

Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law

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I. INTRODUCTION

Recent and very public problems in the nonprofit world point to the need for greater scrutiny and some means to protect charities¹ from overreaching by directors, trustees, and managers. In 1991, investigative journalists exposed lavish personal expenditures by United Way's president, William Aramony.² Aramony himself was later convicted of theft,³ but United Way's problems raise serious questions about corporate governance in the nonprofit context.⁴ United Way's thirty-person board of directors provided little supervision and oversight during Aramony's tenure.⁵ The board's passivity allowed a dominant executive officer to manage the charity in a way that benefited himself and his friends at the expense of the organization.⁶

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¹ Terminology with respect to charities and nonprofits is problematic. The term "nonprofit" refers to an organization subject to a nondistribution constraint, that is, "an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter Hansmann, *Role*]. "Charities" is a subclass of nonprofits, and not all nonprofits are charities. For the most part, the focus of the Article is on charities, and that term will be used predominantly. Nonetheless, much of this Article also applies to entities organized as nonprofits but not necessarily as charities—for example, mutual benefit corporations.

² See Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 633-35 (1998).

³ See Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than \$600,000*, N.Y. TIMES, Apr. 4, 1995, at A1; see also *United States v. Aramony*, 88 F.3d 1369 (4th Cir. 1996), cert. denied, 520 U.S. 1239 (1999) (upholding all but one count of his conviction).

⁴ See Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 455-56 (1996) [hereinafter Brody, *Institutional Dissonance*]; Goldschmid, *supra* note 2, at 634-35.

⁵ See Goldschmid, *supra* note 2, at 634; David Shenk, *Board Stiffs*, WASH. MONTHLY 9-13 (May 1992).

⁶ See Goldschmid, *supra* note 2, at 633; Charles E. Shepard, *Perks, Privileges and Power in a Nonprofit World*, WASH. POST, Feb. 16, 1992, at A1.

Adelphi University also fell victim to conflicts of interest and neglect of duty by its president and its board of trustees.⁷ After alumni, faculty and students formed the Committee to Save Adelphi, the New York Board of Regents investigated and found misappropriation of funds, conflicts of interest of board members, and excessive expenditures by President Diamandopoulos.⁸ At a time when the University's academic reputation and student body was declining, Diamandopoulos was the second highest paid university president in the country.⁹

The most recent example of a major charity facing issues involving breaches of fiduciary duties is the Kamehameha Schools Bishop Estate ("Bishop Estate"). Investigations into the management of Bishop Estate assets have exposed favoritism, incompetence and numerous transactions involving conflicts of interests and private inurement of the trustees and others connected with the trust.¹⁰ Public outcry, an Internal Revenue Service ("IRS") audit,¹¹ and an investigation by the Attorney General¹² eventually led to the resignation or removal of the five Bishop Estate Trustees.¹³

⁷ See JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* (1995)(Supp. 1998) at 9-10; Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1401-02 (1998) [hereinafter Brody, *Limits*].

⁸ See FISHMAN & SCHWARZ, *supra* note 7, (Supp. 1998) at 9-18.

⁹ See *id.* (Supp. 1998) at 10.

¹⁰ See Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 10, 1998) [hereinafter Petition of the Attorney General], available at <<http://starbulletin.com/98/09/11/news/removal.html>>; Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU-STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*.

¹¹ See Rick Daysog, *IRS Wants Bishop Trustees Out*, HONOLULU STAR-BULLETIN, Apr. 28, 1999, at A-1.

¹² See Rick Daysog, *Trustee Lindsey Removed*, HONOLULU STAR-BULLETIN, May 6, 1999, available at <<http://starbulletin.com/1999/05/06/news/story1.html>> (describing the permanent removal of Trustee Lokelani Lindsey). See Petition of the Attorney General, *supra* note 10.

¹³ See Rick Daysog, *Then There Were None*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-1 (describing the resignation of trustee Oswald Stender and the probate court's temporary removal of trustees Richard Wong, Henry Peters, Lokelani Lindsey, and Gerard Jervis); Rick Daysog, *Gerard Quits Trustee Post*, HONOLULU STAR-BULLETIN, Aug. 20, 1999, at A-1 (describing the resignation of Trustee Jervis); Rick Daysog, *For Wong, 'it took courage to resign'*, HONOLULU STAR-BULLETIN, Dec. 4, 1999, at A-1 (describing the resignation of Trustee Richard "Dickie" Wong); Rick Daysog, *Last Trustee Standing, Henry Peters Resigns*, HONOLULU STAR-BULLETIN, Dec. 14, 1999, at A-1 (describing the resignation of Trustee Peters); Rick Daysog, *'End of the line'*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-1 (describing the resignation of Trustee Lindsey which will take effect 30 days after her appeal of her permanent removal is decided).

The United Way and Adelphi University scandals, and now the Bishop Estate problems, have reduced public confidence in charities, while highlighting inadequacies in the regulatory framework that governs the activities of those who manage charities.¹⁴ To protect charities, the law imposes fiduciary duties on the directors and trustees of charitable organizations.¹⁵ These duties require the directors or trustees to act in the best interests of the organization and not to benefit personally at the expense of the organization.¹⁶ Since the restoration of public confidence in nonprofits requires adequate enforcement of these fiduciary duties, the rules governing nonprofit management have recently come under considerable scrutiny.¹⁷

Confronting the problem of fiduciary duty abuse is complicated because, in the words of Professor Deborah DeMott, the fiduciary obligation is "one of the most elusive concepts in Anglo-American law."¹⁸ Fiduciary duties arise in a variety of settings, and the extent and nature of the obligations vary depending upon the context.¹⁹ The fiduciary concept arose in private trust law²⁰ and is now an integral part of corporate law. The regulation of charities does not fit neatly within the rules governing private trusts or for-profit business.

The laws that have developed for charitable organizations do not always work well, in part because they depend on enforcement mechanisms that work in the private trust or for-profit business context, but that do not necessarily make sense for charities.²¹ Oversight by persons other than the trustees or directors is a case in point. The trust beneficiaries of a private trust can sue the trustee for breach of any of the trustee's fiduciary duties. Since the beneficiaries may lose part of their beneficial interest if the trustee violates the trust, the beneficiaries have an incentive to monitor the actions (or inaction) of the trustee. In a corporation, the shareholders keep an eye on the directors since director malfeasance will harm their interests. In addition, the

¹⁴ See Rayna Skolnik, *Rebuilding Trust*, PUB. REL. J. 29, 32 (Sept. 1993) (describing "[t]he public's shift from sympathy to skepticism" following the United Way scandal).

¹⁵ See FISHMAN & SCHWARZ, *supra* note 7, at 158-59.

¹⁶ See *id.*

¹⁷ See Harriet Bograd, *The Role of State Attorneys General in Relation to Troubled Nonprofits* 24 (Program on Non-Profit Orgs., Yale Univ., Working Paper No. 206, Aug. 1994); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457 (1996) [hereinafter Brody, *Agents*]; Goldschmid, *supra* note 2; Shenk, *supra* note 5, at 9-13.

¹⁸ See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988).

¹⁹ See FISHMAN & SCHWARZ, *supra* note 7, at 158-59.

²⁰ See DEBORAH A. DEMOTT, *FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP* 12 (1991).

²¹ See *infra* notes 238 and 245 and accompanying text.

marketplace and the need to make a profit provide other external incentives for directors to perform their jobs properly.

Unlike private trusts, charitable trusts have no specific individuals identified as beneficiaries who can sue to enforce the trust.²² And unlike business corporations, nonprofit corporations have no shareholders.²³ If the nonprofit has voting members, the members may have a legal right to represent the nonprofit by taking directors who misbehave to court, but most nonprofits do not have voting members.²⁴ For both types of charitable entities, the persons who have direct knowledge of the organization and who can sue are often limited to the trustees and directors themselves. In many situations, only the attorney general can sue to protect the charity from overreaching managers.²⁵

Some state and federal laws on charitable management exist. However, without the immediate oversight of shareholders and the marketplace or of private beneficiaries, many charities are controlled by one or a few persons. Those persons may be able to operate undetected if they seek private benefit at the expense of the nonprofit.²⁶

This Article considers what can and should be done to improve enforcement of fiduciary duties in the charitable sector. The Article analyzes the fiduciary duties concept in both trust and corporate law and looks at the development of fiduciary duties law in the charitable context. It then reviews federal tax regulations of fiduciary behavior and considers recent changes that may improve the supervision of charities and the enforcement of the fiduciary duties of charitable directors and trustees. Regulation at the federal level, through the IRS, has become increasingly important. The Article concludes that problems associated with breaches of fiduciary duties lie not so much in the standards of conduct prescribed by the fiduciary duty requirements as in the enforcement of those standards. Greater access to information under new federal rules should help, but alternative means to enforce the standards are also necessary. Nonlegal strategies should complement legal enforcement.

²² See RESTATEMENT (SECOND) OF TRUSTS § 112 cmt. h (1959)(explaining that charitable trusts can be created without named beneficiaries); *infra* notes 281-90 and accompanying text (discussing the special interests doctrine).

²³ See REV. MODEL NONPROFIT CORP. ACT xxiv-ix (1988)(Introduction)("One general rule is that members, unlike shareholders in business corporations, can have no ownership interest in their corporation.").

²⁴ See *infra* notes 267-71 and accompanying text.

²⁵ See *infra* notes 259-63 and accompanying text.

²⁶ James Fishman has been quoted as saying, "Non-profits are essentially unregulated and unmonitored unless the press gets wind of a story." Thomas J. Billitteri, *Rethinking Who Can Sue a Charity*, CHRON. PHILANTHROPY, Mar. 12, 1998, at 26, 35.

II. TRUST LAW

In England and in the colonies, charities organized themselves primarily as trusts.²⁷ After the American Revolution, some states refused to uphold the validity of charitable trusts, and charities began to form as corporations in substantial numbers.²⁸ Charities continue to be organized and operated as either charitable trusts or as nonprofit corporations.

Rules governing the fiduciary duties of trustees of private, noncharitable trusts also apply to the trustees of charitable trusts.²⁹ In addition, the fiduciary duties of directors of nonprofit corporations have developed as a hybrid of trust law and corporate law.³⁰ Thus, to understand the current state of the fiduciary laws that apply to charitable trustees and directors, it is instructive to review the laws of fiduciary duties that have developed for private, noncharitable trusts and for business corporations.

The law imposes a number of stringent duties upon trustees.³¹ In a trust, ownership of the trust property is divided between the trustee, who holds legal title and controls the trust property, and the beneficiary, who holds equitable title and has the beneficial interest in the property.³² The trust provides a useful vehicle for situations in which separating control from beneficial ownership makes sense.³³ Yet, separating control from beneficial ownership creates the risk that people controlling the property will use it for their own benefit or will mismanage it.³⁴ Fiduciary duties are intended to make the division of ownership function properly.³⁵

Trustees must, first and foremost, administer the trust in conformance with the terms of the trust.³⁶ In general, a trustee cannot alter the terms of the trust,

²⁷ See FISHMAN & SCHWARZ, *supra* note 7, at 35.

²⁸ See *id.*

²⁹ See RESTATEMENT (SECOND) OF TRUSTS § 379 (1959).

³⁰ See *infra* notes 140-55 and accompanying text.

³¹ See RESTATEMENT (SECOND) OF TRUSTS, § 2 cmt. h (1959); GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §§ 541-544 (2d rev. ed. 1991). The duty of loyalty and the duty of care are the most significant. See *infra* notes 39-54 and accompanying text.

³² See GEORGE T. BOGERT, TRUSTS § 1 (6th ed. 1987).

³³ See *id.* § 2 ("It was said by an English lawyer many years ago that the parents of the trust were fraud and fear and that the court of conscience was its nurse.").

³⁴ See *id.* § 95.

³⁵ Justice Cardozo provided the classic statement of fiduciary standards:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)

³⁶ See UNIF. TRUST ACT § 801 (1999 Annual Meeting draft); RESTATEMENT (SECOND) OF

although under some circumstances a court may authorize modification or termination of a trust.³⁷ For this reason, the trust form is less flexible than the corporate form.³⁸

A. Duty of Loyalty

Trustees must administer the trust solely in the interest of the beneficiaries.³⁹ The official comment to the Uniform Trust Act describes this "duty of loyalty" as "perhaps the most fundamental duty of the trustee."⁴⁰ The duty of loyalty is integral to the proper functioning of the trust because the trustee must manage the trust property with the interests of the beneficiaries, and not the trustee's own interests, in mind.⁴¹ If a trustee breaches the duty of loyalty by entering into a transaction with the trust on the trustee's own behalf, then the trustee is held strictly liable for that self-dealing.⁴² The beneficiary can require the trustee to undo the transaction, to pay to the trust any profit the trustee made on the transaction, or to repay the trust for any loss suffered by the trust.⁴³ A trustee who deals directly with the trust will have breached his or her duty of loyalty regardless of whether the trustee acted in good faith and regardless of the fairness of the transaction.⁴⁴ For example, if a trustee buys property from the trust, the beneficiary can void the transaction even if the trustee paid fair market value for the property.⁴⁵ A self-dealing transaction is voidable unless a court approved the transaction or the

TRUSTS § 169 (1959). An interesting issue, beyond the scope of this Article, is the extent to which the terms of the trust set forth in Princess Bernice Pauahi Bishop's will have been modified over the years. See *Broken Trust*, *supra* note 10.

³⁷ See discussion *infra* note 252.

³⁸ Charitable corporations may be deemed to hold property "in trust" or subject to a trust, so a charity organized as a nonprofit corporation may be bound by the *cy pres* doctrine if the charity seeks to change its charitable purpose. See *In re Multiple Sclerosis Serv. Org. of N.Y., Inc.*, 496 N.E.2d 861 (N.Y. 1986) (applying New York's quasi-*cy pres* statute for charitable corporations).

³⁹ See UNIF. TRUST ACT § 802 (1999 Annual Meeting draft); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); BOGERT & BOGERT, *supra* note 31, § 543. Note that most charitable trusts have no specifically identified beneficiaries. Instead, the trust may specify a charitable purpose. See discussion *infra* section IV.B.1.

⁴⁰ See UNIF. TRUST ACT § 802 cmt. (1999 Annual Meeting draft); see also BOGERT & BOGERT, *supra* note 31, § 543.

⁴¹ RESTATEMENT (SECOND) OF TRUSTS § 179 (1959); FISHMAN & SCHWARZ, *supra* note 7, at 200.

⁴² See BOGERT, *supra* note 32, § 95.

⁴³ See *id.* The court acts in equity and the penalties and remedies available are subject to the discretion of the court. See *id.*

⁴⁴ See *id.*

⁴⁵ See *id.*

beneficiary approved the transaction after the trustee disclosed all material facts.⁴⁶

A trustee will also breach the duty of loyalty if the trustee causes the trust to enter into a transaction with respect to which the trustee has a conflict of interest. In this situation, the trustee will not have breached the fiduciary duty if the trustee can prove that he or she acted in good faith and that the transaction was reasonable and fair to the trust.⁴⁷

B. Duty of Care

Trustees also must comply with a number of duties relating to the care of the trust property. The overall duty in this regard is the duty of prudent administration, sometimes referred to as the "prudent person" rule.⁴⁸ Trustees must administer the trust as a prudent person would, exercising reasonable care, skill and caution in doing so.⁴⁹ A trustee is expected to use the skills the trustee has, including special skills or ability.⁵⁰

A trustee must control and protect the trust property,⁵¹ earmark the property as property belonging to the trust⁵² and keep the property separate from the trustee's own property.⁵³ Finally, the trustee must exercise all powers granted to the trustee reasonably and in good faith and with due regard for interests of the beneficiaries.⁵⁴

⁴⁶ See UNIF. TRUST ACT § 802 (1999 Annual Meeting draft); BOGERT & BOGERT, *supra* note 31, § 543.

⁴⁷ See BOGERT & BOGERT, *supra* note 31, § 543; see also JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 905, 907 (5th ed. 1995). Related to the duty of loyalty is the duty of impartiality which is the duty to act impartially with respect to all beneficiaries of the trust, taking into consideration their respective rights and interests. See RESTATEMENT (SECOND) OF TRUSTS § 183 (1959); UNIF. TRUST ACT § 803 (1999 Annual Meeting draft).

⁴⁸ See FISHMAN & SCHWARZ, *supra* note 7, at 161; UNIF. TRUST ACT § 804 (1999 Annual Meeting draft) ("Prudent Administration").

⁴⁹ See UNIF. TRUST ACT § 804 (1999 Annual Meeting draft).

⁵⁰ See RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) ("[I]f the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.").

⁵¹ See *id.*

⁵² See *id.* § 179 cmt. d.

⁵³ See *id.* § 179.

⁵⁴ See *id.* §§ 172-182; UNIF. TRUST ACT §§ 809-813 (1999 Annual Meeting draft); BOGERT & BOGERT, *supra* note 31, § 544.

C. Delegation

The existence of these onerous duties of the trustee⁵⁵ raises the question of when a trustee can delegate some of these responsibilities. Historically, rules permitting delegation in the trust context were limited in scope.⁵⁶ The limits on delegation reflect the importance of the trustee's role and the need for the grantor of the trust to place his or her trust in the person designated as trustee.⁵⁷

The traditional formulation of the rule on delegation states that a trustee cannot delegate to others acts that the trustee can reasonably be expected to perform personally.⁵⁸ However, the trustee can delegate those duties that an ordinarily prudent person would delegate to agents.⁵⁹ Over the years, a distinction was drawn between ministerial duties, which could be delegated, and discretionary duties, which could not be delegated due to the need for ongoing analysis and decision making.⁶⁰

A trend to permit trustees to delegate more of their discretionary duties began as early as 1964, when the Commissioners on Uniform State Laws adopted the Uniform Trustees' Powers Act.⁶¹ This act provides that a trustee may employ agents "to advise or assist the trustee in the performance of his administrative duties . . ."⁶² The trustee must act reasonably in selecting the agents and in relying on their advice, but the trustee may act on the recommendations of the agents without independent investigation.⁶³ The trustee may also employ agents to perform "any act of administration, whether discretionary or not."⁶⁴

Important fiduciary duties are associated with investment decision making. Fiduciary behavior has, in the past, been guided by the prudent person

⁵⁵ See *DUKEMINIER & JOHANSON*, *supra* note 47, at 905.

⁵⁶ See generally Jerome J. Curtis, Jr., *The Transmogrification of the American Trust*, 31 *REAL PROP. PROB. & TRUST J.* 251, 253-66 (1996) (describing the history of the duty not to delegate in English and American law).

⁵⁷ See *id.*

⁵⁸ See *RESTATEMENT (SECOND) OF TRUSTS* § 171 (1959).

⁵⁹ See *id.* § 378 cmt. a; see also Curtis, *supra* note 56, at 253-66 (describing the history in England and the United States of the duty not to delegate).

⁶⁰ See 2A *AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS*, § 171 (4th ed. 1987); see also Curtis, *supra* note 56, at 257-65.

⁶¹ See *UNIF. TRUSTEES' POWERS ACT* (1964), 7B *U.L.A.* 741 (1985).

⁶² *Id.* § 3(c)(24).

⁶³ See *id.*

⁶⁴ *Id.*; see also Curtis, *supra* note 56, at 254-55. Sixteen states—Arizona, Florida, Hawai'i, Idaho, Kansas, Kentucky, Maine, Michigan, Mississippi, Nebraska, New Hampshire, New Mexico, Oregon, South Carolina, Utah, and Wyoming—have adopted the approach taken by the Uniform Trustees' Powers Act. See *UNIF. TRUSTEES' POWERS ACT Table of Jurisdictions Wherein Act Has Been Adopted* (1964), 7B *U.L.A.* 741 (Supp. 1999).

standard. That standard, combined with the duty not to delegate investment decision making (an administrative duty), has been criticized as not keeping pace with changes in investment theory and the need for many trustees to work with investment advisors.⁶⁵ The prudent person standard for investment decision making focuses on individual assets and dictates conservative investments to protect principal.⁶⁶ New investment theories, in contrast, advocate managing risk across a portfolio, looking at the investments as they relate to each other rather than individually.⁶⁷

In 1972, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Management of Institutional Funds Act (hereinafter "UMIFA").⁶⁸ UMIFA applies specifically to charities, both to trustees of charitable trusts and to directors of nonprofit corporations.⁶⁹ It eases restrictions on investments that apply under trust law and adopts a business judgment approach in the duty of care it imposes on directors and trustees in connection with investment decision making.⁷⁰ Charitable advisors greeted this loosening of fiduciary standards with enthusiasm.⁷¹

Building on the UMIFA, the Uniform Law Commission promulgated the Uniform Prudent Investor Act in 1994, embracing modern portfolio theory by creating new rules with respect to delegating the power to select investments.⁷² The Uniform Prudent Investor Act adopts a prudent investor standard to replace the prudent person standard regarding investment decisions, recognizing that for many individual trustees, delegating some investment

⁶⁵ See Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960); John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105 (1994).

