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The Legal Framework for Nonprofit Organizations

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Anglo-American philanthropy recently marked the 400th anniversary of the Statute of Charitable Uses (43 Eliz. ch. 4). The 1601 Statute of Elizabeth is celebrated for its preamble enumerating a long list of charitable purposes, ranging from "relief of aged, impotent and poor people" and "supportation, aid and help of young tradesmen, handicraftsmen, and persons decayed" to "maintenance of . . . schools of learning" and "repair of bridges, ports, havens, causeways, churches, sea-banks, and highways." The Elizabethans also began the modern, secular legal system for overseeing charity. Unfortunately, the enforcement mechanism in the Statute of Elizabeth proved difficult to carry out, and fell into disuse. To this day and in the United States, the law provides at best an incomplete solution to problems of nonprofit governance and the protection of the public interest.

In America, the law is a relatively weak force in the realm of charity operations. Within broadly bounded charitable purposes, and subject only to a general proscription against insider self-dealing, no laws tell the entity or its managers how to "do" charity. The American legal structure excels at establishing or requiring processes in which individuals may make substantive decisions, and falters at dictating results. Nor, despite the absence of private shareholders to monitor charities, do we find close state regulation of charitable activities. Weak enforcement is a symptom, however, rather than a cause of the independence of the charitable sector: as a basic premise, we do not want the state to run charities.

This laissez-faire structure leaves several important policy questions unaddressed, or answered only indirectly. To society as a whole, the most important question is, "How private is private philanthropy?" In answer, we find that the law endows a charity's board with full governance authority, and generally grants only the state attorney general with standing to sue for a board's breach of fiduciary duty. Subject only to donor-intent limitations, the law defers to boards to make decisions over charity purposes and operations. Some might believe that "there oughta be a law" governing many areas of nonprofit behavior, but no law requires charities to serve only the poor, prohibits charities from charging for their services, bars charities from paying (reasonable) high salaries, or requires charities to be democratically run.

In fact, as discussed elsewhere in this volume (Boris and Steuerle), only a small percentage of charities devote themselves to poverty relief. Market transactions dominate: donations make up less than 20 percent of the sector's total receipts (less than 10 percent excluding churches), and most workers are paid (volunteers represent only 40 percent of total labor). Most charities have no members, and in that small minority of charities with members, membership is often only ceremonial, resulting in self-perpetuating boards. No law imposes term limits on either the life of a charity (most are perpetual) or the service of a board member; nor does the law mandate including members of the beneficiary class or the community on the board, or prohibit nepotism (family members frequently serve on foundation boards).[1]

The law retains jurisdiction in cases of misfeasance and malfeasance by nonprofit fiduciaries. Unfortunately, it is impossible to determine how big a problem this is, and how well government is doing to address it. Charity regulators themselves generally operate in secrecy (to the extent they act at all). Whether you regard the press as watchdog, sensationalist, or part of the prevailing social network, we know essentially the negative anecdotes we read in the newspaper (Fremont-Smith and Kosaras 2003; Fremont-Smith 2004b; Boston Globe Staff 2003). As charity operations gone wrong constantly make front-page news, however, we need to ask ourselves whether the proper response is a change in

the law. After all, to seek a legal remedy is to raise yet another question: Who decides? On the private side, candidates include the board, donors, beneficiaries, the community, and the public at large; on the public side, we have the attorney general (and other administrators), the legislature, and the courts. Each of these possible loci of authority has advantages and disadvantages, depending on our view of the appropriate control over the assets, structure, and activities of nonprofit organizations.

Currently, few additional legal checks and balances exist to oversee the classic "board governs, attorney general enforces" structure described above. As we will see, this leads to the twin weaknesses of the charitable sector: the lack of energy and initiative on the part of many nonprofit managers, and the lack of resources and zeal in enforcing the public's interest on the part of many charity regulators. Occasionally, though, we find the reverse problem: a board trying to do the right thing, but thwarted by an overreaching regulator. Sometimes, too, cooperation between a board and an attorney general can produce unwarranted results.

This chapter covers the legal issues relating to the formation, operation, and dissolution of nonprofit organizations, as well as to monitoring and enforcement. Because nonprofits lacking voting members present the greatest challenges to the law, the discussion focuses primarily on the typical charity rather than mutual-benefit organizations. (Indeed, this chapter sometimes uses the terms *nonprofit* and *charity* interchangeably.) Tax rules appear in Simon, Dale, and Chisolm (this volume), although the role of the Internal Revenue Service as a regulator of tax-exempt organizations is also covered here. Finally, no discussion of nonprofit law would be complete without acknowledging the limits of the law. Philanthropy is private precisely because society prefers reasonable discretion exercised by different participants under different conditions to the uniformity of government-directed action. Misguided legal "reform" could make the existing regulatory structure worse for compliant organizations while missing the wayward targets. Accordingly, this chapter concludes with an overview of peer and self-regulatory efforts by charity watchdog and nonprofit groups to improve charity governance and operations.

SOURCES OF LAW

Comparatively little authoritative law exists applicable specifically to nonprofit organizations, despite nonprofits' long history and prominence in American life. Under the decentralized U.S. federal system, substantive nonprofit law is a state concern, with differences occurring across states. Generally, the common law of charity develops on those rare occasions when a testator leaves property to a purported charity, and the disappointed heirs seek to defeat the will; or when a state attorney general is faced with a charity scandal that cannot be ignored. Issues implicating the federal constitution rarely arise; two of the most important U.S. Supreme Court decisions dealing with nonprofit organizations appeared 180 years apart, *Dartmouth College v. Woodward* in 1819 and *Boy Scouts of America v. Dale* in 2000, augmented most recently by a series of cases affirming the free-speech limits on state regulation of charitable solicitations. The most complete and thought-through legal treatment can be found under federal tax law.[2]

However, compared with the law governing business corporations—which is more fully developed because of numerous suits by shareholders—it is not easy to say what "the law" is in the nonprofit sector. While legal standards offer a laissez-faire structure, law as actually practiced by charity fiduciaries, their advisers, and regulators might function at a higher level; the herd behavior of similarly trained professionals leads to relatively consistent and (legally) noncontroversial activities (DiMaggio and Powell 1991).

Even where enforcement action might be occurring, few cases involving nonprofit fiduciary issues have reached the courts. Generally, the charity regulator prefers reform to punishment, in order to improve charity performance and to avoid embarrassment to well-intentioned charity managers. Settlements can be quite detailed, often spelling out changes in governance and future operations, but settlements commonly remain secret.[3] Increasingly, though, regulators are requiring disclosure where the transgression reflects more than a minor infraction by a single bad actor.[4] This invisibility at the informal end of the regulatory spectrum makes it hard to judge the level and the effectiveness of regulators in influencing charity behavior—and whether regulators are motivated by their own or the public's interest. However, the courts have the last word, and so can offer relief if the charity wants to litigate a position taken by the attorney general; by the same token, though, courts are not bound to accept a settlement reached by the attorney general (but there might be no private party with standing to complain).

Most challenging, there is no single "law of nonprofit organizations." Much of the common law of charity, property, and wills and trusts has found its way into state statutes. We find state laws on nonprofit corporations, federal and state tax laws, and state (and sometimes local) laws on charitable solicitations. Like businesses, many nonprofits worry about laws (sometimes with special rules for nonprofits) on contracting, labor and employment, torts and insurance, employee benefits, antitrust, bankruptcy, and political activity, as well as laws that govern specific industries such as hospitals and day care.

Of final importance are several sources that are not themselves law but that influence legal development. The American Law Institute (ALI) published the *Restatement (Second) of the Law of Trusts* in 1959, and has published two portions so far of the *Restatement (Third) of the Law of Trusts* (the first, issued in 1992, covers prudent investing; the second, issued in 2003, addresses, among other topics, the definition of charity and the *cy pres* doctrine). Also in 1992 the ALI produced the *Principles of Corporate Governance,* relating to business corporations, and in 2001 opened a project on "Principles of the Law of Nonprofit Organizations," for

which this author is Reporter. The American Bar Association's 1987 Revised Model Nonprofit Corporation Act (the "Model Act") has been enacted (sometimes with variation) in more than two dozen states; the ABA's prior version was adopted in thirty-nine states. The National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972 adopted the Uniform Management of Institutional Funds Act (UMIFA), enacted (sometimes with minor variation) in forty-eight jurisdictions; a major revision of UMIFA had its first of two required readings in 2003. NCCUSL also approved a uniform trust code in August 2000, and states are beginning to adopt it.[5] In discussions below, for simplicity we usually refer to the ABA's Model Act, UMIFA, the Uniform Trust Code, and the various ALI projects in lieu of specific state laws. Finally, an increasing amount of secondary legal guidance is being produced (see, for example, the very helpful ABA Section of Business Law 1993; Siegel 2006).

NONPROFIT FORMATION, OPERATION, AND DISSOLUTION

Constitutional Protections

Private philanthropy and the nonprofit sector rest on the fundamental constitutional guarantees of private property, liberty of contract, and freedom of worship and expression.[6] These rights are not absolute, however: the government retains the power to regulate the use of property short of a "taking" before having to pay just compensation under the Fifth Amendment. The government can infringe on the First Amendment right of expression if it has a compelling state interest and neutrally applies the least restrictive regulatory means. Less familiar constitutional protections include the contracts clause (*Dartmouth College v. Woodward,* 17 U.S. (4 Wheat.) 518 (1819)) and the commerce clause (*Camps Newfound/Owatonna, Inc. v. Town of Harrison,* 520 U.S. 564 (1997) (Brody 1997b). The U.S. Supreme Court rarely agrees to hear a case dealing with state law that raises no federal constitutional issue.

In *Dartmouth College,* the Supreme Court construed a New Hampshire charter granted to a private college to be a contract between the founder and the state, protected by the contracts clause from legislative interference in the appointment of the board.[7] By contrast, the Supreme Court upheld the forfeiture of the Mormon Church's charter for sanctioning polygamy, a criminal act. See *Late Corporation of the Church of Jesus Christ of the Latter-Day Saints v. United States,* 136 U.S. 1 (1890), modified, 140 U.S. 665 (1891).[8]

The establishment clause of the First Amendment prohibits the government from singling out churches for exemption from laws of general application. In 1997 the Supreme Court struck down the federal Religious Freedom Restoration Act of 1993 (as it applies to the States) (*Boerne v. Flores,* 521 U.S. 507 (1997)).[9] In the tax context, the Supreme Court voided a state sales tax exemption granted to religious publications but not to secular publications. *Texas Monthly, Inc., v. Bullock,* 489 U.S. 1 (1989) (See Simon, Dale, and Chisolm, this volume, which also covers the seminal case *Walz v. Tax Commission,* 397 U.S. 664 (1970), upholding a general nonprofit property-tax exemption scheme that included churches.) The line between the free exercise clause and the establishment clause recently shifted further in favor of churches. In *Mitchell v. Helms,* 530 U.S. 793 (2000), the Court terminated an eroding doctrine when it held that a state could provide financing directly to parochial schools to buy computer equipment. The decision was supported by six justices, although no opinion of the Court attracted more than four votes. Apparently, the government can fund a secular activity so long as churches are not singled out for the benefit, and no diversion of the public funds to a religious activity occurs (see also Wuthnow and Cadge, this volume).

Contrary to popular belief, there is no blanket constitutional "freedom of association" (Emerson 1964; Soifer 1995). Rather, the Supreme Court has recognized "a right to associate for the purpose of engaging in those activities protected by the First Amendment—speech, assembly, petition for the redress of grievances, and the exercise of religion" (*Roberts v. United States Jaycees,* 468 U.S. 609, 618 (1984)). Of course, one person's freedom of association could be another's freedom from association, and discriminatory membership practices sometimes lead to a clash between private and public interests. The Supreme Court has held that "expressive" association is protected from regulation unless the government can show "compelling state interests, unrelated to the suppression of ideas that cannot be achieved through means significantly less restrictive of associational freedoms" (*Roberts v. United States Jaycees,* 468 U.S. 609, 623 (1984)). ("Intimate" association, such as in marital choices and small private clubs, is also protected.)

Thus, as held in *Roberts,* a Minnesota antidiscrimination statute applicable to "public accommodations" could require the Jaycees to admit women as members: the state's goal of eliminating sex discrimination is a compelling state interest unrelated to the suppression of ideas, and Minnesota's law is the least restrictive means of achieving that interest. This decision was unconvincing at the time—after all, the Court also held that the state cannot compel the organization to change its purposes (in this case, advancing the interests of young men), but requiring the group to open up its membership to women would seem to change the group's message as well as its voice (see, e.g., Rosenblum 1998a, 1998b; Gutmann 1998).

