The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy

Carter G. Bishop

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THE DEONTOLOGICAL SIGNIFICANCE OF NONPROFIT CORPORATE GOVERNANCE STANDARDS: A FIDUCIARY DUTY OF CARE WITHOUT A REMEDY

Carter G. Bishop

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“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”
LOUIS D. BRANDeIS, OTHER PEOPLE’S MONEY AND HOW BANKERS USE IT 92 (Frederick A. Stokes Co. ed. 1913).

“Act as if you have faith, and faith will be given you.”
UNKNOWN SOURCE

Given the diverse charitable missions of nonprofit organizations and the high rate of unpaid donor and volunteer service among charitable nonprofit boards of directors, few would seriously suggest that a nonprofit corporate director’s fiduciary duty of care to oversee management should exceed that of a for-profit corporate director counterpart. Most for-profit corporate directors’ duty of care breaches are protected by the business judgment rule and statutory exculpation clauses.1 However, systematic abdication of directorial duties can result in ruinous unprotected “liability” for for-profit directors through shareholder derivative suits.2 Unfortunately, abdication and dereliction are far more common on volunteer nonprofit charitable boards.3 Excepting the largest charitable nonprofit corporations, directors often

1. See generally PRINCIPLES OF CORPORATE GOVERNANCE § 4.01, at 138-39 (1992) (business judgment rule); see infra notes 306-09 and accompanying text (statutory exculpation).

2. See Mark Fellows, Note, A Business or a Trust?: Janssen v. Best & Flanagan and Judicial Review of For-Profit and Nonprofit Board of Directors Decisions, 30 WM. MITCHELL L. REV. 1503, 1506-08 (2004); see also infra notes 256-60, 279-82, 412-14 and accompanying text.

view their role as advisory rather than supervisory. Consequently, one might expect parallel duties of care to have even more ruinous effects in the charitable nonprofit corporate sector. In fact, this is not true because most charitable nonprofit corporations do not have shareholders, donors lack standing to bring fiduciary duty suits, and although state attorneys general have standing, they lack resources and interest to enforce the duty of care. So, while nonprofit director abdication is far more common, it is far less likely to result in director liability.

What is the significance of a charitable nonprofit director fiduciary duty of care if it does not result in any liability consequences? First and foremost, the duty, properly explained, is eventually internalized tending to create aspirational care behavior in spite of a lack of breach liability. Second, every charitable nonprofit corporation is classified either as a private foundation or as a public charity for federal tax purposes. Significantly, these classifications attach monetary liability to management self-dealing and excess benefit transactions that becomes monstrous if uncorrected after detection. Moreover, these self-dealing and excess benefit transactions create potential monetary liability for charitable nonprofit directors who “knowingly participate” in such transactions. Specifically, even though charitable nonprofit directors are not directly involved in the culpable manager’s behavior, the charitable directors will incur monetary penalties if they had a duty to act. The failure must be due to deliberate inattention, but the intent may be inferred from the fact that knowledge of the improper behavior would have likely developed had the director not been systematically absent from regular directors’ meetings.

The 2008 Model Nonprofit Corporation Act creates fiduciary duties of care for charitable nonprofit corporate directors comparable to those of

4. See Szymanski, supra note 3, at 1325 (discussing criticisms of the independent director, and noting that “most failures [in the nonprofit context] can be traced to board laxity”).

5. See Fishman, supra note 3, at 256-65 (“A fundamental distinction between the business corporation, where shareholders have formal legal authority to assume fiduciary accountability, and the nonprofit organization is the limited nature of standing to sue by the many classes affected by the nonprofit enterprise. . . . The attorney general usually has the responsibility of supervision and oversight of charitable trusts and corporations, and may maintain such actions as appropriate to protect the public interest. . . . Staffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent.”).


7. See infra Part IV.E.

8. See infra Parts IV.E.1.a, IV.E.2.a.
for-profit corporate directors. The 2007 draft of the American Law Institute Principles of the Law of Nonprofit Organizations adopts a similar approach. While neither drafting project offers compelling reasons for creating and imposing largely symbolic fiduciary duties of care, this Article suggests that philosophical, moral, and legal liability bases do exist and indeed depend upon the existence of such a duty. Absent the duty, not only would charitable nonprofit corporate director management behavior likely deteriorate, scandalous behavior would also likely expand unchecked. The unique combination of state law duty with federal liability and detection appears to be the most efficient and best model because it seldom embroils the finances of the nonprofit corporation for enforcement as in shareholder derivative suits.

An assorted array of other solutions to charitable directorial abdication has been proposed as well, but all have critical defects examined in the context of the charitable nonprofit corporation. Following the Enron-era scandals, the federal Sarbanes-Oxley Act (SOX) was enacted in 2002 and imposed a number of substantive governance provisions on publicly traded for-profit corporations. These measures add superficial luster to state law fiduciary duties by making objectionable management activity and lax board oversight more apparent to shareholders and the public. But those provisions do not apply to charitable nonprofit corporations without members or shareholders, the primary targets of this Article and the largest group of nonprofit organizations. While a few states have adopted similar provisions applicable to nonprofits and a few large national charitable nonprofit corporations have voluntarily elected to comply with SOX, the enforcement paradox continues to plague directorial accountability for lax charitable management oversight.

9. See infra Part II.C.
10. See infra Part II.D.
12. See Dana Brakman Reiser, Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability, 38 U.C. DAVIS L. REV. 205, 244 & n.140 (2004); see also Szymanski, supra note 3, at 1304.
14. See infra notes 24-29 and accompanying text.
Notwithstanding federal charitable director liability, the system could be vastly improved, particularly at the management level. While federal tax law creates monstrous liability against participating managers for uncorrected self-dealing and excess benefit transactions, the initial penalty is low and lacks deterrence effect because of low detection rates.\textsuperscript{16} Higher initial penalties would discourage transactional misbehavior even if not detected. Finally, managers are flatly prohibited from self-dealing transactions in the context of private foundations but only prohibited from "excess benefit" transactions in the context of public charities.\textsuperscript{17} Given the scandalous behavior in several notorious charitable management abuse cases, the absolute prohibition applicable to private foundations ought to be extended to public charities. Finally, greater public information transparency would mobilize the press to examine readily accessible documents for violations. News stories can alert the IRS to otherwise undetected violations. Additionally, both private foundations and public charities of an identified minimum size should be required to post charitable exemption applications and annual IRS filings on their own websites.

This Article argues that the fiduciary duty of care plays an important role in curbing director misbehavior in the nonprofit context, but that enforcement mechanisms can be greatly improved. Part I examines the applicability of SOX to the nonprofit corporate sector, and its effectiveness as a model of governance reform. Part II explores current nonprofit corporate governance models, including reform proposals, as well as various legal theories to analyze design features of legislative reform proposals. Because those governance models are patterned after for-profit governance models, Part III explores normative for-profit and nonprofit corporate governance fiduciary duty constraints as developed under modern Delaware law. Part IV analyzes the important extant federal tax constraints on self-dealing transactions applicable to charitable private foundations and public charities.

I. THE EFFECTIVENESS AND APPLICABILITY OF SOX

Most nonprofit governance legislative reforms, best practices efforts, and legal scholarship on the issue share a common theme but diverge regarding appropriate solutions to extant problems. The familiar pattern identifies the obvious connection between for-profit and nonprofit corporate governance standards,\textsuperscript{18} references similar public scandals\textsuperscript{19}

\textsuperscript{16} See discussion infra Parts IV.E.1.b, IV.E.2.b.
\textsuperscript{17} See discussion infra Parts IV.E.1.b, IV.E.2.b.
\textsuperscript{18} Early case law determined that charitable corporations such as colleges and universities are similar in nature to private corporations and dissimilar to public
involving management self-dealing, and analyzes federal SOX legislative reforms designed to restore public trust and confidence in the public securities markets in the for-profit corporate sector. Severe criticism of the design, implementation, and maintenance costs, along with the conventional wisdom regarding the utilitarian ineffectiveness of SOX in the for-profit sector, inevitably leads to the conclusion that state corporations, meaning that the Contracts Clause of the U.S. Constitution prohibits state modification of the charitable private corporation charter. See Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 616-17 (1819); see also U.S. CONST. art. I, § 10. As a consequence, "the development of business corporation law in the nineteenth century provided guidance for the internal operating rules of charitable corporations." James J. Fishman, The Development of Nonprofit Corporation Law and an Agenda for Reform, 34 EMORY L.J. 617, 642 (1985); see also Evelyn Brody, Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms, 40 N.Y.L. SCH. L. REV. 457, 511 (1996).


20. Corporate management self-dealing, and its effects on the nonprofit world, has generated much scholarship. See, e.g., Fishman, supra note 3, at 219-21 & n.1; Marion R. Fremont-Smith, Pillaging of Charitable Assets: Embezzlement and Fraud, 46 EXEMPT ORG. TAX REV. 333, 340-42 (2004); Glenn T. Troyer, David E. Jose & Andrea D. Brashear, Governance Issues For Nonprofit Healthcare Organizations and The Implications of the Sarbanes-Oxley Act, 1 IND. HEALTH L. REV. 175, 180-82 (2004); Gilkeson, supra note 15, at 832-33; see also Lumen N. Mulligan, What's Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms, 105 MICH. L. REV. 1981, 1982 (2007) ("The United States boasts the largest nonprofit sector in the world, and that sector continues to grow. The Internal Revenue Service, the primary federal regulator of nonprofit organizations, currently oversees 1.6 million tax-exempt organizations holding $2.4 trillion in assets. Unfortunately, this huge sector of the economy recently has been pummeled with a spate of now all-too-familiar corporate scandals. In the seven years preceding 2002, officers and directors of major charitable organizations misappropriated at least $1.28 billion from 152 nonprofit organizations. To make matters worse, a recent Chronicle of Philanthropy study contends that this figure, which is based upon newspaper reports, significantly underestimates the scope of abuses within the nonprofit community." (footnotes omitted)).

legislative efforts should abstain from adopting and imposing some or all SOX reforms on nonprofit organizations.\footnote{See Kathleen M. Boozang, \textit{Does an Independent Board Improve Nonprofit Corporate Governance?}, 75 TENN. L. REV. 83, 86-87 (2007) (arguing that independent boards are not the best way to achieve "mission integrity" in the nonprofit sector); Mulligan, supra note 20, at 1996-2002 (arguing that SOX-like reforms will be of little value in improving non-profit governance); Reiser, supra note 12, at 208-09 (advocating for increased nonprofit self-regulation instead of additional government regulation); Dana Brakman Reiser, \textit{There Ought To Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform}, 80 CHI.-KENT L. REV. 559, 606 (2005) (questioning the ability of SOX’s disclosure-based reforms to “transform the accountability of the nonprofit sector”); Szymanski, supra note 3, at 1315-18 (“Our eyebrows should raise initially at the idea of applying Sarbanes-Oxley to not-for-profits due to a mismatch between the stated goals of the Act and the goals to be served by reforming nonprofit law. The main justifications behind the Act’s passage—protection of investors and the accuracy of SEC disclosures—are not at issue in the nonprofit area.”).} Notwithstanding a few notorious failed legislative efforts in New York, Massachusetts, Michigan, Mississippi, Ohio, Pennsylvania, and Vermont,\footnote{See Mulligan, supra note 20, at 1983 & n.11.} only a few states have successfully adopted SOX-style provisions, including California,\footnote{CAL. BUS. & PROF. CODE § 17510.5 (West 1997 & Supp. 2008); CAL. GOV’T. CODE §§ 12581-12599.7 (West 2005 & Supp. 2008).} Connecticut,\footnote{CONN. GEN. STAT. ANN. §§ 21a-190b, -190c, -190f, -190h (West 2006).} Kansas,\footnote{KAN. STAT. ANN. §§ 17-1763, 17-6002 (Supp. 2006).} Maine,\footnote{ME. REV. STAT. ANN. tit. 9, § 5004 (Supp. 2007).} New Hampshire\footnote{N.H. REV. STAT. ANN. §§ 7:28III-a to -b (LexisNexis 2008).} and West Virginia.\footnote{W. VA. CODE ANN. § 12-4-14 (LexisNexis 2004).} Most only apply to large nonprofit organizations. For example, California’s statute applies only to nonprofit organizations with annual gross revenues exceeding $2 million.\footnote{CAL. GOV’T. CODE §§ 12586(e) (West 2005).} To improve public reputation and rejuvenate public donor support, a few large nonprofit organizations voluntarily adopted some or all of the SOX reforms.\footnote{See Gilkeson, supra note 15, at 845; Johnson, supra note 15.}
However, some commentators argue that smaller nonprofit organizations should receive more compassionate treatment.\(^{32}\)

One common theme against imposing SOX on nonprofit organizations is that such state legislative reforms critically fail to account for the mission-diverse stakeholder nature of the nonprofit corporate board\(^3\), as compared to the unified shareholder profit mission of the for-profit corporate board.\(^{34}\) Indeed, SOX criticisms have led some to question whether a liability system of gatekeeper reputation deterrence is as effective as systems that reward good governance such as whistleblower provisions\(^{35}\), release from SOX requirements for "honest corporations,"\(^{36}\) and payments to outside directors\(^7\) and even lawyers for vigilant conduct.\(^{38}\) Even fewer scholars question whether liability deterrence

\(^{32}\) See, e.g., David W. Barrett, Note, \textit{A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations}, 71 IND. L.J. 967, 968-69 (1996) (contending that "small, charitable nonprofits . . . should be the beneficiaries of more lenient standards for director conduct").


\(^{34}\) See Boozang, supra note 22, at 85-86; Mulligan, supra note 20, at 2002-07.


actually discourages directors from performing their legitimate oversight functions, such as detecting management fraud.  

Moreover, beyond peradventure, state-imposed SOX reforms would be disproportionately burdensome to even large nonprofit corporations. Publicly traded corporations were subject to existing audited financial statement requirements before SOX. In addition, they are better equipped to attract financially sophisticated board members, to reasonably compensate them, and to adopt special independent board committees for at least executive compensation matters. Nonprofit corporate board members are mostly unpaid volunteers, generally less financially sophisticated, rarely benefit from audited financial information, and even more rarely utilize independent board committees to consider executive compensation and special financial matters. Worse, unlike a for-profit board annually elected by shareholders but arguably “captured” by management (because management largely selects the slate of directors for shareholder vote), the non-profit board is subject to an even higher degree of management capture because the board is self-perpetuating and not annually elected.

To make matters even less comparable, for-profit corporations commonly employ stock options for executive and board compensation, whereas nonprofit corporations are not publicly traded and thus do not utilize stock options. Self-interested shareholders use derivative suits to

39. See generally Cunningham, supra note 35 (“Previous literature on gatekeepers concentrated on designing a liability system to achieve optimal deterrence while relying largely on gatekeeper reputation as a self-enforcement device. This Article reviews the previous literature, noting inherent limitations of reputation and liability threats, including how the latter discourage gatekeepers from performing desirable services such as fraud detection.” (footnote omitted)).


43. See Reiser, supra note 13, at 829-30 (“For today’s nonprofits, internal democracy is optional. . . . [S]elf-perpetuating boards are the norm and members are rare, particularly among charitable or public benefit nonprofits.”).

actively police board malfeasance and nonfeasance resulting in poor stock performance.\textsuperscript{45} Lack of similar reliable metrics in the nonprofit sector,\textsuperscript{46} coupled with lack of donor standing to bring derivative suits,\textsuperscript{47} exacerbates the problems associated with measuring and policing board malfeasance and nonfeasance. Functionally, only state attorney general charitable divisions, which are often understaffed and underfunded, have jurisdiction to challenge such behavior and are generally more interested in policing solicitation behavior than other board conduct.\textsuperscript{48} Moreover,

\textsuperscript{45} See Robert B. Thompson & Randall S. Thomas, \textit{The Public and Private Faces of Derivative Lawsuits}, 57 VAND. L. REV. 1747, 1748-50 (2004) (arguing that despite procedural barriers and a decline in use, shareholder derivative actions still have an important role to play in policing corporate misconduct in both private and public corporations).


even if donors are granted standing, there is reason to question whether they will adequately police nonprofit governance. After all, unlike shareholders, charitable nonprofit donors make a gift and generally expect no return of or on their investment, other than reasonable advancement of charitable goals. Indeed, the primary expected return is in the form of an existing tax deduction and that return generally exists regardless of lackluster nonprofit corporate governance.49 While various charitable watchdog groups do analyze nonprofit governance and publish the effectiveness of the charity in implementing the charitable gift,50 most donors pay little attention or are simply not aware of this information. Major news scandals may, however, affect donor generosity toward a scandal-heavy nonprofit organization because of the public’s lack of trust in the organization.

Given these differences, especially the lack of enforcement measures, what justifies the added costs of SOX or any other liability system governance reforms for nonprofit organizations? This question remains particularly important given that charitable nonprofit organizations are already subject to a form of federalism not applicable to for-profit corporations. Although SOX does not apply to charitable nonprofit organizations, federal tax regimes are in place to police management and director self-dealing in private foundations51 and excess benefit transactions in public charities.52 The effectiveness of these federal tax measures is difficult to assess because little empirical evidence exists. Some question whether financial penalties are adequately or even appropriately enforced by a revenue-oriented agency rather than a governance-oriented agency.53 Moreover, the federal tax regime bases enforcement decisions on unaudited, late, inaccurate, and inadequate


52. Id. § 4958(c).
financial information provided initially on the Form 1023\(^5\) exemption application and annually on the Form 990\(^5\) annual report. The information may simply not be trustworthy to disclose adequately problematic self-dealing to the federal tax agency or the public with general access to the same information.

The only problem is that all the problems remain. This may merely suggest that reform agendas have yet to develop appropriate reforms that will truly result in improved management and director behavior in the nonprofit sector. It may also suggest a more fundamentally flawed assumption that corrective legislation is truly effective in altering undesirable human behavior. After all, the nonprofit sector benefits from, or labors under, an altruistic agenda not applicable to for-profit corporations. One generally expects better behavior in such a context than in a money-seeking for-profit corporation.

This Article generally posits that while SOX may present some reasonable reform options, it was ill-designed in the first place to solve even the problems in the for-profit sector. Generally, SOX implemented specific mandates designed to fix specific problems through enhanced information disclosure, transparency, and audit committee independence without an adequate foundation in rule theory or policy. Accordingly, SOX may simply become one of the most expensive and least effective reform efforts of the modern era.