⁶⁶ See BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* 152-57 (1986).

⁶⁷ See *id.* at 156; see also UNIF. PRUDENT INVESTOR ACT § 3 (1994), 7B U.L.A. (Supp. 1999).

⁶⁸ See UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (1972), 7A pt. II U.L.A. 475 (1999).

⁶⁹ See Carolyn C. Clark & Glenn M. Troost, *Forming a Foundation: Trust vs. Corporation*, 3 PROB. & PROP. 32 (May/June 1989); Antonia M. Grumbach & W.B. McKeown, *Fiduciary Responsibilities of Private Foundation Boards*, 125 TR. & EST. 37, 38 (Sept. 1986).

⁷⁰ See UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 (1972), 7A pt. II U.L.A. 500 (1972) ("[M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision . . .").

⁷¹ See, e.g., Grumbach & McKeown, *supra* note 69.

⁷² See UNIF. PRUDENT INVESTOR ACT § 2(b) (1994), 7B U.L.A. (Supp. 1999) ("A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.").

authority is actually the prudent approach.⁷³ The Act reflects changes in investment theory, particularly the development of portfolio theory.⁷⁴

Most recently, the Restatement (Third) of Trusts and the Uniform Trust Act have both adopted the approach of the Uniform Prudent Investor Act, permitting delegation to the extent that a prudent trustee would delegate.⁷⁵ The trustee may delegate only those responsibilities that a prudent person acting on his or her own behalf might delegate, and must exercise care in selecting and supervising the agents who conduct the duties.⁷⁶ Whether delegation is permissible still depends on the terms of the trust, the particular facts surrounding the trust, and the skills and abilities of the trustee.⁷⁷ For example, delegation of certain aspects of trust administration may be more appropriate for an individual trustee than for a corporate trustee.⁷⁸

The impetus behind the changes to the nondelegation rules in the Restatement (Third) and the Uniform Trust Act was concern about the

⁷³ See Langbein, *supra* note 65, at 117-18.

⁷⁴ See *id.* at 105; see also John H. Martin, *A Preface to the Prudent Investor Rule*, 132 TR. & EST. 42 (Nov. 1993); Ronald A. Sages, *The Prudent Investor Rule and the Duty Not to Delegate*, 134 TR. & EST. 22 (May 1995).

⁷⁵ See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 171 (1992); UNIF. TRUST ACT. § 807 (1999 Annual Meeting draft).

The Restatement (Third) of Trusts provides as follows:

§ 171 Duty with Respect to Delegation

A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 171 (1992).

The Uniform Trust Act provides as follows:

Section 807. Delegation by Trustee.

(a) A trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

- (1) selecting an agent;
- (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
- (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

UNIF. TRUST ACT § 807 (1999 Annual Meeting draft).

⁷⁶ See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. j (1992).

⁷⁷ See *id.*

⁷⁸ See UNIF. TRUST ACT § 807 (1999 Annual Meeting draft) ("For example, delegation of trust administration and reporting duties must be prudent for a family trustee but unnecessary for a corporate trustee.").

trustees' duties to make investment decisions.⁷⁹ Comments to the Restatement state that the new rules simply extend and clarify the prudent person rule, noting that in some circumstances a prudent person would employ agents.⁸⁰ Yet, the Restatement (Third) and the Uniform Trust Act do not limit their statements of when delegation is permissible to the investment context.⁸¹ By creating rules that describe a trustee's ability to delegate discretionary duties in general terms, the Restatement and the Uniform Trust Act leave open questions about the delegation of discretionary duties other than investment decision making.⁸² The trustee still must act prudently in deciding when to delegate authority,⁸³ but the Restatement and the Uniform Trust Act reflect an erosion of the duty not to delegate that may go beyond investment decisions.⁸⁴

D. Standing to Enforce the Trust

The fiduciary duties of a trustee of a private trust protect the interests of the trust beneficiaries.⁸⁵ If a trustee breaches a duty, the beneficiaries have standing to sue the trustee.⁸⁶ So important is the beneficiary to the proper functioning of the trust that a valid private trust cannot exist without a reasonably identifiable beneficiary.⁸⁷ A trust must have beneficiaries both because the trust must be administered for the benefit of the beneficiaries and because the beneficiaries can monitor the trustee and enforce the trust if the trustee breaches a duty the trustee owes to the beneficiaries.⁸⁸ In general, the beneficiaries are the only persons who can enforce the trust, although third parties can sue the trustee to protect an interest in the trust property.⁸⁹

In order to protect their interests, beneficiaries need information about the trust.⁹⁰ Therefore, trustees have an additional duty to keep the beneficiaries of the trust reasonably informed about the administration of the trust and to respond promptly to reasonable requests for information from the

⁷⁹ See LONGSTRETH, *supra* note 66, at 158-59.

⁸⁰ See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. a (1992).

⁸¹ See Curtis, *supra* note 56, at 269.

⁸² See *id.* at 269-76 (describing the need for restrictions on delegation and liability for improper delegations).

⁸³ See RESTATEMENT (THIRD) OF TRUSTS § 227(c)(2)(1992)(requiring trustees to act with prudence in deciding when to delegate).

⁸⁴ See Curtis, *supra* note 56, at 252-53, 269 (expressing concern about the erosion of the duty not to delegate).

⁸⁵ See *supra* notes 31-35 and accompanying text.

⁸⁶ See RESTATEMENT (SECOND) OF TRUSTS §§ 198, 199 (1959).

⁸⁷ See *id.* § 112.

⁸⁸ See *id.* § 199.

⁸⁹ See *id.* § 200.

⁹⁰ See BOGERT, *supra* note 32, § 141.

beneficiaries.⁹¹ Adequate information combined with the fiduciary duties imposed on the trustee should give beneficiaries the tools necessary to enforce the trust. Of course, supervision by the beneficiaries is not always effective and mismanagement by trustees of private trusts does occur.⁹² Nonetheless, the existence of beneficiaries greatly increases the supervision of private trusts as compared with charitable trusts.

III. CORPORATE LAW

In a corporation, the directors control the corporate assets while the shareholders own the corporation.⁹³ As in the trust setting, fiduciary duties imposed on corporate directors help to manage the division between control and beneficial ownership.⁹⁴ Although the fiduciary concepts in corporate law are similar to those in trust law, they have evolved somewhat differently. This Part reviews the laws that regulate directors of business corporations.

A. *Duty of Loyalty*

Directors of a corporation have a general duty to put the interests of the corporation above their personal interests.⁹⁵ The Corporate Director's Guidebook explains that the principle underlying the duty of loyalty is that "the director should not use his corporate position to make a personal profit or gain other personal advantage"⁹⁶ Like a trustee, a director must put the interests of the corporation first. Unlike trust law, however, corporate law provides that a transaction between a director and the corporation will not be voidable if the transaction is fair to the corporation at the time the director and

⁹¹ See UNIF. TRUST ACT § 813 (1999 Annual Meeting draft); see also RESTATEMENT (SECOND) OF TRUSTS §§ 172 (duty to keep and render accounts), 173 (duty to furnish information) (1959).

⁹² See Lewis Beale, *An Heir-Raising Enterprise*, L.A. TIMES, Nov. 18, 1992, at E1 (describing complaints by trust beneficiaries against bank trustees).

⁹³ See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4-5 (1932). The separation of ownership (by the shareholders) and control (by the directors) creates a "principal-agent problem." Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 342 (1983).

⁹⁴ See Brody, *Limits*, *supra* note 7, at 1424. The directors owe their duties to the corporation, rather than to the shareholders, but the existence of the duties serves to protect the interests of the shareholders. See *id.*

⁹⁵ See generally, WILLIAM MEADE FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 837.50 (rev. ed. 1994) [hereinafter FLETCHER CYC. CORP].

⁹⁶ 1 AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* 137 (1994) [hereinafter ALI PRINCIPLES] (citing THE CORPORATE DIRECTOR'S GUIDEBOOK 1599-1600).

the corporation entered into it.⁹⁷ The American Law Institute's Principles of Corporate Governance ("ALI Principles") uses the term "duty of fair dealing" for the duty of loyalty.⁹⁸

The ALI Principles provide for a lower level of scrutiny if the interested director makes adequate disclosure and if disinterested directors or shareholders ratify the transaction.⁹⁹ The interested director must disclose to the decision maker (either the disinterested directors or the shareholders) all material facts¹⁰⁰ concerning the conflict of interest and the transaction.¹⁰¹ Disinterested directors who could reasonably have concluded that the transaction was fair to the corporation must either authorize the transaction in advance or ratify the transaction.¹⁰² In the alternative, shareholders may authorize or ratify the transaction if the transaction does not constitute a waste of corporate assets.¹⁰³ The ALI Principles additionally require that the approval by disinterested directors or shareholders be "in good faith."¹⁰⁴ If the director complies with these safe harbor rules requiring disclosure and disinterested approval, then law in most states will provide that the person attacking the transaction will have the burden of proof to show that the transaction lacked fairness.¹⁰⁵

B. Duty of Care

A corporate director must oversee the conduct of the corporation's business and review and approve major corporate plans.¹⁰⁶ The actual management of the corporation is conducted by the senior executives, designated by the directors.¹⁰⁷ Thus, the corporate structure assumes a supervisory role for the directors.¹⁰⁸ In fulfilling his or her duties, a corporate director must act "in

⁹⁷ See *id.* at 206-07 (explaining that, in the past, courts held that interested transactions were voidable without regard to fairness, but that the modern view is to let a transaction stand if the transaction was fair).

⁹⁸ See *id.* at 199-200 (explaining that the duty of loyalty encompasses a director's pecuniary and nonpecuniary interests in a transaction, and that for purposes of the ALI Principles, the duty of fair dealing refers only to pecuniary conflict of interest situations).

⁹⁹ See *id.* § 5.02.

¹⁰⁰ See *id.* § 1.25 (stating that "[a] fact is 'material' if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining the person's course of action.").

¹⁰¹ See *id.* § 1.14.

¹⁰² See *id.* § 5.02(a)(2)(B), & (C).

¹⁰³ See *id.* § 5.02(a)(2)(D).

¹⁰⁴ See *id.* at 212.

¹⁰⁵ See *id.* § 5.02(b).

¹⁰⁶ See *id.* § 3.02.

¹⁰⁷ See *id.* at § 3.01.

¹⁰⁸ See *id.* at 82-88.

good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."¹⁰⁹ This characterization of the duty of care from the ALI Principles reflects the approach taken in most states.¹¹⁰ In general, the duty of care requires a director to oversee the business of the corporation, to make further inquiries if information suggests trouble in the corporation, to obtain adequate information for decision making and to make decisions carefully.¹¹¹

The business judgment rule, now widely adopted,¹¹² modifies the duty of care. The business judgment rule protects a director who makes a decision the director "rationally believes" to be in the best interests of the corporation, if the director does not have a personal interest in the transaction, and if the director is informed "to the extent the director or officer reasonably believes to be appropriate under the circumstances"¹¹³ Comment d to section 4.01 of the ALI Principles explains that the term "'rationally believes' is intended to permit a significantly wider range of discretion than the term 'reasonable'"¹¹⁴ Thus, if a director is not an interested party in the transaction and has obtained adequate information about the transaction, then only a rational belief is necessary to protect the director from liability if the decision made does not produce results hoped for by the corporation.¹¹⁵

In addition to the protection for directors provided by the business judgment rule, many states permit corporations to include a provision in the articles of incorporation limiting director liability under the duty of care.¹¹⁶ Under the Delaware statute, for example, the corporation can reduce liability for a breach of the duty of care but cannot limit liability for a breach of the duty of loyalty for acts not in good faith, intentional misconduct, or acts that result in improper personal benefit to the director.¹¹⁷ Melvin Eisenberg¹¹⁸ has argued

¹⁰⁹ *Id.* § 4.01(a).

¹¹⁰ *See id.* § 401 cmt. a.

¹¹¹ *See* Melvin Aaron Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 951-69 (1990) (describing the moral obligations that underlie the duty of care such as the duty to monitor, the duty of inquiry, and the duty to use reasonable care in performing the decision making function both procedurally and substantively).

¹¹² *See* 1 ALI Principles, *supra* note 96, at 144.

¹¹³ *Id.* § 4.01(c).

¹¹⁴ *Id.* § 4.01 cmt. d.

¹¹⁵ *See* FLETCHER CYC. CORP, *supra* note 95, § 837.50 (describing the fiduciary duties of corporate directors).

¹¹⁶ *See generally* Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 380-82 (1988) (describing "The Parade to Opt Out of Duty of Care Liability"). At least 30 states now permit exclusions from duty of care liability. *See id.* at 381 n.30.

¹¹⁷ *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

¹¹⁸ Chief Reporter of the American Law Institute's Principles of Corporate Governance, Part

that loss of the duty of care through statutes such as the Delaware statute could lead to increased government intervention in the future.¹¹⁹ In his view, the duty of care has served as an important mechanism for director accountability and has reduced the need for government intervention.¹²⁰ Nonetheless, the trend toward greater private control of corporations by removing common law boundaries on shareholder rule may extend to reductions in the duty of loyalty as well.¹²¹

C. Delegation

Increasingly, directors can “delegate functions and powers to committees of the board, individual directors or officers, employees, and other persons.”¹²² The directors continue to have oversight responsibility, but for duty of care purposes the focus has become the care taken in selecting the person who will provide assistance and the reasonableness of reliance on information provided or recommendations made by that person.¹²³ The ALI Principles allow a director who acts reasonably and in good faith to rely on board committees and on individual directors, officers, employees, and professionals hired by the board¹²⁴ for decisions, judgments and performance, as well as for information.¹²⁵ A director must read or understand the information or decision in order to rely on it. The reasonableness of relying without making an independent review can depend on such factors as the importance of the issue

IV of which concerns the duty of care. See Eisenberg, *supra* note 111, at aa.

¹¹⁹ See *id.* at 972; see also, e.g., Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783 (1994) (proposing an amendment to the Securities Act of 1933 authorizing the SEC to condition the availability of certain simplified methods of issuing securities under the Act on the existence of an independent board, as determined by the SEC).

¹²⁰ See Eisenberg, *supra* note 111, at 972; see also Diane L. Saltoun, *Fortifying the Directorial Stronghold: Delaware Limits Director Liability*, 29 B.C. L. REV. 481, 484 (1988) (arguing that the Delaware statute “destroys the balance between shareholder protection and management autonomy by permitting a corporation to eliminate directorial accountability and thus effectively render shareholders defenseless.”).

¹²¹ See generally, Branson, *supra* note 116 (describing and decrying recent proposals to permit corporations to “opt out” of the duty of loyalty).

¹²² 1 ALI PRINCIPLES, *supra* note 96, at 141.

¹²³ See *id.* § 4.02.

¹²⁴ The ALI Principles follow the lead of the Model Business Corporation Act in providing that directors can rely on a wide range of experts. This approach, while consistent with recent statutory provisions and court decisions, has not yet been widely adopted. See *id.* at 193.

¹²⁵ See *id.* §§ 4.02, 4.03; see also Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1487 (1984) (“The law has also become more realistic in recognizing that much of a board’s work is, and must be, done in committee, and in according to the board the privilege of reliance upon the work product of its committees.”).

to the corporation, the complexity of the issue, and the background and experience of the person providing the information or making the decision.¹²⁶

In addition to the fact that directors increasingly rely on persons within and without the corporation, the corporate structure itself operates to remove the board from management of the business. The ALI Principles reflect the fact that corporate directors no longer manage the corporation or make business policy.¹²⁷ Instead, the corporate structure set forth in the ALI Principles assumes that senior executives will manage the corporation, including making business policy, while the directors will supervise the senior executives and review and approve major corporate actions.¹²⁸ Thus, fiduciary duties in the business corporation context have weakened in recent years and cannot serve as a resource for strengthening laws regulating fiduciary duties in the charitable sector. To the contrary, reliance on corporate law developments as a model for change in the rules governing charities may further weaken charitable laws.

D. Standing

To protect their interests in the corporation, shareholders can bring derivative suits on behalf of the corporation.¹²⁹ The introductory note on derivative actions in the ALI Principles explains the need to balance "the availability of legal recourse" to enforce "management's obligations to its shareholders"¹³⁰ with the financial and other costs to the corporation and its managers of nonmeritorious suits.¹³¹ The ALI Principles assign "only a limited role to the derivative action as a mechanism of corporate accountability,"¹³² but recognize that "the derivative action may offer the only effective remedy in those circumstances in which a control group has the ability to engage in self-dealing transactions with the corporation."¹³³

If directors breach their fiduciary duties to the corporation, a shareholder can sue on behalf of the corporation, thereby protecting the interests of all the shareholders.¹³⁴ Any recovery will be paid to the corporation, and not to the shareholder who brought the suit.¹³⁵ Although shareholders theoretically have

¹²⁶ See 1 ALI PRINCIPLES, *supra* note 96, at 190.

¹²⁷ See Eisenberg, *supra* note 111, at 949.

¹²⁸ See 1 ALI PRINCIPLES, *supra* note 96, §§ 3.01, 3.02; see also Eisenberg, *supra* note 111, at 949-50.

¹²⁹ See 2 ALI PRINCIPLES, *supra* note 96, §§ 7.01, 7.02.

¹³⁰ *Id.* Intro. Note, at 4-5.

¹³¹ See *id.* at 6.

¹³² *Id.*

¹³³ *Id.* at 5.

¹³⁴ See *id.* §§ 7.01, 7.02.

¹³⁵ See *id.* § 7.16.

the remedy of a derivative suit, in large corporations, shareholder oversight of management is minimal.¹³⁶ Shareholders can also address concerns about director mismanagement by voting the directors out of office, but in large, public companies, an individual shareholder's only recourse in the face of director mismanagement may be to sell the stock.¹³⁷

IV. CHARITABLE ORGANIZATIONS

A. State Law

Against this background of private trusts and business corporations stand charitable organizations. Like their private counterparts, charities are subject to regulation under state law, either the law of charitable trusts or the law of nonprofit organizations.¹³⁸ A peculiarity of the law of charities is that the organizational form of the entity—whether the charity is organized as a trust or as a nonprofit corporation—will determine the standards to which its fiduciaries will be held. This section reviews these state law rules governing the fiduciary behavior of those who manage charities. Since the fiduciary rules that apply to private trusts also apply directly to charitable trusts, this section focuses on the development of fiduciary rules for directors of nonprofit corporations.

The strict standards for fiduciaries of private trusts apply to fiduciaries of charitable trusts.¹³⁹ In addition, the fiduciary duties under trust law have, in the past, been applied to directors of charitable corporations.¹⁴⁰ Thus, directors of a charitable corporation have been held to the trust law standards, including the restrictive trust law duty of loyalty.¹⁴¹ Indeed, directors of charitable corporations were often called "trustees," reflecting this intermingling of the trust form and the corporate form.¹⁴² In a treatise on trust

¹³⁶ See Berle & Means, *supra* note 93, at 47-48 (discussing the dispersion of stock ownership and the resulting lack of control over director's elections).

¹³⁷ See Brody, *Agents*, *supra* note 17, at 474-75.

¹³⁸ In addition, federal tax law also regulates charities that seek to qualify as organizations exempt from income tax. See *infra* notes 298-302 and accompanying text.