The Court expanded the boundaries of expressive association in *Boy Scouts of America v. Dale,* 530 U.S. 640 (2000). The New Jersey Supreme Court had unanimously interpreted New Jersey's Law Against Discrimination to find the Boy Scouts to be a "public accommodation" because it was open to all boys; accordingly, the Boy Scouts could not dismiss a troop leader on the basis of his sexual orientation.[10] Because the Supreme Court cannot reverse a high state court's interpretation of its own state law, when the Supreme

Court agreed to hear the Boy Scout's case, it could only mean that the Court was prepared to visit the constitutional issue. Not only was this bad news for James Dale, the expelled gay troop leader, but it also put the nonprofit sector in a difficult position: strategically, charities did not want to support the type of discrimination engaged in by the Boy Scouts; tactically, however, they feared that if they did not weigh in on the Boy Scouts' side, the pluralism of the sector could be jeopardized.[11]

Holding that "an association need not associate for the purpose of disseminating a certain message in order to be protected, but must merely engage in expressive activity that could be impaired," the Court upheld the Boy Scouts' First Amendment right to assert that a gay troop leader clouds the group's message that "morally straight" and "clean" means heterosexual. The court further found simply: "The state interests embodied in New Jersey's public accommodations law do not justify such a severe intrusion on the freedom of expressive association." Unlike the unanimous decision in *Roberts,* the *Dale* Court split five to four, and coalition-building among the justices can result in odd opinions. Still, Justice Rehnquist's opinion for the Court seems both result-oriented—almost tailored to achieve victory for the Boy Scouts—and so broad that the limits of the holding are difficult to assess. *Dale* will either dramatically change the associational jurisprudence or be quickly limited to its facts (Brody 2002b).

While private parties can constitutionally engage in some forms of discrimination that are foreclosed to government, courts have worried that enforcing discriminatory terms in private agreements results in state action that violates the equal protection clauses of the Fifth and Fourteenth Amendments. In most cases, though, this is not an impediment. For example, in *In the Matter of Association for the Preservation of Freedom of Choice, Inc.,* 188 N.Y.S.2d 885 (1959), the trial judge had rejected the certificate of incorporation of a hate group, ruling: "Our system of government can only be maintained by the free and untrammeled collision of ideas, but when those ideas run counter to the mores or policies of our laws, no group should be permitted to organize in corporate form with the sanction of the State to espouse such ideas." The New York high court reversed, 174 N.E.2d 487 (N.Y. 1961),[12] declaring: "[Agitating] for the repeal or modification of any law . . . , provided such agitation is not coupled with the advocacy of force and violence[,] . . . is not against public policy whether indulged in by an individual or a membership corporation, but of course approval of a corporate charter devoted to such a purpose does not imply approval of the views of its sponsors. It simply means that their expression is lawful, and their sponsors entitled to a vehicle for such expression under a statute which cannot constitutionally be made available only to those who are in harmony with the majority viewpoint."[13]

Of final, but not least, constitutional importance, the Supreme Court repeatedly affirmed the free-speech rights of charities soliciting for contributions, by invalidating state and municipal requirements that capped payments to fundraisers and certain other measures (see the discussion of state regulation of charitable solicitations below).

Purpose

In general, state organizational law takes a laissez-faire attitude toward nonprofit purposes. Nonprofit corporation statutes generally permit "any lawful purpose," and charitable trust law can accommodate a broadly construed public purpose.[14] Both corporate and trust regimes prohibit insiders from enjoying inappropriate financial benefits—indeed, what has come to be known as the "nondistribution constraint" often operates as the sole limit of nonprofit status (Hansmann 1980). To some, the constraint against distributing profits both explains the existence of the nonprofit sector and keeps it honest, ensuring the dedication of assets and effort toward performing good deeds.[15] However, accepting nonprofit status as a signal of trustworthiness results in the law bestowing a "halo" on any nonprofit organization regardless of merit (Brody 1996a; Steinberg, this volume).

Recognizing an organization as entitled to legal status (as a charitable trust or a nonprofit corporation), however, is separate from whether the nonprofit form should enjoy state favoritism, including tax privileges. State property-tax and sales-tax exemptions are limited, in general, to the subset of nonprofits classified as charities. Similarly, the Internal Revenue Code contains about thirty different categories of income-tax exemption, but generally only the charitable category also offers deductibility for contributions. As a practical matter, tax exemption under Internal Revenue Code section 501(c)(3) is so valuable that charities will routinely adopt appropriate purpose language in their articles of incorporation or charitable trust documents. We should not overstate the distinction, however: the tax definition of charity (under which the nondistribution constraint is termed the "prohibition on private inurement") is barely tighter than the status definition (Simon, Dale, and Chisolm, this volume).

Choice of Form

Creators of a new charity can generally choose between two basic regimes: the nonprofit corporation and the charitable trust.[16] (Informal or other unincorporated voluntary associations, which traditionally function under the laws of agency and partnership, could expose the participants to personal liability.) State nonprofit corporation statutes vary. For example, New York State provides rules for four different types of "not-for-profit" corporations; states following the ABA's Model Act differentiate between "public benefit," "mutual benefit," and "religious" corporations (as does California, whose law inspired the ABA); and Delaware and Kansas have a single statute covering both business and nonprofit corporations. Additionally, some states have enacted statutes for, among others, "unincorporated associations" (granting members limited liability), homeowners associations, cooperatives, health-care corporations, and mutual-benefit insurance companies. Finally, many states, again

with variation, have codified the common law of charitable trusts, and adopted such specific statutes as UMIFA (Fisch et al. 1974; Bogert and Bogert 2000; Fremont-Smith 2004a). American advisers routinely recommend the nonprofit corporate form, although the trust form might be particularly appropriate for a charity (such as a grant-making foundation) that manages a fund of money and makes distributions.

Standards of fiduciary behavior. Fiduciaries—whether trustees of a charitable trust or directors of a nonprofit corporation—owe the entity they govern the twin duties of loyalty and care.[17] Traditionally, the charitable trust standards of fiduciary law have been stricter than the nonprofit corporate standards, but recent years have brought a liberalization of the trust rules. Moreover, as described below, differences can be minimized at the creation stage. The American Law Institute's project on Principles of the Law of Nonprofit Organizations is endeavoring, to the extent possible, to express uniform duties and standards for fiduciaries regardless of the organizational form of the charity (American Law Institute 2005a and 2005b).

Duty of loyalty. Recognizing that no man can serve two masters, the duty of loyalty aspires to requiring the fiduciary to place the interests of the organization above his or her own. In practice, of course, conflicts of interest abound—indeed, a person's ability to provide certain goods or services might be the very reason that that person makes a desirable member of a charitable board. For trusts, the duty of loyalty absolutely prohibits self-dealing and other conflict-of-interest transactions, but the law permits the creator of the trust (the "settlor") to waive this limitation. In the absence of such a waiver, a trustee who breaches the duty of loyalty can be compelled to make restitution to the entity, even if the transaction was fair. For corporations, the duty of loyalty evolved past absolute bans on self-dealing. The ABA's Model Act blesses an interested transaction that either was fair when entered into or was approved in advance, after full disclosure of the material facts and of the director's interest, by disinterested members of the board acting in good faith on the reasonable belief that the transaction is fair to the charity. Alternatively, under the Model Act, the attorney general or a court may approve the transaction, either before or after it occurs. As a separate matter, additional conflict-of-interest restrictions can be imposed by the articles of incorporation, bylaws, or board resolution; employment contracts; grants or contracts; or professional association rules—with varying sanctions.

Duty of care. The duty of care adopts a "prudent person" standard: the fiduciary must exercise such attention to the affairs of the organization (what to do and how to do it) as would a prudent person in managing his or her own affairs. For trusts, an "ordinary negligence" standard traditionally has applied, requiring the trustee to exercise "reasonable" care, but the trust instrument typically relieves the trustees of legal duties to the maximum extent permitted; this generally results in a lenient standard like that imposed on corporate directors. The default rules in recent trust-law reforms are also moving in this direction. For corporations, nonprofit directors who are informed, exercise independent judgment, and act in good faith are protected under a court-created standard of review called the "business judgment rule." As a result, a director can be found liable for breaching the duty of care only by committing gross negligence (basically, acting recklessly).[18]

In practice, it is not always so easy to separate the twin obligations of loyalty and care. For example, a conflict-of-interest transaction between the organization and a director can implicate both the duty of loyalty and the duty of care: the loyalty of the conflicted director and the care exercised by the other directors in approving the transaction.[19] In general, Peter Swords and Harriet Bograd have found a consensus among the more experienced state charity officials that "inadequate board governance also creates the conditions that make embezzlement, misappropriation of funds and self-dealing possible. The case of the domineering executive director and the weak board seems to be quite typical across the country"[20] (Swords and Bograd 1996). Moreover, regulators and the courts seem more willing to listen to duty-of-care complaints if the transaction is tainted by duty-of-loyalty implications.[21]

For many years, without success, numerous commentators have urged that instead of following organizational form, the law should follow function and adopt a uniform law for charity fiduciaries, both trustees and directors (see, e.g., Karst 1960; Fremont-Smith 1965; Hansmann 1981; Fishman 1985; Fremont-Smith 2004a). Under current law, the well-advised charity founder's choice of form bestows on or denies the public particular rights of state supervision and fiduciary obligations. Many yearn for a structure of trust fiduciary duties for all charity managers, be they legally trustees or directors. Indeed, as described below, some administrators and courts fill gaps in nonprofit corporate law by invoking charitable trust principles when asserting attorney general jurisdiction or applying *cy pres* standards. However, in the area of standards of fiduciary liability, the general trend, while indeed toward conformity, is in the opposite direction: to the corporate standard. Courts prefer to defer to the business judgment of charity managers; legislatures relax the investment duties of institutional fund managers; and Congress bows to the determination of independent board members of public charities in setting compensation and other benefits.

In setting the charity-fiduciary legal standard of care, legislators, regulators, and judges find themselves trying to balance the attractiveness of service against exacting requirements. All parties implicitly recognize changes in the size and behavior of the charitable sector itself, and the need of thousands of new charities to reach beyond traditional populations to fill their boards (Hall 1992:138). Many organizations in today's nonprofit sector operate enterprises subject to the management demands of a complex business, where corporate fiduciary standards seem appropriate. At the same time, even "commercial" charities like nonprofit universities and hospitals must generally supervise endowments and restricted gifts under charitable trust standards. Current corpo-

rate standards, observed Michael Hone (the reporter of the ABA's Revised Model Act), allow volunteer directors "to almost be asleep at the gate"; but if the traditional, absolute trust standard were "adopted by the Act, very few sensible people would serve on the boards of nonprofit organizations" (Hone 1988–89:771–72).

Ironically, tightening the standards for nonprofit fiduciaries could worsen the situation. The tension between theory and practice plays out in a somewhat contradictory way. In theory, it is no defense that a director was voluntary and uncompensated. In theory, "D&O" (director and officer) insurance policies and state limits on the extent to which nonprofits can indemnify their fiduciaries remain important concerns of fiduciaries. In theory, then, the fear of potentially high monetary liability discourages good directors from serving. At the same time, in practice, the desire to save directors from financial ruin leads regulators and courts to degrade the legal standards by avoiding findings of liability.[22] In practice, moreover, even where the fiduciary violates the duty of care, lenient enforcement or light punishment nearly always follows. Accordingly, in practice, D&O policies are inexpensive (and might cover the fiduciaries' attorney's fees even in situations of bad faith).[23]

This laxity might change. The existence of a D&O policy now offers all the parties except the insurance company a tempting way to redress the financial harm to the charity. (Of course, as one editorial observed, "You cannot buy a policy that will insure against loss of public confidence" [Columbus Dispatch 2000]). Evidently, attorneys general keep an eye on policy limits in negotiating a settlement. Notably, in October 2000 the attorney general of Hawaii announced a settlement in the case against the highly compensated former trustees of the Bishop Estate for $25 million—the limit of the D&O policy. (Half of the amount went to cover attorney's fees for all parties, including the attorney general's office, with the rest going to the charity.)[24]

Most spectacularly, early 2002 brought a resolution of the civil wrongdoing claims in the largest nonprofit bankruptcy in history. The Allegheny Health, Education and Research Foundation (AHERF), which supported a Pennsylvania-wide umbrella system of health-care institutions, left $1.5 billion in unpaid bills. The state and the parties settled for an agreed total of almost $94 million, of which $24.5 million went to the charity. About $56 million of this total was paid by AHERF's D&O policy, which had already paid at least $12 million for the litigation.[25] If high-dollar investigations and settlements proliferate, D&O insurance companies could be forced to engage in underwriting, and to base lower premiums on improvements in governance practices. Such a market solution could lead to a strengthening of fiduciary standards, akin to the consequences of repealing charity immunity laws (discussed under "Torts," below).

As a policy matter, we would not want to allow caps or waivers of liability for breaches of the duty of loyalty; by contrast, specifying the worst monetary harm a fiduciary could suffer for breaches of the duty of care could be salutary. A voluntary "liability shield," if included in the articles of incorporation and approved by shareholders, is available under many business corporation laws, and the ABA's Revised Model Nonprofit Corporation Act includes it as an option for legislatures. A few state statutes (including Delaware's combined stock and nonstock statute) permit such charter amendments by their nonprofit corporations. With a cap or waiver, the financial risk would be low enough to both continue attracting directors and make attorneys general and courts more willing to find breaches, yet high enough to induce fiduciaries to take their tasks more seriously. This approach preserves the standard of care, while leaving directors at monetary risk for breaches of their duty of loyalty and for failures to exercise care in good faith. Moreover, an attorney general could always seek equitable remedies, such as injunctions and removal of directors or trustees (and other reputational sanctions).

Structural Control

Charitable trusts and nonprofit corporations appear to have radically different structures for control. Trustees of charitable trust are bound by the instructions of its creator, the settlor; any departure requires court approval. By contrast, resort to a court is not generally required for the directors of a nonprofit corporation who are replacing a director or amending the articles of incorporation.[26] However, the trust regime allows for tailoring that minimizes the differences in legal form: a charitable trust instrument would rarely be drafted today without giving broad discretionary powers to the trustees, and the trustees themselves can appoint successors if the instrument provides for self-perpetuation.

