the issue, see Brody, *supra* note 146, at 1433. *See also* Rock & Wachter, *supra* note 221, at 1651.

244. I am using the term "inside director" to refer exclusively to current employees of the organization who are also members of the board. By contrast, "outside director" will be used to refer to those board members who are not current employees of the firm and who do not have significant business ties to the organization.

245. BOWEN, *supra* note 52, at 47.

246. *See* HOULE, *supra* note 111, at 34. This assumes that the CEO is not also the founder of the organization. Zelda Fichandler, co-founder of Arena Stage in Washington, D.C., points to that distinction in contrasting her relationship with the board as compared with Doug Hughes at Long Wharf. "I've had my difficulties with the chairman of the board, but I was in a different position because I founded the theater. We [founders] were in a primary position, and it was the artistic director who was in charge of both educating the board about the theater's mission, and active in raising money." Julie O'Connor, *Long Wharf Theater Responds to an Artistic Director's Departure*, YALE HERALD, Sept. 9, 2001, *available at* http://www.yaleherald.com/archive/xxxii/09.07.01/ae/p13connor.html.

247. Of course, the appropriate relationship will depend on the organization. While it is important to increase the presence of inside directors on the board to create a critical mass capable of impacting the dialogue in the boardroom, this must be balanced against the need to promote a diversity of perspectives on the board. The inside director will tend to approach issues from a relatively monolithic perspective as led by the CEO. Consequently, it is important that enough inside directors are added so that their voices are effectively heard, but not so many that board diversity is unduly sacrificed. *See generally* Langevoort, *supra* note 8, at 816 (discussing that the real issue is "critical mass," not parity between the number of outside versus inside directors). Notably, in the for-profit sector where the number of inside directors has declined over the last few decades, in 1997, 64 percent of the S&P 500 firms still had boards comprised of between 11 and 30 percent inside directors. Bhagat & Black, *supra* note 39, at 922.

not-for-profit) might be more likely realized.[248] Information that is critical to the lay trustees in performing their monitoring function is more likely to be communicated by the staff, who controls vital performance data as well as specialized knowledge of the strategic operating environment, when that staff feels that it is represented on the board.[249] When the "them and us" dichotomy is destroyed, and the staff is actually invested *in* the board, it no longer has an incentive to withhold and manipulate information to protect itself *from* the board.[250] Not only will essential information flow more freely, but with a critical mass of insiders on the board, the information will potentially be processed more effectively. The staff professional will likely have different skill sets and perspectives that effectively complement, as well as challenge, those of the outside directors. As Langevoort points out, both the outside and inside director have their own unique cognitive biases about the organization's strategic position and are generally "disinclined to seek out information that would suggest that they might be wrong."[251] Consequently, changing the demographics of the board by adding a significant number of insiders challenges the lay trustee "to reckon with the better informed, if sometimes unreflective, insight that management naturally has,"[252] while through the course of the interaction, the insider is likely forced to confront the potential insularity of his own views. Balancing the board accordingly can thus serve a critical "*symmetrical* de-biasing"[253] function, facilitating the requisite development of trust in the boardroom that encourages communication amongst the institutional leadership and creates a safe environment for strategic dialogue that benefits the not-for-profit as a whole.

While fully elaborating this proposal is beyond the scope of this Comment, I will briefly address three immediate criticisms. First, simply placing a critical

248. John and Miriam Mayhew Carver claim a not-for-profit staff that distrusts its board will protect itself by withholding information from the board, in ways that are "rarely in the interest of organizational effectiveness." JOHN CARVER & MIRIAM MAYHEW CARVER, REINVENTING YOUR BOARD: A STEP-BY-STEP GUIDE TO IMPLEMENTING POLICY GOVERNANCE 40 (1997).

249. See Langevoort, *supra* note 8, at 812–14 (discussing the institutional costs of chilled communications between the board and the staff that can result from attempts at aggressive monitoring by a solely independent board of directors).

250. This Comment takes no position on whether the CEO should in fact be the President of the board. For the argument in favor of doing so, see BOWEN, *supra* note 52, at 88 (noting that the separation between the board chairman and the CEO typical in the not-for-profit sector is a normative construct largely foreign in the for-profit sector). "It is ludicrous to imagine IBM contemplating for even one moment the recruitment of a nationally respected CEO of Louis Gerstner's stature without simultaneously offering him the chairmanship." *Id.* Bowen argues that given the complexity of today's not-for-profits, the skill sets and visionary leadership capabilities that a for-profit institution looks for in a CEO candidate closely parallel the qualifications the not-for-profit hopes to attract in its CEO candidates. Given that reality, Bowen challenges the logic in the different normative standards in for-profit versus nonprofit governance vis-à-vis the roles of the chairman and CEO. *Id.* at 110.