¹³⁹ See RESTATEMENT (SECOND) OF TRUSTS § 379 (1959) ("The duties of the trustees with respect to the administration of charitable trusts are the same as the duties of the trustees of private trusts. . .").

¹⁴⁰ See RESTATEMENT (SECOND) OF TRUSTS § 379 cmt. b (1959).

¹⁴¹ See FISHMAN & SCHWARZ, *supra* note 7, at 34-38.

¹⁴² See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); *Holt v. College of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964). Courts looked to trust law with respect to other aspects of charitable corporations. Property held by the charitable corporation might be considered held "in trust" by the corporation for charitable purposes. Because the property was "impressed with a

law, George Gleason Bogert and George Taylor Bogert discuss fiduciary duties of trustees of charitable trusts and corporations almost interchangeably, and then explain, "It is in the related areas of the standard of care or conduct imposed and the duty of loyalty owed that some distinctions between charitable trustees and corporate directors have begun to be drawn."¹⁴³

One of the first clear rulings that fiduciaries of a nonprofit corporation would be held to the corporate standard came in 1974.¹⁴⁴ The federal District Court for the District of Columbia held that the trustees of a hospital organized as a nonprofit corporation were subject to the corporate standard rather than the trust standard with respect to fiduciary duties.¹⁴⁵ The court explained:

The applicable law is unsettled. The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. As the discussion below indicates, however, the modern trend is 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.¹⁴⁶

The trend the court identified gained steam with this frequently cited opinion,¹⁴⁷ and the drafters of the Revised Model Nonprofit Corporation Act took this approach.

Shortly before the *Lucy Webb Hayes* decision, the National Conference of Commissioners on Uniform State Laws had adopted the UMIFA.¹⁴⁸ The UMIFA provides rules for investment decision making by both directors of nonprofit corporations and trustees of charitable trusts.¹⁴⁹ The Act adopts the business judgment approach for both directors and trustees¹⁵⁰ and is presumably a part of the trend to apply corporate principles that the *Lucy Webb Hayes* court identified.¹⁵¹

charitable trust," trust rules applied with respect to changes in the purposes of the corporation. *In re Los Angeles County Pioneer Soc'y*, 257 P.2d 1 (Cal. 1953) (in bank).

¹⁴³ BOGERT & BOGERT, *supra* note 31, § 394.

¹⁴⁴ *See Stern*, 381 F. Supp. at 1003.

¹⁴⁵ *See id.*

¹⁴⁶ *Id.* at 1013.

¹⁴⁷ *See, e.g., Raven's Cove Townhomes, Inc. v. Knuppe Dev. Co.*, 171 Cal. Rptr. 334, 344 (Ct. App. 1981); *Louisiana World Exposition v. Federal Ins. Co.*, 864 F.2d 1147, 1151-52 (5th Cir. 1989); *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991).

¹⁴⁸ *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (1972), 7A pt. II U.L.A. 475 (1999); *see also supra* notes 68-71 and accompanying text.

¹⁴⁹ *See Clark & Troost*, *supra* note 69, at 32; *Grumbach & McKeown*, *supra* note 69, at 38.

¹⁵⁰ *See* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 (1972), 7A pt. II U.L.A. 500 (1972) ("[M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. . .").

¹⁵¹ *See Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974).

The Revised Model Nonprofit Corporation Act ("RMNCA"), first promulgated in 1987, adopts corporate standards in the fiduciary duties it imposes on directors of nonprofit corporations.¹⁵² The 1954 Model Nonprofit Corporation Act had been silent on directors' duties.¹⁵³ The RMNCA sets standards of care and loyalty for directors, both to resolve questions of which standard should apply but also to protect directors who act properly in carrying out their fiduciary duties.¹⁵⁴ The introduction explains: "The Subcommittee had little difficulty in rejecting trust standards and adopting the same general language the MBCA [Model Business Corporation Act] uses for directors of business corporations."¹⁵⁵

1. Duty of care

The duty of care adopted by the RMNCA states that directors and officers must act:

- (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 interest of the corporation.¹⁵⁶

Although the standard is in essence the same as the standard used in the business context,¹⁵⁷ the official comments to section 8.30 of the RMNCA note that directors of a nonprofit organization have different goals and resources

¹⁵² See REV. MODEL NONPROFIT CORP. ACT § 8.30 (1988). The official comment to section 8.30, General Standards of Conduct, explains that the section "settles the dispute as to whether directors of nonprofit corporations should meet the general business standards or the trustee standards." See *id.* § 8.30 cmt. 1 (1988).

¹⁵³ See Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 814 (1988-89) (explaining that the drafters of the Model Nonprofit Corporation Act "simply took the Model Business Corporation Act and deleted from it all provisions that seemed inappropriate for nonprofits, such as those dealing with the issuance of stock. The result was a rather empty enactment."). Hansmann writes more favorably about the RMNCA: "In general, and in conspicuous contrast to the old Model Act, the Revised Model Act is marked by careful and detailed draftsmanship throughout." See *id.* at 819. Hansmann approves of the "rigorous but by no means unrealistic duties of care and loyalty" imposed on directors but argues that the same standards should be applied to all nonprofits or at least to all nonprofits that are not organized as clubs. See *id.*

¹⁵⁴ See REV. MODEL NONPROFIT CORP. ACT xxxv (1988).

¹⁵⁵ *Id.* This is not surprising given that a subcommittee of the American Bar Association's Committee on Corporate Laws drafted the RMNCA. The drafters of the nonprofit statute simply took the business corporation act and made modifications to it. The fiduciary duty sections were not modified, so the duties imposed on business directors became part of the model act.

¹⁵⁶ *Id.* § 8.30(a).

¹⁵⁷ See *supra* note 111 and accompanying text.

than the directors of a business corporation.¹⁵⁸ The official comments explain that the standards adopted, including "ordinarily prudent person," "in a like position," and "under similar circumstances" can be applied in a flexible manner.¹⁵⁹ The official comments note that directors of a nonprofit organization have different goals and resources than the directors of a business corporation.¹⁶⁰ The drafters intend that the fiduciary duties imposed on the directors will be applied in a manner that considers the differences between nonprofits and business corporations as well as the variations within the nonprofit sector.¹⁶¹

In the business corporation context, the business judgment rule has modified the duty of care to protect directors who act in good faith and without a conflict of interest with respect to a decision made on a reasonably informed basis and with a rational belief that the decision is in the best interests of the corporation.¹⁶² This rule, sometimes called the "best judgment rule" in the nonprofit context,¹⁶³ has been applied to the decisions of nonprofit directors by a few courts.¹⁶⁴ The official comment to section 8.30 of the RMNCA explains that the use of the rule is consistent with application of the duty of care under the RMNCA.¹⁶⁵

Use of the business judgment rule in the charitable context may be appropriate.¹⁶⁶ The rule requires a director to act in good faith, rationally and after having considered sufficient information to make a reasonably informed decision.¹⁶⁷ The business judgment rule does not apply to a decision in which a director had a conflict of interest,¹⁶⁸ and the duty of loyalty will apply in that situation.¹⁶⁹ Thus, the rule cannot be used to protect a director who attempts to benefit personally from the corporation.¹⁷⁰ The other requirements of the business judgment rule are consistent with the duty of care set forth by the RMNCA and can appropriately be used to protect a director who makes decisions that appear in hindsight to be detrimental to the organization.

¹⁵⁸ See REV. MODEL NONPROFIT CORP. ACT § 8.30(a).

¹⁵⁹ See *id.* § 8.30 cmt. 2.

¹⁶⁰ See *id.*

¹⁶¹ See *id.*

¹⁶² See Goldschmid, *supra* note 2, at 644; see also *supra* notes 112-15 and accompanying text.

¹⁶³ See FISHMAN & SCHWARZ, *supra* note 7, at 185.

¹⁶⁴ See Goldschmid, *supra* note 2, at 644.

¹⁶⁵ See REV. MODEL NONPROFIT CORP. ACT § 8.30 cmt. 3 (1988).

¹⁶⁶ See Goldschmid, *supra* note 2, at 644 ("The assumption is erroneous, however, that the business judgment rule provides directors with an overly protective free ride from liability.").

¹⁶⁷ See 1 ALI PRINCIPLES, *supra* note 96, § 4.01(a).

¹⁶⁸ See *id.* § 4.01 cmt. d.

¹⁶⁹ See *id.* § 5.02.

¹⁷⁰ See *id.* § 5.02(a)(2)(B).

Under the RMNCA, then, the duty of care and the business judgment rule create a flexible standard for nonprofit directors, but still require that directors act with reasonable care. The standard attempts to take into account the differences between nonprofits and businesses. For example, applying the duty of care in the nonprofit context requires consideration of the size and purpose of the nonprofit, the personal expertise of the director, and the circumstances of the particular decision being made.¹⁷¹ Professors Fishman and Schwarz have written that the standard as applied to nonprofits is “quite low.”¹⁷² Even if the standard itself is adequate, the lack of enforcement mechanisms in the charitable context make adoption of the corporate standard without considering enforcement problematic.¹⁷³

2. Duty of loyalty

The duty of care adopted by the RMNCA is similar to the trust law standard.¹⁷⁴ In contrast, the duty of loyalty differs significantly. While trust law provides that a trust can void any self-dealing transaction engaged in by a trustee,¹⁷⁵ the RMNCA permits a director to engage in self-dealing or conflict of interest transactions, if certain requirements are met.¹⁷⁶ The RMNCA creates two standards—one for public benefit corporations¹⁷⁷ and one for mutual benefit corporations.¹⁷⁸

The RMNCA applies the business standard to mutual benefit corporations.¹⁷⁹ A transaction may be approved by either the board or the members, as long as the material facts of the transaction and the director's

¹⁷¹ See *id.*

¹⁷² See FISHMAN & SCHWARZ, *supra* note 7, at 186.

¹⁷³ Harvey Goldschmid suggests that the standard is adequate, even potentially demanding, but lack of enforcement creates the “myth” of low duty of care standards. See Goldschmid, *supra* note 2, at 642-43.

¹⁷⁴ See *supra* notes 48-50 and accompanying text.

¹⁷⁵ The beneficiaries of a private trust can void any self-dealing transaction, regardless of the fairness of the transaction, unless they consented to the transaction after full disclosure. See BOGERT, *supra* note 32, § 95.

¹⁷⁶ See REV. MODEL NONPROFIT CORP. ACT § 8.31(b), (c) (1988).

¹⁷⁷ See *id.* § 1.40 (28); see also *id.* at xxiv-viii (1988) (“Public benefit corporations hold themselves out as doing good works, benefiting society or improving the human condition.”). Public benefit corporations are corporations that benefit the public and not merely their members. This Article focuses on charitable nonprofits organized as public benefit corporations.

¹⁷⁸ See *id.* § 140(23). Mutual benefit corporations are formed for the benefit of their members. Although mutual benefit corporations cannot make distributions to members, mutual benefit corporations can purchase a membership of a member who resigns, see *id.* §§ 6.22(b), 13.01, 13.02, and can distribute its assets to its members on dissolution. See *id.* § 14.06(a)(7).

¹⁷⁹ See *id.* § 8.31 cmt. 2.b.

interest in the transaction were disclosed to or known by the directors or the members.¹⁸⁰ This standard, although perhaps appropriate for mutual benefit corporations whose members will, presumably, monitor the actions of the directors, is insufficiently protective for charitable organizations.

For public benefit corporations, the statute provides that the transaction will not be voidable if it was (1) fair at the time, (2) approved by the board of directors based on disclosure of the material facts of the transaction and a good faith, reasonable belief that the transaction was fair, or (3) approved by the attorney general.¹⁸¹ This standard creates a higher standard than the business judgment rule that many states apply to business corporations,¹⁸² but leaves a significant gap in protecting charities from self-dealing.¹⁸³

The RMNCA rule requires only a determination that the disinterested directors "reasonably believe" that the transaction is fair to the corporation.¹⁸⁴ The rule focuses on the directors' reasonable belief rather than on the actual fairness of the transaction. Given the structure of many charitable boards and the lack of attentiveness of the directors, disinterested directors may be unlikely to challenge the interested director's characterization that the transaction is fair.¹⁸⁵ A reasonable belief in fairness does not require a particular level of scrutiny and does not require that the transaction be the best approach for the charity.¹⁸⁶ Given the lack of external monitoring of charities, the RMNCA relies too heavily on business law.¹⁸⁷

The status of state law with respect to nonprofit organizations, then, is that the form of the organization determines the fiduciary standards to be applied to those who manage the organization.¹⁸⁸ Trust law continues to govern charitable trusts, and the strict duty of loyalty standard continues to apply to trustees of charitable trusts. The law of nonprofit corporations, however, has shifted to something closer to the business standard. With sufficient protections built into the law, a standard other than the trust law standard can

¹⁸⁰ See *id.* § 8.31(c), 8.31 cmt. 2.b.

¹⁸¹ See *id.* § 8.31(b).

¹⁸² See Goldschmid, *supra* note 2, at 648-49 (explaining that although the ALI Principles use an intermediate standard of review for conflict of interest transactions, many states apply the more deferential business judgment rule).

¹⁸³ See Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 137-43 (1993) (explaining why the RMNCA rule is not appropriate for nonprofits and characterizing the rule as "a charade.") [hereinafter DeMott, *Self-Dealing*].

¹⁸⁴ See REV. MODEL NONPROFIT CORP. ACT § 8.31(b) (1988).

¹⁸⁵ See FISHMAN & SCHWARZ, *supra* note 7, at 187 (describing the common problems of inattentive and overcommitted directors); DeMott, *Self-Dealing*, *supra* note 183, at 139-41.

¹⁸⁶ See DeMott, *Self-Dealing*, *supra* note 183, at 141.

¹⁸⁷ See *infra* notes 344-50 and accompanying text.

¹⁸⁸ See FISHMAN & SCHWARZ, *supra* note 7, at 64-67.

work,¹⁸⁹ but the resulting legal anomaly is that the standard to which the law holds a person who manages charitable assets depends on the organizational form of the entity holding those assets.¹⁹⁰ The law protects public interests, but the public has no say in the standard that applies to the organization and its managers.¹⁹¹ Increasingly, those who create nonprofits use the corporate form, but there remain many existing charitable trusts.¹⁹²

B. Who Benefits from Fiduciary Duties?

Before thinking about who can or should enforce fiduciary standards, it is important to determine whom the standards protect. In a private trust, the fiduciary duties protect the interests of the trust beneficiaries from overreaching or mismanagement by the trustees. The beneficiaries can enforce a breach of trust, and the trustees are held to a strict standard with respect to self dealing.¹⁹³ This strict standard is appropriate in the private trust context because it is difficult for beneficiaries to learn about or prove trustee misconduct.

In the corporate context, the shareholders are owners of the corporation and are protected by the fiduciary standards imposed on the directors. If the directors breach their fiduciary duties, shareholders can protect their interests by bringing a derivative action.¹⁹⁴ A less strict fiduciary standard applies in the corporate context, in part because the shareholders have other types of recourse if the directors mismanage the corporation. If the shareholders do not approve of the way the directors run the corporation, the shareholders can sell their stock or, theoretically at least, vote the directors out of office.¹⁹⁵ In contrast, trust beneficiaries have less opportunity for recourse against the trustees.

¹⁸⁹ Deborah DeMott proposes a fairness standard that is not as strict as the trust law standard, but is more appropriate for charities than a business law standard. *See DeMott, Self Dealing*, *supra* note 183, at 143 (1993); *see also infra* notes 351-54 and accompanying text.

¹⁹⁰ *See Brody, Limits*, *supra* note 7, at 1417 (noting that choice of organizational form is not likely to be a well thought-out decision).

¹⁹¹ The persons who establish the charity, or their lawyers, choose the organizational form and that form will determine which standards apply. The public plays no role at this stage.

¹⁹² *See FISHMAN & SCHWARZ*, *supra* note 7, at 64. Princess Bernice Pauahi Bishop created the Kamehameha Schools as a trust under her will. *See Petition of Attorney General*, *supra* note 10.

¹⁹³ *See supra* notes 42-46 and accompanying text.

¹⁹⁴ *See supra* notes 129-33 and accompanying text.

¹⁹⁵ *See Brody, Agents*, *supra* note 17 at 476-77; Eisenberg, *supra* note 111, at 971.

1. Clients/Beneficiaries

In the charitable context, the question of whose interests should be protected is less clear. The charity may serve clients who can be considered "beneficiaries," but the beneficiaries are not specifically identified and usually change over time. For example, the Kamehameha Schools operated by the Bishop Estate serve their students, but the identity of the students receiving services changes from year to year. Further, in addition to serving the students who take classes, the Kamehameha Schools serve the public by contributing to an educated populace. A hospital serves its patients; again there is no defined group of beneficiaries. Similarly, soup kitchens serve changing groups of people. Any person served by the entity has an interest in seeing that it is run properly, but no one person is likely to have the incentive, the ability, or the information necessary to monitor the charity. Further, beneficiaries are unlikely to have standing to enforce their rights as beneficiaries.¹⁹⁶

2. Donors

A charity also serves those who have contributed money or property to it. If an individual donor contributes a substantial amount of money to a charity, that individual will want some assurance that the money will be spent responsibly. In general, however, the law treats donors as having relinquished any legal interest in the organization after making the gift.¹⁹⁷ As a practical matter, to be able to attract future gifts from the same donors or from other donors, the charity must not stray far from its mission and must manage its assets effectively. Nonetheless, potential donors may be able to obtain only limited information concerning the management of the charity. Once a donor makes a gift, if the donor discovers breaches of fiduciary duty on the part of the directors, the donor can choose not to make future gifts. It is unlikely, however, that the donor will have standing to sue the directors for mismanagement.¹⁹⁸

Despite the importance of donors for some charities, in the charitable sector as a whole, donor support is shrinking as a percentage of total support.¹⁹⁹

¹⁹⁶ See *infra* notes 259-63 and accompanying text.

¹⁹⁷ See, e.g., *Carl J. Herzog Found., Inc. v. University of Bridgeport*, 699 A.2d 995 (Conn. 1997) (denying a donor standing to sue the charity).

¹⁹⁸ See *infra* notes 259-63 and accompanying text.

¹⁹⁹ See FISHMAN & SCHWARZ, *supra* note 7, at 14 (reporting that in 1989 contributions constituted 27.2 % of the nonprofit sector's funds); Gabriel Rudney, *The Scope and Dimensions of Nonprofit Activity*, in *THE NONPROFIT SECTOR* 62 (Walter W. Powell ed., 1987) (reporting that in 1980, contributions constituted 34% of the sources of revenue for philanthropic organizations).

Increasingly, fees for services finance the charitable sector.²⁰⁰ In addition, some large charities, like the Bishop Estate, receive funds from a single donor and do not rely on additional contributions. For many organizations maintaining good relationships with donors remains important. However, for the sector as a whole, donors may provide less oversight than in the past,²⁰¹ and except for donors who have made restricted gifts, donors will not have standing to take legal action against the fiduciaries.²⁰²

3. *The public*

The public has a role as both donor and beneficiary of the charitable sector.²⁰³ Most charities receive tax benefits, so the public coffers are depleted to benefit the charity.²⁰⁴ If public dollars, in the form of lost tax revenue, support a charity, the public has an interest in having those dollars used for a public, and not a private, purpose. If directors receive excessive salaries or benefit financially as the result of self-dealing transactions with the charity, the public's indirect support of the charity has been betrayed. The public, as a donor to the organization, has an interest in the charity's use of the money for public purposes.

The public also has an interest in the activities the charitable sector conducts. Although an individual member of the public is not a direct beneficiary of every charity, the existence of the charitable sector benefits the public as a whole.²⁰⁵ Further, since the public benefits, in a general sense, from activities conducted by charitable organizations,²⁰⁶ the public has an interest in maintaining a healthy charitable sector. Throughout the history of the United States, charities have played an important role in providing

²⁰⁰ See Rudney, *supra* note 199, at 62.

²⁰¹ See FISHMAN & SCHWARZ, *supra* note 7, at 12 (noting that many nonprofits no longer rely on charitable contributions).

²⁰² See *infra* notes 259-63 and accompanying text.