State corporate and other enabling statutes generally provide only for the barest of structures for organizational formation and operation, leaving the parties to work out and provide for any additional desired governance restrictions and protections of members, if any. Nonprofit corporations may, but are not required to, have members with rights to elect the board of directors and to exercise other extraordinary powers set forth in the statute or the articles of incorporation, such as approving the board's decision to amend the articles of incorporation or sell substantially all of its assets, merge, or dissolve. If such members do exist, they are entitled to be appropriately informed, and enjoy other procedural rights. Voting membership is more common in the mutual nonprofit: labor organizations, social clubs, and business leagues. For national charities with local affiliates, the affiliates, rather than individuals, might be the formal members. Most charities have no members, or have only ceremonial members. In the absence of "ex officio" or other directors designated in the articles, a memberless nonprofit corporation has a self-perpetuating board of directors.

Avner Ben-Ner has proposed that *all* charities be required to be run by active members, who would acquire their interests in proportion to "contributions," which he defined as monetary donations, purchases, and volunteer time. Specifically, he urged that states grant "stakeholders" the powers to elect the board, to see financial and programmatic in-

formation, and to sue the board "for making undisclosed programmatic changes"; in cases of extremely low stakeholder participation, a state agency would elect the board (Ben-Ner and Van Hoomissen 1994:408–10; Ben-Ner 1994). Some might dispute the practicality of mandating active oversight; in any case, courts will not adjudicate disputes over a group's doctrine, and will enforce only due process or property rights granted internally or by statute or public policy (e.g., in the case of expulsion from a professional society).[27] Cruel as the result can be, a member unhappy with a group's policy, and whose power of voice proves fruitless, can always exercise the power of exit and form another group; compare the power of a dissatisfied donor to withhold future contributions (Brody 2002b). As a "somewhat less severe, but still substantial, remedy" to the loss of social benefits that attend membership-structured nonprofit organizations, Dana Brakman Reiser suggests that "nonprofits with and without members could be treated differently, based on their differing contributions to civil society and to a lesser extent their differential ability to make mission-maximizing decisions and to self-monitor. . . . These differences in treatment could halt and perhaps partially reverse the trend away from members" (Brakman Reiser 2003:832, 890).

To some degree, a founding donor can more easily control a charitable trust than a nonprofit corporation. A living donor can be the sole trustee, whereas most states require a nonprofit corporation to have at least three directors. While a donor could set up the charity as a membership corporation with herself as the sole member, even directors elected by members must exercise independent judgment under their duty of care (see, e.g., *Solomon v. Hall-Brooke Foundation, Inc.,* 619 A.2d 863, 866 (Conn. App. Ct. 1993); Clark and Troost 1989:32–34). The sole-corporate-member structure became common with the restructuring of nonprofit hospital systems. Brakman Reiser (2001) discusses the fiduciary duties of a sole corporate member.

The law generally refrains from dictating how a board should carry out its duties of setting policy and engaging and supervising officers. However, reformers usually recommend separating the identity of those who provide governance and those who provide management. For example, California limits charity managers to 49 percent of the board positions.[28] The new standards used by the Better Business Bureau (BBB) Wise Giving Alliance to rate charities recommend that no more than one person who directly or indirectly receives compensation from the charity should serve as a voting member of the board—and should not serve as chairman or treasurer.[29] In 2002, responding to the corporate governance scandals, Congress enacted Sarbanes-Oxley legislation applicable to publicly traded companies. Notable provisions relate to executive certification of financial results, independent audit committees, and whistle-blower protections. The desirability of extending some of these reforms to the nonprofit sector is a subject of much debate, and could influence the choice of form (as trust or corporation), as well as the choice of state of organization.[30]

REGULATION AND ENFORCEMENT

Nonprofit organizations and their fiduciaries are subject to multiple levels of governmental supervision and scrutiny. State attorneys general have achieved important successes in educating the public about fraudulent fundraising and challenging wrongdoing; educating fiduciaries and staffs in meeting their legal obligations and improving charity governance; rectifying self-dealing and other breaches of fiduciary duty by charity insiders; and assisting charities that have lost their way to restructure or dissolve. The "biggest problem" of top state charity officials (according to a survey in which thirty-eight states responded) relates to charitable solicitations, and whether charities spend their money as represented to donors (Mehegan et al. 1994). The Internal Revenue Service also functions as a regulator—often the only effective regulator.

Just a few states fund and actively engage in charity enforcement (Fremont-Smith 2004a). However, the effective coverage is greater than it sounds: a disproportionate percentage of charitable assets is concentrated in a few states with active charity regulation, and, for the many charities operating across state borders, the inactive states can free-ride on the enforcement efforts of the few. To a large degree, legislatures are coming to view sunshine as the best disinfectant, and Congress and the states are increasing nonprofit or tax-exempt disclosure requirements to allow a better-informed public to provide oversight—although private parties cannot generally enforce nonprofit laws in court.

Depending on regulators to enforce charitable duties brings challenges of its own. While attorneys general have long complained about their lack of resources for this function, at some point we must concede that the public might not want to pay for more (or different) oversight than is occurring.[31] Moreover, even with regard to nonprofit organizations, the attorney general remains an inherently political creature. The incentives of this nearly universally elective office impel the incumbent to ignore cases that are politically dangerous and to jump into matters that are politically irresistible but implicate only "business" decisions of charity managers.[32] Ironically, though, the very lack of state involvement with the organization and operation of nonprofit entities might explain how legislatures, attorneys general, and even courts can sometimes misconstrue their proper roles in the regulation of charities and other nonprofits.[33]

Parochialism is a particular concern in charity law enforcement (Brody 2004).[34] Consider two examples, one involving investment assets and the other operating assets. The 2002 Hershey Trust case amounts to a trifecta—eventually all three branches of Pennsylvania government combined to pressure the Milton Hershey School Trust to abandon plans for selling its controlling interest in Hershey Foods (in order to diversify an investment worth more than $5 billion), thereby preserving the local operations of the publicly traded company. The attorney general, who was running for governor, had won a preliminary injunction against the sale. Shortly after losing the gubernatorial elec-

tion, the attorney general participated in a shakeup of the board that restored local control. The outgoing governor signed a bill that would require the trust to obtain court approval, with attorney general and community input, before any sale.

In the case of the Illinois-based Terra Foundation for the Arts,[35] the board of the financially troubled museum, under pressure from the attorney general, abandoned an exploration of moving to Washington, D.C. The attorney general had sought to read into the purposes of the corporation the desire to benefit primarily "the people of Illinois." A settlement followed when a majority of directors voted to obligate all current board members to step down; to require, for at least twenty-five years, a majority of the board to be residents of Illinois; and to prohibit the assets from leaving the state for fifty years.[36] Terra closed its museum and placed its major pieces on long-term loan to the Art Institute of Chicago.

In some cases when a court is asked to approve the outcome, availability of court review can curb inappropriate regulator zeal[37]—or willingness to compromise.[38] But again, restrictions against private standing might mean no one can challenge attorney general decisions (discussed further below). Moreover, many open questions remain regarding an attorney general's authority over the activities of a charity doing business in-state but incorporated elsewhere.

State-Level Enforcement

Nonprofit corporations obtain their certificate of incorporation from, generally, the state secretary of state's office, and, like other corporations, must file an annual report that is usually quite perfunctory. Charitable trusts and unincorporated associations do not generally file their organizational documents with the state, although wills get filed with a probate or similar court. However, a charity, regardless of organizational form, that applies for recognition of federal tax exemption must provide the Internal Revenue Service with its organizing documents. As mentioned below, an exempt organization must make its application, including these organizing documents, available to the public on request.

A state official, usually the attorney general, can investigate charges of improper charitable activities, view books and records, and subpoena witnesses. The courts, on motion of the attorney general or on their own, can "enjoin[] wrongful conduct, rescind[] or cancel[] a transfer of property, appointment of a receiver, replacement of a fiduciary, compel[] an accounting, redress of a breach or performance of fiduciary duties" (Fisch et al. 1974, §712:549–50), dissolve a corporation, enforce restrictions in gifts, supervise indemnification awards, and surcharge fiduciaries for improperly received benefits (Fishman and Schwarz 2000:255–56).

The other primary focus of state interest relates to statutes governing charitable solicitations, to prevent fraud on donors and the diversion or waste of donated funds.[39] The flood of charitable giving after the September 11, 2001, terrorist attacks on the United States led to a spectacular demonstration of both the legal and political pressures to enforce asserted donor expectations over the use of contributed funds. More than 250 new nonprofit organizations were formed to handle the outpouring of contributions, and obtained expedited federal tax exemption. Yet these new organizations—along with existing major charities like the Red Cross and the Salvation Army—found themselves tripping over each other, unable to ensure that the more than $1.5 billion in contributions was being distributed responsibly.

Most visibly, the American Red Cross chief succeeded in attracting most of the dollars—almost a billion dollars—into a separate "Liberty Fund," a large portion of which, it later transpired, the Red Cross wished to devote to improving its infrastructure, for overhead, and to address the needs of future terrorist events. The adverse public reaction led to charges that the charity was misleading donors, and forced the board of the Red Cross to demand its chief executive's resignation. A congressional body held hearings into the performance of September 11 philanthropy. The Red Cross then promised to spend the balance of the principal of the Liberty Fund on the victims and their families. This position led to reports, however, that the Red Cross to some degree was throwing its money at those who might not need charitable assistance, raising the question of whether the attorney general focused more on his role of protecting donors' expectations and less on his role of ensuring the wise use of charitable resources (see Katz 2003).[40]

In the 1960s and 1970s, the desire to protect charities from "wasting" resources on fundraising led a total of twenty-eight states and countless municipalities to impose ceilings on the percentage of annual revenues that could be spent on fundraising expenses (Hopkins 1996). In the 1980s, however, a trio of Supreme Court decisions blocked these restrictions, on First Amendment free-speech grounds. (*Riley v. National Federation of the Blind of North Carolina, Inc.,* 487 U.S. 781 (1988); *Maryland v. Joseph H. Munson Co.,* 467 U.S. 947 (1984); *Village of Schaumburg v. Citizens for a Better Environment,* 444 U.S. 620 (1980)). To the Court, procrustean percentage limits on fundraising disproportionately impact new charities (with low name recognition and no established donor base) and unpopular causes (which require a greater expenditure to raise a dollar). States may punish fraudulent fundraising speech after the fact, but, as the Court recently confirmed, regulatory approaches seeking to equate fraud with efficiency are invalid (*Madigan v. Telemarketing Associates, Inc.,* 538 U.S. 600 (2003)).[41]

Can nothing be done to address state (and IRS) concerns over excessive fundraising costs? It can be in any given charity's interest to raise another dollar for every $99 pocketed by the fundraiser—not only for a startup charity (whose expenses might even exceed revenues) but also for the desperate charity that perhaps should expire.[42] If the pool of donative dollars is finite, how can the state prevent a tragedy of the commons in promoting the efficient allocation of donative dollars? As a separate question, publicized fundraising excesses by one charity can cause a general decline in confidence in all charities.

The state's desire to eliminate "harmful" competition between charities might evoke sympathy but, in the end, proves futile and misguided. Superficially, one can appreciate the sentiment once expressed by a New York judge: "I do not believe the public should have numerous groups soliciting funds when one well-recognized and well-operated organization is [already] seeking their contributions."[43] However, a solution to these problems that is both efficient and constitutional is not obvious (Steinberg 1997). The marketplace for contributions remains an important check on existing institutions. The regulator still can play an important role in seeking to ensure the efficient use of charitable resources: the New York attorney general prodded the September 11 charities into coordinating their relief efforts by creating a combined database of resources and needs.

While conceding fundraising limits, the states have further concentrated their efforts on requiring charities to increase public disclosure using standardized forms. The majority of states require registration and sometimes annual filings, usually with the attorney general, for charitable trusts and nonprofit corporations that solicit charitable contributions. Most laws also cover professional fundraisers, advisors, and co-venturers. (Thirteen states, though, require no charitable filings.) Statutes commonly exempt small entities, educational institutions, hospitals, and churches—and membership organizations—but variations abound. A charity soliciting in many states will welcome the Uniform Registration Statement accepted in most states requiring registration.[44] However, a number of *localities* also regulate solicitations, sometimes prompting court challenges from overburdened charities and their advisers. (Fishman and Schwarz [2000:304] characterize the multitude of charitable filing requirements as "horrifyingly elaborate"; see generally Fremont-Smith 2004a.)

When the law cannot impose restrictions, voluntary certification can be the solution, as discussed below. However, to some extent nonprofit rating bodies encourage the public to focus overly much on fundraising and overhead percentages.

Federal-Level Enforcement

Federal enforcement over nonprofit activity is primarily confined to the Internal Revenue Service. In general, the Federal Trade Commission has jurisdiction over interstate charitable solicitations only if engaged in by for-profit solicitors, although the FTC does have jurisdiction over a nonprofit used as a shell for the direct private gain of its members.[45] A proposal was introduced in 1990 to bring nonprofit organizations (other than political parties) within the FTC's reach and to define deceptive charitable fundraising as a deceptive trade practice (and preempt state law) (for an earlier proposal, see Yarmolinsky and Fremont-Smith 1977). Some federal enforcement activity against fraud can be credited to the U.S. Postal Service. The Treasury Department has begun to focus on the use of charities to further international terrorist activities (U.S. Treasury Department 2005). Of course, federal regulation, like state regulation, of charitable solicitation is bound by charities' constitutional rights, as described above.

