AGENCY COSTS AND THE OVERSIGHT OF CHARITABLE ORGANIZATIONS

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I. Introduction.

In both the for-profit and the nonprofit spheres, that is, in the world of business corporations as well as that of charitable institutions, agency costs are inevitable.[1] But in for-profit businesses, the form of the corporation itself helps to mitigate these costs. For-profit corporations have well-defined owners (shareholders), well-defined goals (profits), clear voting rights for owners to remove managers, clear signals about performance (profits and stock prices), a market for corporate control, and a market for managers. Owners thus retain both the ability and the incentive to monitor their agents, and agents are constrained in their behavior both by shareholder monitoring and by second-order markets. Furthermore, "the cost of these mechanisms is relatively low because they are self-enforcing."[2]

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[1]*See generally,* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Henry B. Hansmann, *Ownership of the Firm*, 4 J. L. ECON. & ORG. 267 (1988).

[2]William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 913 (1993).

As this article will explain, however, in the nonprofit[3] world owners are not well-defined; their voting rights are questionable or non-existent; charitable goals are ambiguous or, at least, difficult to quantify; no significant second-order markets operate; and the residual claimants are either unable to monitor efficiently or unwilling to do so. In the United States we have relied almost exclusively on broad legal and legislative remedies to solve the mainly contractual agency problem in nonprofits; because the nonprofit form does not lend itself to self control, control has come, where it has come at all, through statutory regulation and the occasional lawsuit.[4] There is no market for corporate control, there are no proxy battles, no shareholder derivative suits, and there is very little market competition.[5]

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[3]For the purposes of this article, I will use the term, "nonprofit entities," narrowly to denote only charitable entities, unless context indicates otherwise. Charitable nonprofits, the primary focus of this article, are those organizations that provide their services for the good of the community at large (or some identifiable subset of the community at large), and receive some or all of their funding from donations or endowments. These organizations are collected by the IRS, in large measure, under Section 501(c)(3), but it is not their status as 501(c)(3) organizations that makes them peculiar. Instead, it is their public directedness which make them 501(c)(3) organizations.

[4]At least one commentator has noted that there are norms in the nonprofit world that provide some self-regulation. *See* Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J. 835, 875 (1980) ("broad compliance with a poorly policed constraint [the nondistribution constraint] is presumably due to adherence to social norms that reinforce the legal restraints on profiteering"). Certainly there are many noble people in the nonprofit sector, dedicated to their charitable purposes, who gain sufficient utility from the successful completion of their work that they do not intentionally engage in behavior harmful to the nonprofit or its patrons. But it would, and does, take a great deal of faith on the part of potential donors, beneficiaries, and founders to think that altruism and the nondistribution constraint are sufficient to overcome the agency problem inherent in the nonprofit form. Absent monitoring, agents will act in their own interest, and their own interest will not likely be the same as the entity's or its patrons'. *See* Section II(A), *infra*.

[5]There is, of course, a competition for charitable dollars. This competition induces contributors to engage in some monitoring, and it creates some incentive for agents to behave. But monitoring costs remain high, and, after some period of time, the incentive to monitor (or,

Because they do not fit neatly into any area of Anglo-American common law, nonprofits are loosely overseen by the government through the attorneys general of the fifty states.[6] Although many nonprofits are structured like for-profit corporations, tax differences and other structural disparities make them dissimilar enough that a straight application of for-profit corporate fiduciary law would be unsuitable. Likewise, typical forms of contractual corporate control from the for-profit sector are, as we will see, unavailable. Thus statutory fiduciary laws, enforced mainly by state attorneys general and operating as default rules, are of primary importance in policing the nonprofit sector.[7]

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more accurately, to overcome the costs of monitoring) dissipates. Nonprofits can thus remain "competitive" even while forsaking their agendas or committing financial abuses. Donations in the university context provide an example. Donors will frequently make donations with conditions attached to them. But because enforcement of those conditions is expensive (and includes the cost of monitoring to learn of violations), universities can and will, if the benefit of violating the conditions is greater than the expected cost of violating them, violate the conditions in time. A donor who gives money to a law school, for example, for the creation of a seminar room with his name on it, may very well get a plaque placed next to the door of "his" classroom. But later, when another donor wishes to contribute money for the creation of a clinical program, the room will likely be converted and the plaque removed, and the school may invoke a sort of private *cy pres* doctrine to justify the conversion. Assuredly, if the original donor knew that three or five or ten years after his gift his classroom would no longer exist, he would have made a correspondingly smaller donation. Universities can, however, count on the donor's inability or disinclination to monitor, and can make such alterations with relative impunity. *See infra* note 75 and accompanying text.

[6]Historically, nonprofit corporations were among the original chartered corporations, and they were monitored by the King (or his proxy). In modern times this form of control is carried out by attorneys general. But because the nature of corporations has changed, because trust law has become increasingly important in the adjudication of nonprofit corporation law, and because the nature of attorney-general control is ambiguous, nonprofits swim in a sea of legal uncertainty.

[7]The IRS, too, polices nonprofits. But, of course, the IRS polices violations of the tax code provisions relating to nonprofits' tax-exempt status. While some of these violations may suggest violations of nonprofits' fiduciary obligations, they do so only coincidentally. For example, the IRS Code imposes a nondistribution constraint on exempt organizations, and the IRS engages in some policing of this rule. *See* I.R.C. § 501(c). But "federal revenue agents have,

I wish to present in this article a better solution to the agency problem created by charitable corporations and charitable trusts. The solution is rooted in contract and aimed at providing a means by which nonprofit founders, donors, and beneficiaries can efficiently overcome the information asymmetries and monitoring costs endemic to the nonprofit form.

Briefly, my solution suggests the creation of private, for-profit monitoring companies. Charitable organizations would contract with these entities and engage them to monitor both the financial and charitable aspects of the nonprofit's operation. The monitoring companies would be granted, by contract, the right to sue in order to rectify perceived violations of a nonprofit's fiduciary duties or the terms of its charter. Concern for reputation and the profit motive would provide the monitoring companies with the appropriate incentives to monitor and enforce, thereby overcoming the nonprofit form's inherent agency problems. Founders and directors of incipient charities and foundations would seek out the services of monitoring companies to the extent that they wished to preserve their organizations' original purposes and financial viability, even after their deaths.

This proposal makes nonprofits accountable under existing laws, but allows them to operate without fear of an excess of frivolous suits. By facilitating the private enforcement of the law, the solution removes the attorneys general from primary importance in bringing control suits

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at best, only an indirect interest in policing fiduciary behavior in nonprofits." And while "federal tax law does effectively make the government a patron of many nonprofits," institutional limitations make the IRS a weak enforcer with respect to most nonprofits. Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 601-606 (1981). Finally, the IRS is saddled with the same liabilities as the states attorneys general. *See infra* notes 95-104 and accompanying text. Because the IRS is subject to essentially the same limitations as the state attorneys general, and because it is not directly concerned with the enforcement of fiduciary rules, I omit discussion of it as a distinct enforcement mechanism in this article. It is worth noting, against nonprofits. It thereby limits the government's tendency to bring policy-induced suits, and makes largely irrelevant the great constraints inherent in the attorney general's office. Furthermore, it provides most conveniently for arbitration rather than litigation, thereby reducing nonprofits' administrative costs, and reducing strain on the legal system. Allowing private market actors to determine which suits ought to be brought should result in increased accountability for nonprofit organizations. Ultimately this accountability should lead to the creation of more charitable entities, increased donations, and an increased confidence in the ability of nonprofits to perform in the public interest.

In Part II of this article I will outline briefly the theory of the firm and its implications for nonprofit organizations, the shape of standing rules as they apply to nonprofits, and the unfortunate and deleterious conjunction of rigid standing rules and high agency costs in the operation of nonprofits. In Part III I will present my market-based solution to the problem of agency costs in nonprofits. And in Part IV I will discuss other proposals for reform and demonstrate their relative inefficacy.

II. The Theory of the Firm, Standing, and Nonprofit Entities.

A. The Theory of the Firm.

The defining characteristic of a charitable nonprofit (whether it is organized as a corporation or a trust) is its adherence to the nondistribution constraint.[8] Charities may, and do,

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however, that the IRS is far from insignificant in this realm.

[8] "A nonprofit organization is, in essence, 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. . . . [T]he nondistribution constraint is imposed, either explicitly or

earn profits, but they may not distribute those profits to officers, directors, or trustees. In effect, then, nonprofit firms are not owned, at least not in the usual legal sense. As a result, they cannot successfully rely on their residual claimants to overcome the agency costs inherent in the corporate (or trust[9]) form, and control of nonprofit agents' behavior must be, generally, exogenous to the firm. Perhaps for this reason, the growing relative importance of the nonprofit (or independent) sector has not been met with the same growth in public confidence in the independent sector: outside the areas of religion and education, confidence in the nonprofit sector lags far behind that of small businesses, even while out pacing confidence in the federal government.[10]

Nonprofits operate in nearly every imaginable aspect of our economy.[11] Most nonprofits, like their for-profit counterparts, are engaged in the act of selling something. In a for-profit

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implicitly, as a condition under which the organization receives its corporate charter." Hansmann, *supra* note 4 at 838. The defining characteristic of a nonprofit is not its tax exempt status. An entity's nonprofit status is a matter of its organization, charter, and purpose, and is determined by state law. Its tax exempt status is a matter of federal law, but the two do not always coincide; of the over one million nonprofits in the United States today, only about half have charitable, tax exempt status under Section 501(c)(3). *See* Carol J. De Vita, *Viewing Nonprofits Across the States*, CHARTING CIVIL SOCIETY (Urban Institute Newsletter), Aug. 1997.

[9]The trust form has many of the same problems as the corporate form since equitable ownership and legal control are separated, and rights are generally only enforceable through legal proceedings. Thus, although the following discussion will be largely couched in terms of corporate entities, the analysis applies equally to trusts.

[10]*See* Lester M. Salamon, *Holding the Center: America's Nonprofit Sector at a Crossroads*, NATHAN CUMMINGS FOUNDATION REPORT (visited October 14, 1998) <http://199.97.60.3/ncf/publications/reports/holding_the_center/hc_report.html>.

[11]Most states permit a nonprofit corporation to be formed "for any lawful purpose." *See MODEL NONPROFIT CORP. ACT* §4 & alt. §4 (19xx). For representative state statutes, see also ALA. CODE § 10-3A-4 (1975); IOWA CODE § 504A.3 (19xx).

corporation this may be apples or rowing machines or financial advice. In a nonprofit this may be religious salvation, education, artistic services such as museums and orchestras, legal services to save the Intercostal Waterway, or homeless shelters. Why do for-profit firms not often offer the services provided by nonprofits? Conventional scholarship has it that

> either the nature of the service in question, or the circumstances under which it is provided render ordinary contractual devices inadequate to provide the purchaser of the service with sufficient assurance that the service was in fact performed as desired. The advantage of the nonprofit form in such circumstances is that it makes the producer a fiduciary for its purchasers, and thus gives them greater assurance that the services they desire will in fact be performed as they wish.[12]

In such a world, because of the information asymmetry occasioned by the customary separation between a nonprofit's patrons and its beneficiaries, itself a product of the service or good being provided, and due to the lack of residual claimants with an incentive to overcome agency costs, monitoring of a nonprofit by a donor or a philanthropist is prohibitively expensive.[13] According to the standard theory, then, nonprofits, operating under strict fiduciary rules and the nondistribution constraint, have formed so that the providers of services (the directors and officers of the nonprofit) in areas of great information asymmetry can bind themselves to behave in their potential patrons' interests. Information asymmetries have occasioned the nonprofit form which itself has given rise to the further agency problem of monitoring, absent residual

[12]Hansmann, *supra* note 7 at 504. Although it is beyond the scope of this article, it is worth noting that this explanation fails to explain why many of the services and products traditionally supplied by nonprofits are quite profitably supplied by for-profits as well.

[13]*See* Henry Hansmann, *Economic Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 27 (Walter W. Powell ed., 1987); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claimants*, 26 J. L. & ECON. 327 (1983).

claimants.[14]

But this is only a part of the picture. Historically, most nonprofits, and particularly the largest ones, began as religious institutions: churches, hospitals, schools, and welfare agencies.[15] The contributors to these worthy causes wanted, no doubt, to make sure that their money was being used for its intended charitable purpose. More important, perhaps, they wanted to be sure that the money was being used for the religious purpose for which it was given. They were willing to restrict their own property rights in the enterprise (in particular by making their investments inalienable) in order to restrict others' rights as well, in order, in turn, to impede the progress of the organization away from its religious purpose. If the firm were a profit-making institution, it might be forced to succumb to other pressures (or sources of money) and, while not

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[14] *See* Hansmann, *supra* note 4 at 845. I am speaking here about organizations that benefit the public at large, or a large sector of the public. One explanation for the nonprofit status of certain mutual benefit organizations (country clubs, for example) is that by being nonpecuniary, these mutual benefit organizations can engage in social exclusivity and gain certain social status without the threat of a rent-seeking owner appropriating any of the value of the members' resulting high status. *See* Hansmann, *supra* note 4 at 892-894. Another explanation, applicable, I think, to all mutual benefit organizations (including especially trade unions), is that nonprofit status emanates from the undesirability of the free alienability of membership rights. Because mutual benefit organization members want to associate only with particular people, and because incumbent members want to be able to extract rents from all new members, they opt for a policy of nontransferability in membership rights. They can thus ensure that other members will neither sell their memberships to undesirable would-be members, nor be able to capture for themselves the benefit accruing from the sale of their membership rights. A policy of nontransferability, coupled with the promise of tax benefits, suggests a nonprofit organizational structure. *See* Donald L. Martin, *Unions as Nonproprietary Institutions, in* THE ECONOMICS OF NONPROPRIETARY ORGANIZATIONS 81-83 (Kenneth W. Clarkson & Donald L. Martin eds., 1980).