²⁰³ See Brody, *Limits*, *supra* note 7, at 1431 (citing George Gleason Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633, 633 (1954)(arguing that "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public.")).

²⁰⁴ A tax-exempt charity keeps money that would otherwise be paid to the government in the form of taxes. In addition to the exemption from income tax, the charity may also benefit from a property tax exemption. The tax exemptions cost the federal government more than \$36.5 billion a year. See FISHMAN & SCHWARZ, *supra* note 7, at 10.

²⁰⁵ See *id.* at 5-9 (describing benefits of the charitable sector).

²⁰⁶ See Regina E. Herzlinger, *Can Public Trust in Nonprofits and Governments Be Restored?*, HARV. BUS. REV., (Mar.-Apr. 1996, at 97)(stating that "we entrust [nonprofits] with society's most important functions—educating our minds, uplifting our souls, and protecting our health and safety.").

services, and the sector continues to play a key role.²⁰⁷ If the public loses trust in the charitable sector, the sector as a whole may suffer through reduced tax benefits, increased administrative costs related to increased supervision, and reduced financial support from donors.²⁰⁸ This, in turn, will lead to loss of benefits to the members of the public who are direct beneficiaries.

V. ENFORCEMENT IN THE CHARITABLE SECTOR

In the charitable setting the enforcement mechanisms on which the fiduciary concepts depend are missing.²⁰⁹ A charity organized as a trust does not have beneficiaries in the sense that a private trust has beneficiaries.²¹⁰ Although beneficiaries of private trusts can obtain information about the trust from the trustee,²¹¹ those who benefit from a charitable trust may have difficulty obtaining information about the trust.²¹² Even if the beneficiaries can obtain sufficient information to determine that the trustees have breached their fiduciary duties to the trust, beneficiaries of a charitable trust usually do not have standing to sue to enforce the trust.²¹³

Similarly, a charity organized as a nonprofit corporation has no shareholders to monitor the directors.²¹⁴ In addition, the market mechanisms that may help to regulate corporations do not exist for nonprofits.²¹⁵ A nonprofit

²⁰⁷ See FISHMAN & SCHWARZ, *supra* note 7, at 34-38 (describing the history of charities in the United States).

²⁰⁸ See Skolnik, *supra* note 14 (describing increased public scrutiny and the importance to nonprofits of maintaining the public's trust).

²⁰⁹ See generally, Brody, *Limits*, *supra* note 7 (explaining that in the charitable context there are no principals to enforce the fiduciary duties of agents).

²¹⁰ See *supra* section IV.B.1.

²¹¹ See, e.g., UNIF. TRUST ACT. § 813(b)(1) (1999 Annual Meeting draft) ("Duty to Inform and Report").

²¹² The disclosure rules enacted in 1996 should help. See *infra* notes 222-31 and accompanying text.

²¹³ See *infra* notes 259-63 and accompanying text.

²¹⁴ See REV. MODEL NONPROFIT CORP. ACT § 13.01 (1988) (stating that a public benefit nonprofit corporation can make no distributions); see also Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 568 (1981) [hereinafter Hansmann, *Reforming*] (comparing the ability of shareholders to obtain information as a result of corporate disclosure requirements and to exercise control through voting power and use of the derivative suit with the lack of oversight available for patrons of a nonprofit); Brody, *Agents*, *supra* note 17, at 465 (comparing the accountability of a corporate board (agents) to the corporation's shareholders (principals) with the lack of "principals" for a nonprofit and the resulting concerns about accountability in the nonprofit context); Brody, *Limits*, *supra* note 7, at 1429.

²¹⁵ See Brody, *Agents*, *supra* note 17, at 476-77 (describing mechanisms of accountability for managers of business corporations: (1) a shareholder's ability to sell the stock if the shareholder loses confidence in management, (2) the price of the shares on the stock market as a

cannot continue to operate in the red indefinitely, so economics do constrain directors of nonprofits.²¹⁶ Yet, the directors of a nonprofit, unlike their business counterparts, do not need to worry about falling stock prices or losing their jobs in a hostile takeover.²¹⁷

Given that neither shareholders nor specifically identified beneficiaries can enforce the fiduciary duties imposed on directors and trustees of nonprofit organizations, two issues must be examined: who has access to information about the nonprofit and who has standing to sue for breach of fiduciary duty? Part V begins by describing tax law changes that have increased public access to information about charities. Increasing the availability of information about charities may improve the effectiveness of oversight by the public. As the following subsections of this Part V explain, however, standing to enforce breaches of fiduciary duties in the charitable context is still limited in most cases to the attorney general. Changes to this general rule include statutes conferring status to sue on private persons as relators and a court-created special interests doctrine that gives certain specifically identified beneficiaries standing. These modest expansions of standing signal attempts to create mechanisms for enforcement beyond the limited resources of the attorney general. Finally, Part V examines the legal structure that provides the IRS with authority to supervise charities, an increasingly important aspect of the regulation of charities.

A. Access to Information

Supervision and enforcement depend upon adequate information. In recent years, changes in the laws regulating charities have increased the reporting requirements that apply to charities and have increased the availability to the public of information about charities.

1. Federal reporting

Each charity exempt from federal income tax and with annual gross receipts in excess of \$25,000 must file an information return, Form 990, annually with the IRS.²¹⁸ The information return provides the IRS with financial data,

reflection of the quality of management and (3) the possibility of a corporate takeover to replace poor managers).

²¹⁶ See FISHMAN & SCHWARZ, *supra* note 7, at 72 (explaining that “nonprofits are more likely to resist closure and simply hold on in the face of economic setbacks than for-profits” but that eventually a nonprofit that cannot satisfy its creditors must dissolve or merge with another organization).

²¹⁷ See *infra* notes 129-37 and accompanying text.

²¹⁸ See Treas. Reg. § 1.6033-2.

information concerning the organization's exempt activities and income-producing activities, and some additional information designed to reveal whether the organization has violated any of the tax rules.²¹⁹ Although the information return reveals some useful information about the charity, limited review by the IRS may mean that problems at the charity are overlooked.²²⁰ Further, until recently, public access to the information was difficult. The Internal Revenue Code required a charity to have copies of its Application for Recognition of Exempt Status (Form 1023) and its most recent Form 990 available for public inspection at its office, but did not require the charity to make copies available.²²¹

As part of the 1996 Taxpayer Bill of Rights,²²² Congress enacted requirements making it easier for members of the public to get information about charities.²²³ The new law requires a charity to provide copies of its Application for Recognition of Exempt Status and its annual returns for the three most recent years to anyone who requests the information.²²⁴ The nonprofit organization can charge reasonable fees for photocopying the form²²⁵ and can make the forms available on the Internet as an alternative to making copies.²²⁶

A former IRS employee, James McGovern, has suggested that the new requirements "will lead to sharply increased oversight of tax-exempt organizations' activities by the public as well as by state and federal regulators"²²⁷ A newspaper devoted to nonprofit issues echoed this sentiment: "Charities nationwide are gearing up for a new era of public scrutiny."²²⁸ The

²¹⁹ See IRS Form 990.

²²⁰ The number of IRS staff is declining at a time when the charitable sector is growing rapidly. See John F. Coverdale, *Preventing Insider Misappropriation of Not-For-Profit Health Care Provider Assets: A Federal Tax Law Prescription*, 73 WASH. L. REV. 1, 15 (1998).

²²¹ See I.R.C. § 6104(e) (1994).

²²² See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996)(Jul. 30, 1996)(codified in scattered sections of 26 U.S.C.).

²²³ See I.R.C. § 6033(b) (1994 & Supp. II 1996); see also Grant Williams, *New Rules for Charity Disclosure*, CHRON. PHILANTHROPY, Oct. 16, 1997, at 37. The new rules took effect June 8, 1999, 60 days after the IRS issued final regulations. See *id.*

²²⁴ See I.R.C. § 6104(d) (1994 & Supp. II 1996).

²²⁵ The IRS has defined "reasonable" as the amounts charged by the IRS for copies: \$1 for the first page and 15 cents for each additional page. Treas. Reg. § 301.6104(d)-3(d)(3).

²²⁶ See Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed. Reg. 17279, 17282 (Apr. 9, 1999)(to be codified at 26 C.F.R. pts. 301 & 602); see also Jennifer Moore & Grant Williams, *Charities May Use Internet to Comply with New Rules*, CHRON. PHILANTHROPY, Oct. 16, 1997, at 41 (describing proposal of Cliff Landesman, founder of the Internet Nonprofit Center, for electronic filing).

²²⁷ Grant Williams, *IRS Issues Final Rules for Charities on Making Tax forms Available to Public*, CHRON. PHILANTHROPY, Apr. 22, 1999, at 58 (quoting James J. McGovern).

²²⁸ Jennifer Moore & Grant Williams, *Return of the Future*, CHRON. PHILANTHROPY, Dec. 17, 1998, at 1.

public's easy access to charitable information returns through the Internet²²⁹ should influence managers to be more careful that the charity's forms report data accurately.²³⁰ In addition, the knowledge of greater public scrutiny should influence behavior because concealing misdeeds or misappropriation of funds will become more difficult.²³¹ Thus, the increased federal reporting and access requirements should improve the level and quality of supervision by the public.

2. State reporting

Most states require charities to register with the attorney general and to file annual reports.²³² The reports, which in some states require attaching a copy of the federal Form 990,²³³ provide a basic level of information and may be a helpful starting point for further investigation if the attorney general receives a complaint from the public.²³⁴ Failure to file the required returns may also signal problems that warrant investigation.²³⁵

So important is the federal filing requirement to the work of the attorney general that a recent IRS proposal to raise the threshold for filing the Form

²²⁹ Several organizations are helping charities make their Forms 990 available on the Internet. See *Help for Charities in Putting Their Tax Forms on the Web*, CHRON. PHILANTHROPY, Dec. 17, 1998, at 33.

²³⁰ See *id.*

²³¹ See *infra* notes 374-78 and accompanying text. A private citizen may find that Form 990 does not convey enough information to provide a clear picture of what an organization has been doing. Requiring the submission of financial data prepared according to Generally Accepted Accounting Principles could help. Further, organizations that represent charities are encouraging charities to add descriptive information to the Form 990 so that potential donors reading the form can get a good understanding of the organization's mission and activities. See Moore & Williams, *supra* note 226, at 32.

²³² See Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, 5 COMM'N ON PRIVATE PHILANTHROPY & PUBLIC NEEDS, RESEARCH PAPERS at 2706 (U.S. Treas. Dep't 1977) [hereinafter *Status of State Regulation*]; see, e.g., OR. REV. STAT. § 128.650 ("Register of charitable corporations and trustees; authority of Attorney General to maintain register") & § 128.670 ("Filing of reports; fees; authority of Attorney General relating to reports; civil penalty") (1997). States also require registration and reporting related to solicitation of donations. As Evelyn Brody has pointed out, "Perhaps because a donor's power is strongest before making a contribution, state oversight concentrates on the aspect of charities that deals with the public as donors." See Brody, *Institutional Dissonance*, *supra* note 4, at 485.

²³³ See, e.g., Or. Dep't of Justice, Form CT-12, pt. 1, sec. IV.

²³⁴ See Bograd, *supra* note 17, at 23-24.

²³⁵ See *id.* at 23.

990 drew criticism from those who supervise charities.²³⁶ Under current law, exempt organizations with annual gross income of greater than \$25,000 must file a Form 990.²³⁷ The IRS proposed increasing that amount to \$40,000 or perhaps even \$100,000 to reduce the burdens on small nonprofits.²³⁸ In a letter recommending against the idea, the National Association of State Charity Officials wrote, "It is often the smaller, less sophisticated charities that have the greatest need for checks and balances and public scrutiny"²³⁹ The states that allow charities to meet their state law filing requirement by submitting a copy of the Form 990 would likely have to create their own form for filing, increasing paperwork for the nonprofits.²⁴⁰ After considering the concerns raised by the state attorneys general, the IRS dropped the plan to increase the minimum amount required for filing.²⁴¹

B. Attorney General

By statute or common law, all states give the state attorney general the authority to supervise nonprofits organized in the state.²⁴² The attorney general, as the representative of the public's interest in a charity, has standing to sue a charity regardless of whether the charity is organized as a trust or a corporation.²⁴³ While the powers of the attorney general are substantial,²⁴⁴ the extent of the supervision the attorney general provides is limited.²⁴⁵

²³⁶ See Jennifer Moore & Grant Williams, *Idea to Change Filing Rules Draws Fire from Regulators*, CHRON. PHILANTHROPY, Apr. 23, 1998, at 45 [hereinafter Moore & Williams, *Idea to Change Filing Rules*].

²³⁷ See Treas. Reg. § 1.6003-2(g)(1)(iii).

²³⁸ See Announcement 97-115, 1997-47 I.R.B. 17.

²³⁹ Moore & Williams, *Idea to Change Filing Rules*, *supra* note 236.

²⁴⁰ See *id.* James J. McGovern, a former official in the exempt-organizations office at the IRS notes that many exempt organizations fail to file as required under existing rules, and raising the threshold would exacerbate that problem. See Jon Craig & Grant Williams, *IRS Plan Would Require Fewer Charities to File Forms*, CHRON. PHILANTHROPY, July 10, 1997, at 49.

²⁴¹ See Jennifer Moore & Grant Williams, *Tax Agency Shelves Idea of Changing Filing Rules*, CHRON. PHILANTHROPY, Nov. 19, 1998, at 39.

²⁴² See *Status of State Regulation*, *supra* note 232, at 2715 (Table 1, "Attorneys General Enforcement Authority: Statutory Basis for Regulation of Charitable Trusts and Foundations (as of August 1974)") & 2773-74 (Appendix A, "Selected Citations to Cases From Twenty-Three Jurisdictions Holding That the Attorney General Retains His Common Law Powers").

²⁴³ See *id.* at 2705 (providing extensive data on charitable registration and reporting requirements, the authority of the attorney general under statutory law and common law, and the extent to which attorneys general are involved in regulating charities).

²⁴⁴ See Hansmann, *Reforming*, *supra* note 214, at 601. "Unfortunately, in most states there has been little effort to exercise even the substantial powers that the attorney general already has." *Id.*

²⁴⁵ See Bograd, *supra* note 17, at 32-33 (explaining that the attorneys general who participated in the study "play a valuable but limited role in dealing with nonprofits. [They]

States vary in the number of staff allocated to supervising nonprofits. In some states, several assistant attorneys general form a charitable division of the attorney general's office. For example, a 1994 study found that Connecticut had four attorneys working in the charities division of the attorney general's office, Massachusetts had seven and New York had seventeen.²⁴⁶ Even Oregon, a much less populous state than any of these three, has three.²⁴⁷ In other states, however, one assistant attorney general supervises the nonprofit sector as only one part of his or her assignment. Hawai'i has reported 0.5 attorneys working with charities, and many states do not list any attorneys specifically assigned to charitable matters.²⁴⁸

Those working in three state charities offices—New York, Connecticut and Massachusetts—report that the registration and reporting system, although useful, is not the source of most of the investigations those offices conduct.²⁴⁹ The attorneys in these three states report that inquiries or complaints from dissenting board members, employees, beneficiaries or other members of the public, including the press, are much more likely to trigger investigations than reviews of annual reports conducted in the attorney general's office.²⁵⁰ In determining which cases to pursue, the attorneys consider the amount involved, the size of the organization, the impact on the public, and the egregiousness of the conduct.²⁵¹ The worst abuses receive attention, but many problems probably go undetected or unaddressed. The attorneys general perform an important supervisory role in the charitable sector,²⁵² but other

come in as a 'last resort' when groups are paralyzed or abandoned . . .").

²⁴⁶ See *id.* at 9.

²⁴⁷ Telephone conversation with Judith L. Woodruff, Assistant Attorney General, Oregon Charitable Activities Section (Oct. 15, 1999) [hereinafter Conversation with Judith L. Woodruff].

²⁴⁸ *Number of Full-Time Equivalent (FTE) Attorney Positions by Selected Practice Areas: "Public Protection"* (Nat'l Ass'n of Attorneys General), 1997, at 18, 20; see also *Status of State Regulation*, *supra* note 232, at 2728 (listing number of personnel—attorneys, accountants and others assigned to charities work in the offices of the attorneys general as of August 1974, and indicating that 11 offices had no attorneys and 17 offices had only one part-time attorney assigned to charities work).

²⁴⁹ See Bograd, *supra* note 17, at 12.

²⁵⁰ See *id.* at 11-13. The attorneys noted that media involvement, while not determinative in a decision about whether to devote staff time to a case, does add pressure. See *id.* at 16.

²⁵¹ See *id.* at 15-16 (citing Pamela Mann, the attorney in charge of the New York charities office, as stating that the focus there is to "get the bad guys.").

²⁵² See *id.* at 14. A charity that can no longer carry out its original mission or comply with the restrictions placed on a gift must notify the attorney general before changing its charitable purpose. Under the trust law doctrine of *cy pres*, change will be permitted only if the original purpose is impossible or impracticable, and the change must be as close as possible to the original purpose. See BOGERT & BOGERT, *supra* note 31, § 431. Nonprofit corporations are deemed to hold property in trust for the public, so courts sometimes apply the *cy pres* doctrine to charities organized as nonprofit corporations. See, e.g., *Lynch v. Spilman*, 431 P.2d 636

forms of supervision are both necessary and desirable.

C. Limited Standing for Others

1. Limited standing

If it is true that attorneys general regulate charities in a "valuable but limited" manner²⁵³ due to limited resources and if "attorneys general rarely pursue their rights with the same zeal that private parties exhibit[.]"²⁵⁴ then some additional means to regulate charities must be found. Persons involved in an organization have access to information about that organization and are more likely than the attorney general to be aware of conflicts of interest or mismanagement issues. Further, they have an interest, even if not an economic one, in ensuring that those managing the organization heed their fiduciary duties.²⁵⁵

The attorney general may be able to respond to complaints raised by trustees, directors or employees of a charity. As noted above, contacts from persons inside charitable organizations account for a substantial number of the investigations conducted by the attorney general.²⁵⁶ Nonetheless, the attorney general will not be able to investigate all complaints.²⁵⁷ Finding a way to harness the knowledge and interest of those connected to the charity without overwhelming the courts and the nonprofit sector with "vexatious" and "harassing" litigation²⁵⁸ may be a key element in improving regulation of nonprofits.

For the most part, states continue to restrict standing to sue a nonprofit to the state attorney general.²⁵⁹ Although some states have begun to supplement

(1967). But in some states statutes have loosened the *cy pres* rules somewhat with respect to charities formed as nonprofit corporations. See, e.g., N-PCL § 1005(a)(3)(A)(McKinney 1997)(requiring a dissolving corporation to distribute assets held for a charitable purpose to one or more organizations "engaged in activities substantially similar to those of the dissolved corporation.").

²⁵³ Bograd, *supra* note 17, at 34.

²⁵⁴ Brody, *Limits*, *supra* note 7, at 1431.

²⁵⁵ See Karst, *supra* note 65, at 444 ("The charity's own representative has at least as much interest in preserving charitable funds as does the attorney general.").

²⁵⁶ See Bograd, *supra* note 17, at 12 (reporting that the Assistant Attorney General in Charge of the Public Charities Unit in Connecticut estimated that of 150 total inquiries, 130 came from dissenting board members and employees).

²⁵⁷ See *id.* (describing criteria used to determine when to intervene).

²⁵⁸ See Hansmann, *Reforming*, *supra* note 214, at 607.

²⁵⁹ See Mary G. Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 40-41 (1993)(describing the history of the principle that the state, through the attorney general, enforces charities).

the attorney general's authority,²⁶⁰ recent cases in two states adhered closely to the rule that only the attorney general has standing to sue a charity.²⁶¹ The Supreme Judicial Court of Massachusetts denied standing to members of a religious congregation who sought to sue the governing board of their church,²⁶² and the Connecticut Supreme Court denied standing to a donor who attempted to sue a grantee who failed to comply with the conditions the donor had placed on the grant.²⁶³ The Massachusetts and Connecticut cases suggest that sweeping changes in standing rules are unlikely, but limited exceptions to the rule that only the attorney general can sue a charity do exist for members of the charity, for persons who can qualify as relators, and for beneficiaries who can establish standing under a special interests doctrine.