Disclosures. Federal tax law obligates a charity to furnish its exemption application and last three tax returns (Form 990) to any person, no questions asked, upon request. Education and tightened penalties have brought increased compliance by charities, which are often reluctant to disclose the salaries and other compensation paid to their top executives and independent contractors. Moreover, third parties have begun to post information on the Internet that will enable donors and other interested parties to compare charities online (see the path-breaking database at www.guidestar.org).

The staff of the Joint Committee on Taxation issued a congressionally mandated study of the disclosure rules that apply to exempt organizations under the Internal Revenue Code (Joint Committee on Taxation 2000). The staff recommended expanding disclosure to: private letter rulings and audit memoranda without "redaction" of identifying information; business tax returns of exempt organizations and their taxable affiliates; and a description of lobbying activities, including amounts spent on self-defense lobbying and on nonpartisan research and analysis that include a limited "call to action." The staff asserted that such disclosure not only allows increased public oversight but "also allows the public to determine whether the organizations should be supported—either through continued tax benefits or contributions of donors—and whether changes in the laws regarding such organizations are needed" (5). Many of these recommendations have attracted strong criticism by nonprofits asserting privacy rights in information that they are willing to file with the tax collector, but not disclose to the public (Williams 2000). It should be appreciated, though, that the charity itself can always release identifying information, and so prospective donors remain free to withhold contributions until satisfied with information obtained from the charity.[46]

Charities that resist increased standardized disclosure worry about releasing a tax form that the public will misunderstand or misinterpret. Today's charity faces competition from a myriad of other charities, as well as high fundraising and administrative costs. The public fails to appreciate the productive demands and fiscal needs of charities, and often expresses surprise that nonprofit managers are paid at all (Brody 1996b). The solution to this problem, though, is more disclosure—nothing prevents an organization from providing a more positive narrative of its goals and accomplishments. Importantly, the voluntary disclosure of information also serves charities that do not solicit donations. The Joint Committee staff's rationale suggests that even a charity totally funded with income from investments and the performance of services cannot necessarily keep its activities to itself.

The IRS as enforcement agency, and federal-state coordination. Like substantive nonprofit law, the tax rules generally address problems of self-dealing (termed *private inurement* by the Internal Revenue Code) rather than weak management. Moreover, until "intermediate sanctions" leg-

islation in 1996, the only sanction for private inurement was loss of the charity's tax exemption, and the wrongdoer went unpunished. Now the IRS can instead impose a penalty tax of 25 percent on the "excess benefits" portion of a transaction between an insider and the charity (a smaller penalty applies to fiduciaries who knowingly approved), and require restitution to the charity (Simon, Dale, and Chisolm, this volume). The intermediate-sanctions regime, however, does not reach other breaches of fiduciary duty. Thus, short of revoking exemption under the poorly understood prohibition against "private benefit," the IRS cannot statutorily address such inadequacies of governance as running an indifferent charitable program, accumulating excess income, or paying insufficient attention to investment returns.[47]

As a practical matter, though, the Service has been able to achieve sometimes fundamental management reforms through negotiation. For example, the IRS can threaten revocation of recognition of exemption in order to bring the charity to the bargaining table, and then settle for a "closing agreement" that spells out detailed governance changes.[48] Such a power is not statutory, however, and I have argued that the new intermediate sanctions legislation undercuts the IRS's ability to claim de facto full equity powers by demanding broad management changes via closing agreements (Brody 1999).

A charity that violates the private inurement proscription also violates state nonprofit law. Depending on the resources and inclinations of the state attorney general's office, the charity might be facing investigations on two fronts. Under current privacy law applying to exempt organizations, the state can share information with the IRS, but the IRS cannot share information about its investigation short of notifying the state of revocation of exemption. However, because this final determination might "not be made for a number of years, a tax-exempt organization may have exhausted its assets through illicit transactions or disposed of its assets or changed its operations in a way which can no longer be corrected by the time the IRS is permitted" to inform the state (Joint Committee on Taxation 2000:103, citing Lyon 1996, at §5.04).

To address these concerns, the Joint Committee staff's disclosure study contained one well-received suggestion: that Congress would require the IRS to inform the appropriate state of the progress of an exempt-organization investigation. To prevent overreliance by states on the IRS, the recommendation would allow such disclosure in only two situations: (1) when the state has made a specific referral of an organization to the IRS before a denial or revocation of tax exemption; or (2) with state officials who regularly share information with the IRS, when the IRS determines that such disclosure may facilitate the resolution of cases. The Tax Relief Act of 2005, passed by the Senate as S. 2020, contains a provision that, in general, would permit the IRS to inform the appropriate state official of a proposed denial of exemption or a proposed revocation of exemption (151 Congressional Record S13137 (amendment 2670), Nov. 17, 2005). In any case when both federal and state investigations are proceeding, principles of federalism suggest that the IRS should have to defer to the state, or at least stay its hand until the proceedings conclude, to protect the charity from inconsistent mandated governance changes.

Senate Finance Committee staff proposals. In June 2004, the staff of the Senate Finance Committee issued a "discussion draft" containing numerous proposals relating to nonprofit governance (Senate Finance Committee 2004). Some of the proposals have a clear tax focus (e.g., extending the private foundation self-dealing prohibitions to insiders of public charities). Other proposals have less of a traditional federal tax focus (e.g., giving the Tax Court the authority to impose equitable remedies for breach of fiduciary duty). Time will tell whether these and the other proposals will lead to legislation, but they signal growing national frustration with perceived abuses by those entrusted with governing charities, and the nonprofit sector is taking the discussion draft very seriously. Notably, at the Committee's request, the Independent Sector organized a Panel on the Nonprofit Sector, which issued a report addressing those reforms appropriate for legislative change, IRS adoption, and consideration as voluntary best practice by the sector itself (Independent Sector Panel 2005).[49]

Nonprofit Derivative Suits and the Issue of Private "Standing"

Traditionally, private parties—including donors—have no legal authority to sue to enforce charitable duties. "Despite the fact that the organization is legally bound by specific terms of the gift; *legally* it is not the donor's concern. It is *society's* concern, to be pursued (or not) by society's representative, the attorney general" (Chisolm 1995:147, emphasis in original). The reason for disabling the donor might be to recognize the completeness of the gift for public purposes, but the rule applies even when the donor is not seeking a return of the gift—indeed, a donor who retains a "right of reverter" in the case of failure of the gift does have standing to sue for its return. In practice, where, as is most likely, the donor wants to make an irrevocable gift to charity, a "gift over" provision can be useful. Thus, when a gift is made "to charity *X,* but if the terms of the gift are not carried out, then to Charity *Y,*" the alternate charity can sue to claim the gift. This direct oversight and prospect of loss would concentrate the mind of the initial donee—but so would granting standing to the donor, a mechanism that might better carry out the donor's original charitable intent.

Nor, except in rare cases, do individual beneficiaries have standing to sue charity trustees or directors, either directly or derivatively on behalf of the charity, because "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public" (Bogert 1954:663; see generally Blasko et al. 1993). Courts will grant standing to a director or trustee who is charging the others with breach of fiduciary duty, although this practice is more appropriately limited to breaches of the duty of loyalty; in an ordinary suit for breach

of the duty of care, outvoted fiduciaries cannot reargue the board's business decision in court.

To minimize the risk of vexatious and multiple lawsuits but to take advantage of the oversight provided by appropriate private parties, a few modern statutes grant standing to an expanded class of private persons to sue fiduciaries, with any monetary recovery going to the nonprofit.[50] Even without statutory authorization, courts will, on rare occasion, grant standing to those with a "special interest" (Fremont-Smith 1997). One commentary also found: "If a court determines that the attorney general is substantially ineffective, the probability increases that a private party will be allowed to represent, in litigation, the public's beneficial interest in a charity" (Blasko 1993:69). In the case of trusts, section 405(c) of the new Uniform Trust Code allows the settlor "of a charitable trust . . . [to] maintain a proceeding to enforce the trust" (Chester 2003). My draft for the American Law Institute's *Principles of the Law of Nonprofit Organizations,* however, generally denies donor standing to enforce a gift restriction in the absence of a provision to the contrary in the gift instrument (American Law Institute 2005a; see also Brody 2005b).[51]

LEGAL ISSUES AFFECTING INVESTMENTS, OPERATIONS, AND CHANGE OF PURPOSE

Enduring Donor Control

The absolute discretion of a donor to give or withhold making a charitable gift—with whatever conditions the donor imposes—is, to some, the essence of private philanthropy. (The charity also has the right not to accept the gift as restricted, but we will assume that the charity desires the gift.)[52] Once a gift has been made or pledged, however, the arrangements could veer from plan. A charity might not use a contribution as the donor directed (or as the charity promised in soliciting the gift). A donor might not fulfill a pledge. Less simply, a charity might shift its initial mission. Or the charity might maintain its mission, but shift its methods of implementation, to the detriment of current beneficiaries.

Traditionally, the law did not accommodate a donor who later regretted or was willing to alter gift restrictions. For the past thirty years, the Uniform Management of Institutional Funds Act has provided a mechanism for releasing donor restrictions: if written consent cannot be obtained because of the donor's death, disability, unavailability, or impossibility of identification, then the charity may apply to court for release of the restriction. Moreover, the draft 2005 revision of UMIFA would liberalize this regime, and confirm that the charity can always petition the court for relief (even without consulting with the donor, or if the donor objects).

The cy pres *doctrine.* Despite the donor's lack of standing, a charity is legally bound to honor donor restrictions (Peregrine and Schwartz 2000a), no matter how confident are the parties that a better use could be made of the funds. No mortal, however, has perfect foresight, so if the donor's dictates cannot be carried out, a court will consider a *cy pres* petition to modify the restriction.[53] Both the 2003 *Restatement (Third) of Trusts* and the 2000 Uniform Trust Code enlarge the *cy pres* threshold test to embrace charitable purposes that have become not only impossible, impracticable, or unlawful but also "wasteful"—an as-yet-undefined term.[54] Once the threshold is met, the court, purporting to determine what the donor would have wanted had he or she known of the unanticipated circumstance, traditionally applied the doctrine by departing as minimally as possible from the original purpose; as the doctrine has been liberalized by Section 67 of the *Third Restatement,* "the court will direct application of the property or appropriate portion thereof to a charitable purpose that reasonably approximates the designated purpose."

States vary in the degree to which they are willing to grant *cy pres* relief. The Buck Trust is the most notorious American *cy pres* case. To simplify, in 1975 Beryl Buck bequeathed $10 million worth of oil company stock to a trust for the benefit of Marin County, California, one of the richest areas in the country. Ten years later, when the stock had ballooned in value to $400 million, the trustee possessing distribution powers sought court approval to spend some of the income to benefit the greater San Francisco Bay area. The attorney general opposed on the ground that the original restriction was not impossible to carry out. The court agreed, and denied *cy pres* relief; the trustee resigned and was replaced (Simon 1987).

Some reformers believe that in a *cy pres* situation, the charity should have absolute discretion to choose a new charitable use for the funds (Atkinson 1993, 1998), but the prospect of unfettered discretion by "philanthropoids" alarms conservative scholars and advisors. Less radically, the draft *Principles on the Law of Nonprofit Organizations* endorses, "without departing from donor intent as a guide . . . a legal framework in which charities bring suit to modify outmoded restrictions; attorneys general support an increased desire by fiduciaries to respond to current needs; and courts grant reasonable relief sought in good faith" (American Law Institute 2005a, §440, General Comments).

Sometimes charity trustees fail to go to court first, but rather act on their own in applying trust assets to purposes different from those specified by the donor, or in deviating from other restrictions (such as investment restrictions). If the trustee is called to account, and the court agrees that the original purpose has failed, no liability will result, but one wonders if a lesser standard is applied in these cases to avoid surcharging the trustees.[55] Worse, trustees might simply let trust funds languish, accumulating income (perhaps enough to cover fees) rather than seeking relief. Section 66 of the *Restatement (Third) of Trusts* imposes an affirmative duty on a trustee "to petition the court for appropriate modification of or deviation from the terms of the trust," in order to keep the trust productive (see also Fremont-Smith 1966:1058).

Technically, a nonprofit corporation does not hold its assets subject to the trust rules; a corporation owns its assets outright, and the same person cannot be both trustee and

beneficiary. Moreover, only a small percentage by value of the typical charity can be traced to donations. We should take care, though, to distinguish between terminology and effect. Corporate donees must still obey any restrictions in a gift, and the modification rules in the draft *Principles on the Law of Nonprofit Organizations* "generally appl[y] in any case where it is appropriate to modify (or release) a restriction on a charitable gift, regardless of whether the property is held in trust or by a corporate charity" (American Law Institute 2005a, §440, General Comments). More broadly, the *cy pres* doctrine exerts its pull on regulators and courts throughout the life of all charities, trust and corporate.

Perpetuities and endowments. Many, if not most, major (and not so major) donors expect immortality of their gift. A donor-imposed prohibition on spending the gift currently is termed an endowment by the common law and by UMIFA. Donors use various expressions to convey perpetuity, such as "to endowment" or "to spend income only" or "to preserve principal intact." The charity enjoys a degree of investment and spending flexibility within such a restriction.

