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WHOSE PUBLIC?

PAROCHIALISM AND PATERNALISM

IN STATE CHARITY LAW ENFORCEMENT

by

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WHOSE PUBLIC?

PAROCHIALISM AND PATERNALISM IN STATE CHARITY LAW ENFORCEMENT

> "I'm there fighting for the people of Hershey and the people of central Pennsylvania. This is the job that I have as the attorney general of Pennsylvania. The fact that I'm running for governor in this great commonwealth of ours has absolutely no role in the action that my office and I are taking in this case."[1]

> [*CNNfn's Bruce*] *Francis:* Now, now, Mr. Fisher, you're on the board of the trust, right? . . . .
> [*Pennsylvania Attorney General Mike*] *Fisher:* No, I am not . . . on the board of the trust. No, the attorney general has what's known as parentis patrae (ph) authority over all trusts in Pennsylvania. And essentially, you know, we don't call the shots, but we . . . certainly have the ability to oversee decisions that the trust has made. And where we will voice our objections is in the Orphans Court where we are today.[2]

> "If we create this doctrine that the attorney general becomes sort of a super trustee, we're putting all the public at risk to the next person who might benefit from that position."[3]

> "It just wouldn't have been right to have Hershey Park called Wrigley Field."[4]

> [*Voice-over in campaign ad:*] "Then he fought to block the sale of Hershey

[1] "Pennsylvania Attorney General Mike Fisher on the Possible Sale of Hershey Foods and What It Would Mean for the State," CNBC News Transcripts (show: Business Center (5:00 PM ET, September 6, 2002), available in LEXIS, News Library.

[2] Bruce Francis and Kathleen Hays, *Pennsylvania Judge Considers AG's Bid to Halt Hershey Sale*, CNNfn Transcript # 090302cb.107 (Money & Markets), 5:00 PM Eastern Standard Time, September 3, 2002 (guest, Mike Fisher).

[3] Comment of President Judge James Gardner Colins, Pennsylvania Commonwealth Court, during oral arguments on Hershey Trust's appeal of the preliminary injunction against any stock sale, quoted in Brett Marcy, *Pennsylvania Attorney General Becomes "Super Trustee" in Hershey Foods Dispute*, [HARRISBURG] PATRIOT-NEWS, Sept. 12, 2002, available at <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_69.html>.

[4] Steven Pearlstein, *For Hershey Trust, the Outcome Is Bittersweet*, WASH. POST, Sept. 19, 2002, at E1 (quoting attorney general Mike Fisher's explanation for why he sought a restraining order on the Hershey Trust's sale of its stock in Hershey Foods).

Foods, saving 6,000 more critical jobs."[5]

INTRODUCTION

Political cynics believe that "A.G." stands not for "attorney general" but for "aspiring governor." In recent years, State attorneys general have dramatically expanded their role in areas ranging from public health (the 1998 multi-billion dollar master settlement agreement with the tobacco companies[6]) to antitrust (the Microsoft litigation[7]) to Wall Street (Merrill Lynch's $100 million fine and agreement to separate research from investment banking[8]). Critics have complained that these types of prosecutions, while lucrative for the States and politically rewarding for the attorneys general, should be left to the appropriate federal agencies or State legislatures.[9]

By contrast, only a few State attorneys general have been much active in a realm firmly committed to State regulation and enforcement: the monitoring and oversight of charities.

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[5] Peter L. DeCoursey, *Pennsylvania Attorney General Will Use Hershey Sale Halt in Campaign Ads*, PATRIOT-NEWS, Sept. 26, 2002 (quoting a new 30-second "Jobs" commercial for the campaign ad of Republican gubernatorial candidate Mike Fisher, which will "air statewide, except in the Philadelphia region").

[6] November 1998 brought a $246 billion settlement agreement signed by 46 state attorneys general and major tobacco companies. The Master Settlement Agreement is available on the website of the National Association of Attorneys General at <www.naag.org/tobac/cigmsa.rtf>.

[7] A few of the States refused to go along with the federal settlement reached by the Justice Department. See, e.g., *Statement by New York Attorney General Eliot Spitzer and California Attorney General Bill Lockyer Regarding a Remedy in the Microsoft Case*, Sept. 10, 2001, available at <http://www.oag.state.ny.us/press/2001/sep/sep10a_01.html>. On November 1, 2002, a federal district court judge rejected most of the remedies sought by the hold-out State attorneys general.

[8] *Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices*. May 21, 2002, available at <http://www.oag.state.ny.us/press/2002/may/may21a_02.html>. *But see* Matt Fleischer-Black, *Independent Means: Eliot Spitzer Can Act Like a Real Lone Wolf*, AMER. LAWYER, Sept. 2002 (describing Merrill's insistence that the deal be contingent on the assent of all 50 States, and acceptance, as of August 2002, of only 31).

[9] *See, e,g,*, Rob Nehring, "National Association of Attorneys General: Opening the Door to a New Era of Regulation Through Litigation," Capital Research Center's Organizational Trends (September 2000), *available at* <http://www.capitalresearch.org/publications/organizational_trends/2000/0009.htm> ("working collectively through the National Association of Attorneys General, AGs have found a powerful vehicle for influencing federal and state lawmakers, appealing to constituents by sacrificing state powers to the federal government on high-profile issues, and advancing political careers by waging destructive campaigns against major industries."). *See, also* Martin Morse Wooster, "How State Attorneys General Police Nonprofits: Court Actions Sometimes Distort Charity, Restrict Free-Market Activity," Capital Research Center's Organizational Trends (Aug. 2000), *available at* <http://www.capitalresearch.org/publications/organizational_trends/2000/0008.htm> (while generally praising attorney general role, criticizing the use of "forced donations" to charities in settlements with businesses charged with wrongdoing).

According to a survey, top State charity officials conceive of themselves primarily as consumer protectors: Their "biggest problem" relates to charitable solicitations, and whether charities spend their money as represented to donors.[10] And those attorneys general who do maintain an active charities bureau – and the ones housing the most charities and the most charitable assets – suffer from chronic underfunding and understaffing.[11] Despite these handicaps, the State attorneys general have achieved important successes in educating the public about fraudulent fund raising and challenging wrongdoing; educating fiduciaries and staffs in meeting their legal obligations and improving charity governance; rectifying self-dealing and other breaches of fiduciary duty by charity insiders; and assisting charities that have lost their way to restructure or dissolve.