In order to avoid similar mistakes in the nonprofit sector, it will be necessary to develop a deeper appreciation for the real world disconnect between non-legal norms and the moral drivers behind nonprofit board governance generally and ethical decision-making specifically. In this environment, managerial and director behavior present an emerging personal calculus that balances personal gain against detection and exposure. This makes nonprofit management and director behavior significantly more suspect under current legal norms because detection and exposure is low and personal gain from self-dealing is high. If true, only a focus on development of a proper moral compass will correct the behavior. The best that legal norms can offer in the short-term is increased detection and liability exposure to shift the personal calculus in favor of moral behavior and ethical decision-making. Unless and until nonprofit directors adhere to a moral philosophy associating moral


behavior with legal behavior, change is incremental at best and prescriptive at worst. Notwithstanding a plethora of legal rules, nonprofit management will continue to behave in rational self-dealing behavior in the shadows, provided that short-term personal financial gains outweigh the risk of long-term reputation costs associated with being detected and exposed.

II. NONPROFIT CORPORATE GOVERNANCE, MORAL NORMS, & LEGAL CONSTRAINTS

This Article assumes that most large nonprofit organizations are organized as nonprofit corporations and not as unincorporated associations or trusts.\textsuperscript{56} State law nonprofit corporate board governance responsibilities are essentially the same as those that apply to the for-profit corporate director. Differences exist primarily in the nature and extent of federal laws and state law fiduciary duty enforcement mechanisms. One area of overlap concerns the problem of self-dealing. As discussed in the next three Parts, self-dealing is treated the same under state law for both for-profit and nonprofit corporations. However, federal tax law generally imposes a stricter rule and penalty against self-dealing in the context of charitable private foundations.\textsuperscript{57} Indeed, the disparate treatment of self-dealing alone might create questions regarding the most appropriate treatment. For example, should the federal tax penalties on self-dealing in the context of private foundations and public charities be relaxed in favor of the corporate model that emphasizes overall fairness to the corporation?\textsuperscript{58} The for-profit corporate fairness standard has been urged as a replacement for the trust sole interest rule.\textsuperscript{59} Others argue against such a transformation.\textsuperscript{60} The

\textsuperscript{56} See Evelyn Brody, Charity Governance: What’s Trust Law Got to Do With It?, 80 CHI.-KENT L. REV. 641, 641 n.1 (2005) (“While we do not know how many charities today are trusts and how many are corporations, the percentage of trusts is assumed to be small.”).

\textsuperscript{57} See infra Part IV.D-E.

\textsuperscript{58} See generally DeMott, supra note 3 (questioning whether “socially desirable consequences [will] follow if standards common in the for-profit setting apply to directors’ self-dealing in the nonprofit context”).

\textsuperscript{59} See generally John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 YALE L.J. 929 (2005) (proposing reform of the sole interest rule to reflect the principle that “the trustee must act in the beneficiary's best interest, but not necessarily in the beneficiary's sole interest,” and stating that “[o]verlaps of interest that are consistent with the best interest of the beneficiary should be allowed”).

\textsuperscript{60} See generally Melanie B. Leslie, In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein, 47 WM. & MARY L. REV. 541 (2005) (arguing that “Professor Langbein fails to prove that the no further inquiry rule is problematic, or that his proposed ‘best-interest’ defense would make trust beneficiaries better off”); Melanie
discussion below first summarizes the state law regarding fiduciary duties from the perspective of the applicable model acts.

A. 1987 Revised Model Nonprofit Corporation Act

The Revised Model Nonprofit Corporation Act of 1987 (1987 RMNPCA) section 8.30(a) provides the normative standards for nonprofit directors. A director must discharge directorial duties: "[(i)] in good faith; [(ii)] with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and [(iii)] in a manner the director reasonably believes to be in the best interests of the corporation." In discharging these duties, "a director is entitled to rely on information, opinions, reports, or statements." These include financial statements and other financial data, if prepared or presented by:

[(i)] one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

[(ii)] legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; and

B. Leslie, Trusting Trustees: Fiduciary Duties and the Limits of Default Rules, 94 GEO. L.J. 67 (2005) ("This article argues that characterizing trustees' fiduciary duties as pure 'default rules' too easily equates trusts with contracts and blinds academics and courts to the need to develop a coherent theory about the extent to which fiduciary duties can be modified."). Although the commercial-seeking character of for-profit corporations may justify conflict-of-interest transactions, there is less to be said for such transactions in the context of a charitable organization with a mission-diverse charitable aspiration. Arguments on both sides attempt to dispute whether the sole interest rule reduces the agency costs in trusts; that is, the cost of monitoring the trustee to determine whether his conduct is in the best interests of the "agent" beneficiaries. See Stewart E. Sterk, Trust Protectors, Agency Costs, and Fiduciary Duty, 27 CARDOZO L. REV. 2761, 2761-62 (2006) (discussing the question of who are the true principals of a trust). Unfortunately, unlike for-profit corporations where directors act as agents for shareholder principals, charitable nonprofit corporations do not have shareholders, and thus the agency cost argument is much less effective. For an ongoing discussion, see Melanie B. Leslie, Common Law, Common Sense: Fiduciary Standards and Trustee Identity, 27 CARDOZO L. REV. 2713 (2006), which argues for disparate statutory fiduciary treatment between professional and non-professional trustees. This argument has obvious analogies to the differences between professional board members of publicly-traded corporations and neophyte directors of, at least, smaller charitable non-profit corporation board members.

61. REVISED MODEL NONPROFIT CORP. ACT § 8.30(a) (1987).
62. Id. § 8.30(a)(1)-(3).
63. Id. § 8.30(b).
[(iii)] a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence. Importantly, provided a director acts in compliance with these duties, the director is not liable to the corporation or any other person for any action taken or not taken.

In addition, nonprofit directors are subject to conflict of interest regulations. A conflict of interest transaction is defined as a transaction between a nonprofit corporation and a director with a direct or indirect interest in the transaction. However, a safe harbor provision dictates that such a transaction is not a basis for imposing director liability if a majority of disinterested directors granted ex ante approval of the transaction following disclosure of all material facts and with a good faith reasonable belief that the transaction was fair to the corporation. The state attorney general has the power to make a determination that the transaction was fair either ex ante or ex post. Absent ex ante approval, the conflicted director may avoid liability by establishing that the transaction was actually fair to the nonprofit corporation.

An optional statutory exculpatory provision provides that the personal liability of a director for monetary damages involving a breach of these duties may be limited or eliminated provided the provision is affirmatively stated in the articles of incorporation. However, such a provision may not limit liability for: (i) "any breach of the director's duty of loyalty to the corporation or its members;" (ii) "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;" (iii) "any transaction from which a director derived an improper personal economic benefit;" or (iv) improper conflict of

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64. Id. § 8.30(b)(1)-(3).
65. Id. § 8.30(d).
66. Id. § 8.31.
67. Id. § 8.31(a).
68. Id. § 8.31(e). If an interested director attends and votes at the meeting, that does not extinguish the otherwise proper approval of a majority of the remaining board. Id.
69. Id. § 8.31(b)(1).
70. Id. § 8.31(b)(1)(i).
71. Id. § 8.31(b)(1)(ii).
72. Id. § 8.31(b)(2)(i).
73. Id. § 8.31(a).
74. Id. § 2.02(b)(5). This provision is listed as an alternative provision of the 1987 RMNPCA.
75. Id. § 2.02(b)(5)(i).
76. Id. § 2.02(b)(5)(ii).
77. Id. § 2.02(b)(5)(iii).
interest transactions, improper loans, or unlawful distributions.\textsuperscript{78} In
addition, a charitable corporation may indemnify a director for any
liability incurred in an official capacity, provided that the director: (i)
acted in good faith; and (ii) reasonably believed the conduct to be in the
best interest of the charitable corporation, or at least not adverse to its
best interests.\textsuperscript{79} However, indemnification is flatly prohibited when the
director is liable because of "improper" financial benefit.\textsuperscript{80} On the other
hand, indemnification for expenses and legal fees is mandatory if the
director was successful in the suit.\textsuperscript{81}

Unfortunately, these codifications creating statutory agency
relationships do little to clarify or articulate the true contours of fiduciary
duty breach and liability. That gloss is left to the common law. Worse,
these statutory norms purport to authorize transactions that federal tax
law flatly prohibits. This creates difficult implementation problems for
advisors and board members. For example, as discussed in Part IV
below, federal excise tax law prohibits self-dealing transactions between
management and board members in the context of a charitable private
foundation. Any such transaction, while permitted under state law if fair,
will result in the imposition of serious financial tax penalties upon the
participant (but not the charitable organization itself). Presumably,
because the federal tax law makes such self-dealing transactions
"improper" regardless of fairness, the charitable corporation would be
prohibited from indemnifying or reimbursing the director for any federal
excise tax personally incurred. However, if the director is successful in a
suit for self-dealing, the charitable corporation would be required to
indemnify him for defense expenditures.\textsuperscript{82}

\textbf{B. 2002 Revised Model Business Corporation Act}

As referenced in Part I, these generalized state law fiduciary duties are
closely aligned to those specified in the 2002 Revised Model Business
Corporation Act (2002 RMBCA). As with case law, the 2002 RMBCA
carefully differentiates between director standards of conduct and
standards of liability.\textsuperscript{83} The board is charged with the responsibility to
manage the affairs of the corporation on behalf of the shareholders.\textsuperscript{84}

\begin{itemize}
  \item \textsuperscript{78} \textit{Id.} \textsuperscript{78} § 2.02(b)(5)(iv); see also \textit{id.} \textsuperscript{78} §§ 8.31-.33.
  \item \textsuperscript{79} \textit{Id.} \textsuperscript{79} § 8.51(a)(1)-(2).
  \item \textsuperscript{80} \textit{Id.} \textsuperscript{80} § 8.51(d)(2).
  \item \textsuperscript{81} \textit{Id.} \textsuperscript{81} § 8.52.
  \item \textsuperscript{82} \textit{See supra} note \textsuperscript{81} and accompanying text.
  \item \textsuperscript{83} \textit{Compare} MODEL BUS. CORP. ACT \textsuperscript{83} § 8.30 (2002) (standards of conduct), \textit{with id.} \textsuperscript{83} §
    8.31 (standards of liability).
  \item \textsuperscript{84} \textit{Id.} \textsuperscript{84} § 8.01(b).\
\end{itemize}
Generally, a director has a duty in discharging that responsibility to: (i) act in good faith; and (ii) in the best interests of the corporation. However, a director is only liable for any decision provided that the action: (i) was not protected from liability by the exculpation statute; and (ii) either the action was not in good faith, was not reasonably believed to be in the best interests of the corporation, or the director was not properly informed.

The exculpation statute provides that an organization's articles of incorporation "may" set forth a provision eliminating or limiting a director's monetary liability damages for "any action taken, or any failure to take action" except for: (i) an excess financial benefit; (ii) "an intentional infliction of harm"; (iii) liability for approving an unauthorized distribution to shareholders; or (iv) "an intentional violation of criminal law." As discussed in Part III, bad faith would be included but not subsumed by the exculpatory language excepting intentional harm. However, the other bases for director liability could generally be eliminated by the exculpation provision. Accordingly, the primary reason for such a liability provision is to cover those situations in which the corporation does not have a permissive exculpation statute in its articles. But, as discussed extensively in Part III, because all director liability can be eliminated by the exculpation statute except for specified conduct, for-profit corporate liability has focused on the disqualification under the exculpation exceptions.

85. Id. § 8.30(a).
86. Id.
87. Id. § 8.31(a). Failure to take action would embrace abdication as a form of inaction sufficient to impose liability.
88. Id. § 2.02(b)(4); see also id. § 8.31(a)(1).
89. Id. § 8.31(a)(2)(i).
90. Id. § 8.31(a)(2)(ii)(A).
91. Id. § 8.31(a)(2)(ii)(B).
92. Id. § 2.02(b)(4)(A).
93. Id. § 2.02(b)(4)(B).
94. Id. § 2.02(b)(4)(C); see also id. § 8.33.
95. Id. § 2.02(b)(4)(D).
96. See id. § 8.31(a)(2).
97. The focus of Part III is on Delaware law. The Delaware exculpation language is somewhat different than the 2002 RMBCA if only because it collapses the "lack of good faith" element with the intentional harm element. Compare id. § 8.31(a)(2)(i) (lack of good faith) and id. § 2.02(b)(4)(B) (intentional harm), with DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2001).
C. 2008 Model Nonprofit Corporation Act

The 2008 changes to the 1987 RMNPCA (2008 MNPCA)\textsuperscript{98} move away from the 1987 RMNPCA and closer to the duty and liability model presented in the 2002 RMBCA. A 2008 MNPCA nonprofit corporation must have a board of directors\textsuperscript{99} that exercises all corporate powers. Accordingly, corporate activities and affairs must be managed by or under the direction of the board.\textsuperscript{100}

Under the 2008 Act, as with a for profit corporation, the board of directors must act in good faith and with a reasonable belief that the action is in the best interests of the nonprofit corporation.\textsuperscript{101} Additionally, the board or a board committee must exercise an ordinary person standard of care in becoming informed to make a decision or in devoting attention to their oversight function.\textsuperscript{102} Also, a director must disclose to the other board or committee members material information not already known by those persons.\textsuperscript{103} However, disclosure is not required where doing so would "violate a duty imposed by law, a legally enforceable obligation of confidentiality, or a professional ethics rule."\textsuperscript{104}

A director may rely on several sources to satisfy the duty of care. First, the director may rely on employees "whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports, or statements provided."\textsuperscript{105} Second, a director may rely on other persons retained by the corporation\textsuperscript{106} provided they normally handle matters involving expertise reasonably believed within the person's competence.\textsuperscript{107} Third, a director may rely on a board committee provided the director is not a member and reasonably

\begin{itemize}
\item \textsuperscript{99} \textit{Model Nonprofit Corp. Act} § 8.01(a) (2008).
\item \textsuperscript{100} \textit{Id.} § 8.01(b). However, the articles may include any provision not inconsistent with law regarding managing the business and regulating the affairs of the corporation. \textit{Id.} § 2.02(b)(6)(ii).
\item \textsuperscript{101} \textit{Id.} § 8.30(a).
\item \textsuperscript{102} \textit{Id.} § 8.30(b).
\item \textsuperscript{103} \textit{Id.} § 8.30(c).
\item \textsuperscript{104} \textit{Id.}
\item \textsuperscript{105} \textit{Id.} § 8.30(f)(1).
\item \textsuperscript{106} \textit{Id.} § 8.30(f)(2).
\item \textsuperscript{107} \textit{Id.}
\end{itemize}
believes the committee merits trust. Finally, a director of a religious corporation may rely on religious authorities such as ministers, priests, and rabbis whose positions justify reliance and confidence.

An important variation from the 1987 RMNPCA and the 2002 RMBCA is that director exculpation in a charitable corporation is now a default rule rather than an optional provision invoked by the articles. Pursuant to the default statute, a director is not liable to a nonprofit corporation for any decision to act or refrain from acting. A director can avoid liability if the articles of incorporation state an exculpation provision, the conflict of interest provisions are satisfied, and the taking of a business opportunity is appropriate. In addition, the director must have acted in bad faith to be liable. A director may be liable if not reasonably believing the action to be in the best interests of the corporation, or if not appropriately informed. The director must also act with objectivity notwithstanding the familial, financial, or business relationship with another person who has a material interest in the conduct. The objectivity must exist even if the relationship or lack of independence could reasonably be expected to affect the director's judgment regarding the conduct. Additionally, a director may be liable if it is reasonable to expect that this effect has been established and the director cannot establish that he reasonably believed the challenged conduct to be in the best interests of the corporation.

As to abdication of duties, "a sustained failure of the director to devote attention to ongoing oversight of the activities and affairs of the corporation, or a failure to devote timely attention, by making appropriate inquiry," where a reasonably attentive director would otherwise have done, will vitiate exculpation. Finally, exculpation is not available upon "receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly

108. Id. § 8.30(f)(3).
109. Id. § 8.30(f)(4).
110. See id. § 8.31(a).
111. Id.
112. Id. § 8.31(a)(1)(i); see also id. § 2.02(c).
113. Id. § 8.31(a)(1)(ii); see also id. § 8.60.
114. Id. § 8.31(a)(1)(iii); see also id. § 8.70.
115. Id. § 8.31(a)(2)(i).
116. Id. § 8.31(a)(2)(ii)(A).
117. Id. § 8.31(a)(2)(ii)(B).
118. Id. § 8.31(a)(2)(iii).
119. Id. § 8.31(a)(2)(iii)(A).
120. Id. § 8.31(a)(2)(iii)(B).
121. Id. § 8.31(a)(2)(iv).
with the corporation and its members that is actionable under applicable law.”

Regarding indemnification for actionable conduct, the 2008 MNPCA provides both a mandatory and a permissive rule. First, a nonprofit corporation “must indemnify a director to the extent the director was successful . . . in the defense of any proceeding.” Also, a nonprofit corporation “may” advance reasonable expenses before final disposition of a proceeding, if the director provides a good faith statement that the standards of conduct have been satisfied, as well as a promise to repay funds advanced if the individual is ultimately not entitled to mandatory indemnification. The promise must be an unlimited general unsecured obligation accepted without reference to the financial ability to repay.

A director may apply to the court for advancement where the court determines that the director is entitled to: (i) mandatory indemnification; (ii) indemnification or advance for expenses pursuant to an authorized provision; or (iii) indemnification is permissible because it is “fair and reasonable” under all circumstances. If the court determines indemnification is appropriate under (i) or (ii), it may also order reimbursement for reasonable expenses for seeking the indemnification. Finally, a nonprofit corporation may purchase insurance on behalf of a director even if indemnification would not have been appropriate.

**D. ALI Principles of Nonprofit Governance**

The American Law Institute 2007 Draft of the Principles of the Law of Nonprofit Organizations (2007 ALI-PLNPO Draft) is more nuanced than the 1987 RMNPCA, 2002 RMBCA, or 2008 MNPCA. Since the 2007 ALI-PLNPO Draft offers “governing principles” rather than a model act intended for legislative enactment, it seeks to influence attitudes and opinions rather than shape the precise contours of future...
legislation. As such, it is far more specific regarding the nature, scope, and immutability of charitable nonprofit corporation director fiduciary duties to oversee management and the affairs of the charitable enterprise. But, a basic premise remains throughout the materials: "if you're on the board, you're on the hook." Thus, under the 2007 ALI-PLNPO Draft, substantial donors and advisors interested in the charitable mission of a nonprofit direct their governance talents and interests toward executive committees and advisory boards where insight is valuable, but their duty and liability are reduced or nonexistent.

Before setting forth the contours of the fiduciary duties of charitable board members, it is worth introducing special definitions discussed in Part IV below, which examines the excise tax liability of private foundation managers who "approve" acts of management self-dealing and public charity organization managers who "approve" management excess benefit transactions. A private foundation manager includes (i) an officer, director, or trustee of a foundation (or similar individuals), and (ii) the employees of the foundation having authority or responsibility to act. A person is considered an officer if so designated, or if regularly exercising authority to make administrative or policy decisions on behalf of the foundation. But a person possessing merely authority to recommend decisions, but not to implement them without approval, is not an officer. The term does not include independent contractors such as attorneys, accountants, and investment managers and advisors acting in those capacities.