As a separate matter, the attraction of perpetual life induces some donors to start a charity with a small fund whose income, its founder intends, is to accumulate until the principal grows to a certain amount. The law cooperates with such a plan by permitting the accumulation of income for long periods of dormancy if for an eventual charitable purpose.[56] For example, courts upheld the accumulation provisions in Benjamin Franklin's bequest to trusts for the benefit of Boston and Philadelphia, although the diligent trustees resorted time and again to the courts to alter outmoded restrictions (see Simes 1955:129–31, 173 [Appendix]). Today, funds classified as private foundations under federal tax law are subject to an annual 5 percent minimum payout rule.

Importantly, only a donor can impose a legally binding income-only restriction. A charity's self-imposed restriction to maintain principal cannot be enforced. Sometimes charities classify free assets as endowment in order to look more needy to potential donors. In 1993, the Financial Accounting Standards Board adopted the controversial Statement No. 117, requiring charities to categorize their assets as "endowment," "quasi-endowment" (self-imposed), or "current fund" (freely spendable or restricted) (see generally Brody 1997a).

The breaching donor. From the other side, what happens when donors fail to perform as promised? States will typically enforce a charitable pledge, even though the charity provides no "consideration" in the traditional contract sense, if the charity has relied on the promise to its detriment or if the pledge induced others to give (Butig et al. 1992). We are starting to see lawsuits by charities against donors who default on their (major) pledges—often when the donor dies, and the will makes no mention of the promise. Charities seem uneasy about their rights and obligations in such a case, worried about the bad publicity and its effects on prospective donors. Some charities have been told they *must* sue, because of the accounting rules that required them to book the pledge up front (Strosnider 1998). While the law does not impose such an obligation, a board that fails to consider the benefits as well as the costs of suing has not exercised its duty of care (American Law Institute 2005a, §470).

As a separate matter, in light of the recent corporate governance scandals that have snared well-known philanthropists, if a major donor is later charged with a crime, can the charity keep the money but remove the donor's name from a building he or she has funded?[57] Charities hesitate to make gifts look too contractual, but specification in the gift documents could forestall trips to court for application of the doctrine of equitable deviation.

Prudent investment. To counter the perceived conservatism of charity fiduciaries who focused on "income"-paying investments, UMIFA (National Conference of Commissioners 1972) permits charity fiduciaries to make such an investment as "deemed advisable by the governing board, whether or not it produces a current return." About the same time, the U.S. Treasury Department's regulations on "jeopardy investments" by private foundations also blessed such a "total-return" approach, as well as a policy of examining investment decisions in the context of the entire portfolio. Congress adopted this flexible approach in the 1974 federal legislation governing pension trustees.[58] Similar reforms later appeared in the American Law Institute's 1992 *Restatement (Third) of Trusts: The Prudent Investor,* devoted exclusively to this topic.

Charities sometimes face program conflicts when managing their endowments. The *Third Restatement* permits a charity to take "social considerations" into account only if consistent with its charitable mission, "financially or operationally." "Program-related investments" are made to advance a charitable purpose rather than to earn a financial return. At the other extreme, a charity might wish to divest or shun holdings in corporations whose activities clash with its charitable purpose—recall the 1980s divestment in companies doing business in South Africa, echoed today for tobacco stocks. George Bernard Shaw embodied this attitude in Salvation Army Major Barbara, who cringed at accepting "tainted money" from a wealthy distiller and arms merchant.[59]

A donor may direct a charity to retain an investment for personal reasons, such as stock in the donor's business (see, e.g., *In re McCune,* 705 A.2d 861 (Pa. Super. 1997)). As described in Simon, Dale, and Chisolm (this volume), federal tax laws prohibit a "private foundation"—but not other charities, including "supporting organizations"—from owning, generally, more than 20 percent of a business. Moreover, this rule ignores any ownership interest not exceeding 2 percent of the company. Thus, a foundation can be 100 percent invested in a very large company without running afoul of the "excess business holdings" rule. An undiversified portfolio might constitute a "jeopardy investment" subject to another private foundation tax, but the regulations ignore investments gratuitously received. Many of the top foundations hold exclusively a single stock, some with disastrous results (Brody 1998; Dundjerski 2000; Bank 2001).

Importantly, not all foundations with concentrated holdings are limited by their organizing documents to invest in the founder's company. Perhaps diversification would be an unthinkable sign of disloyalty by the trustees, who—if not themselves family members—are probably close advisers to the donor's family or executives in the family business. Generally, state nonprofit law should affirmatively require diversification for all charities, regardless of organizational form, within a reasonable period of time following acquisition. An unusual case in which the regulator obtained the right result through negotiation involved seven "supporting organizations" established by *Reader's Digest* founders DeWitt and Lila Wallace and funded with nonvoting stock of the company for the benefit of the Metropolitan Museum of Art, Lincoln Center, and eleven other charities. Because of their designated public-charity beneficiaries, these supporting organizations were not classified as private foundations under the tax rules. In the 1990s, *Reader's Digest* stock plummeted and slashed its dividends; meanwhile, company executives dominated the supporting organizations' boards. The New York attorney general succeeded in obtaining the dissolution of the organizations; the beneficiary charities are now free to reinvest these holdings (Blumenthal 2001).

In recent years, all investors, including nonprofits, became more conscious of asset allocation. In the mid-1990s, the bull market drew in the smallest charity; foundations, due to their payout requirement, were particularly sensitive to their net worth. Subsequently, posting their first losses after years of positive investment returns, charities seemed to be struggling to maintain their endowments—perhaps overly struggling. As of June 30, 2001, the Art Institute of Chicago had invested nearly $400 million of its $650 million endowment in lightly regulated "hedge funds," only to discover in the fall of that year that a $23 million investment had nearly vanished, and another $20 million was at similar risk. In a lawsuit, the museum complained that the fund in which the loss occurred had promised that the museum "could not lose any of [its] investment, even in a declining market, unless the particular stocks in which the fund assets were invested fell in value by more than 30 percent," but that the fund could not divulge details of its "highly proprietary trading strategy" (Rose 2001). The museum's finance committee included, among others, department-store heir Marshall Field, the chief executive of the Chicago Board of Trade, and a former chairman of Sears, Roebuck; a former chairman of Sara Lee Corporation and the current chairman of Hyatt Hotels Corporation also sat on the board. Commented trustee Field: "This is the risk of the game. And we lost. So what?" (Dugan et al. 2002:A8).

Change of purpose, sale, merger, liquidation, and bankruptcy. Where business corporation statutes require shareholder approval of such extraordinary events as merger or dissolution, nonprofit statutes often require the approval of members. What check, then, applies to fundamental decisions by the fiduciaries of a charity lacking members? Attorneys general can become involved in such extraordinary events as merger, sale of substantially all of the assets, or dissolutions, or application to court to alter the restricted use of assets under the *cy pres* doctrine. A charity cannot, of course, distribute its assets to private individuals. (By contrast, mutual nonprofits, such as social clubs, may, depending on state law, make liquidating distributions to members.) Importantly, charity assets are not inalienable—that is, they can be sold—but then the cash realized on sale is permanently dedicated to charitable use.

Drafters of the ABA's revised Model Act worried about whether a corporate charity (unlike a trust) can alter its purposes without applying to court for *cy pres* relief, quoting *Attorney General v. Hahnemann Hospital,* 494 N.E.2d 1011, 1021 n.18 (Mass. 1986): "Those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists." Some states apply "quasi–*cy pres* principles" to a charitable corporation's amendment of its purposes; such a court proceeding accords deference to the board's determination instead of permitting the judge to substitute his or her judgment (see, e.g., dictum in *Alco Gravure, Inc. v. Knapp Foundation,* 479 N.E.2d 752, 753 (N.Y. 1985)). The new-purposes problem is often avoided by adopting in the initial articles of incorporation a statement that the charity is formed "for any charitable purpose" or similar broad expression.

Daniel Kurtz (1988) finds a third duty of nonprofit fiduciaries: the "duty of obedience" to the organization's original mission.[60] At some point, though, obedience to mission can cloud the rational use of nonprofit corporate assets. Consider the case of a college suffering declining applications, but whose alumni and students do not want it to close (King 1981; Beh 1998). Henry Hansmann describes how regulatory structures—and the combination of history and culture that he calls "institutional inertia"—already lock assets into the nonprofit sector (Hansmann 1996:295–96). Mandating the application of the *cy pres* doctrine to a reevaluation of corporate mission furthers the expectation that charity managers must honor the original purposes of the charity through thick and thin.

The better principle would be that rather than having a duty of obedience to a particular mission, the members of the governing board have a duty to keep the purpose of the charity current and useful. Some commentators would, moreover, differentiate between shifting purposes within the same field or expanding the charitable class, on the one hand, and substantial changes of purpose (as in the anti-vivisectionist example), on the other hand. Changes of purpose in the latter category might be made subject to greater public oversight or an elevated standard of review (Goldschmid 1998; Fishman 1998). Thus, a college—whether financially healthy or struggling—might be permitted to close a department without resort to the attorney general and courts, but liquidation or merger might require notice and approval.

Following a change of purpose, gifts made with explicit restrictions must continue to be used for the designated purpose, but courts are split on whether the charity may use operating income and general gifts for the post-amendment

purpose. The standard for reforming a charitable purpose relates to the question of the uses to which the pre-amendment assets may be put. After all, the more liberally a corporate charity may alter its purposes, the more it might be appropriate to impose restrictions on the post-amendment use of previously acquired assets. By contrast, if the standard for amending purpose is the *cy pres* standard then almost by definition the old assets will have to be redirected somewhere—either to the new purpose of the original charity, or transferred to another charity with the same purpose as the old one (American Law Institute 2005a, draft §§240 and 245).

For the nonprofit industry with the most assets, the rules on change of purpose have largely been superseded by the recent wave of "nonprofit hospital conversion statutes." These statutes, though, can make it even harder for a struggling nonprofit hospital to liquidate its assets and redeploy the proceeds to a more socially useful purpose. A few early, poorly supervised conversions led to the sale of nonprofit assets to hospital insiders at favorable prices. The conversion statutes typically require, among other things, public notice and the right of the attorney general to intervene in a proposed sale of assets by a nonprofit hospital corporation to a for-profit (but usually not nonprofit) buyer. Nevertheless, these statutes seem designed less to ensure the highest price for the assets—and thus the largest fund for the resulting "conversion foundation"—and more to provide an opportunity for "the community" to participate in the decision to sell (Hyman 1998). Once the deal is allowed to proceed, the *cy pres* constraint continues: the resulting funds must be used for "health-care purposes" in the community that the hospital served (Fremont-Smith and Lever 2000). In the absence of such a statute, not all trustees have hewn to the original charity's path. One conversion foundation determined that federal and state programs adequately meet the needs of most uninsured patients, and so shifted its focus to education.

Occasionally, a charity "borrows" from the principal of an endowment in order to cover operations.[61] Legally, such a transaction is analyzed as an investment of endowment assets: if such a loan is not prohibited by the gift document, would it be prudent for the charity to invest these funds this way, taking into account the security of the investment and the expected financial return? (Putting the question this way suggests that the answer would often be no.) One might expect, moreover, that these situations arise where the transaction is motivated by financial distress, and so if donor-designated purposes could be jeopardized, court permission might be required.[62]

An extreme version of this issue arose in the tangled proceedings of the AHERF bankruptcy, described above. The attorney general of Pennsylvania obtained an unprecedented *criminal* indictment against the former chief executive officer, chief financial officer, and general counsel. The indictment charged that the officers invaded the endowments and restricted charitable gifts in order to maintain general charitable operations, and by so doing they committed "Theft by Failure to Make Required Disposition of Funds Received" (a felony); "Misapplication of Entrusted Funds" (a misdemeanor); and conspiracy among them. After a preliminary hearing that lasted for months, the judge narrowed the charges to several hundred allegedly misapplied restricted gifts (apparently some $50 million), and dismissed all charges against the former chief financial officer and the former general counsel (Becker 2002). The former chief executive officer pleaded no contest to a single misdemeanor of misapplication of entrusted funds,[63] and served three months of his sentence of eleven-and-a-half to twenty-three months (Becker 2003).

Can general creditors reach donor-restricted funds? Technically, the creditors of a nonprofit organization cannot force the entity into involuntary bankruptcy, but as a practical matter, a troubled charity would have difficulty obtaining goods and services and so might voluntarily file for bankruptcy. Bankruptcy protection extends to the principal of income-only endowment funds of nonprofit organizations. Evidently, though, creditors can reach donations given outright for a charitable purpose of the organization, and not restricted to a specific purpose (see Brody 2005a).

Legal Issues Raised by Commercial Activities

This section provides a few brief comments about how commercial activities ("related" or "unrelated" to the nonprofit purpose) might implicate legal regimes in addition to the fiduciary and tax laws described above and in the Simon, Dale, and Chisolm chapter of this volume.