Even with regard to nonprofit organizations, though, the State attorney general remains an inherently political creature. The incentives of this nearly universally elective office[12] impel the incumbent to ignore cases that are politically dangerous and to jump into matters that are politically irresistible but implicate only "business" decisions of charity managers. Of course, it is unfair to single out the attorney general for blame; after all, in the absence of powers granted in the State constitution, what the attorney does is a function of what the legislature and courts grant or permit.[13] The broader inquiry of this paper is the relationship between charities and the state broadly conceived – how private is private philanthropy?

This paper seeks to develop a legal framework for attorney general and court jurisdiction in charity matters where public parochialism and paternalism appear to hold sway. In Part I, we

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[10] Thirty-eight States responded. Connecticut mentioned the improper use of charitable assets and management self-dealing; Massachusetts mentioned "board stewardship"; Oregon found "that a lot of small and medium-sized charities are being run . . . by one or two people rather than a board, or the board is not involved, or there is self-dealing in terms of benefits"; Pennsylvania offers "training sessions for charities"; Texas reported that "[m]oney is misspent or even outright stolen." Many complained of a lack of resources. Dean Mehegan, Betsy Bush, and Sharon Nacson, *Charity Regulation Today: How the States See It*, NONPROFIT TIMES,. Mar. 1994, at 1.

[11] *But see* Tamar Lewin, *Alumni Fight for "Soul" of Richest Orphanage*, N.Y. TIMES, Nov. 30, 2000, at A18 ("Nationally, with mushrooming philanthropic assets providing an increasingly important pool of money for the public good, attorneys general have become more active in monitoring how the money is used: the number of lawyers in the Pennsylvania attorney general's charitable trust section has doubled in the last three years.").

[12] According to the website of the National Association of Attorneys General: "The Attorney General is popularly elected in 43 states, and is appointed by the governor in five states (Alaska, Hawaii, New Hampshire, New Jersey, and Wyoming) and in the five jurisdictions of American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands. In Maine, the Attorney General is selected by secret ballot of the legislature and in Tennessee, by the state Supreme Court. In the District of Columbia, the Mayor appoints the Corporation Counsel whose powers and duties are similar to those of the Attorneys General of the states and jurisdictions." <http://www.naag.org/naag/about_naag.cfm>.

[13] *See* NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, STATE ATTORNEYS GENERAL: POWERS AND RESPONSIBILITIES 27-39 (Lynne M. Ross, ed.) (1990) (reviewing common law powers as bounded by State constitution, legislation, and judge-made law) [hereinafter "NAAG, STATE ATTORNEYS GENERAL"].

describe the legal structure for State charity oversight, describing the dual strands of charity trust law and nonprofit corporation law.[14] Because the attorney general as enforcer is essentially only a party in a dispute, we also examine the role of the courts. Finally, we see the effects of State ambivalence about attorney general oversight of charities, as revealed in budgetary and staffing decisions and jurisdictional impediments. Part II examines several areas in which parochialism and paternalism have tempted the State to exercise control over charitable assets, or to reduce the control traditionally granted to donors. This discussion reminds us that it was ever thus – that regulation of charities' investment assets as well as operating assets can provide a political cushion for the community or the State.[15] Part III attempts to summarize when attorney general and court action (or inaction) is appropriate, and describes open issues, notably the law that applies to foreign charitable corporations operating in a State.

Finally, an extensive Appendix contains seven case studies, largely drawn from news reports. In these cases I question whether the State – usually the attorney general, but also occasionally a court or legislature – acted inappropriately, or failed to act where perhaps called for. These cases break down into two general categories that seem to attract (or repel) State interest: investments and change in purpose. A third major category of attorney general interest, fund raising, is reflected in only one case. Cutting across all of these categories is a geographic concern to preserve assets in State. To summarize the cases in the Appendix –

Management of Investment Assets

1. Hershey Trust. The Pennsylvania attorney general exerted pressure, compounded by preliminary judicial victories, to prevent the Milton Hershey School Trust from diversifying an investment worth over $5 billion, thereby preserving control of a publicly traded company located in Hershey, Pennsylvania. Although the trust abandoned its plans, the governor signed a bill that would require the trust to obtain court approval, with attorney general and community input, before reconsidering a sale.

2. Boston Red Sox. The Massachusetts attorney general inserted himself into negotiations for the sale of a baseball club by a private trust with a charitable remainderman, claiming authority to ensure a fair market value price for a future charitable asset. The sale resulted in $30 million more for charity and an expansion of the charity's board. While the case did not go to court, there was the threat that prosecution would have held up the deal.

3. Foundation for New Era Philanthropy. No attorney general (so far as is known to the public) asserted breach of the fiduciary duty of care by charities that succumbed to

[14] In addition, federal tax law provide a uniform, minimum level of regulation.

[15] True to charity's trust-law origins, to some degree we are really speaking of property law, not corporate law.

a Ponzi scheme run by another charity which claimed to be able to double investments with matching grants from anonymous donors. New Era had not made proper filings with the State of Pennsylvania and the IRS, and the anonymous donors did not exist. The bankruptcy trustee succeeded in recovering hundreds of millions for the bilked charities from, among other sources, the early successful charities.

Change of Purpose

4. Terra Foundation and Museum. The Illinois attorney general intervened in a board dispute over whether to consider moving a failing museum from Chicago to Washington, D.C. (and possibly merging it with the Corcoran), by joining the minority directors (Chicago businessmen) in their suit asserting breach of fiduciary duty against other directors. A court accepted a subsequent settlement, pursuant to which the foundation adopted amendments to the articles of incorporation adding more local members (and forcing off the incumbents) and pledging to keep the assets in Chicago for 50 years (possibly to merge with the Art Institute of Chicago).

5. Health Midwest. In the Fall of 2002, for-profit bidder HCA, Inc. submitted a winning bid of $1.125 billion to acquire Health Midwest, the largest health system in the Kansas City area – and one that straddles two states. Then the fight began over control of an expected $700-800 million that will create one or more "conversion foundations." Health Midwest brought suit to clarify the jurisdiction of the attorneys general of Missouri and Kansas, both of whom responded by suing to remove the Health Midwest board for abandoning their charitable purpose. As the new year began, Health Midwest proposed two conversion foundation, one for each state, but the attorneys general contest the authority of the Health Midwest board to structure the foundation boards and determine how the funds will be used.