Similarly, the term public charity "organization manager" includes any officer, director, or trustee of such organization or similar individual. A person is an officer if so designated in a constitutive document of the organization, or if that person regularly exercises general authority to make policy decisions. But a person is not an officer if the person merely has authority to recommend policy decisions, but not to

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133. See PRINCIPLES OF THE LAW OF NONPROFIT ORGS., at xxx-xxxi (Tentative Draft No. 1, 2007) (noting that the role of the ALI-PLNPO is to provide guidance to nonprofits, regulators, and judges).
134. Id. § 300 (internal quotation marks omitted).
136. Id. § 4946(b)(2).
138. Id. § 53.4946-1(f)(2)(ii).
139. Id. § 53.4946-1(f)(2).
140. Id.
143. Id. § 53.4958-1(d)(2)(i)(B).
implement them without approval of a superior. Examples include an independent contractor such as an attorney or accountant.\textsuperscript{144} Under a special rule, "[a]n individual who is not an officer, director, or trustee, yet serves on a committee of the governing body of [a public charity] (or as a designee of the governing body [so] described)," may nonetheless be deemed an "organization manager."\textsuperscript{145}

The point is to make clear that the title of a person is not conclusive as to whether such a person will be considered a foundation or organization manager and therefore will be personally liable for excise taxes for approving acts of management self-dealing or excess benefit transactions. Moreover, knowing approval that will trigger the tax includes inaction where the person is under a duty to act.\textsuperscript{146} Therefore, simply not placing a person on the board of directors does not solve the federal excise tax exposure. Because the lack of standing generally precludes enforcement of fiduciary duties, the federal excise tax prohibitions are effectively the minimum standard for director behavior.\textsuperscript{147}

Under the 2007 ALI-PLNPO Draft, all charitable powers are exercised by the governing board.\textsuperscript{148} Accordingly, the governing board manages the charity’s activities and affairs.\textsuperscript{149} The governing board must therefore ensure that it is responsible for the affairs of the charity.\textsuperscript{150} Several normative board functions are specifically listed\textsuperscript{151} including, "establishing appropriate procedures for internal controls . . . including information flow to the board."\textsuperscript{152} The board may delegate matters to committees, officers, and executive staff but must retain ultimate responsibility for the delegated matters.\textsuperscript{153} However, in exercising fiduciary responsibility for a delegated matter, a board member may rely

\begin{flushleft}
\textsuperscript{144} Id.
\textsuperscript{145} Id. § 53.4958-1(d)(2)(ii).
\textsuperscript{146} Id. § 53.4958-1(d)(3).
\textsuperscript{147} See Hansmann, supra note 47, at 602-03.
\textsuperscript{148} PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 320(a) (Tentative Draft, No. 1, 2007).
\textsuperscript{149} Id.
\textsuperscript{150} Id.
\textsuperscript{151} Id. § 320(b).
\textsuperscript{152} Id. § 320(b)(8). This would include internal procedures for whistle blower disclosures. Cf. Richard A. Wiley, Sarbanes Oxley: Does It Really Apply to Non-Profit and Private Corporations?, BOSTON B. J. Mar.-Apr. 2006, at 10, 11-12 (citing 18 U.S.C. § 1513(e) (Supp. V 2005)) (arguing that nonprofit corporations are subject to the SOX criminal penalties for whistleblower retaliation, and suggesting that nonprofits adopt internal policies designed to minimize the possibility of such penalties).
\textsuperscript{153} PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 325(a).
\end{flushleft}
on experts and reports provided the member has no reason to know reliance is unwarranted.\textsuperscript{154} Generally, each governing-board member must act in good faith to fulfill the fiduciary duties of loyalty and care.\textsuperscript{155} The same duties of loyalty and care apply regardless of whether a board member is compensated or serves voluntarily.\textsuperscript{156} A person exercising board authority, although not nominally on the board, is a fiduciary subject to the duties of loyalty and care.\textsuperscript{157} The concept of "good faith" is a component of both loyalty and care and includes dishonest and intentionally harmful conduct as well as conscious disregard of acting in the charity's best interest (dereliction of duties or inattention).\textsuperscript{158} Good faith is particularly important because bad faith disarms all the duty and liability protections enunciated in the governance principles.\textsuperscript{159}

When the organizational documents so provide, fiduciary duties may be modified.\textsuperscript{160} However, a modification may not unreasonably reduce the duty of loyalty;\textsuperscript{161} "[r]educe the duty of care . . . to permit a knowing violation of law, intentional misconduct, reckless conduct, or gross negligence;"\textsuperscript{162} or "[a]bsolve a fiduciary from the obligation to act in good faith."\textsuperscript{163}

The duty of loyalty obligates "each governing-board member to act in a manner that he or she reasonably believes to be in the best interests of the charity, in light of its stated purposes."\textsuperscript{164} The duty of loyalty also requires board members to act properly in connection with conflict of interest transactions between the charity and fiduciaries.\textsuperscript{165} The duty of care requires each board member "to become appropriately informed about issues requiring consideration, . . . to devote appropriate attention to oversight[,] . . . and to act with the care that an ordinarily prudent person would reasonably exercise in a like position and under similar

\begin{footnotes}
\footnote{154}{\textit{Id.} § 325(b).}
\footnote{155}{\textit{Id.} § 300.}
\footnote{156}{\textit{Id.} § 300, cmt. (c)(2).}
\footnote{157}{\textit{Id.} § 300, cmt. (c)(3).}
\footnote{158}{\textit{Id.} § 300, cmt. (g)(1).}
\footnote{159}{\textit{Id.} This explains why the Disney litigation, discussed in Part III below, focused on proof of bad faith. \textit{See infra} Part III.F. Had bad faith been proven, the Disney board would not have been entitled to the protection of the business judgment rule or statutory exculpation from monetary liability.}
\footnote{160}{\textit{PRINCIPLES OF THE LAW OF NONPROFIT ORGS.} § 305.}
\footnote{161}{\textit{Id.} § 305(a).}
\footnote{162}{\textit{Id.} § 305(b).}
\footnote{163}{\textit{Id.} § 305(c).}
\footnote{164}{\textit{Id.} § 310(a).}
\footnote{165}{\textit{Id.} § 310(b).}
\end{footnotes}
circumstances."166 A governing board member who makes a business decision in good faith still complies with the duty of care provided the member (i) is not interested in the subject matter and can exercise independent judgment,167 (ii) is reasonably informed under the circumstances,168 and (iii) reasonably believes the action is in the charity’s best interests.169

The board may approve a conflict-of-interest transaction between the charity and a fiduciary or waive the charity’s opportunity to participate in a transaction between a fiduciary and another person provided the board makes a good faith determination that the transaction is fair to and in the best interests of the charity.170 Generally, the determination must be based on a disclosure of all material facts and the approval must occur prior to the transaction.171 Regarding information flow, every board member is entitled to receive information from management and to inspect all books and records in exercising their fiduciary duties.172 Although confidentiality of such information must be preserved, it may be disclosed in good faith to appropriate persons “to prevent, mitigate, or remedy harm to the charity.”173 Moreover, a board member has an obligation to monitor the fiduciary duties of other directors and officers174 and report suspected violations to the board as a whole.175

In the case of a breach of a fiduciary duty by an officer or a board or committee member, a court or regulatory authority should devise a remedy based on the charity’s best interests.176 Presumably, this would include the IRS where an act of improper self-dealing or an excess benefit transaction has occurred.177

Generally, “[a] member of the governing board, officer, or senior executive is not personally financially liable for a claim based upon any action taken or any failure to take action in the discharge of that person’s duties, except for unjust gain . . . or injury to the charity.”178 The unjust gain or injury must generally arise from a conflict-of-interest

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166. Id. § 315.
167. Id. § 365(a).
168. Id. § 365(b).
169. Id. § 365(c).
170. Id. § 330(b).
171. Id. § 330(c).
172. Id. § 340(a).
173. Id. § 340(b).
174. Id. § 350(a).
175. Id. § 350(b).
176. Id. § 360.
177. See id. § 360, cmt. d.
178. Id. § 370.
transaction, 179 "an intentional breach of the duty of loyalty, or a breach of the duty of care due to lack of good faith in acting or failing to act," 180 or "a knowing and culpable violation of criminal law," 181 or "unlawful distributions." 182 The burden of proving a breach of the duty of loyalty or the duty of care falls on the person challenging the conduct at issue. 183 However, if the person proves a conflict-of-interest violation, the burden of proof shifts to the defendant to prove that the transaction was in the best interests of the charity. 184 Unless immunity, indemnification, or insurance is regulated by law or the charity’s organizational documents, decisions regarding the appropriate protection of fiduciaries are governed by the general rules regarding the proper exercise of fiduciary duties. 185

E. Moral Norms

A rational question that must be considered in the context of nonprofit governance requires understanding why and how the law affects the behavior of those persons when the law imposes minimalist duties and obligations that are rarely enforced. Several theories offer an explanation. For example, if nonprofit corporate management and board behavior is best explained by social psychology or some other social phenomena, then laws designed to alter economic behavior will be less effective. This means that non-legal norms can and do affect behavior and help explain deviation from the adopted legal norm.

A legal positivist theory might suggest that the law is properly distinct from morally mandated behavior. 186 In this context, primary rules are normative and govern behavior because they impose a standard but are followed because of secondary rules that confer validity by public recognition. 187 A legal naturalist theory might resist such a

179. Id. § 370(a).
180. Id. § 370(b).
181. Id. § 370(c).
182. Id. § 370(d).
183. Id. § 375(a).
184. Id. § 375(b).
185. Id. § 380.
186. See generally H.L.A. Hart, Positivism and the Separation of Law and Morals, 71 HARV. L. REV. 593 (1958). Hart rejected the natural law view and defended the utilitarian/positivist view of Holmes, Austin, and Bentham that there should be a separation between law and morals. Id. at 593-94. He argues that law is enforceable because it is the law, not because it has a divine quality. Therefore, law has a utilitarian aspect because it is a means to an end. See generally id.
characterization of the law and suggest that a putative law must be imbedded with some reasonable semblance of moral content to actually become law. 188 A particularly significant approach to understanding the effect of social norms is Eric Posner's model of non-legal cooperation, which posits that "people engage in behavioral regularities in order to show that they are desirable partners in cooperative endeavors," and the resulting social norms "can vastly enhance or diminish social welfare." 189

In this context, governance laws serve to regulate the corporate enterprise by establishing incentives and disincentives for various corporate actors. 190 The threat, fear, or avoidance of liability is not always the most efficient regulator of human behavior. In many cases, corporate actors are motivated by financial gain coupled with social non-legal norms. 191 Whereas financial gain has received the most attention, 192 social norms are beginning to be studied and from various social norm perspectives. 193 Professor Melvin Eisenberg studies norms in the context of corporate law using the term "social norm" to mean "all rules and regularities concerning human conduct, other than legal rules and organizational rules." 194 Legal rules are those adopted by the legal system, and organizational rules are those adopted by private organizations. 195 One type of social norm is an obligational norm whereby actors consciously adhere to the norm even though it is not legal


191. Id.

192. Id. at 1253-54 & n.2.

193. See, e.g., id. ("[T]his Article . . . examines the interrelation of social norms and corporate law."); Eric A. Posner, Law, Economics, and Inefficient Norms, 144 U. PA. L. REV. 1697, 1698 (1996) ("This Article uses theories about the efficiency of the common law and the efficiency of statutory law to shed light on the likelihood that norms are inefficient."); Eric A. Posner, Symbols, Signals, and Social Norms in Politics and the Law, 27 J. LEGAL STUD. 765, 765 (1998) [hereinafter Posner, Symbols, Signals, and Social Norms in Politics and the Law] ("Symbols dominate American politics and permeate the law, but they are poorly understood. . . . This article uses a signaling model to explain why symbols matter."); Eric A. Posner, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 U. CHI. L. REV. 133, 135 (1996) ("[T]his Article addresses two closely related descriptive questions. First, under what conditions will nonlegal sanctions subvert legal rules and cause them to produce no effect or even the opposite of the intended effect? Second, how can the state exploit the existence of nonlegal sanctions in order to attain its goals most effectively?").

194. See Eisenberg, supra note 190, at 1255.

195. Id.
in nature because deviation invites peer criticism. Moral norms are arguably the most important category of obligational norms, and Professor Eisenberg argues that much human conduct can only be explained on this basis. Indeed, the effect of social norms depends on whether the norm is obligational and has been internalized by the actor. It is tempting to respond to the moral obligational norms in terms of an economic cost-benefit analysis with cost measured in terms of guilt and benefit measured in terms of internal satisfaction from doing the right thing. However, this may be inadequate because moral norms naturally become part of one's moral character and are therefore often unconscious, to a degree. There is no cost-benefit analysis. But this analysis fails to consider psychological behavior motivated by commitment and sympathy. The Aristotelian notion argues that one who might die for friends or family does not do so out of satisfaction, because he is risking "all prospect[s] of future satisfaction."

When obligational and moral norms are not internalized however, they will be adhered to only for instrumental reasons. The effect of such norms in any particular environment will depend entirely on a comparison between the immediate external gains of disobedience with the long-term costs and benefits of disobedience, the latter including reputational and esteem losses. Under game theory, disobedience signals to the market that one is not a cooperator and thus costs that person the voluntary cooperation of others.

III. FOR-PROFIT CORPORATE GOVERNANCE FROM THE DELAWARE PERSPECTIVE

The discussion in Part II of for-profit and nonprofit corporate governance standards presents an incomplete picture of management and director fiduciary duties from a limited statutory perspective. While there are precious few nonprofit governance cases, there is a rich but tortured history of for-profit corporate governance standards and the

196. Id. at 1257.
197. See id.
related fiduciary duties. This Part traces that governance history through the Delaware lens because many, if not most, public corporations are incorporated in Delaware. Accordingly, Delaware has developed the most comprehensive pattern of the judicial contours and shaping of common law fiduciary duties.

A. Core Director Fiduciary Duties: Loyalty, Care & The Business Judgment Rule

Delaware director fiduciary duties are derived from a statutory obligation to manage the business and affairs of the corporation.\(^\text{201}\) Thus, Delaware law creates an obligation for directors to manage the business affairs of a corporation on behalf of the shareholders.\(^\text{202}\) The director-shareholder relationship is therefore fiduciary in nature.\(^\text{203}\) Of course, corporate officers are also agents and fiduciaries of the corporation, but they are appointed by and serve at the pleasure of the directors, who are the direct link to the shareholders.\(^\text{204}\) Although the director-shareholder relationship\(^\text{205}\) is statutory in origin, the nature and contours of a

\(^{201}\) DEL. CODE ANN. tit. 8, § 141(a) (2001).

\(^{202}\) See Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (“A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain. If it does not, equity will set it aside.” (citations omitted) (footnote omitted)).

\(^{203}\) See Austin W. Scott, The Fiduciary Principle, 37 CAL. L. REV. 539, 540 (1949) (“A fiduciary is a person who undertakes to act in the interest of another person.”). Fiduciary obligation originated in equity and arose from a relationship of “trust and confidence,” but the term “fiduciary” was adopted to apply to situations falling short of trusts in which a person was nonetheless obligated to act like a trustee. Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 DUKE L.J. 879, 880; L. S. Sealy, Fiduciary Relationships, 1962 CAMBRIDGE L.J. 69, 71-72.

\(^{204}\) Lyman P.Q. Johnson & David Millon, Recalling Why Corporate Officers Are Fiduciaries, 46 WM. & MARY L. REV. 1597, 1601-02 (2005) (“[C]orporate officers are fiduciaries because they are agents.”).

\(^{205}\) Whether fiduciary duties are owed directly to shareholders alone or to the corporation and the shareholders jointly is a matter of statutory language and common law interpretation. See Daniel S. Kleinberger, Direct Versus Derivative and the Law of Limited Liability Companies, 58 BAYLOR L. REV. 63, 108-09 (2006). However, the question has little significance beyond whether an injured shareholder has standing to bring suit for an alleged violation of a fiduciary directly or must bring the action derivatively and on behalf of the corporation. See id. at 88-89. The characterization is important because, unlike a direct suit, a derivative suit is subject to a number of procedural limitations, such as the demand requirement designed to protect the balance of power between management and shareholders to decide who has the power to cause the
Delaware director's fiduciary duties are rooted in common law but are derived from agency and trust law. Because trust law assigns fiduciary responsibilities to a person holding property on behalf of another, it is logical that directorial fiduciary duties evolved from trust law, which was very well developed by the time corporate governance evolved. However, trustee-styled duties are conservative in nature; they are designed to preserve and protect the trust property on behalf of the trust beneficiaries. Thus, they are not well-suited to encourage entrepreneurial expectations associated with directors attempting to maximize shareholder returns.


See RESTATEMENT (SECOND) OF TRUSTS § 2 (1959) ("A trust ... is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it."); id. § 3(3) ("The person holding property in trust is the trustee."); see also RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

Interestingly, various laws define the following relationships differently with different consequences based upon their nature: (i) trust and confidence; (ii) fiduciary; and (iii) agency. For example, while all agents are fiduciaries and all fiduciaries are in a relationship of trust and confidence, the converse is not true. Consequently, not all fiduciaries are agents, and a person might well occupy a position of trust and confidence and yet not be a fiduciary. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1981) (non-disclosure of a fact is equivalent to a positive assertion of that fact "where the other person is entitled to know the fact because of a relationship of trust and confidence"); id. § 169(a) (a person is ordinarily not entitled to rely on an assertion of a mere opinion rather than fact unless that person stands in a relationship of trust and confidence to the person offering the opinion); id. § 173 (a contract between a fiduciary and beneficiary is voidable by the beneficiary unless it is on fair terms and the beneficiary "consents with full understanding of [its] legal rights and of all relevant facts that the fiduciary knows or should know").

See DeMott, supra note 203, at 880-81.

See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 176 ("The trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property."); id. § 181 ("The trustee is under a duty to the beneficiary to use reasonable care and skill to make the trust property productive.").

See Sarah Helene Duggin & Stephen M. Goldman, Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith, 56 AM. U. L. REV. 211, 224 (2006); see also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 393-94 (3d
B. Director Duty of Care & The Business Judgment Rule

Under Delaware corporate law, director duty of care claims were arguably not fully embraced and articulated until 1963, when Graham v. Allis-Chalmers Manufacturing Company determined that directors owe "that amount of care which ordinarily careful and prudent men would use in similar circumstances." Graham considered an allegedly negligent director's failure to institute a system to detect and prevent corporate harm resulting from illegal employee price fixing. Because the directors had no actual or imputed notice of the illegal activity, the Graham court concluded that the directors were not liable, even under the ordinary care standard.