Antitrust. Antitrust laws, which bar restraints on trade and attempts to monopolize a product in a market, apply not only to such mutual-benefit nonprofits as labor unions, trade associations, amateur athletic associations, and professional regulatory associations, but also to commercial charities (notably nonprofit hospitals) and universities (e.g., *California Dental Association v. Federal Trade Commission,* 526 U.S. 756 (1999)). The NCAA can impose its eligibility requirements on student athletes, but was held to have improperly restricted the salaries of coaches (who accepted a $54.5 million settlement) (Fishman and Schwarz 2000:1026–27). The American Bar Association—whose law-school accreditations are usually required for applicants to state bars—signed a consent decree with the Justice Department; as one result, the ABA dropped its ban on proprietary law schools. Eckel and Steinberg (1993) discuss additional issues surrounding the antitrust treatment of nonprofit organizations.[64]

Labor. Universities that long tolerated textbook royalties going to the faculty author are now contending that the (hopefully) more lucrative profits from distance-learning programs belong to the university under the "work for hire" doctrine. Universities face union-organizing lawsuits from graduate students in their roles as teaching assistants. The organizing activities of doctors would affect nonprofit health maintenance organizations. Harvard and Yale have been under pressure from students and other constituencies to pay a "living wage" to service employees.

Torts. Charities (but not other nonprofits) in many states formerly enjoyed immunity from tort liability. In the modern era of insurance, however, such a shifting of risk to injured parties came to be viewed as unfair and inefficient, and charitable immunity has all but vanished (e.g., *President and Directors of Georgetown College v. Hughes,* 130 F.2d 810 (D.C. 1942)). More recently, though, an increasing number of tort suits have been filed against individual charity personnel—or at least the perception of liability has grown—leading to state and federal "Volunteer Protection Acts" (Tremper 1991; Light 2001). These statutes are triggered when harm befalls a third party, and do not, by contrast, protect volunteer trustees or directors from suits by or on behalf of the charity, or by the attorney general, for breaches of fiduciary duty. The boundaries of tort law are now being tested by the proliferation of suits arising out of the pedophile scandals in the Catholic Church (e.g., *Archdiocese of Milwaukee v. Superior Court,* 5 Cal. Rptr. 3d 154 (Cal. App. 2003), ruling that the Roman Catholic Archdiocese of Milwaukee is subject to specific personal jurisdiction in California, because, by covering up the pedophile conviction of a transferred priest, it engaged in conduct expressly aimed at California and knew its conduct would cause harm in California, *cert. denied* 124 S. Ct. 2874 (2004)).

Government contracting. Nonprofits that contract with the government are subject to government review of their performance and cost allocations. In addition, governments often condition grants on compliance with government personnel standards, such as affirmative action requirements. Other contract conditions can blur the distinction between public and private[65]: for example, San Francisco adopted an ordinance requiring any nonprofit organization that receives more than $250,000 in city contracts to allow the public to attend one board meeting a year (Stehle 1998). At what point do government contracting requirements result in "unconstitutional conditions"? An amendment proposed in the 1990s by Congressman Ernest Istook would have barred charitable contract recipients from engaging in lobbying and certain other advocacy activities with their own funds.

SELF-REGULATION AND LEGAL REGULATORY REFORM

Self-Regulation

Private regulation takes many forms, which vary in their degree of voluntariness or compulsion, and attendant sanction: at the individual organization level, the demands of funders or of government contracts; at the industry or professional level, the requirements of accreditation bodies; and at the sector level, trade association best-practices guides and even certification (see generally Brody 2002a).

One longtime charity watchdog, the donor-focused BBB Wise Giving Alliance, published the standards it uses in responding to public requests about specific charities. (www.give.org/standards/). These standards cover board membership, activity and policies, accuracy of public information such as solicitations and Web sites, openness about relationships with commercial entities, use of funds, annual report, budget, and, for established charities, whether the organization spends more than a certain percent on fundraising and other administrative costs. Rating systems that employ formulas or grades are the most controversial. More systematically, state nonprofit associations began to design variously named "accountability codes" and "standards of practice."[66] Two of the most thorough—adopted by the Maryland Association of Nonprofit Organizations and by the Minnesota Council of Nonprofits in substantially similar form—cover mission and program evaluation, governance, human resources, financial management, fundraising, public accountability and communications, and public policy and advocacy. (Indeed, these "best practices" might be too prescriptive for some.) The "intermediate sanctions" tax law is inducing more charities to adopt conflict-of-interest policies, and these private guidelines explain what the documents should require. Finally, the Maryland association offers peer-review certification for nonprofits seeking to demonstrate that they abide by its principles.

Private regulation has advantages and disadvantages compared with the compulsory, but minimal, public regulation. A charity has some discretion in orienting itself toward particular validating private authorities having varying requirements. For example, a member-funded private body generally relies on voluntarily supplied and unverified information. On the other hand, standards could be inappropriate in a given case, and a proliferation of tests could either unnecessarily burden compliant charities, or cause small charities lacking the sophistication or resources to conform to appear unworthy of donor support. The relationship between the private regulator and regulated can become just as complicated as in the public sector, with concerns of "capture" and protection of elite, vested interests (Meek 1977:2842–44).

The real test of the effectiveness of private regulation comes when the nonprofit body is faced with having to expel or impose other sanctions against a nonconforming nonprofit. The process sends not just a signal of trustworthiness, but also a credible and legitimate signal.

State or Federal Oversight Board?

Attorneys general do not want to run charities. While attorneys general have recently become more active with respect to troubled nonprofit hospitals, one study found that the directors of the charity offices in New York, Connecticut, and Massachusetts generally believe they "should not get involved when a group is having financial troubles unless illegal conduct is alleged, nor should they intervene in the internal battles of a group with active participants" (Bograd 1994:5–6). In short, they "do not view themselves as the 'ultimate owners' of the underlying assets of all charitable organizations, though they do represent the public, donors, and beneficiaries in certain legal proceedings."

Nevertheless, proposals have emerged from time to time

to create a variously conceived "charities board," either at the state level (Karst 1960; Ben-Ner 1994) or at the federal level (Filer Commission 1977; Ginsburg, Marks, and Wertheim 1977:2640–44; Yarmolinsky and Fremont-Smith 1977:2857; Herzlinger 1996). Joel Fleishman (1999:185) revisited this debate by urging: "For the long-run good of the sector, we cannot continue to rely on an inadequately staffed and insufficiently powerful IRS, the vagaries of inadequately staffed and usually not-very-interested offices of state attorneys general which, in any event, have difficulty in policing a sector which routinely crosses state and national boundaries many times a day, the limited scope and vision of voluntary watchdog agencies, the new information-providing organizations, and the investigatory, inflammatory press."

Fleishman would leave the nonprofit sector to address "unwise, injudicious, or careless—but not illegal—patterns of actions by bona fide not-for-profit organizations," while confining government enforcement action to fraudulent behavior by those acting "under cover of a fake not-for-profit mask" (186). He then advocates for joint efforts by the sector and government. If these two strategies fail, as a last resort he would adopt a new federal agency (subordinate to state enforcement): "Great pains should be taken to ensure that its powers are narrowly focused, that its charter is restricted to 'the rules of the game' whereby not-for-profits function, that it be prohibited from dealing with the substance or content of the programs of not-for-profits, and that all of its actions be subject to court review by the standards of strict scrutiny required when First Amendment interests are at stake" (187–88).

Society continually debates the question of "how private is private philanthropy?" Nonprofits are subject to conflicting demands from their various stakeholders and from the public at large. In addressing these tensions, we need to distinguish between necessary legal reform and desirable private remedies.

For charities, different legal regimes can apply to charitable trusts and to nonprofit corporations. The law is being reexamined to consider when (and why) these regimes should be conformed. Reform would clarify attorney general jurisdiction, application of the *cy pres* doctrine (and address a possible "duty of obedience"), and availability of the "business judgment" standard for review of fiduciaries' exercise of the duty of care. Congress could usefully delineate the roles of the Internal Revenue Service and state attorneys general in investigating fiduciary wrongdoing. Proposals to increase the disclosure of exempt-organization tax information bear close watching.

As currently framed, regulated, and enforced, the law basically treats charitable trusts, nonprofit corporations, and voluntary associations as legally inviolable in the absence of fiduciary self-dealing or gross mismanagement. Donors and beneficiaries (but not voting members) typically lack "standing" to complain about nonprofit decisions. Performance could best be improved through self-regulation from the nonprofit sector itself. Recently published ethical standards and best-practices guidelines make a useful start. Any tightening of the legal duty of care (as opposed to loyalty), however, risks the practical result that regulators and courts would likely avoid findings of liability, or impose light sanctions in order to avoid penalizing voluntary service. A greater use of reputational sanctions (such as removal from the board) might be salutary in encouraging more attentive board service.

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NOTES

1. Moreover, the nonprofit universe is broader than those religious, charitable, and educational entities customarily collected under the name "charities." Even less regulated is that host of other types functioning as "mutual-benefit" nonprofits, including labor unions, trade associations, social clubs, fraternal associations, health-maintenance organizations and other mutual insurance entities, and homeowners associations.

2. As described in Simon, Dale, and Chisolm, chapter 12 of this volume, the U.S. Supreme Court has decided numerous important cases under the Internal Revenue Code.

3. By contrast, prosecutions for embezzlement and other crimes are very public affairs. See, for example, the New York attorney general's press release announcing a seventy-two-count indictment against Lorraine Hale, the self-dealing former executive director of Hale House, a home for the children of drug-addicted mothers. Separate from these counts of falsifying business records, forgery, grand larceny, and tax evasion, the attorney general brought a civil forfeiture action seeking restitution of more than $1 million. An investigation by a newly appointed board of directors found that Hale created a phony board (including a fictitious board member), falsified board minutes, and forged signatures (Pristin and Bernstein 2002). "We've got to get some living people on this board," Hale was reported to have once commented (Evans and Saltonstall 2001). Pleading guilty to a single count of larceny, Hale agreed to forfeit about $118,000 worth of assets to Hale House, and to have judgments entered against her and her husband for the balance stolen. See New York Attorney General Press Release, "Former Hale House Director Pleads Guilty to Felony Charges Involving the Misappropriation of Charitable Funds" (July 3, 2002), available at www.oag.state.ny.us/press/2002/jul/jul03a_02.html. Lorraine Hale was sentenced to five years' probation.

4. Notably, regulators conditioned settlement on disclosure by Boston University (Massachusetts), Adelphi University (New York), and the Kamehameha Schools/Bishop Estate (Internal Revenue Service). See, too, the numerous press releases on the New York attorney general's Web site, at www.oag.state.ny.us/charities/press.

5. As of December 2005, the Uniform Trust Code was enacted in fifteen jurisdictions.

6. In the twentieth century the Supreme Court gradually "incorpo-

rated" the Bill of Rights (originally binding only the federal government) into the Fourteenth Amendment's due process protection from the states.

7. Legislatures, however, quickly adopted concurring Justice Story's suggestion to insert "reservation clauses" into charters and later general nonprofit corporation statutes, ensuring that future legislatures could enact statutory amendments to the corporation laws that would apply to existing corporations.

8. This case also approved the transfer of the Mormon Church's property to another charitable purpose under the *cy pres* doctrine as then applied. See Fremont-Smith and Horwitz (2003:16) attributing this aberrational application of "prerogative" *cy pres* to Utah's status as a federal territory.

9. Congress tried again, enacting the Religious Land Use and Institutionalized Persons Act of 2000 (RLUIPA). The more targeted RLUIPA bars governments from implementing a zoning or landmark law in a manner that substantially burdens religious exercise, unless it is the least restrictive means to further a compelling governmental interest. In addition, the statute bars governments from totally excluding religious assemblies from a jurisdiction or "unreasonably" limiting religious assemblies, institutions, or structures within a jurisdiction. Court challenges have begun, with opposite outcomes. See discussion in *Westchester Day School v. Village of Mamaroneck,* 280 F. Supp. 2d 230 (S.D.N.Y. 2003), *vacated and remanded by* 386 F.3d 183 (2d Cir. 2004).

10. By contrast, the California Supreme Court held that the Boy Scouts are not a "public accommodation" under the state's Unruh Civil Rights Act. *Curran v. Mount Diablo Council of the Boy Scouts of America,* 952 P.2d 218 (Cal. 1998) (Boy Scouts denied a homosexual the right to be a troop leader); *Randall v. Orange County Council of the Boy Scouts of America,* 952 P.2d 261 (Cal. 1998) (Boy Scouts denied membership for refusing to affirm a belief in God).

11. In the end, thirty-seven nonprofits joined in "friend of the court" briefs on behalf of James Dale; forty-three nonprofits joined in on briefs for the Boy Scouts. Different organizations of Methodists—the largest sponsors of Boy Scout troops—filed on *each* side.

12. Tax exemption under Internal Revenue Code section 501(c)(3) is a separate matter. See *The Nationalist Movement v. Commissioner of Internal Revenue,* 102 T.C. 558, *aff'd per curiam* 37 F.3d 216 (5th Cir. 1994) (denying section 501(c)(3) status to a white supremacist organization chartered under Mississippi law as "a non-profit charitable, educational and fraternal organization dedicated to advancing American freedom, American democracy and American nationalism"). See generally Simon, Dale, and Chisolm (this volume).