[15] "Universally, religious groups are the major founders of nonprofit service institutions." Estelle James, *The Nonprofit Sector in Comparative Perspective*, *in* POWELL, *supra* note 13 at 404. *See also* Brendan F. Brown, *The Ecclesiastical Origin of the Use*, __ NOTRE DAME LAWYER 353 (19xx).

necessarily abandoning its goal of educating, healing, or feeding, it might well be forced to abandon its goal of advancing a particular brand of spiritual salvation. Thus, these services were, and are, provided by nonprofits -- organizations that, without owners and alienable property rights, could preserve (for a time) those patrons' non-pecuniary interests. As others have noted,

> a key feature of nonprofit production is ideology. This may stem from religious faith, from a secular version of a just society, [or] from a belief in a particular theory of education or child development . . . . [M]any organizations are nonprofit because their founders have a set of strongly felt beliefs which motivate them more than money alone. The kind of services they chose to produce [and] the consumers who prefer these services are directly tied to the founders' beliefs[16].

The nonprofit form survives today, even if religious fervor does not remain at its core, due to the relatively recent tax benefits of the form, historical inertia, and the perceived benefits of the form's solution to the problem of "contract failure." Unfortunately, in sacrificing the operation of a market for the firm's ownership, while the patrons may have gained eternal salvation, a tax break, or a modicum of control, they have also gained additional and significant agency costs.

Corporations, whether for-profit or nonprofit, and trusts, whether private or charitable, are contractual relationships in which a principal (a shareholder or a donor, a founder or a settlor) contracts with an agent (a director, a trustee) to provide some service. Necessarily, the provision of this service entails the delegation of some decision-making power from the principal to the agent. Because, as Jensen and Meckling point out, the agent will not likely act on his own in the best interests of the principal, it behooves the principal to monitor the agent's behavior and to establish appropriate incentives in order to deter the agent from diverging from the principal's

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[16] ESTELLE JAMES & SUSAN ROSE-ACKERMAN, THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS 51 (1986).

interest.[17] The costs of monitoring by the principal, the costs of bonding by the agent,[18] and the welfare loss to the principal occasioned by the agent's divergence from the principal's interests[19] are the agency costs.[20] "[A]gency costs arise in any situation involving cooperative effort . . . by two or more people even though there is no clear cut principal-agent relationship."[21] In the case of nonprofit entities, the principals (the donors) and the agents (the nonprofit managers) are identifiable, but the exact contours of their relationships are not. This state of affairs further complicates the traditional agency problem and serves to increase the cost of agency in nonprofits.[22]

We can be sure that it is not in the principals' interests, however, that the managers shirk, pursue their own agendas, or appropriate perquisites for themselves at the nonprofit's expense. The agency conflict in a nonprofit, then, is the same as that in a for-profit corporation; it is merely

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[17] Jensen & Meckling, *supra* note 1 at 308.

[18] The agent may take it upon himself to assure the principal that he will not diverge from the principal's interests by incurring bonding costs that serve to make such divergences expensive. Both bonding and monitoring costs are born by the principals. *See id*. at 325-26.

[19] Because the optimal levels of monitoring and bonding will likely still allow the agent to diverge some from the principal's interests, the cost of this residual divergence must be taken into account. *See id*.

[20] *See id.*

[21] *Id.* at 309. *See also* Alchian & Demsetz, *supra* note 1.

[22] The exact nature of the principal-agent relationship is difficult to identify because it is not readily apparent (as it is in a for-profit corporation) exactly what the principals' interests are, nor, therefore, exactly what they wish the agents to do for them: "The obligation of nonprofit directors and officers with respect to the corporation's mission creates a more difficult and complex decision-making process for them than for their for-profit peers." Harvey J. Goldschmid, *The Fiduciary Duries of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed* Reforms, 23 J. CORP. L. 631, 641 (1998).

exacerbated by the fact that profit maximization is not the primary goal of the entity's "owners." Principals in the nonprofit context, that is, donors and philanthropists (collectively referred to as patrons), may have varying and not readily-identifiable reasons for giving money to a nonprofit. Certainly most will want their money to be used for the purpose for which the nonprofit claims it will be used. And certainly, *ceteris paribus*, most would prefer that that goal be accomplished at the lowest possible cost. Donors and philanthropists may have ulterior motives, however. It may be to their benefit to make a public show of charity. They may seek the tax benefit of a charitable contribution. Or it may satisfy an altruistic urge to give money to a charity, regardless of how efficiently the money is actually put to use. The overall effect of these disparate motivations is to reduce principals' incentives to monitor charitable agents.

Managers have likewise ambiguous interests. Many are committed to the causes for which they work. But many are also motivated by those potential benefits of their position that do not directly benefit the organization.[23] At the same time, directors of charitable organizations often have different charitable ideas from those of their organization's founder (and reflected in its charter). They may diverge from the nonprofit's stated purpose, and their divergences may be all but undetectable.

Neither principals nor agents have an ownership interest in a nonprofit; in a very real sense, nonprofits are unowned.[24] The general lack of residual claimants in a nonprofit entity

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[23]Even to the extent that nonprofit managers do work in their nonprofit's interest, "the absence of net profitability criteria implies that managers of nonproprietary enterprises will choose relatively more pleasant tasks." Kenneth W. Clarkson, *Managerial Behavior in Nonproprietary Organizations*, *in* ECONOMICS OF NONPROPRIETARY ORGANIZATIONS *supra* note 14 at 14.

[24]*See* Hansmann, *supra* note 1 at 300-301. The lack of legal ownership does not necessarily denote the absence of residual claimants. In higher education, for example, the faculty

makes overcoming the inherent agency costs even more difficult. As Jensen and Meckling point out, in the for-profit context the residual claimants (equity holders in a firm, who are also the principals) will bear the cost of monitoring and bonding until the marginal gains from deterring an agents' aberrant behavior no longer exceed the marginal costs of monitoring and bonding.[25] Beyond that point, where incremental units of monitoring cost more than the marginal benefits to the share price from monitoring, the principals will no longer monitor the agent. In the nonprofit context, because monitoring is so costly,[26] because monitoring costs are internalized by the monitors, and because they do not realize corresponding gains simply by making nonprofits more efficient, greater inefficiency will be observed. Likewise, because the perquisites have positive value, and because bonding would not result in a direct gain to the principals, agents will not find it cost effective to guarantee their good behavior.

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members are the residual claimants, even while they do not maintain any ownership interests in their institutions. *See* Henry G. Manne, *The Political Economy of Modern Universities*, *in* EDUCATION IN A FREE SOCIETY 165-205 (Anne Hustead Burleigh ed., 1973). The existence of residual claimants without ownership interests does not mean, however, that those residual claimants will retain the incentive to monitor in order to constrain the entity's agents to act in the best interests of the entity. In the case of faculty members in particular, quite the opposite is true. *See id.* at 189-197.

[25]*See* Jensen & Meckling, *supra* note 1 at 323-26. The agent, of course, faces the exact same calculation in reverse: he will incur bonding costs as long as the benefits from incurring the costs (as a shareholder, he both incurs a portion of the bonding costs, and reaps the reward through higher value in the firm) are more valuable than the opportunity cost incurred by constraining his ability to defect. In a nonprofit, he reaps the reward of higher firm value only very indirectly: "in nonprofit corporations . . . the future consequences of improved management are not capitalized into present wealth of stock-holders. . . . One should, therefore, find greater shirking in nonprofit . . . enterprises." Alchian & Demsetz, *supra* note 1 at 789-90.

[26]Because, as noted above, information asymmetries make observation of outputs expensive, and because nonprofit patrons have little incentive to incur even minor costs of enforcement.

As the discussion thus far demonstrates, it is not readily apparent that the analytical power of the theory of the firm fully transfers into the realm of nonprofits. That is, although the analysis and the language can be applied, the strong conclusions in the for-profit context regarding incentives and capacities to minimize agency problems are weaker in the nonprofit. In particular, although I have identified donors and founders as principals, I have also noted that they retain no legally-enforceable ownership interest in their entities.[27] Managers are quite clearly agents but, again, because the principals are not the owners, the incentive structure identified by Jensen and Meckling is disrupted. Furthermore, other institutions, like the market for corporate control, which serve to make monitoring by principals (in some cases, prohibitively expensive even in the for-profit world) effective, do not operate in the nonprofit sector.[28]

At the same time, principals can be expected to exhibit some of the behavior of typical residual claimants: to the extent that a principal's contribution to a nonprofit stems from his expectation of gaining utility from the efficient functioning of the nonprofit (a certainty in the case of the ideologically-motivated philanthropist), principals will probably be willing to expend some amount of money on monitoring. Likewise, the beneficiaries of a nonprofit's activity, although they retain no ownership interest, will have an incentive to overcome some of the agency costs in order to increase their welfare gains from the nonprofit's efficient operation.[29] But widely-

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[27]Even specifically contracted-for, conditioned gifts may not be enforceable in the courts, at least not without an express reservation of a reversionary interest. *See infra* note 75 and accompanying text.

[28]On the function of the market for corporate control in the for-profit context, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[29]*See* Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. L. & ECON. 351, 358 (19xx) ("[B]ecause the beneficiaries, real or pretend, are

dispersed donors and beneficiaries face severe collective action problems in monitoring, along with legally-attenuated property rights and questionable standing in the courts. And for many beneficiaries, there is the risk of engendering disfavor among management when future dispensations are made.

B. Default Rules and Nonprofit Monitoring.

Nonprofit law recognizes that patrons and beneficiaries will have some interest in ensuring the good behavior of an organization's directors. Recognizing as well the lack of ownership interests, however, the law has sought to win directors' loyalties through the operation of strict fiduciary constraints rather than through private contractual arrangements. As Judge Cardozo articulated it, "[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."[30] More accurately, however, nonprofits are held to the nondistribution constraint and their directors to the strict duties of loyalty and care in an attempt to replace direct monitoring by principals with a system of deterrence.[31] Because monitoring of nonprofits is so expensive, and because the mere separation of management and control does not adequately ensure that

among those who stand to lose most if nonprofits are badly run, beneficiaries can be said to have residual claimant status in the nonprofit organization.").

[30] *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928). The force of Judge Cardozo's admonition in the nonprofit context is only enhanced by the fact that it was delivered in the for-profit.

[31] *See* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698, 700-703 (1968).

"donations are used effectively and are not easily expropriated"[32] the law has seen fit to impose a strict deterrence system on nonprofit managers through the application of default rules.

Whether culled from the law of trusts or the law of corporations, the duties of loyalty and care operate in the nonprofit sector, as they do in the for-profit, as default rules.[33] In the nonprofit sector, however, these default rules are more necessary and, unfortunately, even less effective than in the for-profit. Because private monitoring is so expensive in nonprofits, strong fiduciary rules provide a relatively inexpensive deterrence system, but one which, in theory, accomplishes the same end as more expensive monitoring: "[b]y imposing personal liability on corporate officers and directors for breach of the duties of care (negligence) and loyalty (conflict of interest), litigation is thought to align mangers' incentives with shareholders' interests."[34] In reality, however, the derivative suit "is a relatively unimportant [mode of shareholder protection] which can be used only to police the more blatant forms of wrongdoing. It can never be effective as a device for the policing of mere inefficiency in management."[35] In the nonprofit context, because of the complete absence of the more meaningful protection of the market for corporate control, "shareholder" litigation is the only privately-enforceable mode of protection available. Further, the market for managers, which also serves to align for-profit managers' interests with

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[32] Fama & Jensen, *supra* note 13 at 344.

[33] *See, e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

[34] Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. LAW ECON. & ORG. 55, 55 (1991). Of course trustees frequently contract out of the strict duty of care, just as corporate directors do. *See* RESTATEMENT TRUSTS 2D §222 (19xx).

[35] Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 273 (1967).

those of their principals, cannot function well in a world in which managerial performance is not based on easily observable criteria (like profits or share prices).[36] Thus the rules of standing in the nonprofit sector are a crucial element in the analysis of the effectiveness of the sector's fiduciary controls. To the detriment of nonprofits, standing rules have essentially undermined the effectiveness of default fiduciary rules as they apply to the nonprofit sector.