6. AHERF. The Pennsylvania attorney general obtained a $94 million settlement (funded largely by D&O insurance) of civil claims due to breaches of fiduciary duty by executives of the Allegheny Health, Education, and Research Foundation, the largest health care bankruptcy in the country – while criminally prosecuting the chief executive officer, the chief financial officer, and the general counsel for hundreds of charges of "misapplication of entrusted funds" for spending endowment and restricted gifts on operations. A court dismissed the charges against the CFO and general counsel, and accepted a guilty plea for a single count of misapplication from the CEO, who is expected to serve several months.

7. Empire Blue Cross. The attorney general of New York is challenging the standing of plaintiffs (including the Consumers Union) to contest the conversion of the $1-$2 billion health insurer. As directed by the legislation authorizing the conversion, 95 percent of the proceeds would go to the State to fund pay increases for health care workers.

FUND RAISING

8. American Red Cross. Purporting to enforce donor intent, the New York attorney general obtained an agreement from the American Red Cross that all funds raised by its Liberty Fund – about $1 billion – would be spent for the benefit of the victims of the September 11 attacks.

The manifestation of that particularly State-level problem, parochialism, follows a predictable path. As a threshold matter, parochialism is built into our conception of private philanthropy. Donor wishes must be honored, and donors often think locally. The attorney general then becomes tempted to extrapolate the local nature of a charity's founding and current operations to all of its assets, explicitly restricted or not, with the result of seeking to confine the charity to its "community." Now we mix in paternalism. While attorneys general appropriately concentrate on remedying fiduciary self-dealing rather than second-guessing a board's business judgment, it is not always easy to separate the dual obligations of loyalty and care. An attorney general might convince himself or herself (and the public) that a charity board that acts contrary to the wishes of "the community" is breaching the duty of loyalty. Moreover, as any public-choice scholar would hypothesize, the appealing case is one where the charity occupies a unique position, and is politically isolated from its natural allies, both charitable and for-profit – how many enterprises identify with and feel threatened by the outcomes in the cases described in the Appendix? Finally, attorneys general may become emboldened by short-term success. After all, it is the rare private party who has legal standing to complain about attorney general overreaching, and the charity usually (if not almost always) prefers a quiet settlement to a court contest.

Those seeking to maximize social value from the deployment of charitable resources face two choices of legal regime, one that risks being too constraining and the other that risks being too loose. On the one hand, insistence on honoring the wishes of donors can act as a brake on the responsible administration of charities those facing changed circumstances. Nonprofit boards dealing with economic challenges often must make decisions that upset and mobilize opposition from long-standing constituencies. Where disinterested parties might agree that society would be better off by granting a new charitable scheme framed by the board, the safest course for the regulator is often resistence: "Experience indicates that it is the rare attorney general who is willing to risk defeat in a suit based on amorphous public policy considerations rather than on clear precedent."[16] Similarly, "judges sometimes indicate their reluctance to deal too harshly with the donors of charitable funds for fear of discouraging future benefactors," making "it questionable whether equity courts can be relied upon to recognize and promulgate rules for the conduct of charitable fiduciaries on the basis of a new concept placing public interest ahead of

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[16] Marion R. Fremont-Smith, *Duties and Powers of Charitable Fiduciaries: The Law of Trusts and the Correction of Abuses*, 14 UCLA L. REV. 1041, 1054 (1966) (footnotes omitted) (discussing the *cy pres* doctrine, particularly as it applies to racially discriminatory provisions in charitable trusts).

the motives of donors."[17] On the other hand, some fear that abandoning donor intent as the lodestar opens the door to unfettered discretion by charity managers, the attorneys general, the courts, or some combination of them. (The complex subject of donor intent and the *cy pres* reform doctrine are generally beyond the scope of this paper.)

Inevitably, though, if the proper legal bounds of appropriate enforcement do not become clearer, the role of charities in society could suffer. While our major charities do not face direct seizure of assets – as occurred in England when Henry VIII dissolved the monasteries – strict regulation can accomplish much the same thing.[18] As I once wrote about the Internal Revenue Service in a charity administration matter:

> [F]ew charities, small or large, can afford such a high-stakes gamble by challenging the IRS over their very claims to exemption: Until the case is resolved in court, donations could dry up, tax-exempt bond covenants could be breached, and local governments might challenge property-tax exemption.[19]

Charities facing State attorney general inquiry similarly worry about loss of donations, loss of contracts and patronage, and retention of staff and volunteers. Nevertheless, should charities too quickly accede to attorney general demands over matters of discretionary governance, the sector as a whole can see a degradation in charities' willingness to take risks, and in volunteer directors' willingness to serve. As we have seen on the business corporation side, States that develop a reputation for such action could even find that donors might form their charities elsewhere.

I. LEGAL FRAMEWORK FOR ATTORNEY GENERAL AND COURT OVERSIGHT[20]

The typical State legal regime and political pressures produce the twin weaknesses of the charitable sector: the lack of energy and initiative on the part of many nonprofit managers, and the lack of resources and zeal in enforcing the public's interest on the part of many charity regulators. Occasionally, though, we find the reverse problem: a board trying to do the right thing, but thwarted by an overreaching regulator. Sometimes, too, cooperation between a board and an attorney general can produce unwarranted results. Or the charity and the attorney general

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[17] *Id.*

[18] *See* Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997).

[19] Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999) (Bishop Estate Symposium Issue).

[20] *See generally* Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD L. REV. 1400 (1998); Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (Walter W. Powell & Richard Steinberg, eds., 2d ed., forthcoming).

might reach the right result, but the court misapplies the law. Finally, the legislature can enact "bad" law, raising issues of the appropriateness of attorney general and court enforcement action. Even assuming the law is clear and proper, we thus variously find cases where the attorney general and courts –

A. Know the law, and enforce that law.

B. Know the law, and do not enforce the law (either by doing nothing or by misapplying the law) –

1. For neutral reasons appropriate to prosecutorial discretion (e.g., budget allocation, or hazards of litigation on the merits).

2. For paternalistic reasons –

a. Leniency, to avoid discouraging board service.

b. Meddling (i.e., acting as a "super director").

3. For parochial or other "political" reasons.

C. Do not know the law, and do nothing (i.e., do not understand their responsibilities).

The law, however, is often unclear. Moreover, generalizations mask a great deal of variety, in both States legal regimes for charity enforcement and their level of enforcement. This section briefly reviews the source of the regulators' authority and describes in general what they have been empowered to do.