251. Langevoort, *supra* note 8, at 803.

252. *Id.* at 807.

253. *Id.*

mass of inside directors on the board will not itself foster trustworthy behavior in the boardroom, and may instead be counterproductive by empowering two intractable factions that will paralyze institutional leadership. Second, because there is no market for corporate control, increasing the power of insiders on the board would result in prohibitively high agency costs. And third, even if the presence of inside directors would theoretically benefit the organization, for practical reasons, the not-for-profit board could never be reduced to a size that would allow for a critical mass of inside directors on the board.

I partially concede the validity of the first criticism. Of course, simply placing members of the staff on the board will not in itself create trust in the boardroom. Instead, it is merely a positive first step in that it joins the key members of the leadership team in one body.[254] The quality of the dialogue between them will depend on the internal working norms[255] they develop as a group that will guide their interactions with each other and the organization as a whole. To facilitate the dialogue between the two groups, a third class of directors (gray directors or affiliated directors) can be productively added to the board.[256] The gray director typically has a longstanding relationship with the organization perhaps as an attorney or a business associate, and is thus uniquely positioned to mediate between the invested inside and outside directors. In order to function effectively, the gray director must understand his role on the board, and cultivate the trust of both the inside and outside directors.

The second criticism is that because there is no take-over market to serve as an "external court of last resort for protection of residual claimants,"[257] the board's monitoring functions assume far greater importance in not-for-profit

254. *But see* Dallas, *supra* note 33, at 24 (arguing that instead of combining the inside and outside director into one governing body in the for-profit corporation, there should be a dual board structure comprised of a "conflicts board" (outside directors) and a "business review board" (inside directors)).

255. There have been countless books and articles written on what practices and processes make for a productive board. One purpose of this Comment is to suggest who should be on the board, not how the board, once it is structured, should behave. That being said, there is a strong argument to be made that each board member should have a job description so that she is clear exactly what role(s) she is fulfilling on the board and what skill sets, connections, and/or resources she is expected to bring to the table. *See* Wry, *supra* note 83, at 16. In addition, Lizabeth Moody's proposal that the institutional charter and bylaws should play a central role in establishing the internal rules and standards for the organization, establishing the "law" for the organization in ways that the not-for-profit corporation cannot, should be taken seriously. Lizabeth Moody, *State Statutes Governing Directors of Charitable Corporations*, 18 U.S.F. L. REV. 749, 779 (1984). Therefore, the bylaws must be written accessibly (instead of in the disjointed legalese that typically characterizes not-for-profit bylaws), updated annually, and every board and staff member should be familiar with them.

256. *See* Langevoort, *supra* note 8, at 800; HERMALIN & WEISBACH, *supra* note 11, at 2 n.1 (noting that on the for-profit corporate board, approximately 10 percent of the directors are gray); Bhagat & Black, *supra* note 39, at 950 (observing that the optimal board may be a mix of inside, outside, and affiliated directors, each of whom brings "different skills and knowledge to the board").

257. *Ownership and Control*, *supra* note 35, at 313–14.

governance.[258] Yet even if one concedes that point, it does not follow that the number of inside directors on the not-for-profit board should be reduced instead of increased. Over the past ten years there have been countless studies of the for-profit sector assessing the impact of the powerful movement during the 1980s and 1990s that sought to enhance board accountability by attempting to strengthen the board's monitoring efficacy through the replacement of inside directors with outsiders.[259] These studies have found no convincing evidence that corporate boards that have a majority of independent directors outperform corporations that do not.[260] In fact, there is evidence to suggest that firms with boards comprised of a supermajority of outside directors[261] perform worse than other firms,[262] and that organizations whose boards contain between 30 and 45 percent insiders demonstrate greater profitability.[263] The results of these studies in the for-profit sector are hardly surprising when one recognizes that the board performs both monitoring and managerial functions, and that the inside director is critical to the effective performance of each.[264] These fundamental functions of governance and the value added by the inside, outside, and affiliated director does not change merely because a corporation is organized as a not-for-profit.[265] Although the market for corporate control differs, the demands of corporate governance are predictably similar between the sectors. Furthermore, simply because lay trustee consistently makes sizeable contributions to the organization does not uniquely qualify him to safeguard institutional interests.[266] It is doubtful that members of the professional staff,

258. *Id.* at 319.

259. *See, e.g.*, F. Baysinger & H. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L., ECON. & ORG. 101, 102–03 (1985), Bhagat & Black, *supra* note 39, at 921–22, K. Borokhovic R. Parrino & T. Trapani, *Outside Directors and CEO Selection*, 31 J. FIN. & QUANTITATIVE ANALYSIS 337, 339–40 (1996), J. Byrd & K. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195 (1992); S. Kaplan & D. Reishus, *Outside Directorships and Corporate Performance*, 27 J. FIN. ECON. 389, 390–91 (1990).