To the extent that they may be effective at all, default fiduciary rules lose their deterrent effect if no one can enforce them:

> In an attempt to substitute for the absent shareholders, the law, somewhat awkwardly, still imposes the fiduciary duties of loyalty and care on nonprofit boards. But because of the lack of classes of private persons with standing to sue, in many ways this fiduciary duty is really a legal obligation without a legal sanction.[37]

Along these lines, the lack of shareholder (or other) control over boards of directors points to the nonexistence of the market for corporate control in the nonprofit sector; the lack of legal ownership suggests a concomitant lack of takeover activity. Thus no market operates effectively to ensure managerial competence. In the for-profit world shareholder suits stemming from violations of the duties of care and loyalty are supported (and made effective) by the operation of

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[36]On the market for managers in the for-profit context, see Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980). In the for-profit context, the market for managers is made effective in part by shareholders' ability partially to isolate the effects of managerial performance from that of the noise generated by systemic risk through the use of a hedge. In the nonprofit context, where performance effects are difficult to quantify and even more difficult to attribute, the market for managers is imperfect at best. On the role of derivatives in the effective functioning of the market for managers, see Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 37-38 (1996).

[37]Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N. Y. L. SCH. L. REV. 457, 466-67 (1996) (citing Hansmann, *supra* note 4 at 873, for the notion that states make little effort to enforce the duties owed by nonprofit corporations).

the takeover market. No such market operates in the nonprofit sector.[38] As a result, nonprofit boards go largely unmonitored despite the existence of legal rules purporting to exert supervision.

Much has been written on the application of fiduciary duties to directors of nonprofits, and all of it calls for some reform in this area. Whether from the point of view of further minimizing director liability or increasing control over nonprofits, the current regime is commonly viewed as inadequate.[39] But all of these commentators agree that actual suits against nonprofit directors are rare.[40] The lack of litigation against nonprofit board directors demonstrates not that they are performing admirably, but rather that the fiduciary rules lie fallow. Because "[g]overnance mechanisms are so much weaker in the nonprofit sector, . . . loose controls on self-dealing create unacceptably high risks of misconduct."[41] The most obvious conclusion is that this form of

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[38] *Id.* at 489 (citing Manne, *supra* note 28 at 113 (for the notion that only the takeover market "provides some assurance of competitive efficiency among corporate managers").

[39] *See, e.g.,* David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L. J. 967 (1996); Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131 (1993); Peter Swords, *An Examination of Nonprofit Board Members' Exposures to Liability*, C479 ALI-ABA 165 (1990); Thomas H. Boyd, *A Call to Reform the Duties of Directors Under State Not-for-Profit Corporation Statutes*, 72 IOWA L. REV. 725 (1987).

[40] "The obvious conclusion of all this is that derivative suits do not occur in the nonprofit area . . . ." Swords, *id.* at 169. Furthermore, "In 1985, only 13 states reported a total of 33 lawsuits brought by attorneys general." CASES AND MATERIALS ON NONPROFIT ORGANIZATIONS 247 (James J. Fishman & Stephen Schwarz eds., 1995). In New Jersey, although The New Jersey Nonprofit Corporation Act imposes a duty of care on nonprofit directors, "[u]nder the nonprofit act, there are no reported decisions interpreting this duty of care." James A. Robertson, *The Duty of Care and Duty of Loyalty Under the New Jersey Nonprofit Corporation Act*, 189-FEB N.J. LAW 11 (1998).

[41] DeMott, *supra* note 39 at 146.

control, too, is ineffectual. It should not be relied upon to ensure fair-dealing and financial propriety in nonprofits.[42]

For charitable trusts, the law has likewise provided rules of conduct and theories of suit. A trustee is held to certain fiduciary obligations similar to those of corporate directors.[43] Most important among these, the trustee must adhere to the "unbending" duty of loyalty.[44] But while the rule itself is fairly rigid, its restrictions do little to prevent abuse when they cannot be enforced.

A means to effective enforcement of fiduciary rules is needed. Crucial to the success of such a regime is the existence of a party with both the incentive and the ability to enforce fiduciary rules as well as the incentive and the capacity to monitor.

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[42] There are, of course, other tenable conclusions. Penalties could be vastly increased, the standards could be heightened against nonprofit boards, or standing rules could be greatly loosened. But any of these would be imperfect solutions. All of these alternatives would contribute to potential directors' already marked reluctance to take on jobs as nonprofit directors. In addition, such legal changes could be deadly for small charitable organizations that can already barely afford to pay their directors. While these arguments may apply as well to my proposed alternative, they do so to a lesser degree, and, more important, my proposed solution takes care of other failings of nonprofit law, most notably by increasing donor confidence and helping to overcome information asymmetries. Finally, enforcement costs under any of these alternatives would be greater, and they would contribute to increased litigation, where under my proposal these costs are internalized and litigation is eschewed in favor of arbitration. *See* Section III, *infra*.

[43] Under the contract theory of the firm, this similarity makes sense: directors of corporations are not owners, but are really trustees, or agents, for the residual owners. *See* Jensen & Meckling, *supra* note 1.

[44] *See, e.g., Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928)(where Judge Cardozo noted that "[a] trustee is held to something stricter than the morals of the market place . . . . As to this there has developed a tradition that is unbending and inveterate").

C. Standing.

Though it has gained importance only fairly recently, standing is well solidified in our legal landscape.[45] Similar to the evolution of standing in public law in order to limit instances of suits vindicating "public rights,"[46] private rules of standing have evolved in order to limit suits in the private realm as well. But because of their limiting qualities they have eviscerated the ability of the already tortured application of fiduciary rules to control nonprofit directors and managers.[47] Without a change in the laws of standing as they are applied to nonprofits, the remaining efficacy of those rules will be destroyed for lack of enforcement.

Before he may litigate a matter in court, a plaintiff must have a "sufficient stake in an otherwise justiciable controversy to obtain judicial resolution of that controversy."[48] There are no clear standards for determining whether a plaintiff has a "sufficient stake,"[49] but various areas of

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[45] "Standing is often viewed as a judicial vehicle employed to fend off attacks on mounting and pervasive governmental regulation that began with the New Deal and that significantly expanded during the Great Society in the 1960s." Maxwell L. Stearns, *Standing Back from the Forest: Justiciability and Social Choice*, 83 CALIF. L. REV. 1309, 1322 (1995).

[46] *See, e.g., Lujan v. National Wildlife Fed'n.*, 110 S. Ct. 3177 (1990) (demonstrating the courts' hostility to broad attacks on federal programs by environmental groups without "injury in fact").

[47] "Highly restrictive standing rules and a lack of government enforcement have made duty of care and duty of loyalty standards almost wholly aspirational in the nonprofit sector." Goldschmid, *supra* note 22 at 653.

[48] *Sierra Club v. Morton*, 405 U.S. 727, 731-32 (1972). *See also* Kenneth C. Scott, *Standing in the Supreme Court , A Functional Analysis*, 86 HARV. L. REV. 645, 647 (1973)(Standing addresses "what sort of interest is 'sufficient' for the plaintiff to be regarded as a proper party to bring the action.").

[49] "What constitutes a 'sufficient interest' in the results of a lawsuit to warrant standing, however, is often far from obvious." Michael C. Jensen, William H. Meckling, & Clifford G. Holderness, *Analysis of Alternative Standing Doctrines*, 6 INT'L J. L. & ECON. 205, 208 (1986).

the law have developed their own somewhat generalizable standing requirements.[50] Standing limitations for nonprofit entities are grounded largely in the outdated notion of the state as *parens patriae*, and thus, for much of the nation's history, have relegated enforcement to the exclusive province of the state. "[T]he state, as parens patriae, superintends the management of all public charities or trusts, and in these matters acts through her attorney general."[51] This state of affairs stems from the institution of the special charter in 17th Century England, and the attendant notion that only the Crown could create a legal entity. It is totally at odds, however, with modern notions of the firm as a nexus of contractual relationships, and, certainly, improperly colors our thinking about standing in the context of litigation against firms.

The Supreme Court, in *The Dartmouth College Case*, has confirmed this long-standing limitation on the right to sue, noting that

> In every literary or charitable institution, unless the objects of the bounty be themselves incorporated, the whole legal interest is in trustees, and can be asserted only by them. The donors, or claimants of the bounty, if they can appear in court at all, can appear only to complain of the trustees. In all other situations, they are identified with, and personated by, the trustees; and their rights are to be defended and maintained by them.[52]

Thus neither the students nor the original donors had standing to sue; this right resided exclusively with the attorney general and the trustees. More recently, as courts began to recognize the

[50]At its core at least, prudential standing requires a connection between the action being challenged and the alleged injury. "If the alleged wrongfulness of the injurious action challenged . . . was not causally related to the injury suffered . . . then the suit in question would not be one to vindicate that plaintiff's own rights. One cannot vindicate what has never been threatened." *Steffan v. Perry*, 41 F.3d. 677, 697 (D.C. Cir. 1994). *See also Valley Forge Christian College v. Americans United for the Separation of Church and State*, 454 U.S. 464 (1982).

[51]*People ex rel. Ellert v. Cogswell*, 45 P. 270, 271 (Cal. 1896).

[52]*Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 518, 645-46 (1819).

limitations inherent in state supervision of nonprofits, they began to expand their conception of standing to allow "interested" parties a limited right to sue. As a result, members, directors, and some beneficiaries have been accorded the right to sue in order to enforce charitable obligations. But restrictions on these suits, mostly in an attempt to prevent overly-vexatious litigation, have subsequently limited this right.[53] Most notably, beneficiaries cannot sue nonprofit organizations in order to vindicate their rights, or the rights of the class of beneficiaries as a whole, without showing the requisite "special interest" in the litigation.

Nonprofit organizations, as I have suggested, fall generally into two categories: public benefit organizations and mutual benefit organizations. Mutual benefit organizations are "formed primarily to serve their members,"[54] and receive "their income from prices charged for their services."[55] Public benefit organizations distribute money collected in the form of donations or endowments for the benefit of members of the general public, or some subclass of the general public.[56]

In a mutual benefit organization the members comprise a small, distinct group of people with a common interest in the organization -- a country club or a trade union, for example. The relationship of the members to the entity is not unlike that of shareholders to a corporation: both

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[53]*See infra* notes 72-84 and accompanying text.

[54]Boyd, *supra* note 39 at 730.

[55]Hansmann, *supra* note 4 at 840-41.

[56]*See, e.g.,* Mary A. Jacobson, *Nonprofit Corporations: Conversions to For-Profit Corporate Status and Nonprofit Corporation Members' Rights*, 20 DEL. J. CORP. L. 635, 638 (1995).

receive a direct benefit from the organization in exchange for a financial stake. In many cases, members, like shareholders, have the right to vote for members of the board. "Accordingly, courts have frequently analogized the members' rights in a nonprofit corporation to shareholders' rights in a for-profit corporation."[57] Because members have direct, generally unified interests in the workings of the nonprofit, and because, as the beneficiaries of the nonprofit, they may also observe its functioning, they are able to engage in the monitoring and bonding of their agents.[58]

The right of a member to sue a mutual benefit nonprofit is not as secure as that of a shareholder, however. In many jurisdictions a member does not have the right, as shareholders do, to bring a derivative suit without prevailing upon a director to bring the suit for him.[59] If a director benefits from wrongdoing, and the attorney general will not bring suit, it is possible, or even likely, that the wrong will go unredressed.[60] And where states have recognized the right of

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[57] *Id.* (citing *Oberly v. Kirby*, 592 A.2d 445, 458-59 (Del. 1991) (noting that, in the case before the court, "the members' power was intended to resemble that of stockholders")).

[58] This ability remains limited, of course, by many of the factors I have already discussed: there is no market for corporate control to aid in inducing agents to behave, for example. Despite members' generally allied interests, there is nothing as (relatively) simple as profit maximization for a nonprofit to pursue as its goal. Consequently, it is not a simple matter for either members or agents to know and value the members' interests, and both monitoring and bonding are correspondingly more expensive.

[59] Except in those jurisdictions that have adopted the Model Nonprofit Corporations Act (see MODEL NONPROFIT CORP. ACT §6.30(a)) or have similar statutes (see, for example, CAL. CORP. CODE §§ 5420, 7420, 7710; N.Y. NOT-FOR PROFIT CORP. LAW §§ 623(a), 720(b)(3)), the common law does not generally permit member derivative actions without board participation. *See, e.g., Basich v. Board of Pensions Evangelical Church*, 493 N.W.2d 293 (Minn.App. 1992); *Voelker v. St. Louis Mercantile Library Ass'n.*, 359 S.W.2d 689 (Mo. 1962). Shareholders of for-profit corporations do retain this right. *See, e.g.,* REVISED MODEL BUSINESS CORP. ACT § 7.40, *et seq.*

[60] *See, e.g.,* Brenda Boykin, *The Nonprofit Corporation in North Carolina: Recognizing a right to Member Derivative Suits*, 63 N.C. L. REV. 999, 999 (1985).

members to sue derivatively, they have simultaneously placed many limitations on that right.[61]

Patrons of public benefit organizations stand in an even more precarious position. In public benefit organizations the analogy to corporate law is even more ill-suited, and consequently the right of their patrons to sue is more ambiguous. Beneficiaries and donors of charities have standing to sue a nonprofit only where they can show a "special interest" in the charity.[62] This reflects the courts' unwillingness to recognize the right to a general citizen's suit when the attorney general is in a position to bring suit.[63] No doubt it also reflects the courts' disinclination to insinuate themselves into the mechanics of a nonprofit's charitable pursuits. Generally speaking, "nonmembers have no standing,"[64] and neither, then, do donors.[65]

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[61]*See, e.g.,* The Tennessee Nonprofit Corporation Act, TENN. CODE ANN. §48-51-101 (1988) (allowing for derivative suits by directors, but by members only in groups of fifty or more or members collectively holding five percent of the voting power, and further limiting this right to those members who were members at the time of the proceedings).