2. Members

In some states, statutes provide that a director or trustee has standing to sue the other directors or co-trustees.²⁶⁴ Case law may also provide standing for a director or trustee.²⁶⁵ As a practical matter, however, directors and trustees may be reluctant to sue each other.²⁶⁶

Some state statutes give members of nonprofits organized as membership

²⁶⁰ See *id.* at 48-49.

²⁶¹ See *Weaver v. Wood*, 680 N.E.2d 918 (Mass. 1997), *cert. denied*, 522 U.S. 1049 (1998); *Carl J. Herzog Found., Inc. v. University of Bridgeport*, 699 A.2d 995 (Conn. 1997).

²⁶² See *Weaver*, 680 N.E.2d at 918. Members of the first Church of Christ, Scientist, sued the governing board of the Church and a related publishing organization. The court held that only the attorney general had standing to "bring an action alleging the misuse of charitable assets." See *id.* at 922.

²⁶³ See *Carl J. Herzog Found.*, 699 A.2d at 995. The Herzog Foundation had made a grant to the University of Bridgeport on the condition that the grant plus matching funds would be used for need-based scholarships for students studying medicine. When the university failed to carry out the conditions, the foundation sued to force the university to transfer the funds to another foundation that would carry out the terms of the grant. The court stated that only the attorney general had standing to enforce the restriction on the gift. Responding to this case, Connecticut's Attorney General "pledged to be diligent in supporting aggrieved donors while respecting the rights of charities to financial independence." See Vince Stehle, *Connecticut Supreme Court Blocks Donors from Suing to Enforce Limitations on Gifts*, CHRON. PHILANTHROPY, Sept. 4, 1997, at 12.

²⁶⁴ See, e.g., CAL. CORP. CODE § 5142(a) (West 1990) (granting standing to directors and officers); REV. MODEL NONPROFIT CORP. ACT § 6.30 (1988).

²⁶⁵ See, e.g., *Holt v. College of Osteopathic Physicians & Surgeons*, 394 P.2d 932, 937 (Cal. 1964) (extending the rule that one trustee can sue a co-trustee to directors of a nonprofit corporation: "There is no sound reason why minority directors or 'trustees' of a charitable corporation cannot maintain an action against majority trustees when minority trustees of a charitable trust are so empowered.").

²⁶⁶ See Brody, *Institutional Dissonance*, *supra* note 4, at 484 (explaining that if directors lose a role of the board, they cannot try again in court).

corporations the right to bring derivative suits.²⁶⁷ Similar to the rights of shareholders to bring derivative suits under corporate law, a member can sue the corporation to protect the rights of all the members.²⁶⁸ For example, the RMNCA provides that voting members may bring a derivative suit, but only if the suit is brought by fifty or more members, or, if the nonprofit has fewer than fifty members, by five percent or more of the members.²⁶⁹ The comparable New York statute permits derivative suits by members holding at least five percent of the voting power.²⁷⁰ Although members can sue derivatively in many states, most charities do not have voting members, so these statutes have limited impact.²⁷¹ Thus, neither directors nor members provide a significant source of monitoring for charities.

3. Relators

The use of relators may provide a means to supplement the resources of the attorney general's office while providing an opportunity for private citizens to take a greater role in supervising nonprofits.²⁷² A relator is a private person who sues a charity on behalf of the attorney general.²⁷³ A statute enacted in 1980 provides for relators in California.²⁷⁴ The statute permits persons granted relator status by the attorney general to sue a charity on behalf of the attorney general.²⁷⁵ Pursuant to the statute, a private person can notify the attorney general of abuse by the charity or its fiduciaries.²⁷⁶ If the attorney general agrees, the relator can proceed with the suit on behalf of the attorney general.²⁷⁷ The private relator pays the court costs, but the attorney general remains in control of the action.²⁷⁸ By permitting relators to bring suit on behalf of the attorney general, the statute may enable the attorney general to

²⁶⁷ See Blasko, *supra* note 259, at 53-57; see also, e.g., REV. MODEL NONPROFIT CORP. ACT. § 6.30 (1988).

²⁶⁸ See Blasko, *supra* note 259, at 53.

²⁶⁹ See REV. MODEL NONPROFIT CORP. ACT. § 6.30 (1988).

²⁷⁰ See N.Y. NOT-FOR-PROFIT CORP. LAW § 720(b) (McKinney 1970 & Supp. 1997).

²⁷¹ See Brody, *Institutional Dissonance*, *supra* note 4, at 484; Hansmann, *Reforming*, *supra* note 214, at 612 (criticizing the New York and California statutes that permit suits by members as taking a "narrow and misguided view" as a result of "uncritical imitation of the business corporation statutes."). Hansmann agrees that members should have standing but advocates standing for all "patrons"—members, donors and those who purchase services from the organization. See *id.*

²⁷² See Blasko et al., *supra* note 259, at 49.

²⁷³ See *id.*

²⁷⁴ See CAL. CORP. CODE § 5142(a) (West 1990).

²⁷⁵ See *id.* § 5142(a)(5).

²⁷⁶ See Blasko et al., *supra* note 259, at 49-50.

²⁷⁷ See CAL. CORP. CODE § 5142(a)(5) (West 1990).

²⁷⁸ See Blasko et al., *supra* note 259, at 49-50.

increase enforcement efforts.²⁷⁹ The suit must be one which the attorney general within his or her discretion could have brought, and the attorney general must authorize the suit before the relator can proceed.²⁸⁰

4. *Special interests doctrine*

Courts have occasionally permitted private persons to sue a charity by finding that the persons have a "special interest" in the charity.²⁸¹ In general, the plaintiffs must be identifiable beneficiaries or potential beneficiaries in the organization.²⁸² The plaintiffs must have a specific interest that will be directly affected by the charity's failure to carry out its purpose or by a breach of fiduciary duties.²⁸³ The plaintiff must be a member of an identifiable class of beneficiaries of the charity and not merely a member of the general public who is concerned that the charity be run properly.²⁸⁴ Courts have been willing to let such beneficiaries sue the charity to protect the "special interest" in a manner analogous to a suit by a beneficiary of a private trust,²⁸⁵ but the remedy sought must be a benefit to the charity itself and not money damages for the plaintiffs.²⁸⁶

A study published in 1993 identified factors most likely to induce a court to grant standing to private persons:

- (a) the extraordinary nature of the acts complained of and the remedy sought by the plaintiff; (b) the presence of fraud or misconduct on the part of the charity or its directors; (c) the state attorney general's availability or effectiveness; and (d) the nature of the benefitted class and its relationship to the charity.²⁸⁷

²⁷⁹ *See id.*

²⁸⁰ *See id.*

²⁸¹ *See, e.g., Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 367 F. Supp. 536, 540 (D.D.C. 1973)(granting standing to a group of patients to sue the directors of a hospital for breaches of fiduciary duties); *Kapiolani Park Preservation Soc'y v. City & County of Honolulu*, 751 P.2d 1022, 1025 (Haw. 1988)(granting standing to members of the public as beneficiaries of a charitable trust of which the city of Honolulu was trustee, with respect to a dispute in which the attorney general "has actively joined in the supporting of the alleged breach of trust . . ."); *Jones v. Grant*, 344 So. 2d 1210 (Ala. 1977)(granting standing to students, staff and faculty of Daniel Payne College who sued the college, its president and its directors for misuse of funds given to the college to be used for grants or loans to students and to upgrade the faculty, staff, student body, equipment and facilities).

²⁸² *See Blasko et al., supra* note 259, at 70.

²⁸³ *See id.*

²⁸⁴ *See id.* at 70-72.

²⁸⁵ *See id.* at 59-78.

²⁸⁶ *See id.* at 61-62; *Stern*, 367 F. Supp. at 540 (refusing to allow the plaintiffs to sue under Rule 23(b)(3) for money damages resulting from trustee mismanagement).

²⁸⁷ *Blasko et al., supra* note 259, at 61.

A court will review the seriousness of the allegations and will be more likely to grant standing if the alleged actions threaten the charitable purpose or the existence of the charity or if it appears that fraud or misconduct is involved.²⁸⁸ Courts will defer to a determination previously made by the attorney general. That is, if the attorney general has reviewed the case and declined to pursue it, a court is unlikely to grant standing to a private party, especially in a state with a strong record of charitable enforcement by the attorney general.²⁸⁹ In contrast, if the court perceives lax enforcement efforts or lack of resources or interest on the part of the attorney general, the court may be willing to supplement the "official" enforcement and grant standing to a private party with special interests.²⁹⁰

The Bishop Estate situation presents the sort of facts that would make granting standing to private persons appropriate. A class consisting of students and faculty of the Kamehameha Schools would have been appropriate plaintiffs had the attorney general not brought suit against the trustees. Those persons have a direct interest in the trust and their interests were directly affected by the misconduct of the trustees. A suit brought under the special interests doctrine would have been brought as the result of misconduct by the trustees. The acts complained of certainly were extraordinary: self-dealing transactions with financially costly consequences to the trust,²⁹¹ procedures for setting compensation that created conflicts for the trustees in managing the trust,²⁹² delegation of authority by the trustees to each other in a manner that adversely affected management of the trust,²⁹³ and management decisions that had undermined the administration of Kamehameha Schools.²⁹⁴ The appropriate remedy would be removal of the trustees and recovery from the trustees of losses suffered by the trust as a result of breaches of their duties. Due to the size and public importance of the Bishop Estate, the public would benefit from the suit.

²⁸⁸ See *id.* at 62-65.

²⁸⁹ See *id.* at 68 (pointing out that the charities division of the Massachusetts attorney general's office maintains an active enforcement system and, perhaps for that reason, Massachusetts courts have a history of refusing to grant standing to private plaintiffs). See, e.g., *Weaver v. Wood*, 680 N.E.2d 918 (Mass. 1997), *cert. denied*, 522 U.S. 1049 (1998) (refusing to grant standing in Massachusetts to church members).

²⁹⁰ See *Blasko et al.*, *supra* note 259, at 69 (citing *Holt v. College of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964)).

²⁹¹ See Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and the One Hundred Eleventh Annual Accounts of the Trustees, In *re Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 7, 1998), available at <<http://starbulletin.com/98/08/07/news/masters2/masters2.html>> [hereinafter Master's Report].

²⁹² See *id.*

²⁹³ See *id.*

²⁹⁴ See *id.*

Given the public importance of the trust and the egregious nature of the misconduct, the state attorney general did bring suit against the trustees.²⁹⁵ At the time the Broken Trust article was published, however, the authors noted that “no attorney general had initiated a lawsuit to sanction or remove a trustee.”²⁹⁶ Given the lack of a charities section in the attorney general’s office and the political nature of the position of the attorney general in Hawai‘i,²⁹⁷ granting private standing would have been appropriate had the attorney general not brought the suit. The Bishop Estate provides a good example of the need for the special interests doctrine when an attorney general chooses not to act.

D. Internal Revenue Service

In addition to enforcement by the state attorney general and others of the fiduciary duties of trustees and directors, the IRS enforces tax rules that regulate charities. Indeed, as the charitable sector has shifted increasingly to the use of the corporate form, and the rules governing directors of charitable corporations have moved away from the strict trust law standard,²⁹⁸ concern about whether adequate monitoring of charities exists has led to *increasing* regulation through the IRS. Although IRS resources are limited and the IRS cannot identify every example of wrongdoing, the IRS provides an enforcement mechanism in addition to enforcement of fiduciary duties under state law.

Breach of fiduciary duties can result in federal tax penalties imposed on the organization and, in some cases, on the director or trustee. Although the focus of the tax code is whether organizations are exempt from income tax and whether contributions to organizations are deductible, the rules for tax-exempt status and for deductibility of contributions include restrictions on trustee and director behavior.²⁹⁹ Section 501(c)(3) and section 170(c) of the Internal Revenue Code both include the requirement that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual”³⁰⁰ Thus, if a director, trustee or other person takes advantage of the charitable organization by taking excessive salary or by engaging in a self-dealing transaction that benefits the individual and harms the organization, the organization will fail to meet the requirements of sections

²⁹⁵ See Petition of the Attorney General, *supra* note 10.

²⁹⁶ See *Broken Trust*, *supra* note 10.

²⁹⁷ See *id.* (stating that Hawai‘i has an appointed attorney general).

²⁹⁸ See *supra* notes 140-55 and accompanying text.

²⁹⁹ See I.R.C. §§ 170(c), 501(c) (1994).

³⁰⁰ I.R.C. §§ 170(c); 501(c)(3) (1994).

501(c)(3) and 170(c).³⁰¹ If the situation is sufficiently egregious, the IRS can revoke the organization's tax-exempt status.³⁰² In the Bishop Estate situation, the IRS threatened to revoke the trust's tax-exempt status unless the five trustees resigned or were removed.³⁰³ That threat resulted in the temporary removal of the trustees³⁰⁴ and likely influenced the decision to remove the trustees permanently.

Revoking an organization's exempt status is such a drastic measure that the IRS uses it infrequently.³⁰⁵ If an individual director has benefited at the expense of the nonprofit organization, revoking the organization's exempt status may be disproportionate to the offense committed.³⁰⁶ Rather than penalizing the director who benefited privately, revocation of exempt status penalizes the organization and the public interests served by the organization.³⁰⁷ For this reason, two sets of tax rules create penalties for those who breach their fiduciary duties in specified ways. Rules governing private foundations and intermediate sanctions imposed on excess benefit transactions both provide the IRS with enforcement mechanisms that do not depend on revocation of the organization's exempt status. The private foundation rules apply to a subset of charities, but the intermediate sanction rules, adopted in 1996, give the IRS greater regulatory power over all charities. This section will examine first the private foundation rules and then the intermediate sanctions, both of which reflect increasing regulation of charities by the IRS.

1. Private foundation rules

In the 1950s and 1960s, Congress became concerned about abuses in the charitable sector.³⁰⁸ Testimony described scenarios in which wealthy individuals created charitable foundations, took tax deductions for contributions to the foundations, obtained tax-exempt status for the foundation, and then used the resources of the foundations for private purposes.³⁰⁹ Since the individual donor and his or her family members served

³⁰¹ See Treas. Reg. § 1.501(c)(3)-1(b)(6).

³⁰² See *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1312 (9th Cir. 1987).

³⁰³ See Daysog, *supra* note 11; see also Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999)(discussing this use of IRS authority).

³⁰⁴ See *supra* note 13.

³⁰⁵ See Hansmann, *Reforming*, *supra* note 214, at 603.

³⁰⁶ See FISHMAN & SCHWARZ, *supra* note 7, at 75.

³⁰⁷ See Hansmann, *supra* note 214, at 603. "Withdrawal of exemption, which is the principal threat that the IRS can offer in such cases, will often hurt rather than help those innocent individuals whom the organization is designed to serve." *Id.*

³⁰⁸ See FISHMAN & SCHWARZ, *supra* note 7, at 589-93.

³⁰⁹ See *id.*

as directors and managers of the foundation, outside scrutiny was limited. These family-controlled nonprofits were particularly susceptible to private inurement problems, and at the same time, policing these nonprofits was difficult.³¹⁰

To counter these concerns, Congress enacted new sections of the tax code—the “private foundation rules”—in 1969.³¹¹ The changes in the tax law created two categories of exempt nonprofits—public charities and private foundations.³¹² Public charities are those that have a broad donor base, significant government support, or some form of public control.³¹³ Private foundations are charities created and managed by an individual, a family or a corporation—a limited group of people operating without public involvement or oversight.³¹⁴

The distinction between public charities and private foundations implicitly recognizes the role of the public in supervising charities. Public monitoring occurs through decisions about contributions, through serving as a watchdog for the attorney general, or through the public’s involvement in the operation of the charity itself as employees, trustees, or directors.³¹⁵ The public has incentive and opportunity to monitor public charities but not private foundations. Thus, the changes enacted in 1969 create stricter standards for private foundations than for public charities.

The private foundation rules prohibit activities that Congress determined were the most susceptible to abuse.³¹⁶ Of particular interest with respect to fiduciary duties is an absolute prohibition on self-dealing by a person connected with the foundation—a major donor, a director, or a family member of either.³¹⁷ Congress viewed this extreme approach as necessary due to the

³¹⁰ See *id.*

³¹¹ See Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (1969)(codified in scattered sections of 26 U.S.C.).

³¹² See I.R.C. § 509 (1994)(defining private foundation as an exempt organization that fails to qualify as a public charity under one of the three tests of Section 509).

³¹³ See *id.*

³¹⁴ See Gail K. Neuharth, *A Primer on Private Foundations*, 12 PROB. & PROP. 33, 34 (Nov.-Dec. 1998). Although the Bishop Estate trust was created by the gift of one person, Princess Bishop, the trust is considered a public charity by virtue of its educational mission. See I.R.C. § 509(a)(1).

³¹⁵ Public monitoring is critical to adequate supervision of charities. Increased public access to information about charities may improve the regulation of charities. See *infra* notes 223-32 and accompanying text.

³¹⁶ Private foundations cannot hold majority interests in a business. See I.R.C. §§ 4943(c)(2)(A)(ii) & (B)(i)(ii) (1994). Private foundations cannot make investments that jeopardize the charitable purpose by being too risky. See *id.* § 4944(a)(1). Private foundations cannot make expenditures that are inconsistent with the foundation’s exempt purposes. See *id.* § 4941.

³¹⁷ See *id.* § 4941.

difficulty of monitoring the activities of this type of charity.³¹⁸ The private foundation rules provide for sanctions in the form of taxes imposed on the organization or on the individual involved in the proscribed behavior.³¹⁹ The taxes imposed under the private foundation rules put some teeth into the statute. Since the IRS is in the business of collecting taxes, giving the IRS a tax reason to supervise private foundations should increase the scrutiny on those nonprofits.³²⁰ Further, the taxes provide a way for the IRS to penalize private foundations for bad acts without taking the drastic step of revoking the foundation's tax-exempt status.³²¹ The taxes provide a penalty for the initial act, but perhaps more importantly, the substantial second tier tax provides a strong incentive for the foundation to undo the self-dealing once the IRS identifies the problem.³²² Nonetheless, the supervision is still limited by the availability of IRS staff and the difficulty of identifying acts of self-dealing in the private foundation context.

2. *Intermediate sanctions*

For nonprofits operating as public charities, the only enforcement mechanism available to the IRS until 1996 was the threat of revoking the nonprofit's tax-exempt status.³²³ To address continuing concern about private inurement by directors and others connected with charities,³²⁴ in 1996 Congress enacted Internal Revenue Code section 4958.³²⁵ The new section

³¹⁸ See FISHMAN & SCHWARZ, *supra* note 7, at 648-49.

³¹⁹ See, e.g., I.R.C. § 4941 (1994). If a private foundation enters into a self-dealing transaction with a director or other disqualified person, section 4941(a)(1) imposes a tax of five percent of the amount involved in the transaction on the self-dealer and section 4941(a)(2) imposes a tax of two-and-a-half percent of the amount involved on a foundation manager who knowingly participated in the act of self-dealing, unless the participation was not willful and was due to reasonable cause. If the foundation does not "correct" the transaction by undoing it to the extent possible, under section 4941(b)(1), the tax jumps to 200 percent on the self-dealer and 50 percent on the foundation manager.

³²⁰ See Hansmann, *Reforming*, *supra* note 214, at 604.

³²¹ In this way, the private foundation rules provide a model for the intermediate sanctions enacted in 1996. See *infra* notes 325-34 and accompanying text.

³²² See, e.g., I.R.C. § 4941(b)(i) (1994) (imposing a tax of 200% on the disqualified person who participated in an act of self-dealing if the self-dealing is not corrected).

³²³ See FISHMAN & SCHWARZ, *supra* note 7, at 75.

³²⁴ At congressional hearings conducted in 1993, IRS officials described examples of abuse, many of which involved excessive compensation of officers and directors. See FISHMAN & SCHWARZ, *supra* note 7, at 75 (citing *Report on Reforms to Improve the Tax Rules Governing Public Charities: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 103d Cong. 1415 (1994)).