A. <u>What Is the Source of State Authority Over Charitable Activity?</u>

1. <u>The Charitable Trust</u>

To understand the current state of charity regulation, one has to appreciate the effects of history. The American common law powers of the attorney general and the equity courts trace back to English property rules respecting trusts, and survived the American Revolution.[21] A charitable trust, like a private trust, is valid only because someone has the power of enforcement. The power "implies the duty to oversee the activities of the fiduciary who is charged with management of the trust funds, as well as the right to bring to the attention of the courts any

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[21] But not without controversy. *See, e.g.*, MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT (1965); Brody, *Charitable Endowments, supra*.

abuses which may appear to need correction."[22] In the charity context, however, this is not as easy to accomplish as it sounds because a charitable trust must not have ascertainable beneficiaries who can sue to enforce their rights;[23] after all, "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public."[24]

It is this absence of parties with a property interest that explains why the law grants standing to the attorney general to enforce the trust's terms (including its charitable purpose) and the fiduciaries' duties. However, such a structure puts pressure on the "inclination and budget of a public official to vindicate [the beneficiaries'] rights.'"[25] One might think that the law should automatically privilege the trust settlor or donors with oversight powers. However, American law does not work this way unless the donor retained appropriate rights in the deed of gift. Otherwise, a donor displeased with the use of the funds cannot reclaim them.[26]

Finally, unless the trust instrument so provides, a trustee has no legal authority to amend the terms of the trust. This leads to problems where the purposes established by the settlor have become impossible to carry out (or other restriction imposed by the settlor becomes difficult to adhere to), and the trust instrument provides no discretion to the trustee to adapt the purpose to the changed circumstances. Once again, property law comes to the rescue. The most famous rule of charitable trust law – the *cy pres* doctrine – gives the courts power to reform charitable trusts whose purposes have become impossible or impracticable to carry out. The strict version of this doctrine requires the reformed trust to have a purpose "as near as possible" (*cy pres comme possible*) to that originally established by the trust settlor.[27] Compare the related doctrine

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[22] MARION R. FREMONT-SMITH (Feb. 15, 2002 draft, at Chap. 6, p. 1).

[23] SCOTT & FRATCHER ON TRUSTS, at § 364 (Indefinite Beneficiaries).

[24] George G. Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633, 633 (1954). *See generally* Mary Grace Blasko, Curt S. Crossley & David Lloyd, *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993).

[25] Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991) (quoting the attorney general's brief).

[26] If the charity fails to adhere to a restriction on the donation and the donor had retained a reversion or had failed to express a general charitable intent, the property will revert (even if the breach occurs beyond the dead-hand period). *See, e.g.*, Evans v. Abney, 396 U.S. 435 (1970) (property donated for a municipal park for whites only reverts to the family; the will did not express a general charitable intent, and so *cy pres* modification not available). For a discussion of the range of other mechanisms of donor oversight, see Evelyn Brody, *Enforcement: Legal Standing and Private Remedies, in* ACCOUNTABILITY: A CHALLENGE FOR CHARITIES AND FUNDRAISERS 7 (Putnam Barber, ed., 2001).

[27] "In applying cy pres we must be mindful that courts have no more power to make wills for the dead than contracts for the living. Therefore, basic to that determination is the intention of the testator." In the Matter of the Estate of Edward B. Goehringer, 329 N.Y.S.2d 516, 520 (Surr. Ct. 1972). This philosophical judge also observed: "But all institutions must ultimately fail, if not soon after vesting then decades later. . . . Those which are in

of deviation, which permits a court to approve an alteration to the means chosen by the donor, even if the purpose has not become impossible to carry out.[28] Unfortunately, though, we do not find a bright line between administrative provisions amenable to the more lenient doctrine of deviation and fundamental provisions requiring application of the doctrine of *cy pres*.[29]

Some charities that were created as trusts become corporations, if permitted by the instrument. Some courts want to retain trust-type oversight authority (that is, annual accounts) over the now-incorporated charity. Most courts, however, have found that where "the transfer of the property devised . . . to a corporation was anticipated, all technical trusts ceased."[30] Those decisions that have found continuing court authority cite the terms of the trust instrument calling for a continuing court role.[31]

Consider the case of Mayflower descendant Caroline Weld Fuller. Partially paralyzed in a riding accident at age 20, she determined to make up for her isolated and lonely life by devoting her fortune – estimated at half a million dollars at the time of her death in 1933 at age 70 – to provide a "'haven' and home of refinement for 'helpless, or partially helpless, incurable, indigent, white, American women of the Protestant faith,' provisions later struck down in court."[32] After its retirement home found the residents dwindling to five women, in the 1980's the Fuller Trust obtained court relief to build a full-scale assisted-living facility. Through an unfortunate combination of bad consultants and cost overruns, however, by 1992 the value of the charitable assets had plummeted from $4.5 million to $250,000, and the attorney general of Massachusetts went to court to appoint a receiver.[33] But then the receiver reported to the probate court that the assets had increased by $500,000, apparently as a result of a monetary settlement

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charitable trust and not consumed will invariably be subjected to cy pres." *Id.* at 521.

[28] *See, e.g.*, Daloia v. Franciscan Health System, 679 N.E.2d 1084 (Ohio 1997). In the leading case of Trustees of Dartmouth College v. Quincy, 258 N.E.2d 745 (Mass. 1970), the court applied deviation to expand the geographic pool of admitted students, despite a "gift over" provision in favor of Dartmouth College in the event of the failure of a gift for a school admitting only Quincy-born girls. The non-Quincy natives would pay a higher tuition designed to reflect the full cost of their education, so as not to deplete the trust. *Id.* at 750-51.

[29] As to equitable deviation, compare the *Restatement (Second) of Trusts*, § 167 ("Change of Circumstances") with the draft *Restatement (Third) of Trusts* (approved by the ALI members in 2001), § 66 ("Power of Court to Modify: Unanticipated Circumstances") and the Uniform Trust Code § 411 As to *cy pres*, compare the *Second Restatement* §§ 399 and 400 with the draft *Third Restatement* § 67.

[30] Brigham v. Peter Bent Brigham Hospital, 124 F. 513 (1st Cir. 1904) (the seminal case).

[31] *See, e.g.*, Nixon v. Lichtenstein, 959 S.W.2d 854 (Mo. App. 1997).

[32] Kimberly W. Moy, *Full(er) Fillment; Elderly Complex Finally Getting Off the Ground*, PATRIOT LEDGER [Quincy, Mass.], Sept. 23, 1999, news section, at 15.