260. *See* HERMALIN & WEISBACH, *supra* note 11, at 12; Bhagat & Black, *supra* note 39, at 922.

261. Defined as boards that have only one or two inside directors.

262. Bhagat & Black, *supra* note 39, at 950.

263. *See id.* at 922.

264. *See supra* Part IV.

265. Consequently, it makes little sense for Eugene Fama and Michael Jensen to argue first that "a corporate board can be in the hands of agents who are decision experts. Given that the board is to be composed of experts, it is natural that its most influential members are internal managers since they have valuable specific information about the organization's activities." *Ownership and Control*, *supra* note 35, at 314. But then they refuse to apply this logic to the not-for-profit corporation. Instead, Fama and Jensen argue that inside directors should *not* have a strong presence on the not-for-profit board. *Id.* at 319. How can this be when the demands of governance have not changed significantly from one sector to the other?

266. *See* Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. L. & ECON. 351, 359 (1983) (noting that an individual's decision to donate to a not-for-profit is motivated by many factors, and is ultimately informed by his own personal agenda). *But see Ownership*

with their significant investment of human and reputational capital, have any less of a claim on the institution.[267] After studying board performance in the for-profit sector, Professors Sanjai Bhagat and Bernard Black conclude that "it is not obvious that independence (without knowledge or incentives) leads to better director performance than knowledge and strong incentives (without independence). Maybe a better answer is to build a board with some knowledgeable, incentivized inside directors, and some independent directors—who might thereby become better informed . . . ."[268] This observation is equally salient for the not-for-profit corporation.

The concern that the not-for-profit board cannot sustain a significant reduction in the number of lay trustees and still ensure that the organization has access to needed resources is a more difficult challenge to overcome. This challenge is not insurmountable, but it does require the not-for-profit to manage its human capital differently. A not-for-profit board can easily number fifty or more as compared to a for-profit board that averages between ten to fourteen members.[269] The small size of the for-profit board is hardly surprising given that empirical studies of board performance consistently find that board size is negatively correlated with organizational performance.[270] Despite the conventional wisdom that a large board is inefficient and exasperates agency costs,[271] the large size of the not-for-profit board is typically driven by a need for funding: (1) New members can often access fresh money in the community, and (2) board memberships are often coveted positions used to reward major donors.[272] However, using board seats as a fundraising tool undervalues the

---

and Control, *supra* note 35, at 319 (claiming that by making donations, the lay trustee is signaling "to other donors that board members are motivated to take their decision control task seriously").

267. *See* Bhagat & Black, *supra* note 39, at 951; Fisch, *supra* note 39, at 275; Gulati et al., *supra* note 30, at 923.

268. Bhagat & Black, *supra* note 39, at 951.

269. *See* BOWEN, *supra* note 52, at 43.

270. *See* HERMALIN & WEISBACH, *supra* note 11, at 3.

271. *Id.* at 14.

272. *See* BOWEN, *supra* note 52, at 44; Thorn, *supra* note 26, at 57. While not-for-profit institutions nominate trustees to the board for a variety of reasons including their connection to a key constituent group, their access to funding, or their prominence in the community; the reasons why individuals elect to join boards are even more numerous. Thomas Savage has identified many of the key motivating factors that influence an individual's decision to join a not-for-profit board. They include "[p]ersonal enrichment, fun, prestige, substantive interests, nostalgia, sentiment, friendships and personal associations, opportunities for business, professional and social contacts . . . personal aggrandizement, honor, privilege, psychic rewards, visibility and societal recognition . . . ." THOMAS J. SAVAGE, MEMOS TO THE BOARD: REFLECTION OF BOARD PRACTICE AND THINKING IN ACTION 64–65 (1985); *see also* Shenk, *supra* note 83, at 9 (arguing that the social status derived from board membership is a major drawing card in accepting a board position. He observes that "nonprofit board seats are coveted honorifics snapped up by the half dozen" indicating that the board member is not seriously invested in his governance role at one institution). Janice C. Simpson, *Prestigious Positions on Charitable Boards Now Require Much More Time and Effort*, WALL ST. J., Jan. 7, 1988, at 21 (reporting the result of a 1987 survey of 600 wealthy individuals who ranked sitting on

critical leadership role that the not-for-profit director plays on the board and the level of expertise that the trustee must bring to the table to function effectively as a steward of a complex business. Peter Hall has argued that with the increased number of not-for-profits over the past two decades, there is a tremendous demand for qualified directors that "far exceeds the population of those with either trustee experience or an understanding of traditional trusteeship values."[273] Yet, if we can restructure the not-for-profit board to dramatically decrease the number of lay trustees without sacrificing the organization's critical revenue streams, the not-for-profit can be significantly more selective in whom it recruits for board membership, and thus better positioned to build a board with lay trustees that are committed to the institution and that bring the requisite skills to the table.