³²⁵ See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996) (July 30, 1996) (codified in scattered sections of 26 U.S.C.).

imposes excise taxes on insiders who engage in transactions that result in "excess benefits"³²⁶ to the insiders.³²⁷ The new section defines "insider" as someone who, within the five years preceding the transaction, was "in a position to exercise substantial influence over the affairs of the organization"³²⁸ Thus, the intent is to impose penalties on the persons who benefit personally by reason of their position in the charity.³²⁹ The new section imposes the tax on the insider and on managers who participated knowingly in the transaction, not on the organization.³³⁰ Like the private foundation rules, section 4958 imposes a second tier tax if the transaction is not corrected.³³¹

The rules have been referred to as "intermediate sanctions" because of the intent that these taxes be imposed in lieu of the ultimate sanction—revocation of tax-exempt status.³³² If the organization has provided so much private benefit to individuals that it is no longer charitable, the IRS can seek to revoke its exemption.³³³ In a more typical case in which one or a few individuals have taken private benefits from the organization, section 4958 provides for an excise tax on the wrongdoers and not on the organization itself.³³⁴ The intermediate sanctions seek to preserve the exempt organization's assets for public purposes.

3. *The Bishop Estate*

The IRS audit of the Bishop Estate led to a demand by the IRS that the trustees resign.³³⁵ Within days after the IRS filed its report with the probate

³²⁶ I.R.C. § 4958 (c)(1) (Supp. II 1996)(defining "excess benefit" as an economic benefit provided by the organization directly or indirectly to or for the use of a disqualified person to the extent that the benefit is in excess of the value of the consideration received by the organization. Consideration includes the performance of services).

³²⁷ See *id.* §§ 4958(a) & (b).

³²⁸ *Id.* § 4958(f)(1)(A).

³²⁹ See *id.* § 4958(f) (defining disqualified person).

³³⁰ See *id.* §§ 4958(a) & (b).

³³¹ See *id.* (imposing a first tier tax of 25 percent on the disqualified person and ten percent on the manager, and a second tier tax of 200 percent on the disqualified person).

³³² See Grant Williams, *Stopping Excessive Benefits*, CHRON. PHILANTHROPY, Aug. 13, 1998, at 29.

³³³ See *id.* at 30.

³³⁴ If the organization reimburses the insider for excise taxes paid by the insider, the payment to the insider will be considered compensation. The total amount of compensation must be reasonable or it will be considered an excess benefit. See Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(a)(4))(proposed Aug. 4, 1998).

³³⁵ See Daysog, *supra* note 11.

court, the probate judge permanently removed Trustee Lindsey, accepted the resignation of Trustee Stender, and temporarily removed the remaining three trustees,³³⁶ saying that the exempt status of the trust was at risk. The IRS thus played a role in monitoring the fiduciary duties of the trustees of the Bishop Estate.³³⁷ The IRS may impose penalties for excess benefit transactions that occurred before the removal of the trustees.

VI. WHAT SHOULD BE DONE?

While fiduciary duties exist under both trust and corporate law, corporate standards are less strict. Thus, the shift toward the use of corporate standards for charities has weakened the standards applied to charities organized as nonprofit corporations. Mechanisms for enforcement of those standards exist, but have always been weak. The growth in the charitable sector further depletes existing resources for enforcement. Some recent changes under the tax laws—the intermediate sanctions and the disclosure rules—should improve both monitoring and enforcement. Additional changes may be necessary to strengthen the charitable sector and to guard against further decline in the applicable standards. This section describes a number of proposals, some new and some recommended by others, that could improve the regulation of charities.

A. Strengthen and Protect the Standards

1. Self-dealing and a fairness standard

Self-dealing transactions and conflicts of interests generate much of the concern about proper management of nonprofits. In the Bishop Estate, the Hawai'i attorney general found breaches of both the duty of care and the duty of loyalty, as well as breaches of other duties owed by the trustees.³³⁸ Directors have access to the assets of the nonprofit, assets that are dedicated to the public benefit.

³³⁶ See *supra* note 13.

³³⁷ See generally Brody, *supra* note 303 (arguing that the IRS's role in forcing the removal of the trustees was inappropriate).

³³⁸ See Attorney General's Response to Master's Consolidated Report on the 109th, 110th and 111th Annual Accounts, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 9, 1998) [hereinafter Attorney General's Response], available at <<http://starbulletin.com/98/09/10/news/bronster.html>>; see also *infra* notes 446-56 and accompanying text.

In 1981, Henry Hansmann proposed a flat prohibition on self-dealing transactions between nonprofits and their directors.³³⁹ The federal tax law takes this approach for private foundations,³⁴⁰ but prohibiting all self-dealing transactions could unnecessarily deprive small nonprofits of beneficial opportunities.³⁴¹ A director of a nonprofit may be able to provide office space, goods or services to the nonprofit at a price that is below fair market value.³⁴² Obtaining help from directors may enable some nonprofits, in particular small, local nonprofits, to survive.³⁴³ An absolute prohibition on such transactions seems too drastic.

If permitting some conflict of interest transactions between charities and the persons who control them is necessary, then the standards for when such transactions are permissible must protect charities from overreaching by directors. Trust law sets a high standard for review: any self-dealing transaction is voidable.³⁴⁴ Although charities organized as nonprofit corporations may hold property "in trust" for the public,³⁴⁵ rules governing charities organized as nonprofit corporations have shifted closer to corporate standards.³⁴⁶ Treating charitable directors like their business counterparts is appropriate in some respects, but in connection with fiduciary duties, laws should draw a distinction because of the difference between organizations focused on public purposes and businesses dedicated to private gain, and because of the different mechanisms for monitoring behavior. Further, within the charitable sector the same, or at least similar, standards should govern charitable trustees and charitable directors. Imposing different standards on those who manage charities based on the organizational form of the charity does not make sense.³⁴⁷

³³⁹ See Hansmann, *Reforming*, *supra* note 214, at 569.

³⁴⁰ See I.R.C. § 4941 (1994).

³⁴¹ See FISHMAN & SCHWARZ, *supra* note 7, at 221; DeMott, *Self-Dealing*, *supra* note 183, at 144.

³⁴² See FISHMAN & SCHWARZ, *supra* note 7, at 221; DeMott, *Self-Dealing*, *supra* note 183, at 144.

³⁴³ See FISHMAN & SCHWARZ, *supra* note 7, at 221 (stating that "[a]n absolute ban ignores the reality of much of the charitable sector"); see also Goldschmid, *supra* note 2, at 647.

³⁴⁴ See BOGERT, *supra* note 32, § 95.

³⁴⁵ See *In re Los Angeles Pioneer Soc'y*, 257 P.2d 1 (Cal. 1953) (in bank). Some older cases have applied trust law rules to nonprofits organized as nonprofit corporations because they deem the charities to hold property "in trust" even though the property is not held in trust. See *id.*

³⁴⁶ See *supra* notes 144-55 and accompanying text.

³⁴⁷ In the private sector, trust law imposes stricter standards on trustees than corporate law imposes on directors. This distinction may make sense in the private sector, where different types of monitoring occur. In the charitable sector, monitoring is the same whether the charity is structured as a trust or as a nonprofit corporation.

The RMNCA goes too far toward the corporate standard by permitting a conflict of interest transaction if disinterested directors reasonably believed that the transaction was fair to the corporation.³⁴⁸ The "reasonably believed" test is more stringent than the rationally believed test of the business judgment rule,³⁴⁹ but in the charitable context, a board's review of a self-dealing transaction may be much more cursory than in the business context.³⁵⁰

Deborah DeMott has proposed strengthening the fairness requirement of the duty of loyalty for directors of nonprofit corporations.³⁵¹ She proposes making a self-dealing transaction voidable unless the transaction's proponents can affirmatively establish its fairness to the corporation at the time of the transaction.³⁵² Professor DeMott's approach not only adopts a fairness test, but also puts the burden of proving that the transaction was fair on the proponents of the transaction. As she points out, even "reasonably believed" creates a low standard in the charitable context when board members may be reluctant to criticize each other.³⁵³

Professor DeMott's proposal creates a more appropriate level of restriction on director behavior than does the RMNCA approach.³⁵⁴ The difficulties of supervising charities make a standard that is more strict than the business corporation standard appropriate. Combined with the federal tax rules on excess benefit transactions, the fairness standard should provide an acceptable level of restriction on conflict of interest transactions.

Whether or not a state adopts the DeMott proposal, further erosion of the duty of loyalty standard applied to nonprofit corporations presents risks to charities. In the business sector, corporations can reduce liability of directors for breaches of the duty of care and perhaps even for breaches of the duty of loyalty.³⁵⁵ Protecting directors of charities from liability for some acts may be appropriate,³⁵⁶ but reducing liability in connection with conflict of interest

³⁴⁸ See REV. MODEL NONPROFIT CORP. ACT § 8.31(b)(1)(ii) (1988).

³⁴⁹ See Goldschmid, *supra* note 2, at 648-49.

³⁵⁰ See DeMott, *Self-Dealing*, *supra* note 183, at 137-41.

³⁵¹ See generally *id.* (arguing that importing rules on self-dealing from the business context is not wise, critiquing the RMNCA approach, and advocating stricter requirements).

³⁵² See *id.* at 143.

³⁵³ See *id.* at 140-41. DeMott notes, "directors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment." *Id.* at 140.

³⁵⁴ Harvey Goldschmid finds "considerable strength" in DeMott's proposal. See Goldschmid, *supra* note 2, at 648. He recommends either the DeMott approach or the intermediate standard of judicial review that the ALI Principles use for interested director transactions for business corporations. See *id.* at 648-49.

³⁵⁵ See *supra* notes 116-21 and accompanying text.

³⁵⁶ The Volunteer Protection Act protects uncompensated directors from liability for ordinary negligence, but not from actions brought against the volunteer by the nonprofit organization or a governmental entity. See Volunteer Protection Act of 1997 § 4, 42 U.S.C. §

transactions is not. The current duty of loyalty standards should be tightened and not reduced.³⁵⁷ As corporate standards continue to change, the rules applicable to charities should not blindly follow corporate law. The risk of looking increasingly to corporate law to find standards for nonprofit corporations is that the standards borrowed will not meet the needs of the charitable sector.

2. Large charities and a prohibition on self-dealing

Small organizations may depend on financial help from directors. That assistance may include the provision of goods or services on a below-market cost basis and should be permitted.³⁵⁸ In contrast, the directors of a large charity may be more likely to consider the advantages to themselves of doing business with the charity than to view self-dealing transactions as a way to help the charity.³⁵⁹

Creating a blanket prohibition on self-dealing is too extreme, but prohibiting self-dealing by directors and managers of large charities could reduce abuse without unduly restricting the activities of the charities. The Internal Revenue Code could be amended to create the additional restriction on self-dealing. The new provision would prohibit self-dealing by persons who control a charity³⁶⁰ with assets exceeding a set amount, for example

14503 (1994 & Supp. III 1997). Thus, the attorney general can sue a director for breach of the duty of loyalty.

³⁵⁷ The board's failure to exercise its duty of care can result in excessive executive compensation or self-dealing by an executive going undetected. In the United Way case, the board should have monitored Aramony's behavior and excessive spending. Board inattention is a serious problem. See Goldschmid, *supra* note 2, at 633-34 (describing the United Way scandal and stating that "the most significant question from both a corporate governance perspective and a public policy perspective, is: Where was the Board?"); Shenk, *supra* note 5, at 10 (describing reasons for board detachment).

³⁵⁸ See DeMott, *Self-Dealing*, *supra* note 183, at 144 ("It is not unusual for directors of small nonprofits to sell goods and services to the nonprofit at below-market prices.").

³⁵⁹ See *id.* at 140-41 ("Some [directors] . . . reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal. Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organizations." (footnotes omitted)). The larger the organization, the greater the potential for a lucrative self-dealing contract.

³⁶⁰ The definition of persons to whom the restriction applies could be the same definition used for disqualified person under the excess benefit rules. See I.R.C. § 4958(f)(1); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Requirements, 63 Fed. Reg. 41,486, 41,498 (1998)(to be codified at 26 C.F.R. § 53.4958-3)(proposed Aug. 4, 1998)(defining a "disqualified person" as "any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.").

\$10,000,000.³⁶¹ Reasonable compensation would still be permitted, of course,³⁶² and would be subject to the excess benefit rules.

Since a category based on size of assets would include many hospitals and health maintenance organizations, such a proposal would have to consider whether to provide an exception for health care conversions. A phenomenon in the health care sector is the conversion of hospitals and other health care organizations from nonprofit status to for-profit status.³⁶³ The nonprofit assets must remain dedicated to nonprofit endeavors, but examples of the undervaluation of nonprofit assets and the resulting benefits to successor for-profit entities have led to concern about greater scrutiny of these conversions.³⁶⁴ Because the issue of hospital conversions is a troubling one,³⁶⁵ a prohibition on insider involvement in the transaction could solve some of the concerns.³⁶⁶ It is possible, however, that with respect to conversions, the

³⁶¹ The amount set can be larger or smaller but should be large enough to exclude small, grassroots charities.

³⁶² Hawai'i recently adopted a rule, effective January 1, 1999, under the circumstances limiting trustee compensation to what is "reasonable." See HAW. REV. STAT. § 607-20 (1993, Supp. 1998).

³⁶³ The topic of health care conversions was the core topic of a Nonprofit Symposium issue of the Journal of Corporation Law. See Evelyn Brody, *Introduction to Nonprofit Symposium Issue*, 23 J. CORP. L. 581 (1998). Many of the symposium articles touched on conversion issues, reflecting the importance of the changes occurring in the health care sector as hospitals and other health care providers convert from the nonprofit to the for-profit form. See *id.* For additional discussions of fiduciary issues involved in health care conversions, see Brody, *Limits*, *supra* note 7, at 1465-75 (describing the legal questions involved in determining whether the board of directors of a hospital has the authority to sell the assets of the hospital and whether the board can determine what to do with the sale proceeds); Coverdale, *supra* note 220 (proposing that private citizens be permitted to sue as relators on behalf of the United States to enforce intermediate sanctions in connections with health care conversions); 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 (1998); Goldschmid, *supra* note 2, at 651-52 (citing Harvey J. Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms*, in THE NATIONAL CENTER ON PHILANTHROPY AND THE LAW, CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM 15-16).

³⁶⁴ See FISHMAN & SCHWARTZ, *supra* note 7, at 102-07 (describing health care conversions and giving as an example the conversion of Family Health Program ("FHP"), a nonprofit founded in 1969). Preparing to sell its assets to a for-profit entity, FHP initially valued itself at approximately \$13.5 million. The Department of Corporations rejected that amount and, following negotiations, agreed to a sales price of \$38.5 million. Eight months later, the purchasing entity, owned in large part by insiders connected with the nonprofit FHP, made a public offering of its stock at a market value of \$150 million dollars. See *id.* at 104.

³⁶⁵ See FISHMAN & SCHWARTZ, *supra* note 7, at 103 ("Because of the absence of case law, the lack of rigor of attorney general scrutiny of valuation issues, and the paucity of statutory direction on dissolution, the capacity for abuse in conversion transactions is readily present.").

³⁶⁶ See FISHMAN & SCHWARTZ, *supra* note 7, at 104-05 (describing a number of controversial

approach may be overbroad and not attuned to the reality of the health care sector.³⁶⁷ Conversion transactions depend, of course, on finding a qualified buyer. Precluding insiders from involvement may diminish the potential for finding the best buyer or, indeed, any buyer. Professor Goldschmid's proposal for a "market test" approach,³⁶⁸ combined with the intermediate sanctions for excess benefit transactions,³⁶⁹ may be sufficient to deal with the problems in this area.

In the Bishop Estate, a prohibition on self-dealing would not only have prevented many of the questionable investments in which the trustees engaged, assuming that the trustees complied with the prohibition. A ban on self-dealing also would have enabled the trustees to focus on an investment strategy that was most appropriate for the trust without the distraction of considering benefits for themselves. The advantage of a prohibition on self-dealing for a charity of this size is that the prohibition avoids issues of appropriateness of the investment and removes the temptation of the trustees to self-deal.

B. Require Greater Disclosure to Regulating Bodies and to the Public

To supervise charities adequately and to determine whether the trustees and directors are fulfilling their fiduciary duties, those who monitor charities need adequate information. Easier public access to information, more effective disclosure, and for certain transactions, increased disclosure, will help.

1. Access

Changes in federal tax law adopted in 1996³⁷⁰ increase access to information for the federal government, for state attorneys general, and for the public. Due to the rules on excess benefit transactions, the IRS will likely receive more information on Form 990. In order to provide evidence of intent to treat an economic benefit to a disqualified person as compensation to the person, the organization must report the economic benefit as compensation on

conversions involving self-dealing and financial benefits obtained by insiders).

³⁶⁷ This issue is beyond the knowledge of the author and beyond the scope of this Article.

³⁶⁸ See *infra* notes 392-95 and accompanying text.

³⁶⁹ See, e.g., Coverdale, *supra* note 220, at 11-14. John Coverdale suggests that the IRS may have difficulty using the excess benefit rules to prevent insider misappropriation of health care assets, and suggests strengthening the enforcement potential of the excess benefit rules by permitting relators to sue on behalf of the government. See *id.* at 15-17.

³⁷⁰ The 1996 Taxpayer Bill of Rights added intermediate sanctions and increased disclosure requirements to the Internal Revenue Code. See *supra* notes 324-34 and accompanying text (describing the intermediate sanctions rules), and *supra* notes 222-26 and accompanying text (describing the disclosure requirements).

its Form 990 or on a Form W-2 or 1099.³⁷¹ The charity will have an incentive to provide more information to the IRS,³⁷² and therefore to the state attorney general.³⁷³

New federal rules make information regarding charities much easier for the public to obtain. Internal Revenue Code section 6104(e) requires a charity to provide a copy of its Form 990 to anyone who asks.³⁷⁴ Thus, a private person with a concern about a particular charity will be able to see the information that has been filed with the IRS. Since the attorneys general respond to inquiries and complaints from the public in determining where to allocate scarce enforcement resources,³⁷⁵ putting more information into the hands of the public will increase the role the public can take in oversight of the sector.

The IRS will make Forms 990 filed by charities available on CD-ROM or on the Internet.³⁷⁶ Electronic filing by charities should facilitate this endeavor. In addition, a number of organizations are working to help charities make the informational returns accessible on the Internet.³⁷⁷ A properly managed charity benefits by posting its Form 990 on its web page because by doing so, the charity avoids the cost of photocopying and mailing forms to those who request them.³⁷⁸ In addition, charities can and should provide more information than that required on the Form 990, in particular, information describing how they conduct their exempt activities. Making information available in an accessible form will strengthen the charitable sector as a whole

³⁷¹ See Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,502 (1998)(to be codified at 26 C.F.R. § 53.4958-4(c)(2))(proposed Aug. 4, 1998).

³⁷² If the charity fails to establish by clear and convincing evidence that the economic benefit was provided as compensation for services, then unless the person receiving the benefit provided some consideration other than services, the provision of the benefit will be an excess benefit transaction. See Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,500, 41,502 (1998)(to be codified at 26 C.F.R. § 53.4958-4(a)(1), (c)(3)).

³⁷³ In 35 states, a charity can comply with the state filing requirements by filing the federal Form 990. See Marcus S. Owens, remarks at the panel entitled *Intermediate Sanctions After the Proposed Regulations: How They Impact Charitable Giving and Directors and Trustees of Public Charities*, given at the Estate Planning Symposium, A.B.A. Sec. Real Prop., Prob. & Tr. L. (May 20, 1999) [hereinafter Marcus S. Owens, Remarks]. Thus, the incentive to report benefits aids the state attorneys general as well as the IRS. Further, Mr. Owens, Director of the Exempt Organizations Division of the IRS, indicated that the IRS expects to work with the state attorneys general in reviewing excess benefit issues. See *id.*

³⁷⁴ See I.R.C. § 6104(e) (1994).

³⁷⁵ See Bograd, *supra* note 17, at 14-16.