[33] In the Matter of the Trust under the Will of Caroline Weld Fuller, 636 N.E.2d 1333 (Mass. 1994).

reached by the attorney general with the trustees, who also agreed to resign.[34]

The probate court balked at accepting the settlement, and an appeal was taken to the supreme court as to whether the courts are bound by a settlement entered into by the attorney general. The Supreme Court held that "the corporations must be considered in the context of this case as the alter ego of the trustees," and that "only the Attorney General – and not the Probate and Family Court – is bound by the Attorney General's settlement."[35] Accordingly, the lower court could independently compel an accounting and determine the reasonableness and fairness of the settlement, although it must take into consideration the costs and hazards to the charity of additional litigation. [I have been unable to discover the ultimate settlement amount.] Today, a 15-member board of directors decides on the budget, design and other matters,[36] and residents began moving into the new facility at the end of 2000.[37]

Marion Fremont-Smith comments: "The case is admittedly an unusual one in that, although the trustees, with court permission, many years earlier had transferred the trust's assets to a [corporate] charitable activity, the trustees had never sought court permission to terminate the trust. Nonetheless, it placed a new limit on the enforcement powers of the attorney general in the state. It remains to be seen whether it will affect the ability of the attorney general to reach agreement in other cases."[38]

2. The Nonprofit (Charitable) Corporation

a. Attorney general and court authority in general

Most American charities take the legal form of a nonprofit corporation, as opposed to a charitable trust. What does this mean for the powers of the attorneys general and courts?

A corporation, even a charitable corporation, owns its assets outright: unlike with a trust, legal title and beneficial title reside in the same person.[39] Thus if we view the charity itself as the

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[34] As required by the Will, the parties had gone to court seek appointment of successor trustees.

[35] *Id.* at 1342. The court distinguished this case from Attorney General v. Olson, 191 N.E.2d 132 (Mass. 1963), which did not involve court-appointed directors.

[36] Moy, *supra*.

[37] Kendra Johnson, *Residents Moving Into Townhouses*, PATRIOT LEDGER [Quincy, Mass.], Dec. 9, 2000, news section, at 20.

[38] Marion Fremont-Smith, "Enforceability and Sanctions," paper presented at N.Y.U. School of Law, National Center on Philanthropy and Law, Conference on Governance of Nonprofit Organizations (1997), at 15.

[39] *See* St. Joseph's Hospital v. Bennett, 22 N.E.2d 305, 307 (N.Y. 1939) ("The corporation uses the property, in accordance with the law of its creation, for its own purposes; and the dictation of the manner of its use,

beneficiary, the corporation does not need the help of the attorney general to enforce the proper use of the charitable assets. Such an approach, however, would leave boards of corporate charities unsupervised. If instead we consider the corporate charity as the means by which the public is benefited, a supervisory role for the attorney general and courts continues.

Consider the case: where the corporation's assets were donated and the donor specifically restricts the gift. Courts agree that the corporate charity must honor the restriction, even where it is not technically a trustee.[40] As with a charitable trust, though, only the attorney general may bring suit to enforce the restriction,[41] and the final word rests with the court. As described in a recent decision in the never-ending Barnes Foundation litigation:

> The burden of proof is always on the party seeking the deviation because in the case of "an express trust, favorable presumptions arise, and the burden of proof is on the

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within the law by the donor, does not affect its ownership or make it a trustee. A person . . cannot be a trustee for himself.").

[40] *See, e.g., id* at 308: "No authority has been brought to our attention that a gift to a charitable corporation with the express direction that it be applied to a specific corporate purpose in a specific manner may be accepted by the corporation, and then used for a different corporate purpose in a different manner. No trust arises, it is true, in a technical sense, . . . for the trustee and beneficiary are one. . . . [The charitable corporation] may not, however, receive a gift made for one purpose and use it for another, unless the court applying the cy pres doctrine so commands."

Compare AMERICAN LAW INSTITUTE, RESTATEMENT OF THE LAW OF TRUSTS, TENTATIVE DRAFT NO. 3 (March 5, 2001) (approved by the membership, May 2001):

> An outright devise[] or donation to a nonpropietary hospital or university or other charitable institution, expressly or impliedly for its general charitable purposes, is charitable but does not create a trust as that term is used in this Restatement. A disposition to such an institution for a specific purpose, however, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement.

Section 28, General Comment *a*, at page 42.

[41] *See* St. Joseph's Hospital v. Bennett, 22 N.E.2d 305 (1939). *Cf.* Carl J. Herzog Found., Inc. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997) (an objecting donor has no standing under the Uniform Management of Institutional Funds Act). English charity law still embraces a founder's right of "visitation" over gifts made to charitable corporations. American law generally rejects this doctrine. MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 206 (1965). That the English right is hereditary makes it less appealing here. *See* Wier v. Howard Hughes Medical Institute, 407 A.2d 1051 (Del. 1979), *quoting* GEORGE G. BOGERT AND GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES (2d ed. 1978), § 416: "In a country such as the United States, where primogeniture is obsolete, the vesting of a power of visitation in the heirs of a donor is not desirable. . . . [I]n many cases they would be either wholly uninterested in exercising the right of visitation, or would be openly hostile to the institution which deprived them of a part or all of the fortune of their relatives." *But cf.* N.Y. Estates, Powers & Tr. L. § 8-1.3(d) & (e) (allowing anyone "founding, endowing and maintaining" a public library, museum or educational institution in trust to exercise complete control over administration of the trust during his or her lifetime, and, if granted, to pass on these rights to the surviving spouse, without any obligation to account).

> party disputing its validity or terms." [citations] Appellant [Barnes Foundation] argues that it should have prevailed below because the evidence offered was "uncontradicted," and the proposed charges were "approved" by the Attorney General. Such an argument has no foundation in law. The mere fact that evidence is uncontradicted does not automatically imbue that evidence with sufficient weight to sustain one's burden of proof. [citations] Additionally, although the law requires the participation of the Attorney General's Office in any proceeding to modify the terms of a charitable trust [citation], appellant cites no support for the proposition that the Court is bound by the position espoused by the Office of the Attorney General, and a reviewing judge must exercise his or her independent power of review. See 20 Pa.C.S.A. § 3323.