The Memorial Sloan-Kettering Cancer Center provides a case study of how such restructuring might be successfully accomplished.[274] The Cancer Center created what it calls the "Boards of Overseers and Managers," which has approximately fifty-five members. Publicly, it appears to be one body; therefore membership on it is an effective tool for rewarding the large institutional donor. But only the Board of Managers, with approximately twenty-five members, is the legal voting board, while the Board of Overseers serves merely in an advisory capacity and fills out board committees[275] as is appropriate given its members' interests and skill sets. The Cancer Center provides merely one model of how a not-for-profit might reduce the number of lay trustees without sacrificing critical financial resources.[276] Of course, the appropriate model will depend on the particular institution. Regardless of structure, it is crucial that the board be pared down to a manageable group comprised of both inside and outside directors who understand and identify with the institutional mission and are committed to working together to strategically position the organization so that it consistently and productively fulfills its public purposes over the long-term.

---

the board of a cultural institution as the third most prestigious symbol of personal success and achievement); *see also* Reynolds, *supra* note 24 (describing the perks of board membership for the major cultural institutions of Los Angeles).

273. HALL, *supra* note 25, at 137.

274. See BOWEN, *supra* note 52, at 45, for a brief discussion of the Memorial Sloan-Kettering Cancer Center's board structure.

275. This is not to argue that a board must have committees in order to be successful. However, a not-for-profit board will typically have a finance committee, a nominating committee and a development committee. Other committees are often formed when there is a perceived need for them, such as an endowment committee and a facilities committee. Arguably, a small working board such as the one advocated by this proposal has no need for the traditional executive committee.

276. For example, late in 2001 the Los Angeles Philharmonic began experimenting with its own board of overseers. The board of overseers supplements the organization's main board and is intended as a means of cultivating high-powered busy professionals. Its members are only asked to attend three meetings a year and are heavily rewarded with prestigious social perks such as lunch with architect Frank Gehry. *See* Reynolds, *supra* note 24.

CONCLUSION

Ultimately, then, the health of the not-for-profit sector depends on human interactions at the institutional level. And nonprofit corporate law does have an important aspirational function here. Although the duty of obedience might be the not-for-profit trustee's most important duty, it is generally relegated to a distant third behind the duties of care and loyalty, if it is acknowledged at all. The duties of care and loyalty are more readily accessible, not only because they are informed by a significant body of case law in the for-profit sector, but, particularly in the case of duty of loyalty, a violation is comparatively easy to assess given normative standards governing the point at which self-dealing crosses the line to the detriment of the institution. However, if the not-for-profit is to be legally accountable to its public purpose, the duty of obedience must also be given substantive meaning. But while the law has a critical role to play in articulating standards, it should take a backseat when it comes to actually enforcing them. Instead of looking to the solution for the crisis of legitimacy that currently threatens the not-for-profit sector solely in terms of nonprofit corporate law, we must also examine the vital contributions that can be made through further studies of organizational behavior and group processes in the not-for-profit institution.[277] Arguably, enforcement of the duty of obedience can be more effectively achieved through the development of internal norms that facilitate a culture of trust between the lay trustee and the executive in the boardroom. This could mean restructuring the board to both decrease the number of lay trustees as well as increasing the number of inside directors. In the end, how successful the not-for-profit is at fulfilling its public purposes is driven by what information is presented in the boardroom and how the directors use that information to strategically position the institution within its operating environment on an ongoing basis. Consequently, just as in the for-profit sector, the most effective not-for-profit boards are "ones that have enough diversity to encourage the sharing of information and active consideration of alternatives, but enough collegiality to sustain mutual commitment and make consensus-reaching practicable within the tight time frames in which boards must operate."[278] After all, the construct of the not-for-profit corporation, as with any business form, is nothing but a "legal fiction."[279] The accomplishments of a not-for-profit "cannot be separated from the human beings who deal with

277. As Peter Hall argues, establishing "the nature of private power in a democracy [and] [w]ho can legitimately speak for the public . . . [are questions that must be answered] not in national forums, but in localized nooks and crannies of the institutional infrastructure." HALL, *supra* note 25, at 9.

278. Langevoort, *supra* note 8, at 810–11.

279. Brody, *supra* note 24, at 462.

them in their various capacities."[280] As with any business endeavor, the success of the not-for-profit depends on the quality of the dialogue between the people empowered to lead it.

280. *Id.* at 462–63.