[62]*See, e.g., Kania v. Chatham*, 254 S.E.2d 528, 530 (N.C. 1979) (refusing to grant standing to a potential beneficiary because he could show neither a "special interest" in the action nor a particularized injury). *See infra* notes 72-84 and accompanying text.

[63]I do not wish to imply that the imposition of standing rules in the charitable sector is arbitrary or unwarranted. On the contrary, the charitable sector would probably be less effective (and less important) if standing rules were more lax. They are a necessary, but imperfect, second order rule imposed to correct the inadequacies of the first order rules. *See* Jensen, et al., *supra* note 49.

[64]*O'Donnell v. Sardegna*, 646 A.2d 398, 406 (Md. 1994). *See also, Chambrella v. Rutledge*, 740 P.2d 1008 (Haw. 1987) (barring contributors who were not formally members of a nonprofit corporation from bringing suit); *Leeds v. Harrison*, 72 A.2d 371, 380 (N.J. Super. 1950) (noting that "a member of the public has no standing to question the administration of a charitable trust"); *Keranko v. Washington Youth Baseball, Inc.*, 584 A.2d 1082 (1990) (refusing standing to the parent of a player in a little league baseball league to sue the league).

[65] "Because the nondistribution constraint . . . is for the protection of the organization's patrons [donors, contributors, or purchasers of goods and services], it seems natural to provide for patrons to participate in the enforcement of that constraint by giving them a cause of action

As in any corporation, board members of nonprofit corporations will generally have the ability to sue on behalf of the corporation. But, likewise, they may be sued personally if they engage in wrongdoing. This poses a particular problem for nonprofit corporations which rely heavily on honorary board positions. In the past, due to the limited powers of members and beneficiaries to sue, these board members have engaged in self-dealing and other destructive activities almost without threat of reprisal.[66] And this is only rational: one's calculation before committing a crime is based on the magnitude of the expected penalty and the expected likelihood of successful prosecution.[67] Where this likelihood is diminished almost to the point of non-existence, crimes, or derogations of duty, will most certainly occur. Clearly some check is needed, some method of ensuring monitoring and the energy required to prosecute. But as the likelihood of being sued increases, it becomes increasingly more difficult to find people willing to take on the risks inherent in the position of a nonprofit board member.[68]

Many cases in the nonprofit arena have been decided by reference to the law of charitable

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against anyone who violates it. As it is, however, the nearly universal rule is that patrons generally have no standing to bring such a suit." Hansmann, *supra* note 7 at 606.

[66]Note, however, the recent resignation of the president of the United Way after allegations of self-dealing. *See* Felicity Barringer, *United Way Head Is Forced Out in a Furor Over His Lavish Style*, N.Y. TIMES, Feb. 28, 1992, at A1. Note also the recent, high-profile cases of New Era, PTL Ministries, and Adelphi University. *See infra* notes 110-113. These successful prosecutions are presumably not the norm.

[67]*See* Richard A. Posner, ECONOMIC ANALYSIS OF LAW 223-225 (4th ed. 1992) .

[68] "Many who consider whether or not to join a board of a nonprofit organization worry about exposing themselves to the risk of personal liability lawsuits as a result of their becoming board members. Furthermore, the wealthier potential board members may be, the more they are likely to worry that their wealth alone will attract lawsuits. And yet, for a variety of reasons, it is just this class of persons that nonprofit groups like to attract to their boards." Swords, *supra* note 39 at 172.

trusts rather than that of for-profit corporations, perhaps on the assumption that the implementation of stricter fiduciary rules will help to deter agent misconduct. But over time "[t]he law has moved from rigid trust principles to nearly wholesale adoption of the business corporation director's standards of conduct."[69] Because trust principles are more rigid than those applicable to the corporate setting,[70] the result of this shift has been a general reduction in the oversight of nonprofit entities.[71]

One of the doctrines of the law of charitable trusts that has seen a resurgence is that of standing based on "special interest." "In order to broaden standing to include [some] beneficiaries, the courts have seized upon the concept of a special interest in a charity. A plaintiff with a special interest stands in much the same position vis-a-vis a charity as a beneficiary stands

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[69]James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L. J. 617, 645-46 (1985). *See also Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F.Supp 1003, 1013 (D.D.C. 1974) ("[T]he 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.").

[70]On the flexibility of modern American corporate law, see Easterbrook & Fischel, *supra* note 33.

[71]Where the business judgment rule would have applied in corporate law, for example, trust law, as it was applied to charitable trusts in the U.S. in the nineteenth century, imposed strict limitations on a corporation's holdings of real and personal property and its annual income. *See e.g.,* New York General Incorporation Act of 1848, 1848 N.Y. Laws 319. It is worth noting that the structure of the for-profit firm both suggests and effectuates loose control by contract and default rules. *See* Jensen & Meckling, *supra* note 1. It is those very attributes, however, that comprise a large portion of the institutional differences between for-profit and nonprofit firms, thus leading to the ineffectiveness of corporate law in the nonprofit realm. It is also worth noting that the impetus behind the adoption of the business judgment rule, the encouragement and protection of corporate risk-taking, is inapplicable to nonprofits.

in relation to a private trust, and has equal rights of enforcement."[72] However, in order to show the requisite special interest, a plaintiff must show that he "is a member of a small identifiable class that the charity is designed to benefit."[73] This showing can be quite difficult.

Once a special interest is identified, a party demonstrating that interest in the transaction in question will be permitted to bring an action against a nonprofit organization. But courts tend to define special interests narrowly in an effort to stem the tide of frivolous or vexatious litigation coming from a constantly-shifting and large sector of the population. However,

> [i]f the private party successfully demonstrates the requisite special interest in a charity's philanthropic goals, the action is not likely to be frivolous or needlessly vexatious. The specially interested plaintiff presumably is seeking to uphold the best interests of the charity, and may be able to adequately represent those interests and the interests of the charitable beneficiaries."[74]

Ultimately, however, courts' continued reliance on the notion of the state as *parens patriae* and their disinclination to recognize nonprofit corporations as collections of contracts have caused them to grant special interest standing only grudgingly.

Some examples from various state courts will help to elucidate this point. In perhaps the most egregious example of a court's unwillingness to enforce contractual rights in charitable entities, the Supreme Court of Connecticut denied a donor the right to sue a charity for an alleged

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[72]Mary Grace Blasko, et al., *Standing to Sue in the Charitable Sector*, 28 UNIV. S. F. L. REV. 37, 60 (1993).

[73]*Id*. at 70.

[74]*Id.* at 61.

violation of the terms of his charitable gift.[75] In *Herzog*, the plaintiff foundation provided funds to the defendant university with the restriction that they would be used solely for providing need-based scholarships in medical-related education. When, four years later, the funds were allegedly converted for use by the university for general expenditures, the foundation sued. The trial court ruled that the plaintiff lacked standing to enforce the restriction. The appellate court reversed and the Connecticut Supreme Court reversed again in a 3-2 decision. According to the majority opinion, a donor has no standing to enforce the terms of a restricted donation unless he has expressly reserved a reversionary interest in the gift. Notably, several colleges and universities supported the Connecticut Supreme Court's majority opinion through amicus briefs. Thus contracts for charitable gifts will not be enforceable in Connecticut unless they are drafted with extreme care, and in such a way as to, perhaps, vitiate the donor's tax deduction.[76] A similar rule has been laid down in an Iowa case, in which the settlor of a trust was prevented from suing to enforce the trust without having first reserved some interest in it.[77]

In another case, the residents of a nonprofit retirement community in Tennessee were prohibited from bringing either a derivative or a direct action against the nonprofit's board of directors.[78] The court held that the plaintiffs did not fit within the statutory requirements for bringing a derivative suit, and then proceeded to determine that a direct action for a breach of

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[75] *Herzog Foundation v. Univ. of Bridgeport*, 699 A.2d 995 (Conn. 1997).

[76] *See* Treas. Regs. §§ 1.170A-1(e), 1.170A-6(a), 1.170A-7(a) & (b).

[77] *Amundson v. Kletzing-McLaughlin Memorial Foundation College*, 73 N.W.2d 114, 116-17 (Iowa, 1955).

[78] *State v. Sundquist, et al.*, 1993 WL 166938 (Tenn. App.).

fiduciary duty could only be maintained by the corporation (or its shareholders) itself. The result is that even the well-defined beneficiaries of a nonprofit corporation do not have private standing to sue the charity's board of directors to enforce fiduciary duties. The court did, of course, permit the plaintiffs to bring a relator action on behalf of the state.[79]

The Supreme Judicial Court of Massachusetts has held that individual members of a church are not sufficiently interested in the charity to maintain an action to correct abuses in its administration.[80] "We have never held that membership in a public charity, alone, is sufficient to give standing to pursue claims that a charitable organization has been mismanaged or that its officials have acted ultra vires."[81] The court also held that, except where the plaintiff asserts an interest in the organization distinct from that of the general public, only the attorney general can bring an action alleging the misuse of charitable assets.[82] It is, however, difficult to understand why the members of a church would not stand in this sufficiently interested position.

Finally, the Supreme Court of Georgia has held that, although the relationship between a student and a college is contractual in nature, "a student . . . has no standing in court to challenge the act of the trustees or others in the operation and management of the college."[83]

It is worth noting also that in several cases, seemingly interested plaintiffs could not even

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[79]On relator actions, see *infra* notes 96-98 and accompanying text.

[80]*Weaver v. Wood*, 680 N.E.2d 918 (Mass. 1997).

[81]*Id*. at 923.

[82]*Id*. at 922-23.

[83]*Miller v. Alderhold, et al.*, 184 S.E.2d 172 (Ga. 1971).

compel the attorney general to bring suit on behalf of the state.[84]

These cases closely track a similar trend in public law whereby citizen's suits vindicating the public interest are difficult, if not impossible, to bring. Before the New Deal the Court began to abandon the private-law model of standing for Article III suits by recognizing that statutorily-created rights encompassed also the right to sue to protect those rights.[85] The New Deal initiated the shift toward limiting generalized standing in order to protect newly-created government programs.[86] By the late 1960s, however, the Court frequently granted standing to large groups based on the recognition of statutorily-created injury.[87] But the very tests delineated in *Data Processing*, of injury in fact and zone of interest, were used shortly thereafter to limit the ability of generalized groups to sue.[88] Finally in 1992 the Court invalidated the citizen's suit outright, thereby negating any prior moves toward generalized standing.[89]

Not only can a citizen not sue for injury befalling all other citizens, but neither can a member of a large subclass, say homeless people, sue for injuries befalling all members of the

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[84]*See, e.g., Ames v. Attorney General*, 124 N.E.2d 511 (Mass. 1955).

[85]*See The Chicago Junction Case*, 264 U.S. 258, 262-269 (1924).

[86]*See, e.g., Alabama Power Co. v. Ickes*, 302 U.S. 464, 479-80 (1938) (limiting the ability of competitors of regulated industries to sue).

[87]*See, e.g., Association of Data Processing Service Organizations, Inc., v. Camp*, 397 U.S. 150, 154 (1970).

[88]*See, e.g., Sierra Club v. Morton*, 405 U.S. 727, 734-735 (1972).