In Re Barnes Foundation, 683 A.2d 894, 899 (Pa. Super. 1996).[42]

More generally, unless the State constitution provides otherwise,[43] the legislature can alter, remove or confirm distinctions between charitable trusts and corporations.[44] Indeed, statutory authority is needed to form a corporation in the first place,[45] and some nonprofit

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[42] Technically, it appears that while the Barnes Foundation is legally a corporation, the restrictions imposed on the donated collection appear in a trust instrument:

> A corporation was duly organized under the laws of Pennsylvania to receive and administer the estate, works and property to be conveyed to it by Dr. Barnes. This corporation became known as The Barnes Foundation. On December 6, 1922, Dr. Barnes, by deed of trust, transferred to the Barnes Foundation (hereinafter to be referred to as the Foundation) his art collection, house, property and the grounds known as the Lapsley Arboretum in Montgomery County together with certain sums of money represented in 900 shares of the common capital stock of A. C. Barnes Company, a corporation of Pennsylvania. By medium of an indenture, which eventually embraced 39 paragraphs, a code of procedure was formulated for the maintenance and operation of the Barnes trust.

Commonwealth v. Barnes Foundation, 159 A.2d 500, 502 (Pa. 1960).

[43] *See, e.g.*, Opinion of the Attorney General of Connecticut, 1987 Conn. AG LEXIS 10 (Jan. 29, 1987) ("The Connecticut Supreme Court has consistently held that the administration of a charitable trust is solely a judicial function in which the legislature may not interfere because of the doctrine of distribution of powers as set forth in Article II of the Constitution of the State of Connecticut . . . ").

[44] *See* NAAG, STATE ATTORNEYS GENERAL, *supra* note __, at 31 (footnote omitted):

> Today, Attorneys General derive their power from constitutional and statutory mandates, as well as the common law. No clear lines separate the three sources of authority, for each often supplements the others. In fact, many constitutional provisions and state statutes are merely declaratory of common law.

[45] In some States the secretary of state or the courts once played a gate-keeper role, by having discretionary authority to approval certificates of incorporation. Today, however, incorporation is viewed as a privilege, not a right. *See* NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR (2001).

In 1819, the Supreme Court decided, under the constitutional provision prohibiting impairment of contracts, corporation laws grant broad authority to the attorney general.[46] At the extreme, some legislatures have declared that a charitable nonprofit corporation is deemed to be a trust and its directors to be trustees.[47] In some other States it is the courts that treat the charitable class served by the corporate charity as the beneficiaries of a trust.[48]

Moreover, some courts have held that *unrestricted* gifts donated to a corporation that

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that a corporate charter is a contract that cannot be unilaterally amended by a State legislature. Trustees of Dartmouth College v. Woodward, 4 Wheat. 518 (1819). As described nearly a century later by the high court of New York:

> As soon as it was realized that the principle of the decision applied to the charters of all corporations and placed them forever beyond the power of legislation, the situation caused great anxiety throughout the nation. It was felt that danger threatened the public welfare when a thing created by law was placed beyond control of law.

Lord v. Equitable Life Assurance Society, 87 N.E. 443 (N.Y. 1909). As a result, State corporation statutes began to include reserved powers to enact legislation that would have the effect of amending corporate charters; moreover, the legislature in New York, for example, rejected a proposed exception for "religious, literary and charitable societies." *Id.* The New York Court of Appeals ruled that "the legislature under its reserved power may amend any charter in any respect that is not fundamental when the object of the corporation and property acquired by it are considered . . . [;] it can regulate investments, methods of administration and details of procedure in the interest of the public and of all concerned." *Id.*

[46] Most notably, see the American Bar Association's *Revised Model Nonprofit Corporation Act* (1988), which has been adopted in [14] jurisdictions. The introduction by the Reporter, Professor Michael Hone, summarizes the wide powers and rights of the attorney general under this model act:

> The Revised Act seeks to fill this void by statutorily clarifying existing common law and statutory authority of the attorney general . . . by authorizing the attorney general to monitor and exercise oversight oversight powers over public benefit corporations. The attorney general has authority to bring, must receive notice of , and may join in, derivative actions on behalf of public benefit corporations. The attorney general may approve conflict of interest transactions and must be made a party to proceedings in which a court is asked to approve conflict of interest transactions. The attorney general may sue former or incumbent directors and officers for ultra vires acts, and may bring an action for breach of their duty of care or loyalty. The attorney general may commence proceedings to hold an annual, regular or special meeting of members.
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> The attorney general must be given notice of important corporate actions.. . . : (1) indemnifying directors; (2) merging; (3) selling all or substantially all corporate assets; (4) delivering articles of dissolution to the secretary of state; and (5) transferring or conveying assets as part of the dissolution process.

Id. at xxvii (footnotes omitted).

[47] The American Bar Association's *Revised Model Nonprofit Corporation Act* explicitly rejected this approach.

[48] *See, e.g.*, Holt v. College of Osteopathic Physicians and Surgeons, 61 Cal.2d 750 (1964) (ruling that a minority director could sue to enforce a charitable trust). *See generally Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545, 547 (1967). A trust approach makes monetary judgments for breach meaningless – the corporation would have to sue itself; however, equitable remedies would still be available. *Id.*

amends its charitable purposes are impliedly restricted to the original purpose, and so may be used only for those pre-amendment purpose.[49] The classic statement of this position appears in the Massachusetts attorney general's brief in *Attorney General v. Hahnemann Hospital*: "Those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists."[50]

But hinging oversight authority on carrying out the wishes of donors to charitable corporations risks letting the tail wag the dog. As a policy matter, corporate directors have a legal power to amend the articles of incorporation, in contrast to the inability of a trustee to amend the terms of the trust (in the absence of a grant by the settlor).[51] As a practical matter, overall, gifts represent less than 20 percent of the nonprofit sector's revenues (less than 10 percent, if we exclude churches). Yet, if applied, a donor's wishes can have legal significance at four different stages: formation of the charity (as a trust or corporation); during ordinary operation of the charity; regarding decisions about the gift itself, most important when changed circumstances require a departure from a restriction; and regarding the broader purposes of the institution, especially a change in charitable purpose.