13. One U.S. Supreme Court decision allowed property donated for a municipal park "for whites only" to revert to the family after the fall of Jim Crow laws, ruling that the Georgia courts neutrally applied the *cy pres* doctrine to find that the testator lacked a general charitable intent. *Evans v. Abney,* 396 U.S. 435 (1970). Compare Stephen Girard's will, which created a school for white boys. The Pennsylvania Orphan's Court, on its own, had removed the trustees for refusing to enforce the racial restriction. A federal court found this act to constitute improper state action "which transcended mere testamentary supervision." *Pennsylvania v. Brown,* 270 F. Supp. 782 (E.D. Pa.), *aff'd* 392 F.2d 120 (3d Cir. 1967), *cert. denied* 391 U.S. 921 (1968). Somewhat surprisingly, in 2002, the high court of Maryland unanimously refused to enforce an "illegal racially discriminatory condition by ordering that the proceeds [of a gift for a nursing home benefiting aged white men] be paid to the alternative beneficiary, the University of Maryland Hospital"—although the court assumed for purposes of argument that "judicial enforcement of the racially discriminatory condition, by awarding the proceeds to University Hospital, will not violate the United States Constitution, federal statutes, or the Maryland Constitution." *Home for Incurables of Baltimore City v. University of Maryland Medical System Corporations* 20, 797 A.2d 746, 747 & 750–51 (Md. 2002).

14. Because nonprofit corporations embrace mutual-benefit organizations as well as charities, nonprofit incorporation is permitted for purposes that would not necessarily qualify for charitable trust status.

A charitable trust may not have purposes or provisions that are unlawful or contrary to public policy, but these terms are not self-defining. See section 28 of the *Restatement (Third) of Trusts;* besides finding a prohibition on "invidious" discrimination, as described above, the American Law Institute comments: "A trust for the dissemination of beliefs or doctrines may be charitable although the views are out of harmony with those of a majority of the public. . . . A trust, however, for the dissemination of beliefs or doctrines that are irrational or apparently so foolish as to be of no significant interest to members of the community is not a charitable trust, even though the dissemination is not illegal. A trust to provide instruction in the performance of a criminal act or to induce the commission of such acts is not charitable, although a trust to support the dissemination of literature advocating or explaining the nature and societal benefits of conduct or procedures that are illegal in the state (e.g., assisted suicide) would ordinarily be an educational and thus charitable purpose" (American Law Institute 2003, §28, Comment *h*).

15. Hansmann's compelling construct has even caught the attention of the United States Supreme Court. See *Austin v. Michigan State Chamber of Commerce,* 494 U.S. 652, 675 n.6 (1990) (Brennan, J., concurring) (citations to Hansmann omitted): "The nondistribution constraint helps overcome contractual failure in situations where the activities of the corporation are difficult to monitor, by removing the 'profit motive' and assuring those who contribute to, and contract with, the corporation that the nonprofit's managers will not exploit informational deficiencies to pursue their own private interests. Hence, Justice Kennedy's proposed reliance on a nonprofit's donors to monitor and police the corporation's activities overlooks the raison d'etre of the nonprofit form."

16. From the earliest days of Anglo-American charity, a charity could take either of two legal forms, one court-defined (common law) and the other legislative (statutory). Traditionally, the trust could be created wholly in the private sphere: a settlor makes an agreement with a trustee for the management and disposition of a fund of money or property. If the beneficiaries are indefinite and the trust has a charitable purpose, the trust may exist in perpetuity. A corporation, by contrast, requires the grant of a legislative charter in order to obtain such characteristics as perpetual life. The overwhelming American preference for the corporate form results from historical accident and a combination of institutional forces. As described below, the technical differences between the trust and corporate form for charity are, in practice, minimized by action by the creators and by the existence of charity regulation that applies regardless of organizational form. (See Zollmann 1924; Fremont-Smith 1965; Fremont-Smith 2004a.)

17. The concept of *fiduciary* permeates the law. The word derives from the Latin word for faithfulness. In the nonprofit context, we use the term to refer to trustees of charitable trusts and directors of nonprofit corporations.

18. Practitioner Michael Peregrine and former California charity official James Schwartz distinguish "'passive' errors in judgment"—which courts would not likely find constitute gross negligence—from "consistent and significant failures to exercise board oversight" (Peregrine and Schwartz 2000b:471). They observe that a variety of factors for which nonprofit boards are often criticized will present difficult issues for the courts: "The (unproven and potentially unjust) criticisms typically made against directors in situations involving troubled operations are somewhat uniform, including (a) failure to insist upon timely and understandable reports from management; (b) failure to comprehend (or ask questions regarding) material transactions; (c) failure to insist upon effective internal and external audit functions; (d) over-reliance upon 'dependent' rather than 'independent' advisors; and (e) failure to challenge questionable executive compensation arrangements."

19. For example, the New York State Board of Regents removed

and replaced eighteen of Adelphi University's nineteen trustees for acting "blindly, recklessly and heedlessly" in setting the unreasonable compensation paid to university president Peter Diamandopoulos. Panel of New York State Board of Regents, Report and Recommendations After a Hearing to the Full Board of Regents, *in* The Committee to Save Adelphi, *et al.* v. Diamandopoulos, *et al.* at 26–33 (Albany, N.Y.: Feb. 5, 1997). The Regents also found that several trustees had conflicts of interest, and violated their duty of loyalty. *Id.* at 33–46. As described in note 24 below, in settlement of the subsequent enforcement action brought by the New York attorney general, the former trustees agreed to reimburse the university about $1.6 million it paid in legal fees and other costs.

20. The state charity officials also cited the "self-employment syndrome," where a charity "was created primarily for the benefit of its formerly unemployed executive, and the board, staff, vendors, and contractors include many friends and relatives of the executive."

21. But see *Lynch v. Redfield Foundation,* 9 Cal. App. 3d 293 (1970) (surcharging squabbling directors for permitting funds to accumulate in a non-interest-bearing account for five years).

22. Specifically, under the duty of care, the normative standard of conduct is reasonableness, but the judicial standard of review is more lenient: under the business judgment rule, "a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational" (Allen, Jacobs, and Strine 2001:1296). These authors, who have all served on the chancery court in Delaware, defend the result of insulating director conduct from judicial scrutiny on social utility grounds and "to reduce the likelihood of erroneous judicial decisions that might deter director risk-taking."

23. Typifying—if not parodying—the current standard is the notorious Sibley Hospital decision (*Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries,* 381 F. Supp. 1003, 1021 (D.D.C. 1974) (mem.)), where the court found fiduciary breaches, but generally required only that each director read the court's opinion! See Peregrine and Schwartz (2000:464), suggesting that under similar circumstances today, "removal and/or surcharge of the responsible directors would be ordered (or at least certainly sought by the Attorney General)."

24. Compare, though, the settlement between the New York attorney general and the ousted trustees of Adelphi University, who, without admitting wrongdoing, agreed to pay Adelphi $1.23 million and assume more than $400,000 in legal bills. The attorney general purportedly prohibited the D&O policy from being the source of payment (Halbfinger 1998). Unfortunately, the settlement document merely recites the aggregate amounts owed, providing no specific guidance on how the trustees were surcharged. Compare Allen, Jacobs, and Strine (2001:1318): "In cases where the transaction cannot be undone, the court must conduct a director-by-director inquiry into which specific directors actually engaged in a breach of fiduciary duty sufficient to justify monetary liability."

25. AHERF had typically carried $50 million in D&O insurance, but in the months immediately prior to its bankruptcy filing had purchased four times that coverage; the insurance companies asserted that the later policies were fraudulent (Becker 2002).

26. Reportedly, the Bishop Estate considered moving its state of incorporation in order to escape the oversight of the Hawaii attorney general—indeed, it contemplated moving to an American Indian reservation to get out from IRS jurisdiction as well—but, as a trust, hesitated because of the necessity of obtaining court approval.

27. See, e.g., *Fitzgerald v. National Rifle Association,* 383 F. Supp. 162 (D.N.J. 1974) (requiring the NRA's magazine to accept an advertisement about Fitzgerald's candidacy for the board, but not requiring the NRA to allow his ad to solicit for contributions). The ABA's Model Act grants members a right to inspect and copy an organization's membership list if the request is made in good faith and for a proper purpose. See also *Bernstein v. Alameda-Contra Costa Medical Association,* 293 P.2d 862 (Cal. App. 1956) (additional protections for expulsion from professional association). As to religious organizations, see e.g., *Watson v. Jones,* 80 U.S. 679 (1871) (comparing different organizational structures for churches); *Serbian Eastern Orthodox Diocese for the United States of America and Canada v. Milivojevich,* 426 U.S. 696, 710 (1976) (civil courts have no authority to resolve church disputes turning on church doctrine, practice, polity, or administration); *Jones v. Wolf,* 443 U.S. 595 (1979) (applying a test of neutrality). See generally Chafee 1930; Ellman 1981; O'Melinn 2000.

28. Cal. Corp. Code §5227. Mandating a majority of disinterested directors, though, might simply lead to dummy outside directors (see Fishman 1987:448). The ABA's Model Act offers such a provision as optional section 8.13, commenting: "This section is optional as many members of the Subcommittee . . . felt that its provisions would be ineffective in preventing intentional abuses, while presenting a burdensome or inconvenient requirement. . . . Legitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation."

29. See "BBB Wise Giving Alliance Standards for Charity Accountability" (effective March 3, 2003), and "Implementation Guide to the BBB Wise Giving Alliance Standards for Charity Accountability," available at www.give.org/standards/.

30. For example, on September 30, 2004, the governor of California signed SB 1262, the Charity Integrity Act. Primarily directed to charitable solicitations, SB 1262 also contains some governance provisions. In general, the board or trustee of charities having at least $2 million in annual revenues must: obtain audited financial statements, and make these publicly available; "if it is a corporation, have an audit committee appointed by the board of directors"; and "review and approve the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to assure that it is just and reasonable." In early 2005 the New York attorney general released a set of legislative proposals to amend the Not-for-Profit Corporation Law. (The four separate bills are available at www.oag.state.ny.us/charities/legislation.html.) One proposal purports to mandate executive committees for organizations with more than twenty-five board members, and audits committees would be required for organizations having audited financial statements or more than $2 million of revenue. The proposal, however, permits any not-for-profit corporation to opt out of these requirements by appropriately amending its articles of incorporation (see generally Brakman Reiser 2005). Note that Drexel University made headlines by voluntarily adopting many of the requirements of Sarbanes-Oxley (see the March 10, 2003, memo from its general counsel to the National Association of College and University Attorneys, with links to board documents, at www.nacua.org/documents/Drexel_Sarbanes-Oxley_Memo.doc.)

31. In defending New York State's delay in discovering and exposing the looting of Hale House (a children's shelter that attracted millions of dollars in donations) by its longtime executive director, "[attorney general] Mr. Spitzer said the charities bureau in his office was charged with helping charities comply with state requirements, rather than aggressively policing them. The bureau has only six accountants to oversee 40,000 charities, he said, and it still must rely on information kept on 3-by-5 index cards to track the organizations. Requests for the money to computerize the operation have been repeatedly rejected" (Bernstein 2002). Moreover, Hale House's founder was the executive director's mother, who "was elevated to sainthood" by Ronald Reagan and popular with other politicians (*Bernstein 2002,* quoting the senior vice president for agency services at United Way).

32. Peregrine and Schwartz (2002) cite the "increasing use [by attorneys general] of charitable trust laws to effect remedies that are unavailable under nonprofit law," resistance to applying the business

judgment rule in the nonprofit context, and even asserting "waste" of corporate assets. Moreover, in the absence of a statute, a state attorney general usually has no enforcement authority over a nonprofit corporation other than a charity.

33. Separately, attorney general action might reflect a rivalry between a state's regulatory agencies: depending on the industry in which it operates, a given nonprofit organization might be regulated by such other agencies as the insurance commissioner, the department of health, education, or commerce, or the corporations commission. In some states, the attorney general's *parens patriae* power is exercised by the district attorney.

34. All of these factors are combining to present particular difficulties for multi-state nonprofit hospital systems seeking to consolidate their assets.

35. I was retained as an adviser to the Terra Foundation defendants in July 2001.

36. See *Joint Press Release re Buntrock, et al. v. Terra Foundation, et al.,* PR Newswire, July 26, 2001.

37. See, e.g., *Nathan Littauer Hospital v. Spitzer,* 734 N.Y.S.2d 671 (N.Y. App. 2001). In this case, a hospital wanted to restructure to create a sole member that, in turn, would adhere to directives for Catholic health care. Abortion rights groups protested and the attorney general asserted approval powers over the disposition of nonprofit corporate assets. The court ruled that the attorney general "has failed to offer any persuasive authority in support of the proposition that a change in the composition of Littauer's membership is the functional equivalent of a sale, lease, exchange or other disposition of corporate assets."

38. See, e.g., *In the Matter of the Trust under the Will of Caroline Weld Fuller,* 636 N.E.2d 1333 (Mass. 1994) (rejecting automatic approval of the attorney general's monetary settlement with the fiduciaries), discussed in Fremont-Smith (1997:15).

39. The Internet revolution highlights the long-standing problems of state charity regulators faced with the interstate activities of both look-alike and legitimate charities. Where is Internet charitable solicitation taking place for legal purposes, and who can regulate it (Monaghan 1996)? The National Association of Attorneys General/National Association of State Charities Officials (NAAG/NASCO) released a proposal on this topic—called the "Charleston Principles" after the conference at which it was developed—in September 2000 (www.nasconet.com).

40. The trust law mechanism of *cy pres,* discussed below, is available when more money is donated for a cause than turns out to be needed; with court approval, the surplus can be redirected to a similar purpose.