[89]*See Lujan v. Defenders of Wildlife*, 504 U.S. 555, 575 ff. (1992). *See also* Cass R. Sunstein, *What's Standing after Lujan? Of Citizen's Suits, Injuries, and Article III*, 91 MICH. L. REV. 163, 209 ("By far the most important and novel holding in Lujan was that Congress cannot grant standing to citizens. . . . Article III requires a concrete, particularized, actual, or imminent injury in fact . . . .").

subclass. In the nonprofit realm, something like generalized standing might take care of the problem of lax nonprofit oversight by giving entire classes of patrons the ability to enforce the duties of loyalty and care. But generalized standing would likely inflict sizeable costs on nonprofit entities:

> [S]tanding limitations occasionally have been relaxed in matters of public importance that relate to charities. The general rule, however, remains that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit trust, or a nonprofit corporation. Nor should any member of the public have standing to sue. The effects of a suit on a charitable organization are often more severe than those typically resulting for a business corporation or an individual. Publicity generated by the mere filing of the suit may dry up sources of funds. The reputation of the organization may never recover. Nevertheless, the enforcement problem remains, and abuses do occur.[90]

The resulting costs probably outweigh the benefits, particularly when one considers the problem of finding board members and directors to serve a nonprofit that may be prone to suit against itself and its board.[91]

Certain other prospective plaintiffs in the nonprofit arena will be accorded standing. Standing will clearly be granted, for example, where a director of a nonprofit corporation sues another director or brings a derivative suit. The New York Not-for-Profit Corporation Law permits such suits in order to enforce duties owed to the corporation by its directors or to redress

[90]Fishman, *supra* note 69 at 670-71. In a few well-known instances, courts have relaxed standing limitations sufficiently to grant standing to a large group of people. In one case, *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, et al.*, 367 F.Supp 536, 540-41 (D.D.C. 1973), *supplemented by* 381 F.Supp. 1003 (D.D.C. 1974), the court effectively granted standing to over 10,000 patients and former patients of a hospital. It is important to note that the court's language makes it clear that the fiduciary obligations of the directors run to the organization itself, and not directly to the beneficiaries, but also that the patients were sufficiently interested to bring suit to enforce those duties. *See Christiansen v. National Sav. & Trust Co.*, 683 F.2d 520, 528 (D.C. Cir. 1982).

[91]For a statute that provides an aggressive approach to derivative actions for nonprofits, see OFF. CODE. GA. ANN. §14-3-741.

an injury sustained by the corporation itself.[92] There is no doubt that a director has the requisite interest to bring such a suit, but such suits are very unlikely to occur. Likewise, members have standing to sue nonprofit entities in many states, though often with limitations. Charitable nonprofits, however, rarely have members.

Attorneys general, of course, have standing to sue nonprofit corporations. Since the 19th century the Supreme Court and inferior courts have consistently recognized the attorney general's power of enforcement.[93] In some states, still clinging to the earlier model, the attorney general possesses a nearly-exclusive power of enforcement over charities.[94] And many states have codified the attorney general's power, dispensing with the need to rely on 19th century common law doctrine.[95]

Some states have supplemented the attorney general's oversight by authorizing relator suits. These actions are usually brought by a party with a direct interest in a transaction (although in some cases the relator need not have any direct interest in the matter at all) in the name of the attorney general. But severe limitations undermine the relator's effectiveness. Relator actions can, in some instances, only be brought where the attorney general alone has the right to sue, for example.[96] The attorney general must consent to the suit, the relator must pay for costs recovered

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[92]N.Y. NOT-FOR-PROFIT CORP. LAW §720(b)(1) (1977).

[93]*See Vidal v. Girard's Executors*, 43 U.S. (2 How.) 127, 195 (1844). *See also, e.g., Collier v. Board of Nat'l Missions of the Presbyterian Church*, 464 P.2d 1015, 1018 (Ariz. Ct. App. 1970); *Commonwealth v. Barnes Foundation*, 159 A.2d 500, 505 (Pa. 1960).

[94]*See Dickey v. Volker*, 11 S.W.2d 278, 281 (Mo. 1928).

[95]*See, e.g.,* N.Y. NOT-FOR-PROFIT CORP. LAW §112 (1977).

[96]*See Brown v. Memorial Nat'l Home Fund*, 329 P.2d 118, 133 (Cal. App. 1958).

against the plaintiff, and the attorney general retains control over the suit.[97] Relator actions are, correspondingly, rare. At the same time, although relators are constrained by their own financial resources, they may be tempted to bring suits that are not in the public interest but from which they can expect a positive return.[98] Thus relator actions may help to improve attorney-general oversight, but they do not cure all of the problems inherent in attorney-general enforcement.

And these problems are difficult to overcome. "[M]ost states rely [exclusively] on the attorney general to enforce charitable obligations."[99] But to the extent that the public must rely on attorneys general to regulate nonprofits, regulation

> is likely to be sporadic, at best. 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. This often results in a necessarily selective prosecution of only the most egregious of abuses.[100]

The attorney general's office is often understaffed and underfunded, and it is manifestly more

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[97]These provisions are codified in California, for example, at CAL. CODE REGS. tit. 11, §§1-2, 6, 8 (1984).

[98]One commentator has noticed this exact behavior under the False Claims Act, which likewise allows (and encourages) relator-initiated actions: "[t]he combination of these factors [incentives for relator actions and the ability for relators to profit from them] results in increased incentives to file parasitic qui tam suits." Todd B. Castleton, Comment, *Compounding Fraud: The Costs of Acquiring Relator Information under the False Claims Act and the 1993 Amendments to the Federal rules of Civil Procedure*, 4 GEO. MASON L. REV. 327, 329 (1996).

[99]Blasko, et al., *supra* note 72 at 47. Some states, recognizing the problems of attorney-general enforcement, have shifted that power to other state officials, commissions on charitable enforcement, or district or county attorneys. *See, e.g.,* W. VA. CODE §29-19-3(a) (1966); N.C. GEN. STAT. §36A-48 (1991); ARIZ. REV. STAT. ANN. §44-6553B (Supp. 1991).

[100]*Id*. at 39.

concerned with more politically remunerative areas of law enforcement. It is also a highly political office, and the government's agenda with respect to enforcement of charitable obligations is unlikely to include detached matters of efficiency, and may reflect a political ideology inimical to the aims of certain nonprofits. The attorney general is the most important, and probably least well-equipped, source of enforcement in the charitable sector.[101] And though relator actions help,

[101] They do have one particular advantage over other forms of enforcement, however. The attorneys general may reflect the nation's policy concerns with respect to nonprofits. One reason attorneys general remain in the near-exclusive position to enforce charitable purposes is that, in part, doing so is seen to be in the public interest. Their status reflects the realization that beneficiaries in particular may lack the ability to enforce the obligations of nonprofits: a large, amorphous group of potential beneficiaries is unlikely to garner enough political or legal weight successfully to challenge the actions of a large nonprofit. The attorneys general are viewed as surrogates, maintaining the public interest in nonprofit activity by enforcing their charitable obligations to these beneficiaries.

> [t]he mere existence of relator status [] cannot eliminate all the ills of attorney general enforcement. The attorney general's decision to grant or not to grant relator status can be influenced by extraneous factors. The potential relator may be deterred by the expense of attorney's fees. Even more significantly, the limited resources available to attorneys general's offices makes investigation of relator's complaints and supervision of their suits difficult.[102]

III. Contractual Solution.

This large sector of the economy, ineffectively reined in by the nondistribution constraint and the fiduciary rules under corporate and trust law, and barely amenable to suit, is largely unaccountable to anyone. Fiduciary rules fail effectively to operate without enforcement and their enforcement against nonprofits is grossly inadequate. The nondistribution constraint fails effectively to constrain nonprofit managers because very few limits exist on nonprofit board members' salaries and on other financial matters, and because perquisites may easily be taken in manners which do not run afoul of the nondistribution constraint. In addition, control is hindered by the nonprofit form's inherent information asymmetries: "[t]hat is, by assumption information asymmetries prevent the public from judging the quality of the output. But if no one can judge quality . . . then by definition no one can earn a (justified) reputation -- and no nonprofit could lose it."[103]

As the foregoing discussion suggests, "donors [and philanthropists] of nonprofits have agency problems with internal decision agents similar to those faced by residual claimants in other

[102] *Blasko, et al.*, *supra* note 72 at 50. Note, however, that the use of relator suits does have an advantage over expanding standing in general: "An expanded use of relators to enforce the responsibilities of charitable organizations to the public would provide an appropriate balance between more effective regulation of charitable activities and the protection of nonprofits from nuisance litigation." Fishman, *supra* note 69 at 674.

[103] Brody, *supra* note 37 at 510.

organizations . . . where important decision managers do not bear a major share of the wealth effects of their decisions."[104] At the same time, "a nonprofit is on stronger footing in the competition for survival when it has a decision system that separates the management (initiation and implementation) and control (ratification and monitoring) of important decision."[105] As a corrective, Fama and Jensen note and approve of the existence of outside, perpetual boards of directors in which something like the "mores of nonprofit board participation" ensure board members' fidelity. They fail to address, however, the apparent need for control over nonprofit boards (apparent at least through the existence of strict fiduciary rules for nonprofit board members), and the implications for filling board openings if liability is actually an issue.

My solution to the donor-decision agent problem of nonprofit organizations increases oversight of nonprofit agents while simultaneously relying on the market to minimize the effects of a second-order agency problem. This solution calls for the creation of private, for-profit, monitoring companies (herinafter, "contract plaintiffs") that would contract with nonprofit entities for the right to sue them to enforce charitable obligations, fiduciary duties, and certain members' rights (like viewing corporate records). These companies would act, in effect, as private attorneys general.

The inclusion of a contract plaintiff in a nonprofit's organizational structure would effectively superimpose important elements of classical firm structure onto the nonprofit. That is, the contract plaintiff would have the financial incentive to overcome the agency costs of

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[104]Fama & Jensen, *supra* note 13 at 344. *See also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

[105]Fama & Jensen, *supra* note 13 at 344.

monitoring that are otherwise insurmountable in the nonprofit form. The contract plaintiff's interests would be aligned by contract with the principals of the nonprofit, and they would uphold the nonprofit's charter by monitoring for violations and enforcing the charter in arbitration or in court. And just like a for-profit corporation's board of directors and management, they would be subject to removal by the market for failing in their duties.

Contract plaintiffs would compete with one another for the right to contract with a given charity. Charities, in turn, would pay them for their services and retain control over the selection of the contract plaintiff.[106] The contract plaintiff's duties would include monitoring and determining the appropriateness of potential litigation, and the company itself would have the right, by contract, to bring suit.

The contract plaintiff's standing would arise from the terms of its contract with the nonprofit. The charity would agree both to pay the contract plaintiff a set amount for its services and, in effect restating the purpose clauses of its charter, to adhere to certain charitable conditions. The contract plaintiff would agree to monitor and enforce the terms of the nonprofit's charter. To the extent, then, that the nonprofit violated its charter, it would also stand in breach of contract, and the contract plaintiff would have standing to sue for specific performance.[107]

It is not unthinkable, however, that some judges would consider the inclusion of a

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[106]Because of the indeterminate extent of the contract plaintiff's activity and the corresponding opportunities for manipulation, this payment would likely have to be in the form of a retainer, rather than a performance-based payment for services. A contract plaintiff's market success would thus hinge almost entirely upon reputation.

[107]Specific performance would, presumably, always be available because it would be prohibitively costly to determine the market value of the performance of the nonprofit's unique charitable obligations. *See, e.g.,* Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978).

nonprofit's purpose clauses in the contract as merely an attempt by the parties to waive into court and avoid standing limitations. As long as the terms remain in the nonprofit's charter, a judge might consider them enforceable only by the attorney general or a director of the nonprofit, despite their inclusion in an otherwise legally-enforceable contract. In order to solve this problem, there is no reason why the purpose clauses of the nonprofit's charter could not be removed from it. The charter would contain appropriate language regarding the administrative aspects of the nonprofit's operation, as well as a purpose clause that would state, simply, "formed for any lawful purpose." Its specific purposes would be found only in the contract with the contract plaintiff. The charter would retain a clause requiring, as an administrative matter, that the nonprofit employ the services of a contract plaintiff, and that it utilize the terms of a particular contract in so doing. In this way adherence to the nonprofit's charitable purposes, as defined by the terms of its contract with the contract plaintiff, could be required by its charter, but also enforceable by the contract plaintiff as a matter of private law.

Monitoring and enforcement contracts would no doubt be long-term affairs in order to increase the cost to subsequent directors and officers of removing well-functioning contract plaintiffs. In the case of donative charities, where income is dependent on ever-renewing sources of funding, such an arrangement would cause few problems. The nonprofit would have to demonstrate continued adherence to its purposes, continued financial propriety, and continued monitoring by its contract plaintiff in order to reap the attendant reward of increased donations. Well-established charities, perhaps controlled by self-serving directors, might seek to collude with their contract plaintiffs in an effort to avoid enforcement of the organization's original charitable purpose. Though some subversion would certainly exist, this is an inherent risk when expanding rights to sue , a party being sued will seek to pay some amount up to the expected cost of the suit in order to avoid it.[108] But because this is a market-based solution, even the will to avoid the disruption of the status quo is checked by the competition for dollars: a donative charity that is perceived of as uncontrolled in the midst of well-controlled alternative charities will be at a competitive disadvantage for the scarce dollars that are given to nonprofits. "In the end, the same economic force motivates nonprofit firms as for-profit firms: the desire for a reputation as a worthy recipient of future trade . . . ."[109] Thus the contract plaintiff that fails to boost donor confidence will face the threat of diminished future business in the market, just as the poorly-controlled nonprofit entity itself will face the threat of flagging resources.

In the case of foundations, however, where funding is generally provided for at the nonprofit's inception, long-term contracts could result in indolence on the part of contract plaintiffs, thus allowing for deviation by nonprofit directors. But contract plaintiffs would continue to be constrained by their own profit motive. They would be beholden to their owners, and because their future business would be dependent on their well-established reputations, they would retain the incentive to monitor and enforce even absent the direct threat of removal by an existing client.