Consider an attorney general suit over a breach of fiduciary duty other than violating the terms of a restricted gift – that is, where a director engages in self-dealing (thereby breaching the

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[49] *See, e.g.*, Pacific Home v. County of Los Angeles, 41 Cal.2d 844 (1953); Queen of Angels Hospital v. Younger, 66 Cal. App. 3d 359 (1977) (ruling that a charitable corporation may not "abandon" its purpose). This approach was confirmed by Section 5820 of the California Nonprofit Corporation Law: "Amendment of the articles of a corporation . . . does not, of itself, abrogate any requirement or limitation imposed upon the corporation, or any property held by it, by virtue of the trust under which such property is held by the corporation." Subsection (b) provides: "The Attorney General may, at the corporation's request, and pursuant to such regulations as the Attorney General may issue, give rulings as to whether the Attorney General will or may oppose a proposed action, or article amendment, as inconsistent with or proscribed by the requirements of a charitable trust."

[50] 494 N.E.2d 1011, 1021 n.18 (Mass. 1986). See, too, the description of New York law in the outline by attorney general office's of its obligation to:

> Assure that where the charity's new purposes do not overlap with its original purposes, the charitable assets obtained by a charity for its original corporate purpose continue to be used for that restricted purpose, pursuant to the doctrine of cy pres (the subject of the 1985 Court of Appeals decision in Alco Gravure v. Knapp Foundation, 64 N.Y.2d 458 (1985)).

The Regulatory Role of the Attorney General's Charities Bureau, by assistant attorneys general Nathan M. Courtney and James G. Siegal, Charities Bureau, New York State Attorney General (no date), *available at* <http://www.oag.state.ny.us/charities/charities.html> [hereinafter "NYAG Outline"].

[51] *See, e.g.*, Morales v. Sevananda, 293 S.E.2d 387 (Ga. App. 1982) (citing Georgia Code Ann. § 22-2801 – "A [nonprofit] corporation may amend its articles of incorporation, from time to time, in any and as many respects as may be desired, so long as the amendment contains only such provisions as might be lawfully contained in original articles of incorporation at the time of making such amendment" – and holding that an amendment restructuring the entire board may effect the removal of the incumbents from their directorships).

duty of loyalty) or deals inappropriately with non-donated corporate assets (thereby breaching the duty of care). In the absence of a legislative directive, courts vary over whether the strict trust standards or the more lenient corporate standards apply to fiduciaries of corporate charities, although the modern trend is toward corporate standards.[52] Where the standards differ, the founder of a charitable corporation is choosing a different legal regime.[53]

But in the absence of a statute, what gives the attorney general and courts authority over breaches of nonprofit corporate directors' duties? Most States make clear the jurisdiction of attorneys general and courts over "charitable trusts," and some commentators find the same regulatory and enforcement power exists over all charities, regardless of organizational form.[54] Other commentators find – and criticize – a recent trend in attempts by attorneys general to enlarge their jurisdiction over nonprofit corporations.[55] They cite to "increasing use of charitable trust laws to effect remedies that are unavailable under nonprofit law", resistance to applying the

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[52] *See, e.g.* Stern v. Lucy Webb Hayes Nat'l Training School, 381 F. Supp. 1003, 1013 (D.D.C. 1974):

> The applicable law is unsettled. The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. . . . [H]owever, the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their "pure" corporate counterparts. . . .
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> . . . . [C]orporate directors have many areas of responsibility, while the traditional trustee is often charged only with the management of the trust funds and can therefore be expected to devote more time and expertise to that task.

The 1978 California Nonprofit Corporation Act apply many concepts of corporate law to the regulation and administration of charitable corporations, and, notably, adopt the corporate standard for breaches of fiduciary duty. The ABA Revised Model Nonprofit Corporation Act was based on the California law.

[53] *See, e.g.*, Oberly v. Kirby, 592 A.2d 445, 466-67 (Del. 1991): "[T]he creator of a charitable enterprise recognizes that different legal rules govern the operation of charitable trusts and charitable corporations and selects a form with those rules in mind. . . . One of the cardinal principles of trust law is that the intention of the settlor is paramount. We believe that the decision of Fred M. Kirby to endow a corporation rather than a trust in 1931 is equally entitled to deference."

[54] SCOTT ON TRUSTS; BOGERT, *supra* note__. *See generally* FREMONT-SMITH, chap. 6, at 2 ("Both the enforcement power, exercised by the attorney general, and the regulatory power, exercised by the courts[,] extend to all assets dedicated to charitable purposes, regardless of the legal form – corporation, trust, or voluntary association – in which they are held"). *See also* NAAG, STATES ATTORNEYS GENERAL, *supra* note __, at 15 (footnote omitted) ("a brief statutory reference to the Attorney General's authority may, if liberally construed, enable the Attorney General to exercise some control over the management and disposition of charitable funds.").

[55] The National Association of Attorneys General anticipated this issue in a 1990 study on attorneys general's powers and responsibilities. The section on charity regulation describes the emerging issue of nonprofit hospital and HMO conversions, which NAAG accurately predicted would likely continue to be important. (See part __, below.) The study notes the distinction between the law of charitable trusts and corporate law, and comments: "The propriety of hospital directors' actions may well depend on which set of principles is applied. If . . . pure corporate law applies, . . . [i]t would represent an erosion of the fundamental authority of the Attorney General to represent the public's interest in the preservation and proper application of charitable funds." NAAG, [cite].

business judgment rule in the nonprofit context, and even asserting "waste" of corporate assets.[56]

The recent experience in Virginia illustrates the confusion in this area. A few years ago, the Virginia legislature adopted a targeted statute granting the attorney general and courts detailed powers over for health care conversions. (See generally Part II.C, below.) This prompted the State supreme court – in a 4-to-3 decision – to declare, based on the wording of the statute, that only the State corporations commission (and not its attorney general and circuit courts) has jurisdiction over nonprofit corporations (as opposed to charitable trusts).[57] The majority opinion reasoned that the legislature must have meant at the same time to constrict attorney general authority involving other types of nonprofit corporations. The dissenting opinion highlighted the attorney general's common law jurisdiction over charitable assets, whether held by trusts or nonprofit corporations. Within months, the Virginia legislature overturned this decision.[58]

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[56] Michael W. Peregrine and James R. Schwartz, *Key Nonprofit Corporate Law Developments in 2001*, 11 HEALTH LAW REPORTER 272 (February 14, 2002). The authors discuss three 2001 settlements: in Florida (with Intracoastal Health Systems), in Illinois (Terra Museum), and in Minnesota (Allina Health Systems).

Note the definition of "waste" in the American Law Institute's *Principles of Corporate Governance*:

> A transaction constitutes a "waste of corporate assets" if it involves an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or, if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation had paid.

ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.42 (1992).