41. *Schaumburg* invalidated a municipal ordinance prohibiting the solicitation of contributions by charitable organizations that did not use at least 75 percent of their receipts for "charitable purposes." *Munson* invalidated a statute that forbade contracts between charities and professional fundraisers if, after costs, the fundraiser retained more than 25 percent of collections. *Riley* barred a state from, among other things, requiring professional fundraisers to disclose to potential donors the percentage of prior contributions retained as fees. *Madigan,* which involved a charity whose fundraising contract called for 85 percent of amounts collected to be retained by the professional fundraiser, allowed the Illinois attorney general's suit against the telemarketer to proceed because "the gravamen of the fraud action in this case is not high costs or fees; it is particular representations made with intent to mislead" (123 S. Ct. at 1841).

42. See also the discussion of *United Cancer Council v. Commissioner,* 165 F.3d 1173 (7th Cir. 1999), in Simon, Dale, and Chisolm (this volume). Judge Richard Posner rejected the IRS's assertion that a fundraiser unrelated to the charity became an insider for purposes of the prohibition on private inurement in Internal Revenue Code section 501(c)(3) by negotiating a "one-sided" contract. However, the court remanded the case to see whether the contract resulted in so much private benefit that the charity no longer operated for an exempt purpose. This "private benefit" doctrine is still relatively novel and its boundaries untested; the parties settled before the Tax Court could rule on the issue.

43. *In re Waldemar Cancer Research Ass'n, Inc.,* 130 N.Y.S.2d 426, 426–27 (Sup. Ct. 1954). For a discussion of this and other examples, see Silber (2001:62–63 and accompanying notes).

44. Version v3.00 (September 2004) supports thirty-five jurisdictions (thirty-four states and the District of Columbia), and includes supplemental forms required by six states (www.multistatefiling.org). This form resulted from a joint project of the National Association of State Charities Officials, the National Association of Attorneys General, and the Multi-State Filer Program, a consortium of nonprofits.

45. The post–September 11, 2001, U.S. Patriot Act extended the FTC's authority over charitable-solicitation telemarketing activities. U.S.A. Patriot Act, Public Law No. 107–56, 115 Stat. 272, §1011 ("Crimes against Charitable Americans") (2001), www.ftc.gov/bcp/conline/edcams/charityfraud/index.html.

46. This discussion assumes that donors care about how effectively the charity uses the funds—which could be called "instrumental giving." Giving can also occur for other (or additional) reasons—such as identification with a group, erection of a building, or maintenance of another expressive purpose. Now that disclosure is becoming widespread, we should be able to learn more about the extent to which donors care about the financial position of potential donees. In particular, we can see whether charities with large endowments and other surpluses will change their practices in order to continue attracting contributions.

47. For charities defined as "private foundations," Congress enacted specific penalty taxes for failure to distribute a minimum payout for charitable purposes, maintenance of excess business holdings, and jeopardy investments, as well as self-dealing.

48. See the Kamehameha Schools/Bishop Estate closing agreement, which the IRS insisted be placed on the Web (www.ksbe.edu/newsroom/filings/toc.html#closing). This agreement required, in addition to a payment from KSBE to the IRS of $9 million plus interest (for a total of about $14 million), the permanent removal of the incumbent trustees; the reorganization of KSBE around a chief executive officer to carry out the policy decisions of the board of trustees; the adoption of an investment policy and a spending policy focused on education; adoption of a conflicts-of-interest policy and adherence to the probate court's directive for setting trustee compensation; a ban on hiring any governmental employee or official until three years after termination of governmental service; and the Internet posting of the final closing agreement and of KSBE financial statements for the next five years. Like state settlements, IRS closing agreements usually remain confidential.

49. I was appointed to serve as a member of the Panel's Expert Advisory Group.

50. In a statutory mechanism based on a venerable common law practice, California permits suit by anyone granted "relator" status by the attorney general. "The relator generally takes an active part in the proceeding and is responsible for court costs, but the attorney general retains control of the action and can withdraw, dismiss or compromise it at any time" (Blasko et al. 1993, at 49 [footnote omitted]; see also Fishman [1985:674] urging that successful relators be granted costs and attorney's fees).

51. New York, however, offers a recent contrast. To the surprise and strong criticism of legal scholars, an appellate court in New York granted standing to a donor's widow—as a court-appointed representative of her husband's estate—to challenge the use of his restricted gift, despite an alternative arrangement approved by the attorney general. *Smithers v. St. Luke's-Roosevelt Hospital Center,* 723 N.Y.S.2d 426 (App. Div. 2001). The three-judge majority opinion declared: "We conclude that the distinct but related interests of the donor and the Attorney General are best served by continuing to accord standing to donors

to enforce the terms of their own gifts concurrent with the Attorney General's standing to enforce such gifts on behalf of the beneficiaries thereof."

The lone dissenting judge reviewed the traditional standing rules, distinguishing between any rights that might be held by the donor, the donor's estate, and the donor's heirs. The dissent lamented the effect of the holding in this case on the attorney general's authority to regulate charities: "By determining that the plaintiff may pursue the instant action, the majority necessarily concludes that a decedent's estate, which has no interest in a gift, may prevent the New York State Attorney General from exercising his discretion in determining how to prosecute alleged violations of the law."

52. See, for example, the Association of Fundraising Professionals' November/December 2000 essay on the emerging issue of "How Much Donor Involvement Is Too Much?" at www.afpnet.org/ethics, describing how restrictions might violate a nonprofit's mission statement or conflicts-of-interest policy, as well as public-benefit legal requirements.

53. More frequently applied is the relatively liberal doctrine of equitable deviation, which focuses on means rather than ends. For example, a donor might have specified that the donated building be retained, but if the property is later destroyed or condemned, the resulting insurance or condemnation proceeds would, upon court approval, be re-employed for the original purpose.

54. The *Third Restatement* comments: "The term 'wasteful' is used here neither in the sense of common-law waste nor to suggest that a lesser standard of merely 'better use' will suffice" (American Law Institute 2003, §67, Comment *c(1)*).

As a prerequisite to *cy pres* modification, the donor traditionally must have had a "general charitable intent"; otherwise, on the failure of the charitable purpose, the gift would revert to the donor or his or her successors in interest. Under section 413 of the Uniform Trust Code, a presumption in favor of a general charitable intent exists; moreover, a reversion to a person other than a charity would be permitted only if "(1) the trust property is to revert to the settlor and the settlor is still living; or (2) fewer than 21 years have elapsed since the date of the trust's creation."

55. The *Restatement (Third) of Trusts* comments: "If . . . a trustee (e.g., a recipient institution or community foundation), without prior court authorization, applies property to a purpose other than that designated in the terms of the trust, the trustee is subject to liability for breach of trust. If, however, the application made by the trustee is such as the court would have directed, the court may approve the application, and such approval will be as effective as though the court had authorized the application before it was made" (American Law Institute 2003, §67, Comment *d*). See also Fremont-Smith (1966:1044): "a trustee may be relieved from personal liability for failure to perform a duty or for overstepping the limits of his power but may yet be forced by a court to adhere to that duty in his future conduct."

56. See Fisch et al. 1974, at §119. Courts sometimes exercise equity powers to require that accumulations be reasonable in light of the donor's charitable purpose and public policy. For example, the will in *James' Estate,* 199 A.2d 275 (Pa. 1964) (trust income to accumulate until vesting in the Masons in 400 years). The court stated: "We are reluctant to ascribe to testator the paramount desire merely to turn an approximately $50,000 trust fund into a final gift of almost $15,000,000 at the expense of immediate social needs." Making the gift available immediately to the beneficiary in the absence of evidence that the donor had a specific project in mind, the court observed: "Shifting and advanced social concepts, programs and concerns emphasize the hazards of seeking to correct or alleviate social problems so distantly removed from testator's generation."

57. One college took the donor's money to build a building yet refused to put the donor's name on it. It transpired that when the college's board of regents was voting to accept the gift and name the wing, "unknown to them, appellant had for years been secretly mailing anonymous letters to families and individuals of mixed race and religion. These letters denounced mixed marriages, professed a viewpoint based on racial purity, and, according to some recipients, produced fear in them." Nevertheless, the court noted: "Appellant does not argue that his extracurricular activities did not give Augsburg College a legitimate reason to change its mind to not memorialize his name by naming an important wing of a new building after him. What appellant can claim is that once Augsburg changed its mind, it had a legal obligation to return his money, as the specific reason for giving the $500,000 no longer existed." *Stock v. Augsburg College,* 2002 Minn. App. LEXIS 421, at n.2 (Apr. 16, 2002) (unpublished). Evidently no trend is developing for universities to remove the names of donors now tainted by financial scandal. Compare Hanley (2002) and Pulley (2003).

58. The Employee Retirement Income Security Act (ERISA) also adopted the corporate standard of care and prudence.

59. See Shaw (1906:25–26): "[The Salvation Army] would take money from the devil himself and be only too glad to get it out of his hands and into God's. . . . The notion that you can earmark certain coins as tainted is an unpractical individualist superstition."

60. A New York court recently upheld the attorney general's objection to the sale of assets by one nonprofit hospital to another, invoking such a duty of obedience. The court observed: "Embarkation upon a course of conduct which turns it away from the charity's central and well-understood mission should be a carefully chosen option of last resort. Otherwise, a Board facing difficult financial straits might find sale of its assets, and 'reprioritization' of its mission to be an attractive option, rather than taking all reasonable efforts to preserve the mission which has been the object of its stewardship." *Matter of the Manhattan Eye, Ear & Throat Hospital v. Spitzer,* 715 N.Y.S.2d 575, 595 (1999). Other commentators view the traditional duties of loyalty and care as subsuming a faithfulness to mission, but perhaps with more flexibility.

61. An indirect version of such a transaction can be quite profitable: when the charity can earn a market return on its endowment but borrow from the public by issuing tax-exempt bonds, the charity benefits from the spread. The charity must take care that it does not secure the bonds with its endowment, or else the Internal Revenue Code would require the charity to refund the "arbitrage" profits to the federal government. In practice, a charity will seek a favorable bond rating by granting a security interest, either in real estate or in the income stream from the real estate (see Brody 1997a).

62. In *In the Matter of Estate of Othmer,* 710 N.Y.S.2d 848 (Surrogate's Court of New York, 2000), the court applied *cy pres* to permit a hospital to use a sufficient portion of an income-only fund to secure nearly $90 million in new debt that would implement strategic capital projects and provide working capital. The court cited dramatic changes in the health-care industry since 1995 (notably the growth in managed care, the deregulation of the private sector hospital rate-setting system, the reduction in Medicare reimbursements, and the shift from higher-paying inpatient care to lower-paying ambulatory care). The hospital's bankruptcy and closure, concluded the judge, would frustrate the general charitable purpose of the donors, while the income on the funds was not sufficient to fund long-term operations. The judge cited both the changed circumstances and the "exponential growth" of the donors' assets in approving the recovery plan.

63. A week earlier, the attorney general's press release acknowledges, the court had "dismissed felony theft charges against [former CEO] Abdelhak, saying he did not use the endowment money for his own personal gain." [Pennsylvania] Office of Attorney General Mike Fisher, press release: "AG Fisher: Former AHERF Official Pleads to Raiding Endowments; CEO Sentenced to 11 to 23 Months," August 29, 2002, available at www.attorneygeneral.gov/press/pr.cfm.

64. The Justice Department charged several Ivy League schools and MIT (the "Ivy Overlap Group") with agreeing not to compete over scholarship awards to commonly accepted students. In *United States v. Brown University,* 5 F.3d 658 (3d. Cir. 1993), the court suggested that a

nonprofit might be able to establish a public benefit in order to avoid liability, but the parties settled before the lower court could make findings. In 1994 Congress codified the settlement in a temporary antitrust exception, allowing institutions of higher education awarding need-based student aid to adopt general principles for determining need (but prohibiting agreements on awards to specific students); in 2001, Congress extended the exemption through 2008 and directed the General Accounting Office to study and assess current practices. Need-Based Educational Aid Act of 2001, Public Law 107–72, 115 Stat. 648 (Nov. 29, 2001). With the extension, asserted Congressman James Sensenbrenner, "there will be more money to go around to more good students and to open the doors to these well-endowed, prestigious private colleges and universities to more people to be able to go there." 147 Cong. Record (Nov. 6, 2001): H7731. To Senator Herb Kohl, however, "Our antitrust laws guarantee competition, and competition means lower prices and higher quality for consumers—including students purchasing a college education, but the colleges and universities using the exemption believe that the market functions differently in this case. I am therefore willing to extend the exemption for another seven years but believe that any further activity in this area must be coupled with hard objective data proving that his line exemption does indeed benefit students and their families." 147 Cong. Record (Nov. 3, 2001): S10252.

65. Technology-transfer laws, on the other hand, are allowing researchers to keep more profits.

66. For management-focused membership groups, see the Evangelical Council for Financial Accountability, *Seven Standards of Responsible Stewardship,* at www.ecfa.org; the Maryland Association of Nonprofit Organizations, *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector,* II.B.6 (1998), available at www.mdnonprofit.org/ethicbook.htm; the Minnesota Council of Nonprofits, *Principles & Practices for Nonprofit Excellence* (1998), available at www.mncn.org/pnp_doc.htm#intro; and the Association of Fundraising Professionals (formerly the National Society of Fund Raising Executives), which requires those applying for certification to adhere to its *Code of Ethics and Standards of Professional Practice* in addition to its *Donor Bill of Rights,* available at www.nsfre.org/about/certification/about_certification.html.

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