Various other articulations of the duty of care include a "subjective element," requiring the director to act in a manner that he or she personally but reasonably believes to be in the best interests of the corporation. An "objective element" also exists, requiring one to act "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."

However articulated, an alleged breach of the ordinary negligence duty of care is subject to the business judgment rule. This generally means that director liability will not be imposed absent gross negligence. The
business judgment rule exists in several formulations, including both statutory and common law forms. All forms absolve directors from liability even when the ordinary duty of care may otherwise have been breached.

In *Aronson v. Lewis*, the Delaware Supreme Court articulated the Delaware version of the business judgment rule as follows:

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

> ... [The business judgment rule] has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.

Importantly, the business judgment rule presumption is only available to “disinterested” directors who “neither appear on both sides of a transaction nor expect to derive any personal financial benefit,” other than one that benefits all shareholders proportionately. In this context, director self-interest may be overcome by disclosure of all material facts and the approval by a disinterested majority of the remaining board members.

As articulated, the Delaware business judgment rule has two operative effects—a procedural presumption that shields director decisions from judicial review, and a substantive aspect that shields directors from personal liability:

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222. *Aronson v. Lewis*, 473 A.2d 805, 812-13 (Del. 1984) (citations omitted) (footnote omitted). Other formulations exist with slightly different language and effect. *See, e.g., Model Bus. Corp. Act § 8.30(a)-(b) (2005); Principles of Corporate Governance § 4.01(c) (providing that “[a] director or officer who makes a business judgment in good faith fulfills the duty,” provided that person (i) “is not interested . . . in the subject of the business judgment”; (ii) is properly informed; and (iii) “rationally believes that the business judgment is in the best interests of the corporation”). The ALI language creates a safe harbor rather than the presumptive approach of Delaware law.*


"The rule operates as both a procedural guide for litigants and a substantive rule of law. As a rule of evidence, it creates a 'presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company.' The presumption initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of 'fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.'\(^{225}\)

The procedural aspect is mostly superficial in that the plaintiff already has the burden of proof and can only satisfy that burden by proving gross negligence, causation, and damages.\(^{226}\)

On a far more serious level, the *Aronson* formulation of the rule has been criticized as fundamentally flawed and overbroad.\(^{227}\) While not challenging the procedural aspects of the *Aronson* formulation,\(^{228}\) critics argue that the substantive aspects needlessly conflated the "duty" of care with the "liability" for breach of the duty. Specifically, the business judgment rule arguably should not be regarded as a "generalized liability shield," nor as a presumption that the duty of care was not breached, and certainly not as a substantive standard for reviewing whether conduct breached the duty of care in the first instance.\(^{229}\) Rather, the business judgment rule is best understood merely as "a policy of judicial non-review."\(^{230}\)

In this view, the business judgment rule blocks judicial review of the quality of a business decision, regardless of whether or not ordinary care was exercised.\(^{231}\) As such, a poor but nonetheless "rational" decision should never be evidence of the failure to exercise due care. The decision itself only becomes evidence of a lack of due care when it is not even minimally rational. While it is common to characterize conduct as unreasonable, it is rare to characterize the same conduct as irrational.\(^{232}\)

\begin{itemize}
  \item 226. Balotti & Hanks, *supra* note 206, at 1345.
  \item 228. *See id.* at 628.
  \item 229. *Id.* at 628-31.
  \item 230. *Id.* at 631.
  \item 231. *Id.* at 632.
  \item 232. Eisenberg, *supra* note 218, at 443.
\end{itemize}
Thus, cases involving liability for an erroneous decision will succeed only when the decisions themselves cannot be rationally explained and the directors fail to provide any rational reason for conduct, such as developing a plant directors knew could not be operated profitably. Liability does not attach merely by way of an unreasonable decision; rather, the decision must be irrational. In all other cases of rational decisions, the process of gathering information and making the decision itself is the proper focus of the rule.

Because the substantive formulation of the business judgment rule is overbroad, it may operate to subsume the duty of care. This, in turn, masks the proper inquiry into whether the duty of care itself has been breached—a question quite separate and distinct from whether liability should attach to that breach. Moreover, nightmarish distinctions are required to apply the duty of care and the business judgment rule together. In a 1993 case, Cede & Co. v. Technicolor, Inc., the Delaware Supreme Court noted that it had "consistently held that [a] breach of the duty of care, without any requirement of proof of injury, is sufficient to rebut the business judgment rule." But how do you rebut the rule that presumes that care was not breached?

The conflation of the duty of care into the business judgment rule has had further troubling aspects. Most serious is that proof of a breach of duty of care shifts the burden to the directors to prove the entire fairness of the transaction. Prior to the 1993 Cede case, the entire fairness review was limited to cases involving a breach of the duty of loyalty. Fortunately, the entire fairness standard was satisfied in the 1995 case Cinerama, Inc. v. Technicolor, Inc., but the better reasoned approach

236. See Lyman Johnson, Rethinking Judicial Review of Director Care, 24 DEL. J. CORP. L. 787, 803-05 (1999) (discussing why director informedness is effectively the only way to show a breach of the duty of care).
237. Cede, 634 A.2d at 361 ("If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."); see also Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) ("Where . . . the presumption of the business judgment rule has been rebutted, the board of directors' action is examined under the entire fairness standard.").
239. Cinerama, 663 A.2d at 1179-80.
would have been to keep the burden of proof on the plaintiff to establish a breach of duty of care, corporate harm, and causation. This was Chancellor Allen's approach when *Cinerama* came before the Chancery Court in 1991, where it was determined that the duty of care was breached, but that the corporation was not harmed thereby. In any event, Delaware statutory exculpation would cure most transactions, even if not fair, as no liability would attach from even gross negligence.

The duty of care investigation extends much further than the decision itself and incorporates the question of whether an unreasonable decision-making process was utilized to reach the decision. In these cases, even a good decision might be preceded by a negligent or deficient process. While a favorable outcome or good decision likely means the plaintiff will not be able to prove the corporation suffered any harm, the analysis under the duty of care is different than under the business judgment rule. The duty of care also covers process failures such as inattention or nonfeasance where no decision was made. Thus, the risk of an overbroad business judgment rule is the conceptual failure to review process independent of any actual decision. Where directors employ an unreasonable process or unreasonably fail to employ a rational process to carry out their duties to manage the business and affairs of the corporation, liability should attach under the duty of care. Liability is independent of the quality of any decision provided only that the plaintiff can establish corporate harm as a result and that the unreasonable conduct was the cause of that harm.

Whatever else one might observe about the proper form and function of the business judgment rule, there is little room for doubt that its overall impact and effect have been some of the most important aspects of fiduciary duty law. In Delaware in particular, the skilled application of the rule allows the courts to police ridiculous behavior while shielding unreasonable, but not irrational, behavior. The rule allows courts to balance proper entrepreneurial risk-taking against aberrant behavior


243. *See* id. at 93.


without accountability. The ancient theory of the sound business rule is most likely to prosper when managers are free to make decisions unencumbered by judicial second-guessing regarding the wisdom of their choices.

A famous example of the business judgment rule’s application is *Shlensky v. Wrigley*. In the 1960s, Wrigley Field, home of the Chicago Cubs, remained the only major league stadium without lights and, thus, could not hold night games. The Cubs’ board of directors decided not to equip the stadium with lights. Shlensky voted the other way and then challenged the board’s action. The remaining directors denied that their action was based on the mere preferences of Phillip Wrigley, the president and majority shareholder. Rather, they asserted that they had exercised sound business acumen because night games would negatively affect the surrounding neighborhood. The court agreed, arguing that absent fraud, illegality, or conflict of interest, it should not interfere with board decisions. Indeed, the business judgment rule arguably extends protection in the corporate context to those whose ordinary negligence might violate the duty of care and compel liability in other contexts.

Unfortunately, the business judgment rule has always been affirmatively used to protect poor business decisions. When the conduct does not result from a business decision, the application and policy of the business judgment rule is less persuasive. An early case determined that a director could be accountable for “general inattention” to directorial

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249. *Id.* at 777.
250. *Id.* at 778.
251. *See id.* at 780.
252. *Id.*
253. *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (“Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled [sic] the business judgment rule.” (citations omitted)); *see also* Timothy P. Glynn, *Beyond “Unlimiting” Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 396-98 (2004) (arguing that extending vicarious tort liability to senior corporate officers for enterprise torts would promote diligence).
responsibilities. While the director there was not liable for his negligent conduct, as there was no provable harm to the corporation, the court nonetheless set the early stage for abdication or dereliction of duty liability not being protected by the business judgment rule. The doctrine thus established was that one serves as a mere figurehead at peril of liability. The doctrine was later reinforced in a case involving a closely held family corporation, Francis v. United Jersey Bank. There, the owners of the corporation—a husband, wife, and their two sons—also made up the board of directors. Following her husband’s death, the defendant widow let her sons run the company. Ignoring prior warnings from her husband, she neglected her directorial duties and allowed her sons to run the company into bankruptcy. The bankruptcy trustee sued her and her estate for a breach of fiduciary duties and prevailed after showing that her neglect caused serious corporate harm.

C. Pre-Stone Duty of Loyalty

Delaware corporate directors owe a fiduciary duty of loyalty to their shareholders. Corporate law loyalty discourse tends to be highly contextual, condemning or approving particular behavior in moral terms. As a result, it is common to see disloyal conduct penalized because of its context rather than in broader general terms.

255. Id. at 617-18.
256. Id. at 616.
258. Id. at 818-19.
259. Id. at 819.
260. Id. at 816, 829.
261. The classic duty of loyalty was articulated in a partnership context. See Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd." (citation omitted)).
263. Some argue that fiduciary duty moral rhetoric has no purpose for economic actors; rather, fiduciary duties are much like other contractual undertakings. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & ECON. 425, 427 (1993); see also Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary
Because this occurs frequently, cases must focus on the particular circumstances of the personal benefit or self-interest in order to distinguish loyalty cases from care cases. For example: (i) an allegation that fails to assert directors' actions were the result of an improper personal reason does not state a claim for breach of the duty of loyalty; \(^{264}\) (ii) the essence of a loyalty claim asserts that a director misused power over corporate property to derive personal benefit; \(^{265}\) (iii) alleged disclosure violations do not implicate loyalty absent a showing that the directors received a personal benefit; \(^{266}\) and (iv) because care and loyalty are distinct, liability depends on a breach of the duty of care, and not loyalty or good faith, unless director self-motivations are present. \(^{267}\)

Consequently, there remains reasonable disagreement over whether there are adequate measures to properly distinguish loyalty claims from care claims. \(^{268}\) These are often contextual but nonetheless illustrate the difficulty in easily categorizing a claim as dealing with purely care or purely loyalty. Illustrations include: (i) mere absence of a conflict of interest is not adequate to fulfill loyalty or distinguish it from care; \(^{269}\) (ii) in a contest for corporate control, director duties are not easily categorized as relating to care or loyalty; \(^{270}\) (iii) evidence of disloyalty includes, but is not limited to, motives of entrenchment, fraud, abdication....

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**Duties: A Response to the Anti-Contractarians**, 65 WASH. L. REV. 1, 8-10 (1990). Others argue that while fiduciary relationships may and often do arise by contract, duties of that special relationship, unlike strictly non-fiduciary contractual relationships, have a special character defined more by private law norms. See, e.g., DeMott, supra note 203, at 887 ("[C]ontract law doctrines operate so differently from fiduciary obligation that to invoke them, even vaguely, . . . confuses the analysis. For starters, these creatures of contract law are controlled by the parties' manifest intention; fiduciary obligation sometimes operates precisely in opposition to intention as manifest in express agreements. The terms of an express agreement are surely not irrelevant to the fiduciary obligation analysis, but once a court concludes that a particular relationship has a fiduciary character, the parties' manifest intention does not control their obligations to each other as dispositively as it does under a contract analysis."); see also Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 622-24 (1997); Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 47-48 (2003).

264. *In re* Gen. Motors Class H S'holders Litig., 734 A.2d 611, 618 (Del. Ch. 1999).


of director duties, and the sale of votes;\textsuperscript{271} (iv) a breach of loyalty can be unintended and can occur even when action is taken in good faith;\textsuperscript{272} (v) loyalty is implicated when a director seeks to thwart the lawful action of the company’s shareholders;\textsuperscript{273} and (vi) acting on motivations other than pecuniary gain can result in disloyalty, as can conscious disregard of one’s duties.\textsuperscript{274}

As a result, breaches of oversight and disclosure duties are not clearly identified as care violations because of the presence of actual or inferred intent and motive: (i) abandoning oversight responsibility may constitute either a care or loyalty violation;\textsuperscript{275} (ii) a reckless or intentional breach of care in oversight can be construed as a breach of loyalty or good faith not available for exculpation;\textsuperscript{276} and (iii) a director’s duty to abide by disclosure requirements derives from the duties of care, loyalty, and good faith.\textsuperscript{277} At the very least, these examples illustrate that it is not always easy to determine whether care or loyalty is invoked in an isolated manner. Disloyal conduct may occur in good faith, and good faith permits self-interest. Before the exculpatory provision,\textsuperscript{278} these overlaps were less important. Now that care is the isolated duty available for exculpation, loyalty and good faith are more important.

The most widely articulated definition of the duty of loyalty in Delaware corporate law is found in the early 1939 case, Guth v. Loft, Inc.:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the

\begin{itemize}
  \item \textsuperscript{271} Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993).
  \item \textsuperscript{272} Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988).
  \item \textsuperscript{274} Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del. Ch. 2000).
  \item \textsuperscript{275} See Cede, 634 A.2d at 368 (duty of care); infra notes 279-82 (duty of loyalty).
  \item \textsuperscript{276} In re Abbott Labs. Derivative S’holders Litig., 325 F.3d 795, 809-11 (7th Cir. 2003); McCall v. Scott, 250 F.3d 997, 1000-01 (6th Cir. 2001).
  \item \textsuperscript{277} Malone v. Brincat, 722 A.2d 5, 11 (Del. 1998).
  \item \textsuperscript{278} DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).
\end{itemize}
A Fiduciary Duty of Care Without a Remedy

A corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.\textsuperscript{279}

This formulation of loyalty includes the negative duty to refrain from harmful conduct but, more importantly, the positive duty to affirmatively protect the interests of the corporation.\textsuperscript{280} While the duty to refrain from harmful conduct has been referred to as one to avoid betrayal, the affirmative duty is less understood. As a result, both courts and scholars often refer to it as encompassed by the notion of positive devotion.\textsuperscript{281}

In this sense, the duty of loyalty creates an obligation of devotion that can be breached by abdication, including innocent dereliction of oversight or disclosure. Failure to perform as required, without more and without deliberate bad faith, can therefore constitute disloyal conduct.\textsuperscript{282} Although\textsuperscript{283}\textsuperscript{284} Guth involved personal benefit in the form of a corporate opportunity, that is not a requisite to a breach of the duty of loyalty. While a court may hesitate to attach liability to a mere disloyal abdication unconnected to a personal benefit, that is a decidedly different matter than whether the duty was breached in the first place. Loyalty breaches can exist independent of corporate harm, and in such cases, the claim is based upon disgorgement of the personal benefit.\textsuperscript{285} It is not a defense that the corporation itself was not harmed.\textsuperscript{286}

\begin{itemize}
\item \textsuperscript{279} Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).
\item \textsuperscript{280} In an interesting twist, although directorial fiduciary duties (including loyalty) evolved from trust law, but were eventually scaled back to account for directorial entrepreneurial responsibilities, see supra notes 207-12 and accompanying text, some advocate that trust law should likewise scale back the responsibility of the trustee to act solely for the benefit of the beneficiary. See, e.g., Langbein, supra note 59, at 931-32; see also RESTATEMENT (SECOND) OF TRUSTS § 170 (1959) ("The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."). But see sources cited supra note 60.
\item \textsuperscript{281} See Johnson, supra note 263, at 37-41.
\item \textsuperscript{283} Guth v. Loft, Inc., 5 A.2d 503, 508, 510 (Del. 1939).
\item \textsuperscript{284} Strassburger v. Earley, 752 A.2d 557, 581 (Del. Ch. 2000).
\item \textsuperscript{285} Guth, 5 A.2d at 510 ("If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.").
\item \textsuperscript{286} See id.
\end{itemize}
In most cases, however, corporate harm exists as the basis of the lawsuit for breach of the duty of loyalty. Many disloyal acts are intentional and usually thought to include an element of bad faith. But bad faith is not a prerequisite to disloyal behavior; a director may disregard an unknown duty of oversight or disclosure with all good intention and nevertheless cause great harm to the corporation. Indifference to a director’s duty to protect is adequate to breach the duty of loyalty. This feature of the duty requires a review of the role and scope of good faith.

D. The Van Gorkom Legacy & Statutory Exculpation

Perhaps more than any other case, *Smith v. Van Gorkom* fueled the concern that the Delaware business judgment rule was not as protective as predicted. The Delaware Supreme Court ultimately held an extremely competent board liable for its uninformed decision to sell the company too cheaply. In the case, Jerome Van Gorkom, Trans Union’s chairman and CEO approaching retirement, personally negotiated the sale of the company at fifty-five dollars per share to Jay Pritzker, “a social acquaintance.” Van Gorkom negotiated the price privately, without the board’s knowledge or participation. The agreed price was a substantial premium over Trans Union’s stock price, which had ranged from approximately twenty-five to thirty-nine dollars per share over the previous five years. Van Gorkom had based the price not on a valuation but on an internal feasibility study of a leveraged buy-out. The agreement set forth a ninety-day “market test” to allow Trans Union

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287. *Strassburger*, 752 A.2d at 581. There, the court found that corporate directors breached their fiduciary duty of loyalty to minority stockholders by causing the corporation to repurchase eighty-three percent of its outstanding shares from its two largest shareholders, under circumstances that benefited no one except the corporation’s president. *Id.* at 560, 581. Two of the four directors who approved the repurchases were held liable for rescissory damages even though the two were not unjustly enriched, had not obtained a special benefit, and had not acted in bad faith or with intent to harm the minority shareholders. The directors violated their duty of loyalty because they subordinated the minority's interests to the conflicting interest of their selling stockholder employer in exiting its investment. *Id.* at 581.


290. See *id.* at 894-95 (McNeilly, J., dissenting).

291. *Id.* at 874, 893 (majority opinion).

292. *Id.* at 864-67.

293. *Id.* at 866-68.

294. *Id.* at 866 n.5.

295. See *id.* at 866.
to test the price for other market offers, but serious restrictions existed on Trans Union’s ability to negotiate with other purchasers. The agreement also required swift approval by the Trans Union board. Accordingly, the board approved the proposal on the basis of a twenty-minute account of Van Gorkom’s negotiations with Pritzker. Approval came without review of the agreement itself, underlying financial data, or any discussion with the company’s investment advisers.