It may, of course, be overly optimistic to assume that nonprofits would implement such a plan themselves; there are too many cross incentives. In the first place, it is not unequivocally beneficial for nonprofits to be in a position to be sued. Though some amenity to suit is an

[108]Note, however, that in this context the expected cost of a suit may not be very high, given that a certain number of suits, even unsuccessfully defended ones, is necessary to preserve public confidence and to confer the attendant benefits.

indispensable aspect of engendering confidence in potential donors who otherwise lack control over the money they give, nonprofits will certainly fear excessive suits. And as is the case with any expansion of the rights of parties to sue, there is an increased likelihood of frivolous or vexatious suits. Yet there is little doubt that nonprofits lack suitable control as they now stand. Recent high-profile debacles such as those at Adelphi University,[110] New Era,[111] the United Way,[112] and PTL Ministries,[113] highlight the potential for more, seemingly-justified suits. It is possible, of course, that state legislatures might require nonprofit corporations to include a provision in their charters providing for a similar type of service. Assuming that the legislatures do not meddle in the mechanics of the plan (perhaps a vain hope), mandating the use of contract plaintiffs by statute would not be objectionable -- it would, in effect, merely be an attractive adjunct to the fiduciary rules of corporate and trust law.

At least one example of an arrangement similar to the one I am advocating exists today. The Roe Foundation's *Application for Amendment of its Eleemosynary Charter* provides that "no grant shall be made [by the Roe Foundation] to any organization . . . whose activities or public statements reflect a belief in a collectivist world view or any view inconsistent with those set forth

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[109]Brody, *supra* note 37 at 461.

[110]*See* Bruce Lambert, *New York Regents Oust 18 Trustees from Adelphi U.*, N.Y. TIMES, Feb. 11, 1997 at A3.

[111]*See* Karen W. Arenson, *Bankruptcy Case May Cost Charities Heavily*, N. Y. TIMES, May 16, 1995 at A4.

[112]*See* David Cay Johnston, *United Way, Faced with Fewer Donors, Is Giving Away Less*, N. Y. TIMES, Nov. 9, 1997 at A6.

[113]*See Donors to Bakker Got Nothing*, N. Y. TIMES, Nov. 15, 1992 at A

[elsewhere in the charter].”[114] It further provides that “[a]ny violation of paragraph A of this article [quoted above] may be challenged in any state or federal court having jurisdiction over the matter by The Mont Pelerin Society, The Philadelphia Society, or any Director of the Corporation.”[115] The dynamics differ somewhat from those of my proposal, but the impetus is the same. In this instance the Mont Pelerin Society and the Philadelphia Society would act as private attorneys general, empowered to sue the foundation for breach of its charitable purposes.[116]

In the for-profit context, at least one entrepreneur has proposed the creation of somewhat analogous corporate monitoring firms. These organizations would be chosen by a company’s shareholders (as required by a suitably-amended corporate charter) to nominate director candidates. Presumably this would provide both corporate management and directors with an additional incentive to behave in shareholders’ interests (or raise the cost to them of defecting from shareholders’ interests) by increasing the amount and effectiveness of shareholder monitoring of the board of directors. Such an intermediary would be beholden to the profit motive and concerned for its reputation, and would thus expend resources to identify and nominate appropriate directors. The corporate monitoring firm, like the contract plaintiff, would help to ameliorate the effects of the agency problem occasioned by the separation of ownership

[114]Roe Foundation Application for Amendment of Eleemosynary Charter, The State of South Carolina, County of Greenville, Art. 5, §A (on file with author).

[115]*Id.* at Art. 5, §B.

[116]It is, of course, another matter entirely whether the organizational charters of these nonprofits would permit them to bring such suits, or to act in this capacity. Furthermore, the use of another nonprofit organization as the contract plaintiff merely attenuates the problems wrought by insufficient market control of the nonprofit sector. While such a set up would, doubtless, have some benefits to the Roe Foundation, the dynamic is a fragile one.

and control by insinuating an independent, competitive monitor between a corporation's relatively uninformed and rationally complacent owners and its rent-seeking managers.[117]

The effect on a nonprofit from utilizing a device comprising the incentive to monitor and the capacity to litigate would be greater accountability for its directors and managers. It is important to note, however, that along with increased accountability would come a concomitant difficulty in encountering willing participants to serve on nonprofit boards. Under the status quo it is unlikely that a board member would ever be sued.[118] If contract plaintiffs stand in a position to bring suit, however, this would certainly change. And even now, with little likelihood of a suit, board members are fearful of lawsuits; they would only be more so if the risk were actual.[119]

But the specter of greater difficulty in finding willing board participants, while worthy of consideration, is probably insufficient to answer the most salient question: if the idea is such a good one, why do we lack such contractual arrangements now? An appealing aspect of this proposal is that it can be freely adopted; that is, it is a solution based in contract, the incidence of which requires no special governmental mandates or legislation. And yet apparently nonprofit

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[117]*See* Mark Latham, *The Corporate Monitoring Firm*, forthcoming in *Corporate Governance -- An International Review*, January, 1999, (visited February 12, 1999) available at <http://www.corpmon.com>.

[118]Swords, *supra* note 39 at 168-169 (noting that "rarely will one board member sue another," and that the attorney general's office "brings suits against board members only where there has been criminal, near criminal or the most exacerbated circumstances . . .").

[119]*Id.* at 167 ("Individuals . . .who serve on the boards of nonprofit corporations continue to be concerned about becoming personally liable for claims arising out of their stewardship, and the difficulty of obtaining Directors and Officers (D&O) liability insurance to cover that liability."). D&O liability insurance would also only be available for breaches of the duty of care, and not for breaches of the duty of loyalty.

corporations have not decided to adopt such plans on their own.[120]

One explanation is that the market for charitable contributions is simply not as efficient as stock markets, which force firms to adopt efficient arrangements in order to attract capital. Although efficiency and constancy are doubtless desirable in the charitable sector, they are hard to come by where market limitations on managerial abuses are weak and where rent seeking by nonprofit managers provides them with positive returns. In such a market there is a real collective action impediment to the adoption of any efficiency-enhancing mechanism, but there is a particular impediment to the adoption of a mechanism, like this one, that relies on relatively widespread use to assure its efficacy.

Another reason may be that, as noted above, such a plan would likely increase the amount of litigation leveled against a nonprofit, at least initially. The intent of the proposal is, of course, to augment the accountability of nonprofit corporations by overcoming agency costs, in turn by artificially creating and positioning an entity with the incentive and the ability to monitor and litigate. On one level nonprofit managers and directors would oppose greater accountability: insofar as individuals within nonprofits are able to benefit privately or subvert their charitable purposes to their own ends because of a lack of controlling litigation, they would not likely favor such a plan. In the long run, however, greater accountability is demonstrably beneficial for any nonprofit, or at least for the objects of its charitable activities.

Nonprofit entities (and, importantly, individuals within those entities) exist and thrive only to the extent that they are able to secure donations, contributions, and memberships. But, as I

[120]With the exception, that is, of the similar Roe Foundation proposal. I can only assume that similar proposals have surfaced elsewhere, but they are certainly not the norm.

have noted, it is in the nature of nonprofits that nearly all donors (and many beneficiaries) are unable to control or even observe the disposition of the corporation's income. In the case of a charity like the Red Cross, for example, money spent to buy blankets in Uganda is not readily verifiable by donors. Because there is no monetary return on the contribution, there is no easy mechanism by which to monitor the efficacy of the nonprofit's activities. And because, unlike in the for-profit setting, donors are concerned not with the bottom line, but are concerned instead with the specific disposition of their donations, they will make smaller donations to the extent that they cannot be assured that the money will be put to its intended use.[121] It is for this reason that nonprofits are held to the nondistribution constraint: people are more secure in their donations if they know that money cannot (legally) be siphoned off for personal use or simply used to make more money.[122]

But the nonprofit form, without monitoring or the opportunity for litigation, cannot effectively provide assurances of fidelity. The nondistribution constraint alone, while it contributes to the public's confidence in nonprofits, is insufficient substantially to assuage fears of impropriety or mismanagement.[123] Insofar as a nonprofit has a fiduciary duty to its patrons, this duty can only be enforced if the patron (or his agent) has the power to punish the nonprofit for

[121] "Because the patron has no contact with the intended recipients, he or she would have no simple way of knowing whether the promised service was ever performed, much less performed well. Consequently, the owners of the firm would have both the incentive and the opportunity to provide inadequate service and to divert the money thus saved to themselves." Hansmann, *supra* note 7 at 505.

[122] "The advantage of the nonprofit form . . . is that it makes the producer a fiduciary for its purchasers, and thus gives them greater assurance that the services they desire will in fact be performed as they wish." *Id.* at 504.

[123] *But see* Hansmann, *supra* note 4.

perceived violations. Nonprofits, then, should favor the ability to be sued in order that they may provide some assurance of propriety to potential donors, and thereby persuade those potential donors to become actual donors.

Of course a divide exists between the interests of newly-formed charities and their long-extant counterparts. While the founder of a new nonprofit will be willing to incur a greater risk of litigation in order to ensure longevity and preserve his original purpose, the trustees or board members of a long-standing nonprofit may have already forsaken those interests, or may not be seeking new contributions. A significant impediment to the adoption of this plan, therefore, would be the hostility of present directors of well-established charities. These are the people who are most likely to bilk the charity or seek to alter its charitable purpose to suit their own ends or, less nefariously, their own charitable goals. But, as previously noted, they, too, are in competition for scarce dollars. Ultimately the risk of losing charitable donations and, consequently, salaries and even jobs, should mitigate the inclination to avoid accountability, and should make even these established charities amenable to the scheme.[124] A further, related, impediment may be the fact that even honest directors of nonprofits may still be negligent or not detect either the indolence or greed of their officers. Such directors would not, at first blush at least, be inclined to choose a stiffer liability regime for themselves , they might reasonably prefer declining contributions.

The contractual arrangement I have suggested here strengthens the checks on nonprofit

[124]At any rate, even if existing charities do not freely adopt such a structure, it will gain credence among donors, members, and the public as new nonprofits adopt it, and may even force existing charities to conform.

directors and managers by securing greater control for donors and beneficiaries, tempered by the forces of the market.[125] But still we do not observe such relationships in practice. In addition to the pessimistic rationales given above (that self-dealing within nonprofits is enabled by the lack of litigation, and that self-dealers are disinterested in augmenting their accountability), another explanation may lie in the belief that the status quo is acceptable as it stands. The difficulty in overcoming the associated collective action problem may provide some explanation for the absence of such relationships. Certainly, much of the efficacy of the system arises from its market characteristics. Thus inaugurating such a system may initially result in few gains over existing levels of accountability as donors may not have confidence in the system until it is well-established, and there will be no market to ensure its effectiveness.[126]

Yet another possible explanation is simply the rational fear of increasing litigation. But the system I have outlined, particularly when contrasted with merely expanding standing rights

[125]Note that giving beneficiaries some effective control over nonprofits does not stem from the need to provide them with the incentive to become beneficiaries, of course. Instead, it contributes to the assurances provided to donors, for who better than the potential beneficiaries themselves to judge the adequacy of the services provided. Presumably a donor will be more secure in his donation if he knows potential beneficiaries will have the ability to ensure that his money is used properly.

[126]As the example of the Roe Foundation's amended charter demonstrates, some charities are engaging in a similar sort of contractual solution. Not surprisingly, the "contract plaintiff" in that instance is another similarly-ideological nonprofit. Because there is no market yet for a service like the one I am advocating here, it is necessary for credibility and to engender the requisite public approval that the right to sue reside with a respectable, ideologically similar entity, especially another nonprofit. The Mont Pelerin Society and the Philadelphia Society are organizations dedicated to the promotion of liberty and free markets. Both are primarily comprised of well-respected academics and professionals, the boards of which represent the most conscientious of these people. Thus, for the conservative Roe Foundation to rest the right to enforce its charitable provisions in those bodies ought to instill confidence in potential donors, except to the extent that the Mont Pelerin Society and the Philadelphia Society may have neither the incentive nor the ability to engage in effective monitoring.

against nonprofits, should effectively contain the level of litigation at a market-determined level. On the one hand, contract plaintiffs will want to exercise restraint in order to placate fears of excessive litigation. Thus in courting nonprofits for business, contract plaintiffs will demonstrate careful control over the character and extent of the litigation they bring. At the same time, they will exercise judicious consideration in an effort to avoid frustrating the purpose for which they were created in the first place , ensuring the efficient and proper application of the nonprofit's purpose. Thus a contract plaintiff that made a practice of not bringing any suits would not likely be hired by a philanthropist looking to protect his charity after his death. Likewise, a nonprofit that did hire such a company may fail to benefit from increased accountability if the donating public became aware that the contract plaintiff was not diligently exercising its contractual obligation. The desired result would be a level of litigation that lies somewhere between the amount that the public requires to see that the contract plaintiff is doing its job and the amount that the nonprofit requires in order to preserve its original purpose and assure the public of its propriety without litigating itself out of existence.