³⁷⁶ The IRS plans to sell Forms 990 on CD-ROM. See Marcus S. Owens, Remarks, *supra* note 373. Making the filed forms available on the Internet without cost to the public will be even better. Many Forms 990 are already available at <<http://www.guidestar.org>>.

³⁷⁷ See *supra* note 229.

³⁷⁸ See Treas. Reg. § 301.6104(d)-4.

and may benefit an individual charity by making it more appealing to donors. In fact, well-run charities should tout the accessibility of their information, thereby, by negative implication, raising questions about those charities that do not make information accessible.

2. Accounting

Increased access to information will help, but a remaining problem in the charitable sector is the need for standardized accounting practices. Regina Herzlinger advocates greater accountability for nonprofits through increasing disclosure requirements.³⁷⁹ She recommends requiring that nonprofits follow Generally Accepted Accounting Principles ("GAAP") as articulated by the Financial and Governmental Accounting Standards Boards in preparing annual financial statements.³⁸⁰ Although Professor Herzlinger recognizes that some improvements could be made before applying these accounting principles to nonprofits,³⁸¹ the benefits of standardized accounting are significant. Requiring charities to prepare financial statements using a standardized format would help all those who monitor charities. In addition, standardized financial statements should make it easier for directors and trustees to exercise their duty of care. Since all charities with gross receipts in excess of \$25,000 must meet federal reporting requirements,³⁸² the appropriate place to require a standardized format would be through the tax rules related to the Form 990 annual report. Since these reports will now be more accessible to the public,³⁸³ requiring standardized reporting in connection with the Form 990 will make it easier for persons to compare charities' use of assets and income.

In addition, Professor Herzlinger recommends that nonprofits prepare annually a "management discussion and analysis" ("MD&A") report comparable to the MD&A report required by the Securities and Exchange Commission for business corporations.³⁸⁴ Requiring audited financial statements and a MD&A Report for all charities would be unduly burdensome on small organizations. Making audited statements a requirement for nonprofits of a significant size, based on assets, gross revenues or a

³⁷⁹ See Herzlinger, *supra* note 206, at 100-02.

³⁸⁰ See *id.* at 102.

³⁸¹ See *id.* at 103.

³⁸² See *supra* notes 218-19 and accompanying text (explaining that charities with gross receipts in excess of \$25,000 must file an annual report with the IRS).

³⁸³ See *supra* notes 222-26 and accompanying text (describing the requirement that a charity mail copies of its Form 1023 and its three most recent forms 990 to anyone who requests the forms).

³⁸⁴ See Herzlinger, *supra* note 206, at 103.

combination of the two, would provide an additional check on the sector and could reinforce the reviews conducted by the IRS and the state attorneys general. In a similar way, requiring a MD&A Report could assist those who monitor charities. A federal requirement, perhaps that a MD&A Report be submitted with the organization's annual Form 990, would be an effective approach. Creating a federal commission to supervise charities could also work, but would require a much greater commitment of resources than adding to the IRS's existing role in the supervision of charities.³⁸⁵

Financial reporting, conducted in a clear, intelligible and appropriate form, is essential to adequate monitoring of charities. In the Master's Report filed in the Bishop Estate, the Master noted that the duty of the trustees to provide meaningful financial information to the court requires appropriate financial accounting.³⁸⁶ The Master stated that the accounts prepared by the trustees "made it difficult to obtain an overview of the financial status of the Trust Estate and its subsidiaries."³⁸⁷ Following an independent audit of the trust's financial statements, Arthur Andersen LLP made a number of recommendations concerning the presentation of the financial data, including preparing the financial statements in accordance with GAAP.³⁸⁸ The Master asked that the court order the trust to adopt the financial statement presentation format that Arthur Andersen LLP recommended.³⁸⁹ Although the trustees argued that the information sought was available and that "format" was of secondary importance,³⁹⁰ it seems clear that providing information in a format that is understandable is indeed necessary. For financial information in particular, reporting data in a manner that does not conform to generally understood accounting methods hampers the person reviewing the information. The Attorney General concluded that the trustees failed to fulfill their duty to account and that the accounts intentionally concealed the true condition of the Bishop Estate.³⁹¹ Requiring standardized accounting procedures for all charities, or at least for all charities of a significant size, will enhance monitoring of those charities.

³⁸⁵ See *infra* notes 407-09 and accompanying text (considering the establishing of a state commission on charities to assist the attorney general's office with supervision at the state level).

³⁸⁶ See Master's Report, *supra* note 291.

³⁸⁷ *Id.*

³⁸⁸ See *id.*

³⁸⁹ See *id.*

³⁹⁰ See Trustees' Response to Master's Consolidated Report on the One Hundred Ninth, One Hundred Tenth, and One Hundred Eleventh Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 9, 1998) [hereinafter Trustees' Response], available at <<http://starbulletin.com/98/09/10/news/trustees.html>>.

³⁹¹ See Petition of Attorney General, *supra* note 10.

3. Conversion transactions

Harvey Goldschmid has recommended greater scrutiny and a new mandatory disclosure system for transactions in which a nonprofit converts to a for-profit.³⁹² Even if the transaction does not involve conflicts of interest, Professor Goldschmid advocates involving disinterested outside experts in the transaction and applying a “market test” that would provide:

- (i) public disclosure of the proposed transaction; (ii) the provision of relevant information (subject to appropriate confidentiality safeguards) to responsible persons interested in making a competing offer; and (iii) adequate time for competing offers to be made.³⁹³

Goldschmid would also require enhanced scrutiny “with respect to the placement of the proceeds of a conversion transaction into a new nonprofit foundation and with respect to any joint venture undertaken by the nonprofit entity (or its successor) and a for-profit purchaser.”³⁹⁴

Professor Goldschmid first presented his proposal at a conference focusing on issues associated with health care conversions. He has expanded his original proposal to require that other “similar sensitive transactions” meet the market test and increased disclosure rules he proposes for conversion transactions.³⁹⁵ Professor Goldschmid does not specify what these additional transactions should be or who should make the determination. Nonprofits vary widely in structure and activity, so flexibility in determining what constitutes a “sensitive transaction” for a particular charity will be important.

Conversion transactions present a good starting point for heightened scrutiny. Additional transactions that should be subject to enhanced scrutiny include transactions involving the sale of a significant portion of a charity’s assets or the sale of an asset with significance to the charity. These transactions carry with them both the risk of self-dealing and the public’s need for disclosure and enhanced review.

In the case of Bishop Estate, a transaction such as the sale or closure of the Kamehameha Schools would be the sort of transaction that should be subject to additional disclosure and heightened scrutiny. The recent problems did not involve an attempt to close the schools, but the trustees did adopt a new

³⁹² See Goldschmid, *supra* note 2, at 651-52.

³⁹³ *Id.* at 651-52 (citing Harvey J. Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms*, in THE NATIONAL CENTER ON PHILANTHROPY AND THE LAW, CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM 15-16).

³⁹⁴ Goldschmid, *supra* note 2, at 651-52 (citations omitted).

³⁹⁵ See *id.*

strategic plan, the first plan of such magnitude since a 1961 strategic plan.³⁹⁶ A once-in-a-generation strategic plan intended to shape the future of the trust and the Kamehameha Schools is the kind of sensitive matter deserving heightened public scrutiny. Subjecting routine transactions to heightened scrutiny is unnecessary and would undermine the board's authority. Nonetheless, a charity contemplating significant change such as the strategic planning initiative could benefit from the application of Professor Goldschmid's approach.

C. Increase Enforcement

The standards governing fiduciary behavior are, for the most part, adequate,³⁹⁷ and disclosure requirements have increased. Given human nature, however, violations of fiduciary duties will likely continue to occur. The critical issue is whether the enforcement mechanisms in place are working and if not, whether they can be strengthened.

1. Federal enforcement through the IRS

The intermediate sanction rules create a distinction that applies stricter standards to self-dealing transactions than to other transactions.³⁹⁸ The rules focus on conduct that poses a significant risk of harm to the charity without detection: benefits authorized by and received by those who control the charity. By imposing sanctions on "excess benefits," benefits for which the organization did not receive adequate consideration, these rules will penalize those who use a charity's assets for personal benefit.

The intermediate sanction rules do not prohibit self-dealing but rather, require that any self-dealing transaction, including the payment of compensation for services, be conducted for adequate consideration. The rules complement existing trust law and nonprofit corporation law, which imposes a duty of loyalty on trustees and directors. The intermediate sanction rules add an enforcement mechanism, giving the IRS a regulatory role. The

³⁹⁶ See Master's Report, *supra* note 291.

³⁹⁷ The fiduciary duties under trust law and nonprofit corporation law provide reasonable standards for fiduciary behavior in the charitable context. Changes needed, such as Deborah DeMott's proposal for a fairness standard for nonprofit corporations, and the proposal made in this Article to prohibit self-dealing in large charities, address the difficulty of monitoring the behavior and enforcing the standards.

³⁹⁸ See I.R.C. § 4958 (Supp. II 1996). The intermediate sanction rules use the term "excess benefit" rather than "self-dealing," and the definition applies more broadly than the section 4941 definition of self-dealing. See I.R.C. § 4941 (1994).

prospect of substantial penalties for violations may provide incentive for the IRS to enforce these rules.³⁹⁹

The new rules raise questions as to how "excess benefit" will be determined and whether excessive salaries and self-dealing can be curtailed using the intermediate sanctions. The parties to a transaction must prove that the transaction was reasonable, but there is a range of reasonableness. Nonetheless, the intermediate sanctions provide an important new enforcement tool, and will likely encourage charities and their directors and trustees to look more carefully at self-dealing transactions.⁴⁰⁰

With respect to the Bishop Estate, the intermediate sanction rules will apply to transactions that occurred before the trustees resigned or were removed.

2. Attorney general

Increasing IRS enforcement may help, in particular for large, national charities. Many charities, however, operate locally or on a statewide level. Those charities may be better supervised by those closer to them, both the state attorney general and the public.

Given the limited time state attorneys general can devote to supervising charities, observers of the charitable sector have repeatedly voiced concerns that the attorneys general do not provide adequate enforcement.⁴⁰¹ Some increase in the staffing of the charities sections of the offices of state attorneys general has occurred over the past twenty-five years, but the number of

³⁹⁹ See Williams, *supra* note 227, at 58 (quoting James J. McGovern, a former IRS employee, as saying that the penalties will provide an incentive for the IRS to begin "a relatively significant enforcement effort."); see also Hansmann, *Reforming*, *supra* note 214, at 604 (stating that "federal revenue agents have, at best, only an indirect interest in policing fiduciary behavior in nonprofits" since the goal of the income tax is "to produce revenues to finance the government."). Although the penalties provide incentive for enforcement, John Coverdale worries that an understaffed IRS may still be unable to monitor charities adequately. See Coverdale, *supra* note 220, at 15. Professor Coverdale proposes allowing private parties to sue for excess benefit transactions as relators on behalf of the United States. See *id.* at 16.

⁴⁰⁰ The new rules have generated much interest concerning compliance among those who advise charities and their directors. See, e.g., Carol G. Kroch & Marcus S. Owens, address at the panel entitled *Intermediate Sanctions After the Proposed Regulations: How They Impact Charitable Giving and Directors and Trustees of Public Charities*, given at the Estate Planning Symposium, A.B.A. Sec. Real Prop., Prob. & Tr. L. (May 20, 1999).

⁴⁰¹ See FISHMAN & SCHWARZ, *supra* note 7, at 247 ("Staffing problems and a relative lack of interest in monitoring nonprofits makes attorney general oversight more theoretical than real."); Blasko et al., *supra* note 259, at 39 ("Lack of money, coupled with the obligation to discharge the other important duties of the attorney general's office, contributes to inadequate staffing for the purpose of supervising charities."); Hansmann, *Reforming*, *supra* note 214, at 601 (describing the inadequate enforcement of the nonprofit sector by the attorney general as a "sad state of affairs"); Karst, *supra* note 66, at 433.

charities being supervised by those offices also has grown.⁴⁰² At the same time, the attorneys who work in three of the most active states suggest that they can investigate only a small fraction of inquiries concerning charities in their state;⁴⁰³ that they respond primarily to inquiries from outside their office rather than from an independent review of documents filed by the charities;⁴⁰⁴ and that, in their view, the attorney general should not be the watchdog for the nonprofit sector.⁴⁰⁵

To improve enforcement at the state level, states should strengthen the attorney general's office by providing funds for additional staff for charitable supervision.⁴⁰⁶ In states that do not have staff assigned specifically to charitable work, creating a charities section will help. In all states, adding additional attorneys, paralegals, investigators and accountants will improve monitoring. Unfortunately, increasing the number of employees may not be economically feasible.

An additional possibility for enforcement by the state would be the creation of state commissions or even a federal commission in charge of charitable oversight.⁴⁰⁷ Creating a separate government agency to monitor charities could work, but the additional bureaucracy involved might divert resources from actual monitoring.

States like Hawai'i, in which the attorney general is appointed and politics may affect the monitoring of charities, might benefit from the creation of a separate agency. Concerned that political pressure would prevent the attorney general of Hawai'i from investigating the Bishop Estate, the Broken Trust article called for the creation of an "independent watchdog" to monitor all

⁴⁰² A 1974 study found that Oregon allocated one attorney to charities work and New York allocated 10. *See Status of State Regulation*, *supra* note 232, at 2728. As of 1994, New York had 17 attorneys doing charitable work. *See Bograd*, *supra* note 17, at 9. Oregon now has three attorneys assigned to the charitable section, but the number of charities the office supervises has increased comparably, so there may not be a significant increase in the ability to supervise charities. *See Conversation with Judith L. Woodruff*, *supra* note 247.

⁴⁰³ *See Bograd*, *supra* note 17, at 14-16 (discussing the criteria for intervening in charity in New York, Massachusetts, and Connecticut).

⁴⁰⁴ *See id.* at 12.

⁴⁰⁵ *See id.* at 5. The study focused on three states that have separate charities offices that are well-staffed and may be "among the most active in the country." *Id.* at 11. The statements reflect the circumstances of their attorney's own offices and may not be representative of the views of attorneys general across the country.

⁴⁰⁶ *See Status of State Regulation*, *supra* note 232, at 2708-09 (recommending increases in staff attorneys and accountants assigned to charitable work).

⁴⁰⁷ *See Blasko et al.*, *supra* note 259, at 83 (suggesting the creation of a national committee or equivalent state committees to evaluate claims against charities and either make recommendations to the state attorney general or be given authority to pursue claims against the charities in federal court).

charitable trusts in Hawai'i.⁴⁰⁸ Such an independent entity may still be an appropriate idea for Hawai'i, but the supervision should extend to all charities, whether organized as a trust or as a nonprofit corporation.⁴⁰⁹ Regardless of whether a state increases the charities section of the attorney general's office or creates a separate agency to monitor charities, more resources should be devoted to supervision of charities at the state level.

3. *Private citizens*

If IRS and attorney general supervision is not enough, what other options exist? Those connected with a charity, as donors, employees, volunteers or beneficiaries, are often in the best position to monitor the charity's activities and the actions of the trustees or directors. Persons with information about problems in the management of the charity can notify the attorney general, but the attorney general cannot handle every case.⁴¹⁰ In finding a means to use private persons to supplement the supervisory and enforcement work of the attorney general's office, there must be a balance between the potential for improved enforcement and the need to minimize vexatious and unnecessary litigation.

The most promising way to increase the involvement of private citizens in enforcing fiduciary duties appears to be the use of relators.⁴¹¹ Permitting members of the public to sue on behalf of the attorney general's office expands the reach of the attorney general's office without the use of additional state resources. Relators cannot provide a complete solution, since only the most dedicated observers of charity are likely to take the step of suing a charity as a relator. As an additional weapon against egregious behavior, however, permitting suits by relators makes sense.

Another means to increase the enforcement of fiduciary duties is for courts to adopt more flexible standing rules for persons with "special interests." Again, care must be taken to permit suits only in situations in which the potential abuse is serious and the persons suing are directly connected to the charity. The framework of analysis developed by Mary Grace Blasko, Curt S. Crossley and David Lloyd indicates when a court will likely find "special interests," based on existing decisions.⁴¹² The framework provides a good

⁴⁰⁸ See *Broken Trust*, *supra* note 10.

⁴⁰⁹ The trustees of the Bishop Estate attempted to transfer estate assets into a nonprofit corporation, perhaps to avoid this sort of monitoring.

⁴¹⁰ See Bograd, *supra* note 17, at 14-16 (describing the criteria used by New York, Massachusetts and Connecticut's attorney generals' offices for intervening in troubled nonprofits).

⁴¹¹ See *supra* notes 272-80 and accompanying text.

⁴¹² See Blasko et al., *supra* note 259, at 61-78.

resource for courts to use as a guideline in determining when to allow such suits.

Expanding standing in any manner, whether by the use of relators or by finding standing for those with "special interests," must be carefully considered, keeping in mind the competing interests. The law should not attempt to second guess charitable managers with respect to every decision, but ways to enforce the fiduciary duties of those managers must be found so that the managers do not benefit at the expense of the charity. Professor Hansmann reported that for the period during which Wisconsin permitted suits by ten or more donors or beneficiaries, he could find no reported cases in which donors or beneficiaries actually brought suit against a charity under the statute.⁴¹³ This may indicate that the risk of a flood of lawsuits is small. In addition, the requirement that the attorney general must approve any suit under a relator statute will help to minimize abuse. Continued monitoring of the use of relator statutes and findings of "special interests" may help to determine whether permitting more law suits helps or hurts the charitable sector. Despite fears of proliferating litigation, the countervailing concern, that breaches of fiduciary duties will otherwise go unchecked, is quite real.

D. Delegation

The Restatement (Third) of Trusts has loosened the rules on delegation by trustees.⁴¹⁴ Corporate directors already enjoy considerable power to delegate.⁴¹⁵ As laws change to reflect changes in investment theory, the changes should not undermine the duty of care for trustees and directors of charities with respect to significant policy matters.

The trustees of the Bishop Estate delegated their duty of care to an extreme degree, in breach of their duties under trust law and in violation of the terms of the will that created the trust.⁴¹⁶ The trustees used a "lead trustee" system of management in which each trustee took responsibility for an aspect of the trust's administration.⁴¹⁷ For example, Trustee Lokelani Lindsey served as the lead trustee for education, and the other trustees delegated the management of the Kamehameha Schools to her. The other trustees did not supervise Ms. Lindsey's management of the schools. Despite growing problems, the other

⁴¹³ See Hansmann, *Reforming*, *supra* note 214, at 609-10.

⁴¹⁴ See *supra* notes 75-84 and accompanying text.

⁴¹⁵ See *supra* notes 122-28 and accompanying text.

⁴¹⁶ Princess Bishop's will requires the trustees to act by majority vote and requires that at least three trustees join in all acts. See Petition of Attorney General, *supra* note 10 (citing article 14 of the Will).

⁴¹⁷ See *id.*

trustees did not intervene until public criticism forced them to remove Ms. Lindsey as lead trustee.⁴¹⁸

Trustee Henry Peters served as lead trustee for asset management and, in that capacity, concealed financial information from the other trustees.⁴¹⁹ The lack of supervision enabled Mr. Peters to engage in several self-dealing transactions with the trust.⁴²⁰

Despite the central role of the Kamehameha Schools in the trust and the importance of investment management for any trust, the trustees failed to supervise the delegated activities. The trustees ignored the probate master's recommendation that they abandon the lead trustee system.⁴²¹ The attorney general of Hawai'i determined that the delegation was a breach of the trustees' duties to the trust.⁴²² The Bishop Estate situation provides an extreme example of delegation by charitable trustees who went even beyond the relaxed delegation rules. The case presents a cautionary look at excessive delegation and points to the need for continued legal restrictions on delegation in the charitable context.

E. Continue to Improve the Efficacy of Nonlegal Constraints

Although the law must provide for enforcement of fiduciary duties of directors and trustees, in the charitable sector nonlegal constraints are also important. The lawyers that write about this area have recognized that laws alone cannot ensure a healthy charitable sector.