A shareholder derivative action challenged the board’s decision, and the Delaware Supreme Court determined that the directors were grossly negligent in breaching the duty of care because they had failed to properly inform themselves before voting to approve the merger. The court further clarified that a failure to make an informed business judgment violated the duty of care rather than the duty of loyalty. The board was simply ill-prepared to determine the fairness of the merger price. In so holding, the Delaware Supreme Court reversed the Chancery Court’s opinion that the decision was protected by the business judgment rule, even though there were no allegations of fraud, bad faith, or self-dealing.

Commentators largely criticized the Van Gorkom opinion for creating board liability on the basis of the quality of its decision-making process and, thus, largely eliminating the protection of the business judgment rule. The corporate community reacted with shock, and Delaware quickly enacted the exculpatory statute the following year. Nearly every state quickly adopted a similar statute, and just as quickly, large numbers of corporate charters were amended to enable the exculpatory protection. Nonetheless, the decision and subsequent statutory

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296. Id. at 868-70.
297. Id. at 867.
298. Id. at 868-69.
299. Id.
300. Id. at 863, 872-73.
301. Id. at 872-73.
302. Id. at 872-73, 881, 893.
303. Id. at 873, 893.
306. See J. Robert Brown, Jr., The Irrelevance of State Corporate Law in the Governance of Public Companies, 38 U. RICH. L. REV. 317, 331-33 & nn.92-93 (2004);
exculpation arguably increased the formalism of board decision-making without improving the quality of the decisions. 307

Delaware's exculpation statute allows the articles of incorporation to provide ex ante monetary liability exculpation to directors, provided the conduct at issue did not involve: (i) "any breach of the director's duty of loyalty;" (ii) "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;" (iii) payment of unlawful dividends; or (iv) "any transaction from which the director derived an improper personal benefit." 308 Because none of the exceptions relate to the duty of care, the statute, by design, immunizes Delaware directors from monetary damages when plaintiffs allege a breach of the duty of care. What remains after exculpation? Those seeking to impose liability upon corporate directors must assert one of the exceptions to statutory exculpation. 309 Director liability remains for breaches of loyalty as well as for acts or omissions not in good faith. Given the obvious importance of claims sounding in loyalty rather than care, how does one characterize director behavior as one or the other?

E. Cede's Triadic Addition of Independent Good Faith

A modern understanding of Delaware director fiduciary duties normally begins with the Delaware Supreme Court's view in the 1993 Cede case (discussed before) that collectively treated good faith, loyalty, and due care as the "triads" of fiduciary duty. 310 The Delaware courts had previously determined that the "fiduciary duty of disclosure . . . is not an independent dut[ y]" but rather a part of good faith, loyalty, and care. 311 The Cede triadic formulation was repeated in Cinerama in

James J. Hanks, Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 BUS. LAW. 1207, 1209-11 (1988).


308. § 102(b)(7); see also Douglas M. Branson, Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors, 57 FORDHAM L. REV. 375, 380-81 (1988).

309. In re Lukens, Inc. S'holders Litig., 757 A.2d 720, 728 (Del. Ch. 1999); see also Johnson, supra note 263, at 31-32.


311. Malpiede v. Townson, 780 A.2d 1075, 1086 (Del. 2001); see also Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) ("[I]t is more appropriate . . . to speak of a duty of disclosure [that is subsumed in the traditional duties] rather than the unhelpful terminology that has crept into Delaware court decisions as a 'duty of candor.'"). See generally Hamermesh, supra note 266 (discussing the history and development of the director's duty of disclosure to stockholders).
1995,312 Malone in 1998,313 and Emerald Partners in 2001,314 and has been repeatedly used in Delaware case law since 1993.315 In many areas of the law, standards of conduct and standards of liability are the same, but not so in corporate fiduciary duty law.316 Mostly, the corporate law divergence between conduct and liability standards can be justified because, unlike in other areas of law where conduct alone is involved, corporate law must balance desirable conduct with the fact that directors are required317 to make complex decisions in which the outcomes are inherently risky.318 Linked conduct and decision rules are therefore necessary to encourage and tolerate ex ante decisions that might have been decided otherwise if made with ex post hindsight.319 Unfortunately, because loyalty, care, and good faith are not uniformly triadic, divergent corporate law standards must account for varying policies that do not easily co-exist in one formulation. This has led to intolerable confusion and incoherence.320

While good faith has a long history in Delaware corporate law,321 its prominence has recently taken center stage as shareholders struggle to hold directors accountable for alleged corporate harm not involving personal benefit or conflict-of-interest transactions.322 The absence of

315. See Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 31 DEL. J. CORP. L. 1, 12 & n.23 (2006) (“One commentator counted more than a dozen Delaware cases decided by mid-2002 that adopted the triadic formulation of the duties of corporate managers.” (citing Charles Hansen, Sowing the Seeds of Confusion: The Ephemeral Triad, 73 ASPEN L. & BUS. CORP. 1, 2 (2002))).
316. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 DEL. J. CORP. L. 859, 867-68 (2001); Eisenberg, supra note 218, at 437-38; see also Allen, Jacobs & Strine, supra note 220, at 450.
317. DEL. CODE ANN. tit. 8, §141(a) (2001) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”).
319. See id.; cf. Meir Dan-Cohen, Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law, 97 HARV. L. REV. 625, 630-36 (1984) (“[T]he possibility that conduct or decision rules may have unintended side effects creates the potential for conflict between decision rules and conduct rules in the absence of acoustic separation. A decision rule conflicts with a conduct rule if the decision rule conveys, as a side effect, a normative message that opposes or detracts from the power of the conduct rule.”).
320. See Johnson, supra note 236, at 788-90; Johnson, supra note 227, at 626-28; see also Johnson, supra note 263, at 30-33.
321. E.g., Veasey & Di Guglielmo, supra note 241, at 1439, 1442.
322. See, e.g., id. at 1439-41.
personal benefit excludes the harm from claims for breach of loyalty under a narrow conception of loyalty that does not include the positive element of devotion. This legal posture directs litigants to a claim for breach of the duty of care, which is protected by a robust business judgment rule that presumes good faith and otherwise requires a showing of gross negligence. Moreover, even gross negligence is protected by statutory exculpation, as long as the director acted in good faith. Good faith is thus the Achilles' heel of both the business judgment rule and statutory exculpation. Some corporate law statutes positively require directors to act in good faith. Requiring good faith is an overt attempt to characterize the director's conduct in a way to ensure statutory exculpation.

Delaware further conditions permissive indemnification on good faith conduct. It also excuses director liability for self-interested transactions if the transaction is approved by disinterested directors acting in good faith. As a consequence, even though no Delaware case has determined that a director is liable for violating the duty of good faith, no one can deny the importance of the directors acting in good faith. At the very least, bad faith conduct: (i) will not qualify for statutory exculpation, even if not disloyal; (ii) will not qualify for permissive indemnification; and (iii) will not qualify for protection under the business judgment rule. Given the considerable judicial and statutory presence of good faith, scholarly commentary on the role and definition of good faith in relation to corporate fiduciary duties has been extensive.

323. See supra notes 264–67 and accompanying text.
324. See supra notes 219-22 and accompanying text.
325. See supra notes 308-09 and accompanying text.
326. N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003); MODEL BUS. CORP. ACT §§ 8.30 (director good faith), 8.42 (officer good faith) (2005).
327. DEL. CODE ANN. tit. 8, § 145(a)-(b) (2001).
328. Id. § 144(a)(1).
329. See Eisenberg, supra note 315, at 6-12.
330. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).
331. See id. § 145(a)-(b).
F. Disney & Stone Legacy

The recent series of events involving the Walt Disney Company litigation is an excellent example of this tension between the Cede triadic formulation of fiduciary duties and the Delaware exculpation statutory language. The Disney litigation began as a shareholder derivative demand case, where no pre-suit demand by shareholders was made on directors alleging misconduct by the Disney Board in connection with the hiring and termination of Michael Ovitz. Specifically, the complaint alleged that the Board breached its general fiduciary duties and duty of nondisclosure claims in approving a lucrative employment contract for the new president, Michael Ovitz, and then, fourteen months later, in approving a $140 million payout under a "no fault" termination clause in Ovitz's employment contract. The Chancery Court granted a motion to dismiss the fiduciary duty and waste claims against the Board for the failure to make a pre-suit demand "or to allege particularized facts that excuse such demand." The court also granted a motion to dismiss the disclosure claim for failure to state a proper claim. Reviewing the case de novo, the Delaware Supreme Court affirmed most of the dismissals with prejudice, except that the fiduciary duty and waste claim dismissals were affirmed without prejudice. This allowed the plaintiffs to file an amended complaint on remand to the Chancery Court. On remand, following a denial of a new motion to dismiss the amended complaint...
and following a successful motion to exclude expert testimony on the basis that it was directed to Delaware law and not the facts of the case, the case was finally tried on its merits.

In evaluating the fiduciary duty claims, Chancellor Chandler first determined that a breach of loyalty was not implicated by the facts. The court explained that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests[, ] that are "not shared by the stockholders generally." Rather, "the duty of loyalty . . . mandates that the best interest of the corporation and its shareholders take[] precedence over any [personal] interest[s]" of the officers or directors; thus, it does not provide any safe harbor for divided loyalty. Unfortunately, the court proceeded to define loyalty narrowly: it is classically implicated by the receipt of "a personal benefit not shared by all shareholders" or when a director or officer is standing "on both sides of a transaction." The court determined that Ovitz did not breach his duty of loyalty as a director or officer by accepting the termination payment. He played no part in the decision-making process to be terminated, he was entitled to the payment under the terms of his contract, and an ordinarily prudent person would not call for further inquiry. No other director breached a duty of loyalty because there was no allegation of personal benefit or conflict of interest.

The court also determined that no board member violated the duty of good faith. Acknowledging that the Delaware courts have not been clear as to whether good faith is a separate actionable duty, the court defined good faith by the absence of bad faith. Further, bad faith was described as "authorizing a transaction "for some purpose other than [the best interests of the corporation] or [when the transaction] is known to constitute a violation of . . . law." This means that any "[a]ction taken

343. Id. at 750 (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).
344. Id. at 751 (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).
345. Id. (quoting Cede, 634 A.2d at 361) (second alteration in original).
346. Id.
347. Id. at 757-58.
348. Id. at 760.
349. See id. at 753-54.
350. Id. at 753 (quoting Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996)) (second alteration in original).
... to harm the corporation is a disloyal act in bad faith," and the reason why the director so acted is irrelevant. As such, a claim of bad faith may include evidence that a director intentionally placed his own interests before the best interests of the company and may include a "systematic or sustained shirking of duty." Because the business judgment rule presumes good faith, a shareholder must prove by a preponderance of the evidence that the director acted in bad faith. The court found that the directors "did not act in bad faith, and were at most ordinarily negligent, in connection with the hiring of Ovitz and the approval of the [contract of employment]." Because the Board exercised business judgment, "ordinary negligence [was] insufficient to constitute a violation of the fiduciary duty of care."

On appeal, the Delaware Supreme Court affirmed the Chancery Court and determined that the directors were not liable. In so doing, the

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351. *Id.* at 753-54; *see also* Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("The reason for the disloyalty . . . is irrelevant, the underlying motive . . . for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless."). *quoted in In re Walt Disney Co.*, 907 A.2d at 754 n.453; Nagy v. Bistricer, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000) ("If it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder . . . that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes."). *quoted in In re Walt Disney Co.*, 907 A.2d at 754 n.453.

352. *In re Walt Disney Co.*, 907 A.2d at 754.

353. *Id.* at 755. The same complaint in this case survived a motion to dismiss because the pleadings "alleged that Disney's directors 'consciously and intentionally disregarded their responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision.'" *Id.* at 754-55 (quoting *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003)). But the evidence did not prove the allegation. *Id.* at 779.

354. *Id.* at 760.

355. *Id.* In the discussion of the business judgment rule, the court stated that "the appropriate standard for determining liability [in cases of director inaction] is widely believed to be gross negligence." *Id.* at 748. However, the court noted that, in one such Delaware case, ordinary negligence was applied as the standard because the business judgment rule does not apply in cases of inaction. *Id.* This occurs where the Board makes no decision whatsoever. *Id.* at 748 & n.418 (citing Rabkin v. Philip A. Hunt Chem. Corp., 1987 WL 28436, at *1-3 (Del. Ch. Dec. 17, 1987)). The same principle would apply when bad faith blocks reliance on the business judgment rule. *See id.* at 750.

356. Brehm v. Eisner (*In re Walt Disney Co. Derivative Litig.*), 906 A.2d. 27 (Del. 2006). The court stated that:

It is notable that the appellants do not contend that the Disney defendants are directly liable as a consequence of those fiduciary duty breaches. Rather, appellants' core argument is indirect, i.e., that those breaches of fiduciary duty deprive the Disney defendants of the protection of business judgment review, and require them to shoulder the burden of establishing that their acts were entirely fair to Disney.

*Id.* at 46.
court developed the conceptual range of good faith in some detail by delineating three categories of fiduciary behavior often considered as bad faith: (i) "subjective bad faith" whereby a fiduciary actually intends to harm the corporation (category I); (ii) gross negligence with no malicious intent (category II); and (iii) conscious and intentional dereliction or disregard of known duties (category III). The court dealt with each category separately.

The shareholders argued that category II, "care" bad faith, existed in this case because the Disney directors were grossly negligent. Even though the Chancery Court properly determined that gross negligence did not exist, the Delaware Supreme Court clarified the appropriateness of treating mere gross negligence as bad faith. The court refused to conflate or infer bad faith from mere gross negligence (including the failure to be properly informed). The court justified its refusal by its interpretation of two Delaware statutes that retain a separate and distinct role for both gross negligence and good faith. Therefore, conflation would specifically contravene statutory intent by making the distinctions meaningless. First, the exculpatory provisions of Delaware corporate law specifically permit, by way of a failure to make an express exception, exculpation for a breach of the duty of care. The statute was adopted to permit exculpation of even grossly negligent conduct. At the same time, one of the four express exceptions to permissive exculpation preserves liability for acts or omissions not made in good faith. Thus, as the argument goes, conflation ignores the reality that the statute requires retaining the distinction. Bad faith may not be exculpated, but gross negligence may be exculpated. This disregards the difficult task of defining the boundary between the two.

A second Delaware statutory pattern further requires separation of gross negligence and good faith. Delaware corporate law provides for permissive indemnification of any former or current officer, director, employee, or agent against all expenses, including judgments resulting from an unsuccessful defense, provided the person acted in good faith.

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357. Id. at 64, 66.
358. Id.
359. Id. at 64.
360. Id. at 64-65 & n.104.
361. Id. at 65-66.
362. See id. at 65 (citing DEL. CODE ANN. tit. 8, § 102(b)(7) (2001)).
363. See Duggin & Goldman, supra note 212, at 231-33; see also Bruner, supra note 305, at 1143-47.
364. See Brehm, 906 A.2d at 65.
365. Id.
366. Id. at 65-66 (citing tit. 8, § 145).
Accordingly, a person who acted in good faith but with gross negligence could be indemnified, whereas a person acting in bad faith could not. As a result, conflation of gross negligence and bad faith frustrates a Delaware statute suggesting the concepts are distinct. 367

The problem with this second statutory approach is that at least the exculpation statute is a modern innovation and is predicated upon distinctions in common law, including a manageable definition of good faith. It does little good after the statute is enacted to mandate the separateness of good faith because it is in the statute, at least when the statute was predicated on common law in the first place. Few argue that good faith does not have an independent role in corporate law. 368 That question can be directed by statutory reference but, absent a statutory definition, common law must supply the answer to that puzzle.

Category III, “loyalty” bad faith, includes conscious abdication of a known duty. The Delaware Supreme Court determined that this category is important and independent in order to catch conduct in between subjective bad faith and gross negligence. 369 First, the court determined that if disloyalty is classically defined to include the presence of personal benefit or a clear conflict of interest, it would naturally exclude the positive notion of devotion; therefore, good faith is necessary to fill that void. 370 Secondly, and again relying on Delaware statutory use of the good faith concept, the court explained that it must remain a distinct duty precisely because the exculpatory statute assigns it an independent role. 371 Specifically, through the use of the conjunctive “or,” the Delaware exculpation statute distinguishes good faith from “intentional misconduct” and a “knowing violation of law.” 372 Characterizing the latter two concepts as forms of category I, “subjective bad faith,” and assuming an independent function of good faith separate from intentional misconduct (not exculpated) and gross negligence (exculpated), it follows that unintentional but nonetheless culpable bad faith must exist. In short, statutory exculpation exists for gross negligence but not for knowing conduct or inferred conduct that is

367. Id. at 66.
368. See Duggin & Goldman, supra note 212, at 213.
369. See Brehm, 906 A.2d at 66.
370. Id. at 66-67. Chancellor Chandler determined that an expanded version of loyalty embracing elements of positive devotion could fill the gap currently filled by good faith. In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 760 n.487 (Del. Ch. 2005), aff’d, Brehm, 906 A.2d. 27 (citing Johnson, supra note 263).
371. Brehm, 906 A.2d at 67 (citing DEL. CODE ANN. tit. 8, § 102(b)(7)(ii)(2001)).
372. See id.
between gross negligence and intentional misconduct. This could certainly include serious abdication or dereliction failures. 373

None of these categories is particularly helpful. First, except for cases involving provable subjective bad faith (the "smoking gun" memorandum), proof of such behavior is quite difficult, particularly when there are objective justifications for the behavior. Secondly, measures framed in terms of exceeding gross negligence, but less than intentional negligence, are not particularly useful, either. Gross negligence itself is an elusive concept. To suggest that unintentional bad faith must be worse than gross negligence is not a helpful standard.

A more plausible role for good faith would be to make it not an actionable independent standard, but to relegate it to a status that simply defeats the privilege of asserting various statutory and judicial referents that work to shield behavior from liability. The net effect would then be to eliminate the business judgment rule presumption, eliminate statutory exculpation, and eliminate permissive indemnification. This alone does not create liability. As evidenced by the Delaware Supreme Court, pleading bad faith to deconstruct the business judgment rule is not adequate to create liability if the directors can prove entire fairness. 374 More is needed. Absent a claim of personal benefit, liability will follow only upon a showing of breach of duty, corporate harm, and causation. Without a showing of personal benefit, the breach is more likely to be defined in terms of the duty of care. However, bad faith eliminates reliance upon both the business judgment presumption, as well as statutory exculpation. Once these protections are stripped away by bad faith, the standard of care should be ordinary care. The Chancery Court determined that, at most, the directors exhibited ordinary negligence, but because the business judgment rule presumes good faith and that presumption was not rebutted in this case, ordinary negligence was not adequate to create liability. 375 If the business judgment rule had not applied because no decision had been made, what standard would apply? Gross negligence can hardly be the standard because the business judgment rule does protect gross negligence. 376

Although the presence of a decision makes proving bad faith more problematic, because the business judgment rule presumes good faith, bad faith should have no role beyond determining the appropriate liability standard—ordinary negligence. If bad faith is present, neither

373.  Id. at 66-67.
374.  Id. at 46.
375.  See In re Walt Disney Co., 907 A.2d at 760.
376.  See supra notes 219-20 and accompanying text.
the business judgment rule nor statutory exculpation is available. Is the bad faith itself, then, independently actionable as a positive duty? If so, is it strict liability or is there a separate duty? Treating bad faith as a method to disarm statutory and judicial favoritism toward directors seems appropriate, as no policy can be advanced to justify presumptions and exoneration for intentional or near intentional bad behavior. Stripping away this favoritism, then, leaves a base duty of ordinary care, with a showing of breach, harm, and causation shifting the burden to the directors to establish that the transaction or conduct nonetheless did not impede an otherwise fair result to the corporation. Fairness is not a correct defense at this instance; one hopes that, in an appropriate case, the Delaware courts will strike the Cede analysis that applies entire fairness to a duty-of-care breach. Indeed, this explains the curious passage of the employment contract and the approach of the shareholders in Disney—or at least the plaintiff's confusion over their behavior.