Similarly, the absence of a contractual enforcement mechanism may arise from a misunderstanding about the extent of control the system would allow. If a wealthy philanthropist wishes to establish a charitable trust for the purpose of fostering education in and promotion of liberty and free markets, for example, he also wants to ensure the continuation of his charitable purpose after his death. He might fear that a system like the one outlined here would expand standing so much as to enable savvy parties (or savvy attorneys) to turn his trust from its original purpose and compel it to give money to environmental causes and National Public Radio.[127] In fact, exactly the opposite should occur.

Once a market is established for providing the service of suing nonprofit corporations, concern for reputation and the profit motive will form contract plaintiffs into protectors of the original charitable purposes of nonprofit entities. At a foundation's inception the philanthropist will secure the services of a contract plaintiff that he hopes will not bring unwarranted suits against the foundation or those that would serve to frustrate his original purpose. By competing with each other for future business, contract plaintiffs will be forced to establish and live up to a reputation for preserving the original character of charitable nonprofits. Rather than contributing to the destruction of a foundation's original purpose, the contract plaintiffs should function to secure that purpose.[128]

A final concern with the system outlined here is that of collusion between contract plaintiffs and nonprofits. Until now I have addressed the efficacy of contract plaintiffs based on their decision to bring suits and the appropriateness of those suits. But there is, of course, another component to any suit: the likelihood of success. One can certainly conceive of contract plaintiffs and nonprofits colluding not only to bring fewer suits, but also colluding merely to influence the outcome of a suit. In this manner the contract plaintiff may be able to claim that it

[127]Such is, evidently, exactly the nature of the history of the Pew Charitable Trusts. *See, e.g.,* Robert Holland, *A Pew View of Agenda-Setting, Paid-For Media in Tow*, RICH. TIMES-DISP., October 30, 1996 at A17

[128]Both the nonprofits and the contract plaintiffs will, of course, still have recourse to the *cy pres* doctrine. Thus either entity could safely alter the organization's charitable purpose when the original purpose was frustrated. Competition will prevent the doctrine from being abused; it will not prevent it from being used at all.

effected its role in bringing and litigating the suits, while the nonprofit can likewise claim that it is effectively monitored. Perhaps most important, the nonprofit can also claim to have won these suits, thereby falsely demonstrating its adherence to its charter or its proper management of funds. This is likewise a problem endemic to both derivative suits and class actions.

For the public, the trouble with this type of collusion is the difficulty in observing it. This, in turn, renders market forces relatively impotent. In such an instance there may be a continued role for the attorneys general (and even the Department of Justice). The fear of collusion is probably not unwarranted. As noted above, there are currently many officers in nonprofits who enjoy their perquisites and who have a great interest in maintaining a low level of accountability. These individuals may be expected to attempt to thwart the system. But this is not a complaint against the system itself. Implementing more accountability, despite imperfections in enforcement, makes it more expensive for malfeasant managers to abuse the system, and thus would deter some of their aberrant behavior. In addition, institutions presently exist in order to deal with fraudulent behavior. The costs incurred by them in policing this type of collusion will certainly be less than the offsetting reduction in the cost of policing nonprofits in toto.

Furthermore, the market will tend to deter even this type of collusion; it will reward those contract plaintiffs that can credibly purport not to collude, even where detection is unlikely. Thus some contract plaintiffs will put up bonds or publicly advertise their honesty as a means of binding themselves to behave appropriately. Bonding (and likewise, advertising[129]) creates an incentive for both the owners of the contract plaintiff (probably its partners, but conceivably the public) and

[129]For a very brief discussion of the way in which companies use advertising as a form of bonding, see ARMEN A. ALCHIAN & WILLIAM R. ALLEN, EXCHANGE AND PRODUCTION;

other market participants to engage in yet another level of monitoring. The owners will monitor to minimize the risk that their residual claim will be dissipated by the loss of the bond, and other contract plaintiffs will monitor in order potentially to capitalize on the market advantage of exposing the callous deceit of their competitors. It is worth noting that in a market that evolves the need for bonding as a requisite for entry, the cost of entry into the market will rise somewhat. It should only marginally deter under-capitalized, start-up monitoring companies, however, and should not sufficiently increase the cost of entry to make the market inefficient.

Beyond enabling the effective monitoring of charitable entities, there is a further efficiency rationale for this type of contractual standing: its ability to centralize claims against nonprofits. Beneficiaries and donors of any given charity are a diverse group of people. It is difficult for them to overcome the collective action problem inherent in bringing effective, broad-based suits against nonprofits. By centralizing all suits in a contract plaintiff whose interests are essentially aligned with those of a nonprofit's beneficiaries and patrons, the contract plaintiff can effectively give voice to otherwise prohibitively costly complaints, and can even act as a clearinghouse for the disparate claims brought against the nonprofit.

A model for this sort of centralization exists in the institution of bond indenture trustees. Prior to the advent of class action suits (and even since, given their cost) it was difficult for bond holders to enforce the terms of indenture agreements against the issuers. Bond holders, like beneficiaries, are a diverse group, and the costs of organizing are quite high. To counteract these problems, bond indenture trustees, usually banks, came into existence. As the name implies, the trustee acts in trust for all of the bond holders to enforce the terms of their indentures. By

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COMPETITION, COORDINATION AND CONTROL 278 (3d ed. 1983).

centralizing this function, enforcement became not only possible, but also more efficient. Though unlike in the nonprofit sector, bond holders would clearly have retained the right to sue the issuer for breach, the difficulty in bringing such suits made them rare. Just as in the bankruptcy arena, centralization of standing in the nonprofit sector can increase efficiency and provide for more effective enforcement. Most important, the competition for business between contract plaintiffs (and bond indenture trustees) ensures that the interests of the beneficiaries (and bond holders) are well served.

Finally, it is important to be cognizant of the costs of implementing such a system, and more specifically, how these costs will affect small charitable organizations. Some of the costs have already been noted: increased defense costs (whether in arbitration or litigation), the contract plaintiff's fee, and the increased cost of finding willing board members. These costs are not insignificant; nor are they insuperable. In the first place, if contract plaintiffs are able to make nonprofits run more efficiently, the system will pay for itself. The threat of punishment ought, in principal, to be sufficient to deter malfeasance, and thus, in an ideal world, the defense costs would be zero. Because the system is not frictionless, because, of course, agency costs will remain, the cost will never reach zero. However, the savings in reducing financial waste should effectively offset the cost of mistakes. If the contract plaintiffs are successful in engendering confidence among donors, their fees will be covered through increased donations. And though board members will be subject to more scrutiny, the contract plaintiffs will filter the majority of vexatious litigation. Non-vexatious suits ought not be deterred, and the cost of these in alienating potential board members is simply a necessary operating cost for a well-functioning nonprofit.

All of this does raise the corollary question, however, of how much money nonprofits should spend on operating costs given that every dollar spent on administration is a dollar not spent directly on charity.[130] Closely related to this is the question of what small charities should do if the costs of preventing abuses is close to 100% of their budget. There is no simple answer to the first question. Nonprofits have diverse organizational structures, goals, and inputs; we should not attempt to impose on them a generally-applicable financial rule. Contract plaintiffs would themselves provide a measure of financial monitoring, and although on the issue of their own fees we might expect some divergence from patrons' interest, the market will serve to cap those administrative costs. Thus my proposal allows for the determination of appropriate administrative expenditures on an individuated basis.

To the second question, the simplest, and most glib, answer is that they should close and their donations should go elsewhere , this is what happens in the for-profit world when a company is inefficient. But in the nonprofit world the answer is not so obvious. Small charities often support unpopular or unseemly causes. It would appear unacceptable if the marginal cost of deterring abuse under this regime (abuse which does not necessarily exist in all nonprofits) were greater than the marginal benefit to the nonprofit, and so priced these nonprofits out of the market. One possible solution would be for small nonprofits to share the costs of monitoring, or

[130]In part because it is relatively easy to observe, and in part because it functions as a (weak) proxy for efficiency, monitoring of nonprofits' administrative costs as a percentage of expenditures is quite prevalent. And it is a relevant concern. It is not, however, the most important. Such monitoring cannot effectively demonstrate the effectiveness of the nonprofit in attaining its charitable goals. It fails to reveal what percentage of administrative costs are being misappropriated. And it discloses nothing about the specific disposition of donors' dollars, particularly with respect to their own idiosyncratic intentions. It is relevant to a particular nonprofit's financial viability, and is therefore of some importance, but it is doubtless not as important as its proponents suggest.

for certain contract plaintiffs to facilitate their fiscal union in order that they may more easily share these costs. On the other hand, small nonprofits simply may not need the services of contract plaintiffs. The local, independent abortion clinic does not likely compete for the same dollars as the United Way, and financial impropriety is far less likely in such a nonprofit. Small, localized nonprofits will tend to attract mainly volunteer, ideologically-motivated workers and local donors. They present a small, close environment in which social norms likely play a significant role in restraining aberrant behavior. Monitoring is correspondingly undemanding. And the returns from the risk-taking of financial self dealing are diminished where the stakes are so limited.

Ultimately my proposal would make nonprofit directors, trustees, and officers accountable to their donors, founders, and beneficiaries. In the current state of affairs, agency costs have eroded anyone's incentive to monitor, and standing rules have eroded the ability of the courts to exercise judicial oversight. Predictably, malfeasance has occurred. My contractual proposal would ensure that nonprofits are monitored, that the courts (or alternative fora) are able to enforce fiduciary rules, and that nonprofits operate under a rule of law. But importantly, it will do so without causing the advent of excessive frivolous suits and without undue concern for political ramifications. Other proposals cannot successfully make those claims. It is to these proposals that I now turn.

IV. Other Proposals For Reform and Their Shortcomings.

A. Expanded Use of the *Cy Pres* Doctrine , Restricting the Nonprofit Sector.

The first, and perhaps most obvious, proposal for reform in the nonprofit sector is to restrict the size of the nonprofit sector itself by expanding the use of the dead hand rule.[131] Expanding use of *cy pres* would have three major effects: first and foremost, it would limit the size of the nonprofit sector by discouraging the creation of nonprofits and by suggesting the creation of nonprofits with rigid, and relatively short, time horizons. Second, it would limit the ability of deceased benefactors to continue to tie a charity to a purpose that may have outlasted its time. Although the greater problem lies with subsequent trustees deviating from the initial intent of the charity, strict continued adherence to obsolete initial intents continues to be a problem.[132] Finally, it would have the effect, at the margins, of disabling future trustees and management from merely following the traditional purposes of their nonprofits and ignoring significant societal changes. Though I do not doubt that expanding *cy pres* would have some beneficial effects (most notably in removing a powerful excuse from the hands of future trustees who use adherence to traditional purpose as an excuse for their continued, but unwarranted, positions), its costs outweigh its benefits. First of all, expanding *cy pres* would probably have little effect on those nonprofits organized as nonprofit corporations , it can generally reach only nonprofits organized as trusts.[133] Second, although it would remove some control from the hands of future trustees, it

[131] *See, e.g.,* Roger G. Sisson, Comment, *Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of* Cy Pres, 74 VA. L. REV. 635 (1988).

[132] For a recent, and already classic, example of this problem, see *In re Estate of Beryl H. Buck*, No. 23259 (Cal. Super. Ct. Filed Jan. 30, 1984). For somewhat less expansive, although still permissive, interpretations of the *cy pres* doctrine, see, for example, *Blumenthal v. White*, 683 A.2d 410 (Conn. App. 1996); *Campbell v. Board of Trustees of the James Barry-Robinson Home for Boys*, 260 S.E.2d 204 (Va. 1979).

[133] There is, however, some dispute on this point. *See, e.g.,* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 489 (1996). *But cf, e.g.,* John D. Colombo*, A Proposal for an Exit Tax on Nonprofit Conversion Transactions*, 23 J. CORP. L. 779, 784, n. 29 (1998)("*Cy pres* principles are applicable to both charitable trusts and charitable

would also remove control from the deceased, original trustee. In so doing, the expanded use of *cy pres* would reduce the incentives for wealthy, would-be foundation creators to create those foundations in the first place: "[a]ny limitation . . . will reduce the value of the charitable bequest both absolutely and in relation to an alternative devise."[134] It is impossible to say ex ante whether it would be better for all charities to be limited in duration or not. A charity that operates under a term limit will eventually face problems finding good management , who will want to operate the organization during its last years?[135] Further, expanding *cy pres* would actually do little to give greater control over nonprofits to anything resembling market forces. While future trustees would no longer have the excuse cited above, they would also be granted greater ability to alter trusts without adherence to their intended purposes, and they would be better able to convert any profits to their own benefit. A supposedly controlling standard for the use of *cy pres* like that of charitable efficiency would do little to deter trustees, particularly if they are given considerable deference (as they are) in defining efficiency. And as we have seen, charitable efficiency, especially when measured in terms of charitable output, is a uniquely vague concept.[136] Finally,

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corporations."). In *Alco Gravure, Inc. v. Knapp Foundation*, 479 N.E.2d 752 (1985), the New York Court of Appeals held a nonprofit corporation to "quasi-cy pres principles" before it could ammend its articles of incorporation. It is important to note, however, that the New York Not-For-Profit Corporation Law expressly incorporates a "quasi-cy pres principle." *See* N. Y. NOT-FOR-PROFIT CORP. LAW §§ 513(b), 522, 1005(a)(3)(A) & 1008(a)(15) (19xx).