Professor Hansmann has suggested that normative constraints serve to reinforce the legal constraints.⁴²³ The social norms against stealing, especially important in the charitable sector, may guard against abuses. Professor Brody adds that charities have an incentive to operate at a level of behavior higher than the law requires to maintain the public trust and thereby discourage the adoption of more restrictive legislation.⁴²⁴

⁴¹⁸ See *id.*

⁴¹⁹ See *id.*

⁴²⁰ See *id.*

⁴²¹ See Master's Report, *supra* note 291 (describing the problems with the lead trustee system, including the lack of oversight by other trustees, and recommending that the court order the trustees to end use of the lead trustee system and adopt a CEO-based management system). The probate master noted that the lead trustee system benefits the trustees financially. The trustees can argue that they deserve a high level of compensation due to their management duties as lead trustee and due to the lack of a CEO. See *id.*

⁴²² See Petition of the Attorney General, *supra* note 10.

⁴²³ See Hansmann, *Role*, *supra* note 1, at 875.

⁴²⁴ See Brody, *Limits*, *supra* note 7, at 1414-15 (arguing that "a laissez-faire structure for charity fiduciary law makes sense" because courts would be no better than corporate boards in

But norms also cut the other way. Social constraints in the boardroom may operate against proper exercise of the duty of care. Directors may serve for social reasons, and proper etiquette may proscribe questioning the executive director, the staff, or other board members.⁴²⁵ Charitable directors may be overcommitted and inattentive.⁴²⁶ Some directors view a charitable board position as a mark of social status.

Nonlegal constraints may become more important as charities face increasing government regulation and increasing public awareness through the Internet. Charities themselves must take the lead in establishing oversight procedures within the charities and in educating their directors.⁴²⁷ Charities must be certain that new directors understand their responsibilities and fiduciary duties. Having procedures in place to deal with conflict of interest transactions will make it less likely that directors will take advantage of the charity in a conflict situation. Lawyers and others who work with charities can also play a role in educating and in helping the directors and trustees supervise the charity properly.

The trustees of the Bishop Estate had an opportunity to obtain expert advice about their fiduciary duties.⁴²⁸ The newspaper article *Broken Trust* noted that a "nationally recognized authority on the law of trusts and fiduciary duties"⁴²⁹ offered to meet with the trustees and explain their fiduciary duties.⁴³⁰ The trustees never met with the expert, Professor Edward C. Halbach, Jr., and never "had a single session in which their fiduciary duties have been systematically explained to them."⁴³¹ The authors of *Broken Trust* describe this failure by the trustees to educate themselves as "reckless, at the least."⁴³²

VII. THE BISHOP ESTATE

The Bishop Estate provides an example of charitable trustees accused of engaging in self-dealing and conflict of interest transactions with the large charitable organization they manage.⁴³³ Princess Bernice Pauahi Bishop created a trust under her will to provide educational benefits to Hawaiian

running charities and the need to retain the public's trust provides incentive for proper behavior).

⁴²⁵ See FISHMAN & SCHWARZ, *supra* note 7, at 186.

⁴²⁶ See Shenk, *supra* note 5, at 9.

⁴²⁷ See Brody, *Limits*, *supra* note 7, at 1501.

⁴²⁸ See *Broken Trust*, *supra* note 10.

⁴²⁹ *Id.*

⁴³⁰ See *id.*

⁴³¹ *Id.*

⁴³² *Id.*

⁴³³ United Way and Adelphi University faced similar problems. See *supra* notes 2-9 and accompanying text.

children, particularly those with aboriginal Hawaiian ancestors.⁴³⁴ The trust operates the Kamehameha Schools and a number of other educational programs.⁴³⁵ Five trustees, appointed by the Supreme Court of Hawai'i, administer the trust.⁴³⁶

The Bishop Estate trust is unique, with a history tied to the history of Hawai'i itself.⁴³⁷ Its size⁴³⁸ and the politics surrounding the trust⁴³⁹ make the Bishop Estate an anomalous case study in some ways, and yet the fiduciary standards that apply to all trustees apply to the Bishop Estate trustees. The enforcement of these standards by the attorney general of Hawai'i, the IRS and the public serves as an example of the way in which the enforcement mechanisms work. Yet, the Bishop Estate may also serve as a warning about how egregious fiduciary conduct must be before enforcement of fiduciary duties actually happens.

The Bishop Estate demonstrates both the difficulty of holding charitable trustees accountable and the power of existing constraints to control wayward fiduciaries. Action was taken against the trustees only after years of allegations and after escalating abuses.⁴⁴⁰ Yet, eventually the attorney general petitioned the probate court to remove the trustees and the court did so.⁴⁴¹ The size of the Bishop Estate probably made uncovering and understanding the problems more difficult,⁴⁴² but in the end, the size and public importance of the trust created some of the needed scrutiny.⁴⁴³ A review of the Bishop Estate is instructive both to understand how the existing monitoring process worked and to consider what improvements can be made.

⁴³⁴ See Master's Report, *supra* note 291. The will did not exclude non-Hawaiian boys and girls from the schools, but Princess Bishop's intent was to benefit primarily these children with some aboriginal blood. The trustees have honored the spirit of the will by limiting admission to the Kamehameha Schools to children of Hawaiian ancestry. See Gladys Brandt, Samuel P. King, Walter Heen & Randall Roth, *Renewed Trust*, HONOLULU STAR-BULLETIN, Oct. 23, 1999, at B-3, reprinted in Appendix D.

⁴³⁵ See *id.*

⁴³⁶ See *Broken Trust*, *supra* note 10.

⁴³⁷ See Master's Report, *supra* note 291.

⁴³⁸ The Master's Report sets the value of the trust at more than \$6 billion. See *id.*

⁴³⁹ See *Broken Trust*, *supra* note 10 (suggesting that politics play a role in the selection of the Supreme Court Justices and in their selection of the trustees).

⁴⁴⁰ The trustees received arguably unreasonable compensation since 1987. See Petition of Attorney General, *supra* note 10. The probate master had recommended changes in the management structures as early as 1985. See Master's Report, *supra* note 291.

⁴⁴¹ See Daysog, *supra* note 11.

⁴⁴² See *Broken Trust*, *supra* note 10.

⁴⁴³ Public complaints made a difference in addressing the problems in the Bishop Estate. Whether the mechanisms in place would have uncovered theft in a much smaller charity remains an open question.

A. Breaches of Fiduciary Duties

As trustees of a charitable trust, the trustees of the Bishop Estate are subject to the fiduciary standards of trust law.⁴⁴⁴ The trust law duty of loyalty applies a strict standard to self-dealing by trustees, permitting trust beneficiaries to undo any transaction involving self-dealing by a trustee.⁴⁴⁵ In the trust context, self-dealing should be minimal, and preferably nonexistent. In the Bishop Estate, it appears to have been rampant.

The Master's Report and the Petition of the Attorney General describe numerous examples of alleged self-dealing and conflict of interest transactions by the trustees of the Bishop Estate.⁴⁴⁶ In one example, the trustees invested personally in a Texas methane gas deal in which the trust also invested.⁴⁴⁷ The trust lost money on the deal and the decisions the trustees made for the trust could have been influenced by their personal interests in the deal.⁴⁴⁸

In one rather bizarre example of conflict of interest, the trustees authorized the use of trust funds to lobby against enactment of the intermediate sanctions provisions.⁴⁴⁹ These provisions protect charities by penalizing those who obtain benefits in excess of services rendered to the charity. Lobbying *against* these rules is clearly in the interests of the trustees in their individual capacity and counter to the interests of the trust. The attorney general identified this lobbying effort as an attempt by the trustees to preserve their excessive compensation.⁴⁵⁰

In yet another transaction, two trustees, Mr. Peters and Mr. Wong, entered into a condominium project which benefited Mr. Wong's brother-in-law.⁴⁵¹ The two trustees then received kickbacks by selling apartments at inflated prices to an entity connected with the brother-in-law.⁴⁵² In addition, Trustees Peters, Wong, and Lindsey benefited friends and family members by arranging for jobs or consulting contracts with the trust.⁴⁵³ The trustees even used trust employees and resources on personal matters.⁴⁵⁴ These breaches of trust

⁴⁴⁴ See Master's Report, *supra* note 291 (discussing Hawai'i cases acknowledging the duty of loyalty imposed on trustees).

⁴⁴⁵ See BOGERT, *supra* note 32, § 95.

⁴⁴⁶ See Master's Report, *supra* note 291; Petition of the Attorney General, *supra* note 10; *see also Broken Trust*, *supra* note 10.

⁴⁴⁷ See *Broken Trust*, *supra* note 10.

⁴⁴⁸ See *id.*

⁴⁴⁹ See Master's Report, *supra* note 291.

⁴⁵⁰ See Petition of the Attorney General, *supra* note 10.

⁴⁵¹ See *id.*

⁴⁵² See *id.*

⁴⁵³ See *id.*

⁴⁵⁴ See *id.*

became counts in the Attorney General's petition to remove the trustees.⁴⁵⁵ The petition also seeks to recover from the trustees amounts the trust lost due to their breaches.⁴⁵⁶ It should be noted that these breaches are alleged and not yet proven, but the scope of the allegations is staggering.

B. Problems of Accountability

The Broken Trust article raises the important issue of accountability.⁴⁵⁷ Harvey Goldschmid has described fiduciary duties in the charitable context as aspirational.⁴⁵⁸ The duties exist, but if no accountability mechanisms enforce those duties, then compliance depends on the good intentions of the trustees.⁴⁵⁹

In the Bishop Estate, the trustees violated their fiduciary duties, initially, at least, with impunity. The probate court supervises the trust and each year appoints a master to review the annual account filed by the trustees.⁴⁶⁰ Although the master could provide some oversight, the authors of the Broken Trust article explain that the master had not been able to effectively review the performance of the trustees of a trust as large and complicated as the Bishop Estate.⁴⁶¹ Further, the trustees simply ignored recommendations made by the master in the 1992, 1993, and 1995 reports.⁴⁶²

In Hawai'i, as elsewhere, the attorney general has the authority to supervise charities. But in Hawai'i, as in only six other states, the governor appoints the attorney general.⁴⁶³ If, as the Broken Trust article alleges, political considerations played a role in the Bishop Estate situation,⁴⁶⁴ a politically appointed attorney general may be reluctant to investigate the trustees of a politically well-connected charity. The Broken Trust article noted that despite

⁴⁵⁵ *See id.*

⁴⁵⁶ *See id.*

⁴⁵⁷ *See Broken Trust*, *supra* note 10 ("In the case of the Bishop Estate, we believe that accountability is almost totally missing.").

⁴⁵⁸ *See Goldschmid*, *supra* note 2, at 632.

⁴⁵⁹ *See Hansmann*, *Role*, *supra* note 1, at 875 (explaining that in the charitable sector, "ethical constraints may be far more important than legal sanctions in causing the managers of nonprofits to adhere to their fiduciary responsibilities."); *see also* Shenk, *supra* note 5, at 10 (describing the lack of legal constraints and adding, "So, aside from personal virtue, there's often no incentive whatsoever for a board member to act responsibly.").

⁴⁶⁰ *See Master's Report*, *supra* note 291.

⁴⁶¹ *See Broken Trust*, *supra* note 10. It is possible that a probate master provided with necessary funding could adequately review the trust, but in practice that had not been happening.

⁴⁶² *See id.*

⁴⁶³ *See id.*

⁴⁶⁴ *See id.*

allegations of abuse, no attorney general had investigated the trust.⁴⁶⁵ Just days after the article appeared, however, the attorney general announced an investigation.⁴⁶⁶ The investigation led to an action for removal of the trustees⁴⁶⁷ and ultimately to the resignation or removal of the trustees.⁴⁶⁸

Other than the attorney general, the only persons who potentially have standing to sue a charity are those with "special interests" in the charity.⁴⁶⁹ In general, courts grant standing infrequently to those who benefit from charitable trusts.⁴⁷⁰ Na Pua a Ke Ali'i Pauahi ("Na Pua"), an organization created to enforce the will of Princess Bishop,⁴⁷¹ argued in court that students, parents and alumni should be recognized as the beneficiaries of the Bishop Estate trust.⁴⁷² The trustees challenged this request for standing, arguing that the physical school was the beneficiary.⁴⁷³ The issue of standing was not resolved,⁴⁷⁴ but the students and faculty, in particular, appear to have the special interests that sometimes lead to the granting of standing in connection with a charitable trust.

Na Pua staged a march on May 15, 1997, to publicize the group's concerns about the management of the Bishop Estate.⁴⁷⁵ The group kept up the public pressure, and on June 6, 1997, the Kamehameha Schools faculty "went public."⁴⁷⁶ On July 20, the *Honolulu Advertiser* published a story in which Trustee Stender detailed his concerns about mismanagement by the other trustees.⁴⁷⁷ Finally, on August 9, 1997, the *Honolulu Star-Bulletin* published

⁴⁶⁵ See *Broken Trust*, *supra* note 10.

⁴⁶⁶ See *AG Expects Inquiry Plan This Week*, HONOLULU STAR-BULLETIN, Aug. 19, 1997, at A-1. The article states that the Governor instructed the Attorney General to make a preliminary investigation "last week," presumably just after the article appeared. The Attorney General met with the five authors of the Broken Trust article and then announced she would investigate. See *id.*

⁴⁶⁷ See Petition of the Attorney General, *supra* note 10.

⁴⁶⁸ See *supra* note 13.

⁴⁶⁹ See *supra* notes 281-90 and accompanying text.

⁴⁷⁰ See *supra* notes 259-63 and accompanying text.

⁴⁷¹ See the homepage of Na Pua a Ke Ali'i at <<http://www.napua.com>>. Na Pua organized in 1997 in response to concerns of faculty, students, parents and alumni about Trustee Lindsey's management of the Kamehameha Schools. See *The Timeline*, available at <http://www.napua.com/time_line.htm>.

⁴⁷² See *id.*

⁴⁷³ See *id.*

⁴⁷⁴ See *id.*

⁴⁷⁵ See *id.*

⁴⁷⁶ See *Kamehameha Faculty Goes Public*, HONOLULU STAR-BULLETIN, June 6, 1997, at A-1.

⁴⁷⁷ See Greg Barrett, *Kamehameha Board Criticized*, HONOLULU STAR-BULLETIN, July 20, 1997, at A-1.

the Broken Trust article.⁴⁷⁸ That article, written by five respected and prominent public figures, got the Governor's attention and led, almost immediately, to an investigation by the Attorney General.⁴⁷⁹

In the Bishop Estate, the enforcement mechanisms worked, but only after years of mismanagement and only after significant publicity, first through Na Pua's public demonstrations, and then through publication of the Broken Trust article.⁴⁸⁰ Thus, the role of the public in triggering the investigation cannot be underestimated. Those who were closest to the problems, the student beneficiaries of the trust, and the employees of the trust, had the information that the trustees were not carrying out their duties properly. Their willingness to take public steps to address the problems resulted, ultimately, in the removal of the trustees.⁴⁸¹ The lesson, if one can be drawn, is that even if the attorney general and the IRS must actually enforce the trustees' duties, the public plays a critical role in monitoring charities.

VII. CONCLUSION

This Article's analysis of the law of fiduciary duties of charitable trustees and directors and a review of the Bishop Estate yields several recommendations. Some of these recommendations have been suggested elsewhere by other authors. This Article advocates their adoption and recommends some additional proposals.

1. Heighten the standard of the duty of loyalty to provide that a charity can void any self-dealing transaction unless the proponent of the transaction can prove that the transaction was fair to the charity at the time the charity entered into the transaction.⁴⁸² This change in the law that applies to directors of nonprofit corporations would not have affected the Bishop Estate because trust law holds trustees to a stricter standard, permitting the trust to void any self-dealing transaction. Ideally, the same standard should apply to both charitable trusts and nonprofit corporations, since there is no reason to distinguish between charities based on organizational form. Given that most charities now organize as nonprofit corporations, tightening the standard that applies to nonprofit corporations will be a good start.

⁴⁷⁸ See *Broken Trust*, *supra* note 10.

⁴⁷⁹ See *AG Expects Inquiry Plan This Week*, *supra* note 466.

⁴⁸⁰ See *Daysog*, *supra* note 13. Following the probate court's temporary removal of the four remaining trustees, Randall Roth, one of the authors of the Broken Trust article, was quoted as saying, "This legal system is slow but it does deliver." *Id.*

⁴⁸¹ The reports of the probate master had for years identified problems, but the trustees simply ignored the reports. See *Broken Trust*, *supra* note 10.

⁴⁸² See *supra* notes 351-53 and accompanying text (describing Deborah DeMott's proposal).

2. Prohibit trustees and directors of charities with assets in excess of \$10,000,000 from engaging in self-dealing transactions. This prohibition, applicable to charitable trusts and nonprofit corporations, would prevent self-dealing transactions of the type involved in Bishop Estate, assuming that the trustees understand their duties and do not act in breach of those duties.⁴⁸³ The Bishop Estate is instructive of the types of problems that can develop in a large charity and provides an example of why fiduciary law should prohibit trustees and directors of large charities from self-dealing.
3. Increase the monitoring of charities at the state level, either by increasing the number of attorneys, paralegals, investigators, and accountants devoted to charitable work in state attorney general offices or by creating a new agency or commission dedicated to supervising charities. Regardless of whether a state increases the charities section of the attorney general's office or creates a separate agency to monitor charities, more resources should be devoted to supervision of charities at the state level. In addition, providing for the use of relators or permitting suits by beneficiaries under the special interests doctrine will allow interested members of the public to supplement the resources of the attorney general's office. Tapping into the public's monitoring of charities can improve enforcement by the attorney general. Greater Internet access to information about charities should make public monitoring easier, and the attorneys general should work to harness the public's interest and concern.
4. Heightened scrutiny for sensitive transactions. The sale of a charity or the conversion of a nonprofit charity into a for-profit business should be subject to increased disclosure. Requiring that charities provide information to the attorney general and the public before the sale takes place could help curb abuses.
5. Improve disclosure by requiring uniform financial reporting, at least for large charities. Requiring charities to report financial information using GAAP would aid those who review the charities' disclosures in analyzing the data. One of the probate masters who reviewed the Bishop Estate described the difficulties of reviewing the trustees' performance.⁴⁸⁴ Arthur Andersen LLP, the probate master and the attorney general of Hawai'i all requested that the Bishop Estate trustees follow GAAP and make other modifications in the

⁴⁸³ The trustees of the Bishop Estate trust acted in breach of their fiduciary duties under current law and appeared not to understand the scope of those duties. *See Broken Trust*, *supra* note 10.

⁴⁸⁴ *See id.* (quoting Jim Duffy, a former Bishop Estate master, "You really can't get your arms around everything, especially the mainland deals.").

presentation of the financial data to make the data easier to understand.

6. Educate charitable trustees and directors and improve the efficacy of nonlegal constraints. This recommendation is a nonlegal one, one which charities themselves must embrace for the health of the nonprofit sector. Charities have a significant self-interest in maintaining the trust of the public.

Creating training sessions for new directors⁴⁸⁵ and seeking legal advice when appropriate can keep charitable trustees, directors, and managers from inadvertently violating their fiduciary duties. The Bishop Estate trustees claimed that they did not understand that some of their actions breached their fiduciary duty of loyalty. Yet, the trustees declined an offer from an expert in trust law to educate them about those duties. Trustees and directors must take an active role in educating themselves.

Many charitable trustees and directors do keep the interests of the charity and the interests of the public in mind. The sector as a whole accomplishes a great deal of good, and ethical constraints serve to guide most directors and trustees. The Bishop Estate, like United Way and Adelphi University, reminds those that monitor charities that not all trustees, directors, and managers will comply with their fiduciary duties. The monitoring system must keep in mind that charities should be subject to the same level of supervision, regardless of their organizational structure as a trust or a corporation. The laws governing charities can draw from those governing private trusts or business corporations, but these laws must be tailored to the needs of the charitable sector. As the sector continues to grow and evolve, more effective enforcement mechanisms and more effective use of enforcement mechanisms can ensure its continued viability.

⁴⁸⁵ See *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974)(requiring new directors to read the court's opinion outlining the directors' duties as an attempt to ensure that directors understood their fiduciary duties).