Disney did not consider a direct case of directorial abdication of duty or failure to act. Although certain aspects of the case could have permitted such an argument, the case was instead couched in terms of bad faith tacit approval of exorbitant compensation. So, after Disney, the question remained how the newly defined concept of bad faith would apply in the context of a pure abdication of duty case. It did not take long for an answer to arrive. In Stone v. Ritter, the Delaware Supreme Court clarified that the Disney categories of bad faith were not an independent basis of liability but rather a component of the duty of loyalty. The Delaware Supreme Court stated that the Chancery Court had classified Stone as a "classic Caremark claim." The facts were relatively simple. AmSouth Bancorporation branch bank employees failed to file "Suspicious Activity Reports" as required by federal law. As a result,

377. See supra notes 330-32 and accompanying text.
378. See In re Walt Disney Co., 907 A.2d at 747 (The business judgment rule "can be rebutted by a showing that the board violated one of its fiduciary duties in connection with the challenged transaction. In that event, the burden shifts to the director defendants to demonstrate that the challenged transaction was 'entirely fair' to the corporation and its shareholders." (footnote omitted)).
382. Id. at 364 (internal quotation marks omitted). The Chancery Court decision was not reported. Stone v. Ritter, No. 1570-N, 2006 WL 302558 (Del. Ch. Jan. 26, 2006).
383. Stone, 911 A.2d at 365.
in 2004, AmSouth paid $40 million in fines and $10 million in civil penalties to settle investigations into those failures.\textsuperscript{384} No fines or penalties were imposed on the directors.\textsuperscript{385}

AmSouth shareholders William and Sandra Stone brought a derivative suit action against current and former AmSouth directors without making a pre-suit demand.\textsuperscript{386} They alleged that the directors failed to implement reasonable and proper compliance and reporting system procedures to detect and ensure there would be no violations of the federal Bank Secrecy Act.\textsuperscript{387}

The Chancery Court dismissed the complaint for failing to plead facts with requisite particularity to excuse making a demand on the directors to bring the action before bringing a derivative action.\textsuperscript{388} In affirming, the Delaware Supreme Court emphasized that a critical component of pre-suit demand excusal is whether the alleged directorial conduct can be excused under Delaware’s exculpation statute.\textsuperscript{389} Exculpation excuses monetary liability for a breach of the duty of care, but not for bad faith conduct or a breach of the duty of loyalty.\textsuperscript{390} In discussing director liability in the Caremark line of abdication cases, the Delaware Supreme Court made clear that to act in good faith does not require directors to "possess detailed information about all aspects of the operation of the enterprise."\textsuperscript{391} Rather, liability predicated on ignorance of liability-creating corporate activities will only exist where there is a "sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists."\textsuperscript{392}

Importantly, directorial oversight liability depends upon the failure of a director to act in good faith.\textsuperscript{393} Citing the Disney bad faith categories, the court referenced a need to establish that a director intentionally fails to act despite a duty to act, thus indicating a conscious disregard for directorial duties.\textsuperscript{394} More importantly, the Delaware Supreme Court

\begin{itemize}
  \item \textsuperscript{384} Id.
  \item \textsuperscript{385} Id.
  \item \textsuperscript{386} Id. at 364.
  \item \textsuperscript{387} See id. at 364, 366.
  \item \textsuperscript{389} Stone, 911 A.2d at 367; see also DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).
  \item \textsuperscript{390} Stone, 911 A.2d at 367.
  \item \textsuperscript{391} Id. at 368 (quoting In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).
  \item \textsuperscript{392} Id. at 369 (quoting In re Caremark, 698 A.2d at 971).
  \item \textsuperscript{393} See id.
  \item \textsuperscript{394} Id. (quoting Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27, 67 (Del. 2006)).
\end{itemize}
indicated that a director who fails to act in good faith may incur liability because good faith is a "subsidiary element" of the duty of loyalty.\textsuperscript{395} This means bad faith oversight liability is a part of the duty of loyalty.\textsuperscript{396} Somewhat astonishingly, the Court thereby characterized \textit{Caremark} oversight liability as a duty of loyalty species rather than a duty of care species even though \textit{Caremark} itself suggests it is a duty of care case.\textsuperscript{397}

In any event, \textit{Stone} clearly collapses the "triad" of fiduciary duties by subsuming good faith into the duty of loyalty and eliminating it as an independent basis of liability.\textsuperscript{398} At the same time, \textit{Stone} appropriately expands loyalty cases in Delaware corporate law by eliminating the requirement that a financial interest be involved for director conduct to violate the duty of loyalty.\textsuperscript{399} Consequently, a systematic oversight failure can result in a duty of loyalty breach through the lens of bad faith even when the directors failed to profit financially from the oversight failure. Even after this expansion, however, a \textit{Caremark} bad faith loyalty oversight failure claim is still ""possibly the most difficult theory"" under which to obtain a judgment against directors.\textsuperscript{400}

\section*{G. The Future of Shareholder Trust \\& Control}

The gap between shareholder expectations of directorial control over management excess and abuse has created a serious\textsuperscript{401} trust gap in

\begin{thebibliography}{99}
\item[395.] \textit{Id.} at 369-70 (quoting Guttmann v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).
\item[396.] \textit{Id.}
\item[397.] \textit{In re Caremark}, 698 A.2d at 960, 967. \textit{See generally} Claire A. Hill \\& Brett H. McDonnell, \textit{Essay: Stone v. Ritter and the Expanding Duty of Loyalty} (Univ. of Minn. Law Sch., Legal Studies Research Paper Series, Research Paper No. 07-35, 2007), \textit{available at} http://ssrn.com/abstract=1008930 ("In this essay, we argue that the court in \textit{Stone v. Ritter} got it right, and indeed, should have gone further. \textit{Stone v. Ritter} recasts \textit{Caremark}-type 'care' as a species of the duty of loyalty; we think the duty of care more generally is properly understood as largely subsumed by the duty of loyalty."); Justin Nemunaitis, \textit{On Good Faith and the Future of Scienter in Delaware Corporate Law} (Mar. 28, 2008) (unpublished note, \textit{available at} http://ssrn.com/abstract=1114347) (stating that the most important element of the \textit{Disney} and \textit{Stone} conception of good faith is scienter, and arguing that "[b]y emphasizing scienter, the Delaware Supreme Court has undermined the rationale for many of its longstanding decisions" regarding corporate fiduciary duties).
\item[398.] \textit{Stone}, 911 A.2d at 370.
\item[399.] \textit{Id.}
\item[400.] \textit{Id.} at 372 (quoting \textit{In re Caremark}, 698 A.2d at 967).
\end{thebibliography}
corporate America. This Part has examined various initiatives to control abusive corporate management behavior. Sarbanes-Oxley attempted to shape lawful behavior by imposing various constraints upon the conduct of critical managers. Delaware adopted a different and arguably more effective approach. The expansion of loyalty to encompass a positive duty of devotion to corporate governance matters is far less easily avoided than specific negative controls. Collapsing

(arguing that while norms are important, "incorporating them into the theory of the firm has been very difficult." Norm is defined as "a rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with") (quoting Richard A. Posner, Social Norms and the Law: An Economic Approach, 87 AM. ECON. REV. 365, 365-69 (1997)).

402. See generally Lawrence E. Mitchell, Fairness and Trust in Corporate Law, 43 DUKE L.J. 425 (1993) (arguing that trust is essential to corporate relationships); Lawrence E. Mitchell, The Importance of Being Trusted, 81 B.U. L. REV. 591, 614-17 (2001) (discussing the importance of trust in fiduciary relationships). Cf. Robert Cooter & Melvin A. Eisenberg, Fairness, Character, and Efficiency in Firms, 149 U. PA. L. REV. 1717 (2001) (explaining how firm-specific fairness norms promote efficiency by encouraging trust and loyalty); Lyman P.Q. Johnson, Faith and Faithfulness in Corporate Theory, 56 CATH. U. L. REV. 1 (2006) (suggesting that corporate governance scholarship is essentially secular, while society remains essentially religious). It is simple to suggest that shareholders simply “vote” by selling their shares and move fluidly from one liquid investment to the other, but this remedy is inadequate. Voting by selling shares retains a component of the lack of trust in the marketplace itself by moving liquidity from less risky investments to more risky investments. Moreover, there is a time lag between the discovery and reporting of mistrust in the market and the timing of shareholder investment. By the time the bad news is disclosed, the shareholder has already suffered the loss, and the liquidity movement simply locks in the distrust.

403. See discussion supra Parts I-III. Director compensation remains relatively small and, hence, not a factor in the equation. See generally SHEARMAN & STERLING LLP, 2005 TRENDS IN THE CORPORATE GOVERNANCE PRACTICES OF THE 100 LARGEST US PUBLIC COMPANIES 6 (2005) available at http://www.shearman.com/cg_survey05/ (follow “View Full Text” hyperlink for .pdf document) (noting that director compensation levels have increased in recent years, but that many top-100 corporations still report director compensation in the $40,000 annual range). For an interesting analysis arguing that employee stock options create a norm in favor of non-conflicting fortunes within the financial community of a company, see Saul Levmore, Puzzling Stock Options and Compensation Norms, 149 U. PA. L. REV. 1901 (2001).


405. See discussion supra Part III; cf. Larry E. Ribstein, Law v. Trust, 81 B.U. L. REV. 553, 554-56 (2001) (arguing that mandatory rules designed to increase trust have precisely the opposite effect when the rule is used opportunistically simply to avoid penalized behavior without engaging in trustworthy behavior).

406. For example, serving passively on several boards for aggregate larger returns is a rather simple target for abdication claims. See Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1395 (2002), quoted in Lyman P.Q. Johnson, The Audit Committee's Ethical
good faith into actionable loyalty thus at once serves the function of making the duty, breach, and liability more intuitive, while also making the fact of liability infinitely more flexible to fit the design of the Delaware courts. By imposing a positive duty of devotion upon directors, expanded loyalty fills the gap left by the more amorphous concept of bad faith. Although the Delaware Supreme Court made abundantly clear that isolated instances of oversight failure will not be actionable, it did not define the precise contours of when oversight failure is systematic and actionable. This way, directors are encouraged to take affirmative steps to be more involved in management oversight. While it is impossible to quantify the precise market effect of this expansion of loyalty, that very lack of precise predictability discourages actionable managerial behavior.

This expansion is only effective provided it restores and maintains investor trust in corporate management and the marketplace. Absent trust, investors will simply shift their capital from the marketplace to public and private debt as a less risky alternative. Accordingly, trust is crucial to the success of the marketplace and the public corporation.

Instilling and maintaining trust in the marketplace for entrepreneurial

and Legal Responsibilities: The State Law Perspective, 47 S. TEX. L. REV. 27, 38 (2005) ("If an overly busy person serves on the boards of five public companies . . . , takes on challenging duties on each of those boards, and then finds himself in a situation where one of his companies is accused of serious wrongdoing that the board arguably should have prevented, he should not be surprised if his good faith comes under severe attack in the financial press and in the courts.").


408. See Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d. 27 (Del. 2006).

409. See Duggin & Goldman, supra note 212, at 214 ("The Delaware courts' recent articulations of the duty of good faith respond to a deep need to find ways to restore trust in corporate directors."); cf. Geoffrey Christopher Rapp, A New Direction for Shareholder Environmental Activism: The Aftermath of Caremark, 31 WM. & MARY ENVTL. L. & POL'Y REV. 163, 176 (2006) (noting that compliance programs preserve the reputation of a firm).

410. See Lynn A Stout, The Investor Confidence Game, 68 BROOK. L. REV. 407, 408 (2002) ("Investor trust provides the foundation on which the American securities market has been built."). Federalism can only maintain a degree of investor trust by guaranteeing that the federal government will intervene in intra-corporate internal affairs to police abusive management behavior. Provided such laws are vigorously enforced, it simply gives investors some degree of assurance that near-criminal behavior will be prosecuted. As long as investors believe that such norms are effective to deter undesirable behavior, that belief restores a measure of trust, but only against near-theft and waste.
enterprises in competition with other forms of risk investment can only be maintained by some meaningful positive duty that directors act in the best entrepreneurial interests of the shareholders. The question is then, simply, how effective directorial fiduciary duties are in maintaining that trust. Certainly, the fiduciary duty of care cannot be relied upon to instill or maintain trust. At the moment, care has been reduced to an excusable and indemnifiable minimum. After Disney, it is difficult to argue that care is so meaningful a standard bearer for shareholder trust that directors will take care of the corporation and its best interests. In order to induce qualified directors to serve, the risk of liability for risky decision-making has been reduced to sanction even grossly negligent behavior, provided the director subjectively believed that the decision was in the best interests of the company.\textsuperscript{413} Subjective belief in the correctness of a decision later proven to be grossly negligent but nonetheless rational does little to maintain investor trust. Of course, it may make directors more comfortable with even sloppy behavior and could, therefore, increase the pool of persons willing to serve in that capacity, but is that outcome alone adequate? Is a fiduciary duty truly meaningful to the beneficiary of the duty when it is reduced to such minimal levels? Such a proposition is highly doubtful. The only way to seriously argue that the duty of care is meaningful to the investment community is to claim that the community simply does not and has not internalized how the duty of care has been reduced to near inapplicability as a liability standard. But such an understanding gap assumes enormous market inefficiencies without adequate proof.

The duty of loyalty, on the other hand, has more marketplace trust potential and promise,\textsuperscript{412} especially after Disney and Stone. By Disney first identifying that bad faith encompasses serious abdication or dereliction of directorial duties, and Stone conflating bad faith into loyalty, as well as freeing loyalty from its prior economic interest constraints, the Delaware Supreme Court has revitalized trust by mandating meaningful diligence to directorial duties.\textsuperscript{413} Of course, liability follows only from systematic or serious duty abdications, but the exact contours of "systematic" are not clearly defined. That mystery, as defined by further Delaware case law, offers the best hope for restoring

\begin{footnotesize}
\begin{enumerate}
\item See discussion supra Part III.E.
\item See Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms and the Self-Governing Corporation, 149 U. PA. L. REV. 1619, 1661-62 (2001) ("[T]he role of the duty of loyalty is to provide a check on directorial or controlling shareholder opportunism.").
\end{enumerate}
\end{footnotesize}
and maintaining marketplace trust, especially after serious public cases like Enron.

H. Conclusion Regarding For-Profit Judicial Fiduciary Duties

The Disney and Stone cases first developed the contours of "good faith" and then conflated it with "duty of loyalty," while at the same time freeing loyalty from its traditional Delaware economic interest limitations. In so doing, the Delaware Supreme Court internalized social norms into Delaware corporate governance jurisprudence by requiring an affirmative element of devotion to directorial duties. This approach arguably improves the clarity of a simple Caremark abdication of duty claim by maintaining the viability of the action, while emphasizing that the abdication must be systematic to implicate the bad faith destruction of exculpation and indemnification. While the Delaware courts could have chosen a different path for bad faith, such as removing the protection of both the business judgment rule and exculpation, the path chosen has other advantages. The most significant is the indoctrination of social norms of loyalty into Delaware corporate governance. Additionally, the path chosen arguably allows for a correction of the Cede formulation, applying the entire fairness test to duty of care cases. Now that loyalty has been released from its economic interest shackles, there is little reason to continue to apply entire fairness to justify a duty of care violation at any level.

IV. FEDERAL TAX GOVERNANCE OF NONPROFIT SELF-DEALING AND EXCESS TRANSACTIONS: OBSCURE POLICING THE DUTIES OF LOYALTY AND CARE

The term "nonprofit" organization has many meanings in different contexts. The most common definition focuses on the legal "nondistribution constraint" prohibiting the organization from distributing profits or net earnings to persons controlling the entity such as members, officers, directors, and trustees. Under this formulation, a nonprofit organization is not prohibited from making a profit, but any such earnings must be retained and devoted exclusively to financing the services the organization was formed to provide. Other formulations

416. Id.
exist and focus on "altruism, [the] level of support through donations, or the products they supply." Federal tax law does not dictate the organizational charitable form and Form 990 does not identify organizational form.

A. Federal Tax Definition of Nonprofit Organization

Federal tax law does adopt the nondistribution restraint formulation, albeit in a private inurement construct, as a qualification for all democracy, that have been fading, shifting, and criss-crossing: the lines "between public and private, profit and non-profit, and secular and religious." 418


419. See Treas. Reg. § 1.501(c)(3)-1(b)(2) (as amended in 1990). Most tax-exempt organizations are organized under specific state nonprofit "corporation" statutes. However, § 501(c)(3) also interprets the term "nonprofit corporation" to include unincorporated associations (including limited liability companies) and charitable trusts. Id. (noting that definitions of the terms "articles" or "articles of organization" generally include "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created"). Because a trustee's fiduciary duties arguably exceed those of a comparable charitable board of directors, most charitable organizations are organized as corporations and not trusts. Limited liability companies have more contractual flexibility with regard to fiduciary duties. However, if a limited liability company is "determined to be, or claims to be," an exempt organization, it will be "deemed" to have made an election to be classified as an association taxable as a corporation. Treas. Reg. § 301.7701-3(c)(1)(v)(A) (as amended in 2006). Moreover, most state laws require nonprofit organizations to be in the form of non-stock entities, so there are no "owners" of the entity or its profits. In a state that permits a limited liability company to be formed and operated with no economic members, this condition might be satisfied. However, most state limited liability company laws require any limited liability company to have members. See, e.g., DEL. CODE ANN. tit. 6, § 18-101(6) (2001) ("Limited liability company... means a limited liability company formed under the laws of the State of Delaware and having 1 or more members."). For this reason, limited liability companies are used mostly in joint ventures with another tax-exempt entity or as a wholly owned subsidiary of such entity. See A. L. Spitzer, The IRS Stakes Out Its Position on Joint Ventures: But Is It Defensible?, SD32 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. COURSE OF STUDY 133, 136-37 (1998); see also infra notes 428-29 and accompanying text.