[134]*Brody, id.* at 491. *See also* Daniel Webster's brief for the college *quoted in Dartmouth College v. Woodward*, 17 U.S. 518, 599 (1819) (warning of the ill effects of allowing the legislature to alter a charitable corporation's charter).

[135]*See, e.g., Tax Reform Act of 1969: Hearings Before the Senate Comm. on Finance*, 91st Cong., pt. 1, 676-77 (1969).

[136]On *cy pres* reform generally, see Rob Atkinson, *Reforming* Cy Pres *Reform*, 44 HASTINGS L. J. 1111 (1993).

broad use of *cy pres* would provide a means by which activist courts, in collusion with directors no longer in sympathy with a founder's purposes, could subvert unpopular purposes , an outcome surely to be discouraged.

B. State or Federal Review Boards.

Another proposal would create, at either the state or federal level, review boards whose sole purpose would be to regulate the functioning, financial dealings, and outputs of nonprofit activities.[137] In some jurisdictions similar boards already exist. In New York, for example, the Board of Regents exercises control over New York colleges and universities, and retains the ability to remove some or all of a university's trustees for mismanagement or neglect of duty.[138] Umbrella groups exist as well. Although they do not possess statutory authority, they do exert some degree of oversight.[139] The problems with utilizing these groups are similar to the problems inherent in attorney general control over nonprofits. On the one hand, such review

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[137]See, for example, the proposals for self-regulation contained in Peter Swords, *Tax-Exempt Charitable Organizations: Study Outline*, SB30 ALI-ABA 201 (1996).

[138]Recently the Board of Regents removed the President and most of the Board of Trustees at Adelphi College in New York for mismanagement and conflict of interest. But this measure is rarely used (only three times in the last 80 years). Other states have the ability to revoke a college's charter, but this has never been done. See Joseph Berger, *Law Lets Regents Punish Leaders, Sparing Colleges,* N.Y. TIMES, Feb. 7, 1997 at B1.

[139]In some cases, their monopoly status imbues them with something very much like statutory authority, however. The American Bar Association operates to regulate nonprofit behavior, for example, and it does so with nearly unimpeachable authority. (*Nearly* unimpeachable because of the current DOJ investigation for antitrust violations. On the cartel-like behavior of the ABA, see George B. Shepherd & William G. Shepherd, *Scholarly Restraints? ABA Accreditation and Legal Education*, 19 CARDOZO L. REV. 2091 (1998).) More general nonprofit watchdog and promotion groups also exist including Independent Sector and The Center on Nonprofits and Philanthropy at the Urban Institute.

boards could control too much. With the ability to set salaries, determine output and results, and control finances, they are bound to be terribly inefficient, as all nonprofits, even those which come under one umbrella, will have different specific requirements. The ability of a central rule-making authority to deal effectively with these disparities is questionable even to the point of impossibility. Centralized standards are bound to have needlessly disastrous effects on the margin, even regulating some charities out of existence.[140]

On the other hand, the negative effects of these review boards would probably be tempered by the same limitations that plague the attorneys general now. Monetary and time constraints would certainly exist, and politics would inevitably enter the equation to such an extent as to forsake efficient control for more political concerns.[141] Likewise, if review agencies were accreditation agencies, nonprofits might be forced to sacrifice estimable and well-executed goals in order to satisfy requirements of accreditation only cursorily related to those goals. "An organization seeking accreditation might make major structural sacrifices, perhaps reflecting a power struggle over the accreditation body itself."[142] While the creation of independent review

[140]When, between 1960s and 1980, many states and municipalities attempted to impose fund-raising limits on charities, the limits did ensure that most donations were used for charitable purposes. "Unfortunately, fund-raising limits had other, much less desirable consequences. Stringent fund-raising limits threatened the existence of advocacy groups and charities that promoted unpopular or fringe causes." Leslie G. Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 S. CAL. L. REV. 605, 606 (1991). The Supreme Court abolished state-mandated fund-raising limits for charities in *Sec'y of State v. Joseph H. Munson Co.*, 467 U. S. 948, 959-68 (1984), but such limits could very likely be imposed by private accreditation agencies.

[141]*See* Fishman, *supra* note 69 at 671 (arguing that few people see additional governmental controls as beneficial in curing any social ills).

[142]Brody, *supra* note 37 at 525 (noting also that law schools "must meet several objective standards, not all of which bear on the quality of education" in order to obtain ABA

boards might have the effect of enabling more monitoring of nonprofits, it would fail to overcome the primary problem inherent in the nonprofit form: the absence of residual claimants. The mere creation of an independent monitoring agency would be insufficient if the proper incentives were not also simultaneously created.

C. Expanded Standing.

In addition to the problems already noted with expanded standing (vexatious suits, frivolous control), one further point should be considered. Information asymmetries, a root cause of the problems in the nonprofit sector, would not be overcome merely by expanding standing. New prospective litigants would still find it too costly to overcome this asymmetry, and the lure of large settlements might induce them to bring suits where they perceive even the most minute transgression, even without first obtaining necessary, but costly, information.

> The public appears uneducated about the fiscal needs of charities, as many people express surprise that nonprofit managers are paid at all and reveal ignorance of charities' productive demands. The public seems less inclined, not more, to become involved in collective activity. A public that does not understand cost constraints cannot perform effective oversight.[143]

Broadening standing would not likely improve the public's general ignorance about the financial needs of nonprofits. Furthermore, it would not serve significantly to alter the public's incentives: whereas shareholders in a for-profit corporation have strong monetary incentives to exert some control over the operation of the corporation, donors are less concerned with financial efficiency. Donors generally have less at stake, and are therefore unlikely to find it cost effective to exert

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accreditation).

[143]Brody, *supra* note 133 at 502 (footnotes omitted).

control, even where it is easier for them to do so.

A related point is that extremely broad standing rules further open all board and managerial actions, even salutary ones, to the threat of suit. They would thus make the basic functioning of nonprofits concomitantly more expensive. While this expense would be substantially tempered by donors' disincentives to monitor, even a marginal cost increase might be unfortunate insofar as it would chill legitimate actions by nonprofits and their boards, at perhaps greater marginal cost than the corresponding benefit of chilling illegitimate ones.[144]

D. Non-Stakeholding Voters.

Some commentators have proposed that nonprofits create non-stakeholding "shareholders" without monetary interests in the corporation.[145] This idea suggests that these "shareholders" would retain a voting interest, exert an extra level of control, but that they would do so without owning shares in the organization. Similarly, nonprofits might accord "member" status to certain donors, consumers, and sponsors. "Members' rights should include improved access to information about organizations, a power to vote (with a weight proportional to contributions) for the board of directors and on matters of great importance, and legal standing in court to challenge mismanagement."[146] But these non-stakeholding voters would lack the

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[144]On the economic effects of expansive standing, see Clifford G. Holderness, *Standing*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (forthcoming, 1999), *available at* <http://www.ssrn.com/papers/9811/98110504.pdf>. *See also*, Jensen, et al., *supra* note 49.

[145]*See, e.g.,* Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393, 408-410 (1994).

[146]Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public*

financial incentives to exert thorough control over their organizations, and, in some (but doubtless not all) instances, would provide seemingly disinterested support for otherwise questionable activities by a charity's officers or directors.[147] Further, in the continued absence of market forces, there is little reason to believe that these "members" would act any more appropriately, or any more effectively, than existing boards of directors. Although the solution appears to be a sound one, because it leaves out the powerful force of the market it would likely fail to achieve any significant increase in control over nonprofits.

E. Bifurcated Boards of Directors.

Professor Fishman, in his article, *The Development of Nonprofit Corporation Law and an Agenda for Reform*,[148] recognizes existing problems in nonprofit law, and proposes a bifurcated board of directors to correct them. Half of this board would act as advisors only, having no control over the daily functioning of the corporation, while still retaining the ability to sue on behalf of the corporation. Although the idea stems from a concern for the supervision of nonprofits, his plan does nothing to avoid the attenuated agency problem of nonprofit control. The same incentives (the desire for perquisites, for example) that impel current nonprofit board

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Policy Towards Nonprofit Organizations, 104 YALE L. J. 731, 735 (1994).

[147]*See* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991) ("The recent wave of nonshareholder constituency statutes gives undesirable leeway to incumbent management to rationalize dubious or arbitrary corporate strategies that reduce the overall value of the firm on the suspect grounds that some nonshareholder constituency will benefit."); Carney, *supra* note 2 at 920-21 (noting that "other constituency" statutes lead to the "erosion of shareholders' property rights to insist that agents act only within specified bounds").

[148]*Supra* note 69.

members to forsake the interests of the corporation for their own interests would apply to this advisory board as well. Without market control, any board, advisory or otherwise, is unlikely to act consistently in the public's or corporation's best interest. A market-based solution is preferable as the market can ensure public interested actions where even a wholly independent board cannot.[149]

F. Statutory Reform

Professor Hansmann, in his article, *Reforming Nonprofit Corporation Law*,[150] suggests an elaborate scheme of statutory modifications aimed at reforming the nonprofit sector. He suggests, with varying degrees of intensity, imposing stricter statutory financial controls,[151] expanding patron and even beneficiary standing,[152] further restricting[153] or regulating[154] the permissible activities of for-profit corporations, imposing some sort of financial disclosure requirement,[155] and imposing tougher fiduciary rules.[156] Such a scheme of largely statutory

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[149]While it is impossible to bring full market forces to bear on nonprofits (there will never be a market for corporate control in the nonprofit realm), the imposition of something resembling firm structure onto a nonprofit will result in significant market oversight.

[150]*Supra* note 7.

[151]*Id.* at 522.

[152]*Id*. at 608-12.

[153]*Id*. at 547-48

[154]*Id*. at 552.

[155]*Id*. at 615-622.

[156]*Id*. at 569-573.

reform would be difficult to achieve. As Hansmann himself recognizes, various minor problems coupled with the more serious shortcomings of "simple inertia and conservatism, can be expected in many cases to hinder the adoption of the proposed statutory revisions."[157] And, even if adopted, Hansmann's amendments lack the ability to overcome the nonprofit agency problem. His reforms depend on the ability, not the inclination, of patrons and beneficiaries (and members) to bring suits against nonprofits. His proposals might make these suits more successful and, therefore, somewhat cheaper, but that would have only a marginal effect on the inclination of non-owner patrons to bring suits. Furthermore, Hansmann's proposals would do little to enable or encourage patrons to monitor nonprofits, and the general nature of the reforms would invariably render them inefficient in their application.

V. Conclusion.

Nonprofit charities constitute an important and sizable aspect of our national economy and, like for-profit corporations, they provide necessary and useful services. Currently, charities remain effectively uncontrolled due to the absence from the nonprofit form of shareholders and the market for corporate control. Other forms of control, most notably the enforcement of default fiduciary rules, have proven unsuccessful. A market-based solution to the problem of nonprofit accountability would enable effective control and would encourage nonprofits to act more efficiently and in the public interest. Although existing nonprofits may be hesitant to accept increased supervision, greater accountability is in both nonprofits' and the public's interest.

Ultimately one may question the necessity of any control at all, however. Is this mere

[157] *Id*. at 598.

paternalism? Why is this a public matter? Should not a philanthropist who sets up a charity that then "goes bad" be forced to suffer the consequences? The answer is, I think, that preserving the original purpose of a charity, or ensuring efficiency and legality in the operation of a nonprofit, is a form of contract enforcement. Improving oversight is a matter of upholding private contractual decisions; that is, it is a matter of guaranteeing the reliability of contracts as an efficient market mechanism.[158] Upholding the intent of the founder, or ensuring that charitable donations are used for their originally-intended results, will simultaneously encourage the creation of charities and secure their continued funding. Where these guarantees cannot be made, patrons are merely seduced into thinking that they can be certain of, and can control, the disposition of their money.

Furthermore, nonprofits occupy a peculiar position in our economy. Their existence is often described as filling a void, providing funds for unpopular causes, and providing welfare more efficiently (and less politically) than the government. As such nonprofits are imbued with an inherent public interest. At the same time, while "the accountability of nonprofit directors and officers and the effective functioning of their institutions are legitimate public policy concerns, . . . there must be concomitant concern about the need to encourage individuals with vision, ability, resources, and expertise to serve the nonprofit sector."[159] These dual goals of accountability and participation may be attained only through an arrangement in which nonprofit agents are appropriately supervised, but in which their level of accountability is limited by an informed perception of their behavior. By ensuring that the oversight of nonprofits is accomplished apolitically and efficiently, nonprofits may be able to fulfill their particular role honestly, reliably,

[158] *See, e.g.,* ECONOMIC ANALYSIS OF LAW*, supra* note 67 at 89-96.

[159] Goldschmid, supra note 22 at 637.

and effectively.