420. See Form 990, supra note 55. "[E]very organization exempt from taxation under section 501(a)," including, therefore, § 501(c)(3) charitable private foundations and charitable public charities, must file an annual tax return. I.R.C. § 6033(a)(1). Neither churches nor public charities with less than $5,000 annual gross receipts, however, need to file annual returns. Id. § 6033(a)(3)(A)(i)-(ii). The annual filing must be on Form 990 for public charities and Form 990-PF for private foundations. Treas. Reg. § 1.6033-2(a)(2)(i) (1971). The treasury regulations control the information to be reported. See, e.g., Treas. Reg. § 1.6033-3 (1985) (requiring private foundations to report additional information, send a copy to the attorney general's office, and file notice to the public of its inspection availability).

421. I.R.C. § 501(c)(3) (2000) (providing in part that "no part of the net earnings [may] inure[] to the benefit of any private shareholder or individual").
charitable organizations seeking exemption from federal income taxation. Most nonprofit organizations are exempt from taxation because they are "charitable" under § 501(c)(3). The status is not automatic and must be approved by application. The status is an important fund-raising element because donors are permitted to take a federal tax deduction for the amount of contributions to such "donative charities" and private foundations and governmental agencies generally make grants only to such tax-exempt organizations. Other "commercial charities" raise funds through commercial-style operating activities designed to further their charitable purposes. The latter often "compete" with commercial and governmental agencies providing the same services, particularly in the health care industry. While this feature often creates questions regarding whether a hospital should enjoy favored tax-exempt status, the exemption has been empirically defended on the basis that the nonprofit hospital generally satisfies a public interest by providing services that are unlikely to be offered by for-profit and government hospitals. Nonetheless, the need for capital by nonprofit hospitals has created a splurge of joint venture activity with

422. Id. § 501(a).
423. Id. § 501(c)(3). The tax exemption for charitable organizations is quite ancient, predating the income tax system and originating with various pre-income tax tariff exemptions. See James J. McGovern, The Exemption Provisions of Subchapter F, 29 TAX L. 523, 525 (1976).
425. I.R.C. § 170(a) (2000) (allowing a federal income tax deduction for a "charitable contribution"). A charitable contribution is defined, most importantly, by I.R.C. § 170(c)(2), as one made to an organization essentially described in I.R.C. § 501(c)(3). Id. § 170(c)(2).
427. See generally Horwitz, supra note 418 (arguing that tax-exempt nonprofit hospitals act in the public interest by providing services unlikely to be offered by government or for-profit hospitals, thereby justifying the continued existence of the public charity tax exemption for such institutions).
various for-profit organizations. The joint venture structure places additional pressures on operating exclusively for charitable purposes and generally requires the charitable institution to maintain operating control over the joint venture to assure devotion to the charitable mission rather than a profit motive.

B. Public Charities and Private Foundations

While donative and commercial charities share a common public charitable purpose requiring organization and operation exclusively for charitable purposes, classification is importantly further subdivided into two separate charitable nonprofit organization categories: "public charities" and "private foundations." The term "private foundation" is defined in § 509(a) of the Internal Revenue Code simply by excluding organizations specifically defined as "public charities." Consequently, all § 501(c)(3) organizations not specifically defined as "public charities" are considered private foundations.


430. Treas. Reg. § 1.501(c)(3)-1(a)(1), (c)(1) (as amended in 1990); I.R.C. § 501(c)(3) (providing that the charity must be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, . . . or for the prevention of cruelty to children or animals"); see also BISHOP & KLEINBERGER, supra note 429, ¶ 1.09[1][b] (describing the exclusivity test as only generally requiring that the organization operate "primarily" for charitable purposes, further meaning that no more than an "insubstantial" part of its activities may be devoted to non-charitable operations).

431. See Marsh, supra note 6, at 179-81 (arguing the public/private distinction is an outdated proxy for the donor control metric and substantially undermines large community foundations). The recent gift to the Gates Foundation by Warren Buffet is an excellent example. The Bill and Melinda Gates Foundation has a current endowment of approximately $38.7 billion, including the first Warren Buffet donation of $1.6 billion. When the $31 billion Buffet gift is complete, the donation endowment will reach more than $65 billion. See Bill & Melinda Gates Foundation, Foundation Fact Sheet, http://www.gatesfoundation.org/MediaCenter/FactSheet/ (last visited Apr. 28, 2007); Bill & Melinda Gates Foundation, Implementing Warren Buffett's Gift, http://www.gatesfoundation.org/aboutus/relatedinfo/buffett.htm (last visited, Apr. 28, 2008); see also Lior Jacob Strahilevitz, Wealth Without Markets?, 116 YALE L.J. 1472, 1511-12 (2007) (book review).


433. See id.
C. Public Charity Defined

A public charity therefore includes any § 501(c)(3) organization described in one of the four specific categories § 509(a). First, a public charity includes an organization described in § 170(b)(1)(A)(i)-(vi). These include various publicly supported charities and three “automatic” public charities not subject to a public support test: churches, educational institutions, and hospitals (including medical research institutions). The remaining categories of organizations that fall under § 170(b)(1) are those that receive a substantial amount of their support from public (government) donations. Second, a public charity can be a public service organization. These organizations must receive more than one-third of their income from small public donations and not receive more than one-third of their income from investments. Third, a public charity can be an organization organized and operated for the benefit of other charitable organizations (supporting organizations). Finally, a public charity can be an organization “organized and operated exclusively for testing for public safety.” All other organizations are considered private foundations by exclusion.

D. General Restrictions on Private Foundations

These definitions reveal that private foundations are generally funded and controlled only by a few donors. Consequently, private foundations are subject to several restrictions not imposed on public charities because private foundations are more prone to abuse of power and a lack of real public benefit. For example, private foundations are subject to special

434. See id.
435. Id. § 509(a)(1).
436. Id. § 170(b)(1)(A)(i).
437. Id. § 170(b)(1)(A)(ii).
438. Id. § 170(b)(1)(A)(iii).
439. Id. § 170(b)(1)(A)(iv)-(vi) (including educational benefit organizations, governmental units, and organizations proving public benefit services such as museums, libraries, and the United Way).
440. Id. § 509(a)(2).
441. Id. § 509(a)(2)(A).
442. Id. § 509(a)(2)(B).
443. Id. § 509(a)(3).
444. Id. § 509(a)(4).
445. See id. § 509(a).
446. See William H. Byrnes, IV, The Private Foundation’s Topsy Turvy Road in the American Political Process, 4 HOUSES. BUS. & TAX L. J. 496, 498-99 (2004) (describing the historical derivation of the private foundation conceptualization, as well as the codification of its treatment in the Internal Revenue Code in 1969). The governing instrument of a private foundation must expressly state that the organization is prohibited from engaging
reporting requirements, a tax on net investment income, and a series of five separate penalty excise taxes. Donors are generally subject to less favorable limitations on the amount that can be deducted in any one taxable year, as well as a special penalty tax if private foundation status is terminated.

in transactions that would subject the organization to penalty taxes. See I.R.C. § 508(c)(1)(B) (West Supp. 2007).

447. I.R.C. § 6033(a)(1) (West Supp. 2007) (requiring exempt organizations to “file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe”). A private foundation must file an annual return on Form 990-PF. Treas. Reg. § 1.6033-2(a)(2)(i) (1971); see also Internal Revenue Serv., Dep’t of the Treasury, Form 990-PF: Return of Private Foundation (2007), available at http://www.irs.gov/pub/irs-pdf/f990pf.pdf. The information generally required includes, but is not limited to: gross income (not including contributions); dues and assessments; expenses; exempt disbursements; detailed balance sheet; donations, names, and addresses of those contributing $5,000 or more in any one year; the names and addresses of all officers, directors, trustees and foundation managers; the names and addresses of the five persons receiving the most compensation in excess of $30,000; and the number of all independent contractors receiving more than $30,000 in compensation. Treas. Reg. § 1.6033-2(a)(2)(ii). The Form 990-PF is available for inspection by the public at the Internal Revenue Service. I.R.C. § 6104(a)(1)(A) (2000). However, compensation details are generally not available. Id. § 6104(a)(1)(C). The application and annual reports must also be available for inspection at the charity. I.R.C. § 6104(d)(1)(A) (West Supp. 2007). If the request is made in person, the information must be made available immediately. I.R.C. § 6104(d)(1)(B) (2000). Private foundations, but not public charities, must disclose the names of their contributors. See id. § 6104(d)(3)(A). However, if an organization fails to disclose as required, there is no private right of action to enforce the failure. See Schuloff v. Queens Coll. Found., Inc., 165 F.3d 183, 184 (2d Cir. 1999) (per curiam) (holding that Congress intended that the right be enforced exclusively by the IRS and not by private civil action).

448. I.R.C. § 4940(a) (2000). The net investment tax is an annual 2% tax imposed on a tax-exempt private foundation’s “net investment income.” Id. Net investment income means the excess of “the sum of the gross investment income and the capital gain net income” over allowable expenditures. I.R.C. § 4940(c) (West Supp. 2007). Importantly, the net investment income tax is not imposed on public charities. This has generated debate as to whether huge university endowments should be subject to a similar tax on net investment income. See generally Henry Hansmann, Why Do Universities Have Endowments?, 19 J. LEGAL STUD. 3 (1990).


450. I.R.C. § 170(b)(1)(A)-(B) (2000) (contributions to public charities may not exceed 50% of the taxpayer’s contribution base, while contributions to a private foundation are limited to 30% of the contribution base). Contributions by individuals and corporations not allowed in one taxable year may be carried forward to the next five taxable years. Id. § 170(d)(1); I.R.C. § 170(d) (West Supp. 2007).

The five restrictions state one affirmative obligation and four negative covenants. First, a private foundation must annually distribute an amount approximately equal to 5% of its investment assets to either a public charity or to a private operating foundation. Failure to do so subjects the foundation to an initial tax equal to 30% of the undistributed required distribution. If the remaining amount is not distributed by the end of the year, it is subject to a second 100% tax. The distribution requirement and tax do not apply to public charities, thereby largely enabling university endowments to grow disproportionate to their institutional needs.

The remaining four foundation penalty taxes are in the form of negative covenants. The first is a tax on the excess business holdings of a private foundation. An initial 10% tax and a second uncorrected 200% tax are imposed on the excess business holdings of the foundation. Unfortunately, this tax discourages large gifts of publicly traded stock to private foundations. However, the tax is mitigated by a special rule allowing the private foundation to dispose of the excess business holdings within five years. Also, because the maximum allowable level of ownership in a corporation by a private foundation is 20% of the voting stock, there is little likelihood that a private foundation could control a publicly traded corporation through concentrated ownership.

The second tax is on investments that jeopardize the private foundation's charitable purpose. An initial 10% tax and an uncorrected 25% tax on the value of the jeopardy investment are imposed on the foundation. An additional 10% tax and uncorrected 5% tax are imposed on a foundation manager for knowingly making and failing to correct a jeopardy investment. An important exception exists

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452. I.R.C. § 4942(e)(1).
455. See Hansmann, supra note 448, at 6-7 (arguing that other countries impose distributional requirements on university endowments and that various proposals have been considered in Congress to extend the tax to public charities).
457. Id. § 4943(a); I.R.C. § 4943(b)-(c) (2000).
461. Id. § 4944(a)(1); I.R.C. § 4944(b)(1) (2000).
for program-related investments designed to promote charitable purposes without a significant profit motive.\textsuperscript{463}

The third tax is on expenditures that do not generally promote charitable purposes, such as lobbying or grants to individuals or organizations that are not charitable.\textsuperscript{464} An initial 20\% tax and an uncorrected 100\% tax are imposed on specified taxable expenditures.\textsuperscript{465} An additional 5\% tax and uncorrected 50\% tax are imposed on a foundation manager knowingly making and failing to correct a taxable expenditure.\textsuperscript{466}

\textbf{E. Foundation Self-Dealing & Charity Excess Benefit Taxes}

The final excise penalty tax is imposed separately and differently on self-dealers and management of private foundations and public charities, but never on the entity itself.\textsuperscript{467} Because the Internal Revenue Service enforces the tax as violations are discovered through mandatory information filings, the enforcement cost is low. All nonprofit corporations that desire tax-exempt status must file an application on Form 1023 and an annual report on Form 990.\textsuperscript{468} These reports are being revised to require increased disclosure to enable detection of actionable self-dealing and excess benefit transactions.\textsuperscript{469} While these forms are available upon request from both the IRS and the charity, the request process is cumbersome and timely, resulting in a lag of information. Far greater transparency would result if charities are required to timely post the forms on a website maintained by the charity.\textsuperscript{470}

Because private foundations and public charities are treated differently, they are analyzed separately below. However, there are many overlaps, particularly regarding the management approval tax elements.

\textsuperscript{463} I.R.C. § 4944(c) (2000).
\textsuperscript{464} See I.R.C. § 4945 (West Supp. 2007).
\textsuperscript{465} Id. § 4945(a)(1); I.R.C. § 4945(b)(1) (2000).
\textsuperscript{466} I.R.C. § 4945(a)(2) (West Supp. 2007); I.R.C. § 4945(b)(2) (2000). The maximum initial management tax is $10,000 and the maximum secondary tax is $20,000. I.R.C. § 4945(c)(2) (West Supp. 2007).
\textsuperscript{467} I.R.C. § 4941 (West Supp. 2007).
\textsuperscript{468} Treas. Reg. § 1.6033-2(a)(2)(i) (1971); supra note 425.
\textsuperscript{469} See Reiser, supra note 22, at 568-80 (discussing various state and federal proposals for disclosure regulation of nonprofits, particularly a Senate Finance Committee discussion draft proposal that would increase the disclosures required by Form 990 in an effort to improve nonprofit accountability).
\textsuperscript{470} See id. at 578 (noting that the Senate Finance Committee proposal calls for mandatory electronic filing of Form 990). Most enforcement cases are initiated by inside whistleblowers and the press. Greater transparency would result in greater enforcement to prevent the charity management from playing the audit lottery (hoping to avoid an audit after filing false information).
In the end, it will become evident that in many instances the excise tax regime imposes more stringent standards than imposed by state fiduciary duty law. Nonetheless, in many instances, those taxes are related to or dependent upon some semblance of a state fiduciary duty.

1. Private Foundations

A fourth tax is imposed on "self-dealing between a disqualified person and a private foundation." Roughly stated, this excise tax imposes a two-tier monetary penalty on the self-dealer and equates to a stricter duty than developed under the remaining duty of loyalty discussed in Part III above. First, an initial "breach of duty of loyalty" tax is imposed on the self-dealer for engaging in a self-dealing transaction. Then, a second tier penalty tax follows unless the self-dealer makes complete restitution to the foundation by unwinding the transaction.

a. Self-Dealer Tax

An initial 10% tax is imposed on any disqualified person (but not the foundation itself) on the amount or value of any self-dealing transaction between that person and a private foundation. It is generally irrelevant whether the self-dealer knew the act constituted self-dealing. The amount involved is generally the sum of the money and fair market value of property given or received, except with regard to excess compensation transactions where the amount involved is only the "excess" compensation.

If not corrected within the taxable period, there is an additional 200% tax imposed on the self-dealer. Correction generally requires "undoing the transaction" and also requires that the private foundation be put in the same position as would have occurred had the self-dealer been dealing with the private foundation according to the "highest fiduciary standards." For example, in a prohibited sale of property to

472. Id.
473. I.R.C. § 4941(b)(1) (2000); see also id. § 4941(e)(3).
476. The taxable period generally begins with the date of self-dealing and ends on the earliest of three dates, generally meaning that the transaction must be corrected before a notice of deficiency with regard to the initial tax is issued. I.R.C. § 4941(e)(1) (2000); Treas. Reg. § 53.4941(e)-1(a).
478. Id. § 4941(e)(3); Treas. Reg. § 53.4941(e)-1(c).
the foundation for cash, correction usually involves a return of the cash to the foundation.\textsuperscript{479}

A "disqualified person" broadly includes, among others, a substantial contributor, a foundation manager, an owner, or a family member of any of these.\textsuperscript{480} A foundation manager is defined to include an officer, trustee, or director and any other person having similar powers.\textsuperscript{481} Also included in the definition of foundation manager are foundation employees with "authority or responsibility with respect to any act (or failure to act)."\textsuperscript{482} It is clear, therefore, that both managers and directors are subject to the same self-dealing standards.

Self-dealing is broadly defined to include any transaction between a disqualified person and the foundation:

\begin{quote}
[T]he term "self-dealing" means any direct or indirect—

[(i)] sale or exchange, or leasing, of property between a private foundation and a disqualified person;

[(ii)] lending of money or other extension of credit between a private foundation and a disqualified person;

[(iii)] furnishing of goods, services, or facilities between a private foundation and a disqualified person;

[(iv)] payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

[(v)] transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

[(vi)] agreement by a private foundation to make any payment of money or other property to a government official . . . other than an agreement to employ such individual for any period after the termination of his government service if such
\end{quote}

\textsuperscript{479} Treas. Reg. § 53.4941(c)-1(c)(1).

\textsuperscript{480} I.R.C. § 4946(a), (d) (2000) ("[T]he family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.").

\textsuperscript{481} Id. § 4946(b)(1). A person is "considered an officer of a foundation . . . if [h]e is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or . . . [h]e regularly exercises general authority to make administrative or policy decisions on behalf of the foundation." Treas. Reg. § 53.4946-1(f)(2) (1972). But a person possessing "authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer." Id. Moreover, the term does not include "such independent contractors as attorneys, accountants, and investment managers and advisers, acting in [those] capacities." Id.

\textsuperscript{482} I.R.C. § 4946(b)(2).
individual is terminating his government service within a 90-day period.\textsuperscript{483}

Applied literally, the prohibition on compensation for services would prevent any disqualified person from working for the private foundation.\textsuperscript{484} Accordingly, a special exception permits a disqualified person to receive reasonable compensation for services provided the payment is not excessive.\textsuperscript{485} The services must be necessary to carry out the charitable mission of the foundation and the payment must be reasonable.\textsuperscript{486}

This approximates the duty of loyalty in the context of for-profit and nonprofit governance law. Moreover, the self-dealing amount is only the compensation in excess of reasonable compensation.\textsuperscript{487} This approximates the "fairness" exemption for conflict of interest transactions. Because of these definitions, almost all self-dealing transactions are directly prohibited, except the rendering of services to the foundation in exchange for reasonable compensation.\textsuperscript{488} The 200\% uncorrected tax on the self-dealer makes such transactions extremely expensive and, thus, generally makes 100\% restitution to the foundation much less expensive. However, the low 10\% initial tax may enter into the personal calculus of whether to enter into the transaction. Initially, the self-dealing transaction might not be identified as such by the Internal Revenue Service, thus encouraging the disqualified person to play the audit lottery. Even if detected, the penalty is simply 10\% plus restitution. Once imposed, the initial tax may not be abated,\textsuperscript{489} though the taxpayer may avoid the second-tier tax correction.\textsuperscript{490}

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{483} \textit{Id.} § 4941(d)(1). The statute then provides a series of special rules regarding self-dealing transactions. First, a transfer of property is treated as a prohibited sale if a foundation assumes a mortgage placed on the property by the disqualified person within the prior ten years. \textit{Id.} § 4941(d)(2)(A). Second, a disqualified person may lend money interest free to the foundation, provided the loan is used to carry out the charitable mission of the foundation. \textit{Id.} § 4941(d)(2)(B). Third, a disqualified person may furnish goods or services to a foundation as long as there is no charge and the goods are used in furtherance of the charitable mission of the foundation. \textit{Id.} § 4941(d)(2)(C). Fourth, a foundation may furnish goods and services to a disqualified person provided the foundation is fairly compensated, just as it would have been had it been dealing with the general public and not with a disqualified person. \textit{Id.} § 4941(d)(2)(D).
  \item \textsuperscript{484} \textit{See id.} § 4941(d)(1)(D).
  \item \textsuperscript{485} \textit{Id.} § 4941(d)(2)(E).
  \item \textsuperscript{486} Treas. Reg. § 53.4941(d)-3(c)(1) (as amended in 1984).
  \item \textsuperscript{487} I.R.C. § 4941(e)(2) (2000).
  \item \textsuperscript{488} \textit{See supra} note 483 (listing three other limited exceptions).
  \item \textsuperscript{489} I.R.C. § 4962(a)-(b) (2000).
  \item \textsuperscript{490} \textit{See id.} § 4941(b).
\end{itemize}
\end{footnotesize}
b. Foundation Manager Approval Tax

In addition to the two-tier tax on the self-dealer discussed above, a two-tier management approval excise tax may also apply to managers who were not self-dealers.491

The “approval” excise taxes include an initial 5% tax and an additional 50% tax if the transaction is not corrected.492 The tax is imposed on the participation of the foundation manager only when the manager actually knew the transaction was a self-dealing act, but is not imposed when “such participation is not willful and is due to reasonable cause.”493 Liability is joint and several when the tax is applicable,494 but the management approval tax is limited to a maximum of $20,000 for each of the first- and second-tier taxes.495 The second-tier tax encourages the manager to police the disqualified person’s restitution of the original act of self-dealing. When the disqualified person makes restitution to avoid the imposition of the 200% uncorrected tax, the manager avoids the second 50% uncorrected tax.

The foundation manager approval tax is only applicable when “(i) [a] tax is imposed [on a self-dealer], (ii) [the] participating foundation manager kn[ew] that the act [was] an act of self-dealing, and (iii) [t]he participation by the foundation manager [was] willful and [was] not due to reasonable cause.”496 Several key terms are specifically defined. “Participation” is defined to “include silence or inaction,” or an abdication of duties, where the foundation manager “is under a duty to speak or act, as well as any affirmative action by such manager.”497 Participation does not include any self-dealing where the foundation manager opposed the act “consistent with the fulfillment of his responsibilities to the private foundation.”498 The foundation manager “knows” the conduct constitutes self-dealing only where:

(i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing,

491. I.R.C. § 4941(a)(2) (West Supp. 2007); I.R.C. § 4941(b)(2) (2000). Notably, if the self-dealer is also a foundation manager, both the self-dealer and management approval excise taxes are imposed on the same person. Treas. Reg. § 53.4941(a)-1(a)(1)(iii) (as amended in 1973). For the definition of foundation manager, see supra notes 481-82 and accompanying text.
496. Treas. Reg. § 53.4941(a)-1(b)(1).
497. Id. § 53.4941(a)-1(b)(2).
498. Id.
(ii) He is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing, and

(iii) he negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act. 499

Moreover, while the term “knows” does not mean merely having “reason to know,” the latter is relevant evidence to establish actual knowledge. 500 “Willful” is defined to be voluntary, conscious, and intentional conduct. 501

As a defense, the foundation manager’s participation is excused when it is due to reasonable cause, meaning that the manager “exercised his responsibility on behalf of the foundation with ordinary business care and prudence.” 502 This generally means that the approval excise tax will not be imposed where the duty of care is satisfied. It is unclear whether the duty of care is protected by the normative corporate governance business judgment rule, but presumably this would be so. Indeed, the government has the burden to prove liability for the tax 503 so the business judgment rule should protect a director from an allegation that the duty of care was not satisfied, at least when a decision has been made. Finally, a foundation manager can avoid the approval excise tax if he relied on the advice of counsel. 504 Thus, provided a foundation manager “relies on the advice of [legal] counsel expressed in a reasoned written legal opinion that an act is not an act of self-dealing,” the manager will be protected as long as counsel was fully advised as to all relevant facts. 505 This remains true even if the transaction is later determined to constitute an act self-dealing. 506 An opinion is “‘reasoned’ even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law.” 507 An opinion is not reasoned within the definition “if it does nothing more than recite the facts and express a conclusion.” 508 Importantly, the absence of an opinion does not create “any inference that [the manager] participated . . . knowingly, willfully, or without reasonable cause.” 509

499. Id. § 53.4941(a)-1(b)(3).
500. Id.
501. Id. § 53.4941(a)-1(b)(4).
502. Id. § 53.4941(a)-1(b)(5).
504. Treas. Reg. § 53.4941(a)-1(b)(6).
505. Id.
506. See id.
507. Id.
508. Id.
509. Id.
This statutory summary establishes that these excise taxes reasonably reflect the duties of loyalty and care imposed by the 1987 and the 2008 RMNPCA on managers and directors of nonprofit corporations classified as private foundations, as discussed in Part II and expanded upon in Part III. Indeed, in many cases, the "excise tax" duty of loyalty is stronger than the duty of loyalty imposed by state law, which generally only requires basic fairness. Basic fairness is not a defense to the self-dealing tax nor to the management approval tax. The tax on the self-dealer is an absolute prohibition except for narrow exceptions, including reasonable compensation. The federal excise tax duty of care for a director approving a self-dealing transaction is also greater than that applicable to for-profit directors. Because fairness is not a defense, normally only a reasoned opinion of counsel that the transaction is not self-dealing will exonerate the director from the tax. In the absence of such an opinion, the government will argue that the absolute prohibition against self-dealing should give directors of private foundations adequate notice that every transaction between management and the foundation involves self-dealing.  

2. Public Charities

The self-dealing penalty excise taxes apply only to private foundations, and not to public charities. However, a public charity is subject to a separate tax on excess benefit transactions not applicable to a private foundation. Until the 1996 enactment of the excess benefit tax, such transactions threatened the tax-exempt status of the charity because of their violation of the private inurement prohibition. The applicable taxes are imposed on any disqualified person that engages in an excess benefit transaction and any manager who knowingly approved the transaction, and in neither case is the tax imposed on the organization.

511. See id. § 4941(a).
513. Id. § 4958(e).
514. See Allison M. Sawyer, Student Article, Intermediate Sanctions: Protection for Charitable Organizations and the Donations They Receive, 15 LOY. CONSUMER L. REV. 125, 132-33 (2003). Technically, private inurement could result in the loss of tax exemption and also trigger the imposition of the excess benefit tax. However, Congress generally intended revocation of the tax-exempt status only where the transaction threatens the charitable basis and nature of the organization. See Caracci v. Comm'r, 118 T.C. 379, 414 (2002), rev'd on other grounds, 456 F.3d 444 (5th Cir. 2006) (finding no excess benefit).
a. Self-Dealer Tax

The excess benefit tax imposes an initial 25% tax on any disqualified person who becomes a self-dealer by engaging in an excess benefit transaction. A second 200% tax is imposed if the excess benefit is not timely restored to the public charity. Correction to avoid the second tax requires "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." Accordingly, as with private foundations, it is far less expensive to unwind the transaction by making restitution to the public charity than to incur the second 200% tax.

Because public charities are more likely to be involved with other organizations, the definition of a disqualified person is somewhat different than for the definition of private foundations. A disqualified person includes: (i) "any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization"; (ii) a family member of such an individual; (iii) "a 35-percent controlled entity"; (iv) any of these persons with respect to another public charity organized to carry out the purposes of the public charity engaged in the transaction; (v) the donor or donor advisor of a donor advised fund; and (vi) any investment advisor in a sponsoring organization. A 35% controlled entity is defined to include:

(i) a corporation in which persons [with substantial influence or their family members] own more than 35 percent of the total combined voting power;

(ii) a partnership in which such persons own more than 35 percent of the profits interest, and

\[516. \text{See id. } \S 4958(a)(1). \text{ An "excess benefit transaction" is "any transaction in which an economic benefit is provided by [a public charity] directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration . . . received for providing such benefit." Id. } \S 4058(c)(1)(A). \text{ The "excess benefit" is the excess amount involved in an excess benefit transaction. Id. } \S 4958(c)(1)(B). \]
\[517. \text{Id. } \S 4958(b). \]
\[518. \text{I.R.C. } \S 4958(f)(6) (West Supp. 2007). \]
\[519. \text{I.R.C. } \S 4958(f)(1)(A). \]
\[520. \text{I.R.C. } \S 4958(f)(1)(B) (West Supp. 2007). \]
\[521. \text{Id. } \S 4958(f)(1)(C). \]
\[522. \text{Id. } \S 4958(f)(1)(D). \]
\[523. \text{Id. } \S 4958(f)(1)(E), (f)(7). \]
\[524. \text{Id. } \S 4958(f)(1)(F), (f)(8). \]
(iii) a trust or estate in which such persons own more than 35 percent of the beneficial interest.\textsuperscript{525}

Special constructive ownership rules apply to determine the outcome of these ownership tests.\textsuperscript{526} If more than one person is liable for the tax, the liability is joint and several.\textsuperscript{527}

\textit{b. Charitable Manager Approval Tax}

As with the private foundation self-dealing tax, there is also a 10% tax imposed on the amount of the excess benefit on any organization manager who participated in the transaction.\textsuperscript{528} Unlike with private foundations, there is no second tax imposed on an organization manager if the transaction is not corrected.\textsuperscript{529} But, like private foundations, the maximum tax imposed upon approving managers is $20,000.\textsuperscript{530}

An organization manager is defined more narrowly than a disqualified person to include only "any officer, director, or trustee" of a public charity or "any individual having powers or responsibilities similar to those of officers, directors, or trustees."\textsuperscript{531} A person is an "officer" if he is "specifically so designated under the certificate of incorporation, by-laws, or other constitutive documents of the organization; or [r]egularly exercises general authority to make administrative or policy decisions on behalf of the organization."\textsuperscript{532} But a person is not an officer if he has "authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior," or if he is an independent contractor, such as an attorney or accountant.\textsuperscript{533}

Under a special rule, "[a]n individual who is not an officer, director, or trustee, yet serves on a committee of the governing body" of a public charity may nonetheless be deemed an organization manager.\textsuperscript{534}

The tax is imposed if the manager participated in the excess benefit transaction knowing it to be an excess benefit transaction, unless such participation was not willful and was due to reasonable cause.\textsuperscript{535} Thus, while the excess benefit tax on the disqualified person imposes strict

\begin{footnotes}
\footnote{525}{I.R.C. \S\ 4958(f)(3)(A) (2000).}
\footnote{526}{Id. \S\ 4958(f)(3)(B); see also id. \S\ 4946(a)(3)-(4).}
\footnote{527}{Id. \S\ 4958(d)(1).}
\footnote{528}{Id. \S\ 4958(a)(2).}
\footnote{529}{See id. \S\ 4958(b) (providing for an additional tax imposed on disqualified person, but no similar tax imposed on management).}
\footnote{530}{I.R.C. \S\ 4958(d)(2) (West Supp. 2007).}
\footnote{531}{I.R.C. \S\ 4958(f)(2) (2000).}
\footnote{532}{Treas. Reg. \S\ 53.4958-1(d)(2)(i) (2002).}
\footnote{533}{Id. \S\ 53.4958-1(d)(2)(i)(B).}
\footnote{534}{Id. \S\ 53.4958-1(d)(2)(ii).}
\footnote{535}{I.R.C. \S\ 4958(a)(2) (2000).}
\end{footnotes}
liability and does not depend upon knowledge that the transaction resulted in an excess benefit, the manager participation standard is subject to a willful requirement and may be avoided if participation was due to reasonable cause. The manager therefore has several levels of defense not available to the disqualified person who received the excess benefit. First, the manager participation must be "knowing," meaning actual knowledge. However, facts demonstrating a reason to know are relevant in proving actual knowledge. A manager knowingly participates in an excess benefit transaction only when (i) the person has "actual knowledge of sufficient facts" that demonstrate (on those facts alone) that the transaction is an excess benefit transaction; (ii) the person is aware that these acts may violate federal tax laws governing excess benefit transactions; and (iii) the person either is aware that it is an excess benefit transaction or negligently fails to determine whether it is such a transaction.

Importantly, even when the manager suspects the transaction is an excess benefit transaction, the penalty will not apply where reliance is based on a reasoned opinion. An opinion is "reasoned," even though it incorrectly concludes that the transaction was not an excess benefit transaction, as long as the opinion considers and addresses both the relevant facts and applicable law; an opinion is not reasoned if it "does nothing more than recite the facts and express a conclusion." The regulations provide that the absence of a written opinion does not, by itself, create an inference that the manager knowingly participated. Professionals who may issue reasoned opinions include "[l]egal counsel, including in-house counsel; .... [c]ertified public accountants or accounting firms with expertise regarding the relevant tax law matters; and .... [i]ndependent valuation experts."

c. Abatement of Tax

Finally, the 200% second-tier excess benefit tax imposed on the disqualified self-dealer may be abated if imposed and the transaction is thereafter corrected. In addition, the first-tier tax against both the disqualified self-dealer and the approving organization manager may be

538. Id. § 53.4958-1(d)(4)(i)(A)-(C).
539. Id. § 53.4958-1(d)(4)(i)(A)-(C).
540. Id.
541. Id.
542. Id.
abated where it is established that: (i) the excess benefit transaction “was due to reasonable cause and not to willful neglect, and [(ii)] such event was corrected within the correction period for such event.”

As previously noted, the initial tax on the organization manager is subject to a reasonable cause defense in the first instance. The initial tax on the disqualified self-dealer is not. However, the disqualified person is granted an opportunity for abatement on essentially the same grounds. The abatement provisions do not extend to private foundations.

3. Self-Dealing and Excess Benefit Comparative Analysis

Perhaps the most striking difference between the self-dealing tax on private foundations and the excess benefit tax on public charities is that the latter permits all fair and reasonable transactions. The private foundation tax permits, by contrast, only reasonable compensation. When the excess benefit tax applies, it only taxes the excess over the fair and reasonable amount. The private foundation tax imposes a tax on the full amount of the self-dealing transaction. In addition, it is simpler to correct an excess benefit transaction than a self-dealing transaction, because only the “excess” needs to be returned to the public charity, whereas the entire self-dealing transaction must be corrected.

By way of contrast, the 1987 RMNPCA section 8.31 permits all self-dealing or conflict-of-interest transactions provided the transaction is either fair, like the excess benefit tax, or is approved in advance by directors knowing the material facts with a good faith reasonable belief that the transaction was fair. The approval must occur by a majority vote of disinterested directors. Thus, the excess benefit tax and the 1987 RMNPCA adopt a similar fairness standard while private foundations are subject to a punitive tax even if the transaction was permitted under state law. Given that nonprofit directors are often not compensated and less financially sophisticated than for-profit directors, and given that reporting and transparency are less direct, it is arguable that the “reasonable belief” standard of 1987 RMNPCA section 8.31 is a “charade” and totally ineffective. Under this interpretation, the private foundation tax approach arguably should be extended to public charities to replace the more liberal excess benefit tax. While this would

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544. *Id.* § 4962(a).
545. *Id.* § 4962(b); see also I.R.C. § 4941(a) (West Supp. 2007).
547. *Id.* § 8.31(b)(1).
548. *Id.* § 8.31(e).
prohibit the public charity from participating in some beneficial transactions, the benefit of a stricter foundation rule more than likely outweighs the advantages of engaging in self-dealing transactions. In any event, if the transaction is desirable, the disqualified person or organization manager can simply dissociate from the public charity, or otherwise restructure the transaction, in order to permit it.\textsuperscript{551}

Of equal importance is the fact that the 1987 RMNPCA refers to a broader "conflict-of-interest" transaction rather than a more narrow self-dealing transaction. However, broader conflicts transactions such as competition and opportunity doctrines are far less applicable in the nonprofit sector than in the for-profit sector.

V. CONCLUSION

Extensive problems exist regarding the enforcement of the state law fiduciary duty of care of a charitable nonprofit corporate board to detect and correct management excesses. Moreover, even in the for-profit sector where the robust shareholder derivative suit remains to enforce breaches of the fiduciary duty of care—enhanced by SOX disclosure, information transparency, and independence—director monetary liability is rare except in extreme systematic cases of abdication of directorial responsibility. That said, directorial abdication is much more likely in a more passive, captured, and volunteer charitable nonprofit board with a diverse charitable mission. As a reasonable duty of care surrogate for directors without financial conflicts of interest, federal excise taxes on self-dealing and excess benefit transactions are reasonable, government-enforced, cost-effective proxies for charitable board inattention. The taxes, therefore, superimpose limited monetary liability on a careless or absentee board. However, federal excise tax liability is triggered in the first instance by a breach of the state law fiduciary duty of care. As a result, the 2008 MNPCA has, and future reform proposals must, maintain the current fiduciary duty scheme, even though it seldom results in state law enforcement or liability.

Nonetheless, the true problem is that management behavior is the normative cause of charitable nonprofit corporation abuse, often leaving in its wake a weakened charity with a crippled reputation and inability to sustain its charitable mission because its fund-raising ability has been tarnished. The particular reforms discussed in this Article attack the core of the abuse. Significant increases in the initial excise tax while keeping the 200\% penalty for failure to correct will operate as a powerful disincentive against management excesses. Moreover, the absolute

\textsuperscript{551} See id. at 571-72.
private foundation prohibition for self-dealing should be extended to public charities. Although the 1987 RMNPCA authorizes “fair” transactions in for-profit corporations, the risk of abusive transactions far outweighs the benefits to a charitable organization from allowing “fair” self-dealing transactions. In order to increase the likelihood of detection, all charitable nonprofit corporations required to file an initial Form 1023 tax exemption application and annual Form 990 information report should be required to timely post those reports to a website maintained by the charitable institution. The press and interested public will likely help police abuses once this information is more available. Finally, whistleblower reforms specific to the tax should be enhanced so that charitable insiders will be encouraged to report abuses.