[57] Commonwealth of Virginia, ex rel. Beales, Attorney General v. JOCO Foundation, 558 S.E.2d 280 (Va. January 11, 2002); *see also* Rex Bowman, *Judge's Power to Remove Foundation Chief at Issue*, RICHMOND TIMES DISPATCH, Aug. 15, 2000; Jay Conley, *Philanthropist's Case Near End*, ROANOKE TIMES & WORLD NEWS, Jan. 25, 2002. *Cf.* Van de Kamp v. Gumbiner, 221 Cal. App. 3d 1260 (1990) (no attorney general jurisdiction over health care plan, even if settlement with plan predated statute).

[58] The full text follows:

> Section 2.2-507.1 Authority of Attorney General Regarding Charitable Assets. The assets of a charitable corporation incorporated in or doing any business in Virginia shall be deemed to be held in trust for the public *for such purposes as are established by the donor's intent as expressed in governing documents or by other applicable law*. The attorney general shall have the same authority to act on behalf of the public with respect to such assets as he has with respect to assets held by unincorporated charitable trusts and other charitable entities, including the authority to seek such judicial relief as may be necessary to protect the pubic interest in such assets.
>
> Section 17.1-513.01 Jurisdiction of Circuit Courts with Respect to Charitable Assets. The circuit courts shall have the same subject matter jurisdiction over matters pertaining to assets of charitable corporations, incorporated in or doing any business in Virginia, as the circuit courts have with respect to assets held by unincorporated charitable trusts and other charitable entities, including the power to require accountings, appoint receivers, award damages and enter injunctive relief against such charitable corporations, their

b. The special case of change of charitable purpose

The charity fiduciaries' twin duties of loyalty and care combine to require charity trustees and directors to keep the funds productive for the benefit of a charitable class.[59]

Some commentators find a third duty of charity fiduciaries: the "duty of obedience" to the organization's original mission.[60] Such a duty would have particular application to nonprofit corporations, because of the power typically enjoyed by the directors to amend the articles of incorporation, including the purposes clause. Blind obedience to mission, though, can impede the rational use of nonprofit corporate assets. Consider the case of a college suffering declining applications, but whose alumni and students do not want it to close.[61] Henry Hansmann describes how regulatory structures – and the combination of history and culture that he calls "institutional inertia" – already lock assets into the nonprofit sector.[62] Mandating the application of the *cy pres* doctrine to a re-evaluation of corporate mission furthers the expectation that charity managers must honor the original purposes of the charity through thick and thin.

The duty of obedience has been recognized (at least at the trial court level) in New York.[63] Upholding the attorney general's objection to the sale of assets by one nonprofit hospital to another, the court invoked such a duty of obedience,[64] commenting: "Embarkation upon a

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> officers, directors, agents, employees and others may be necessary to protect the public interest in such assets.

LEXIS 2002 Bill Text VA S.B. 676 (enacted April 8, 2002) (emphasis added). The language in italics did not appear in the bill as introduced on January 18, 2002, but was apparently added out of a concern that the attorney general's discretion would otherwise be too broad.

[59] An attorney general can bring a court action to force *cy pres*. In England, the trustees have an affirmative statutory duty to make trust property productive. I thank Marion Fremont-Smith for these points.

[60] DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS (1988).

[61] Harriet M. King, *The Voluntary Closing of a Private College: A Decision for the Board of Trustees?*, 32 S.C. L. REV. 547 (1981); Hazel G. Beh, *Downsizing Higher Education and Derailing Student Educational Objectives: When Should Student Claims for Program Closures Succeed*?, 33 UNIV. GEO. L. REV. 155 (1998).

[62] HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 295-96 (1996).

[63] Matter of the Manhattan Eye, Ear & Throat Hospital v. Spitzer, 715 N.Y.S.2d 575 (1999).

[64] *Id.* at 593:

> It is axiomatic that the board of directors is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the "duty of obedience." It requires the director of a not-for-profit corporation to "be faithful to the purposes and goals of the organization," since "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations

course of conduct which turns it away from the charity's central and well-understood mission should be a carefully chosen option of last resort. Otherwise, a Board facing difficult financial straits might find sale of its assets, and 'reprioritization' of its mission to be an attractive option, rather than taking all reasonable efforts to preserve the mission which has been the object of its stewardship."[65]

By contrast, the Supreme Court of Massachusetts recognized the right of the board of a nonprofit corporate hospital to amend its articles of incorporation to allow it to sell its assets. In accepting the view, as described above, that pre-amendment unrestricted gifts may not be used for the new purpose, the Massachusetts supreme court rejected the attorney general's argument that the board of a nonprofit corporation could not amend its articles to adopt new purposes for future activities and gifts.[66]

Even where State law permits a charity to sell its assets and alter its purpose (the "front-end *cy pres* issue"), the next question is whether resulting funds must be used for the original purpose (the back-end *cy pres* issue")[67] – and who decides. For example, because of the language of the statute providing for a more lenient standard, New York courts apply a "quasi-*cy pres*" standard to distributions by liquidating corporate charities.[68] The New York Court of Appeals found that under the Not-for-Profit Corporation Law "it is the board of directors which adopts the plan of distribution" and that the legislature "intended also that not-for-profit corporations have 'a strong board of directors'. . . ."[69] Practitioners in States will, prior to the *cy pre* filing, negotiate proposed changes with the attorney general's office, which has a similar

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are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization." (Bjorklund, op. cit., § 11-4 [a], at 414.) Analysis of the duties of charitable directors more commonly arises in an action brought by the AG alleging breach of the duties owed to the corporation under N-PCL 112 and 720, and does not appear to have been discussed in any reported decision under section 511. But the duty of obedience, perforce, must inform the question of whether a proposed transaction to sell all or substantially all of a charity's assets promotes the purposes of the charitable corporation when analyzed under section 511.

[65] *Id.* at 595.

[66] Attorney General v. Hahnemann Hospital, 494 N.E.2d 1011 (Mass. 1986).

[67] These phrases are Richard Allen's, former top charity official in Massachusetts.

[68] In the Matter of Multiple Sclerosis Service Organization, 496 N.E.2d 861 (N.Y. 1986).

[69] *Id.* at 868. Some commentators urged an elevated standard of review for organic changes. *See, e.g.*, Harvey J. Goldschmid, *The Fiduciary Problems of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631 (1998); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998).

interest in arriving at a useful restructuring in order to avoid multiple trips to court.[70]

Whether a particular organic change opens the door to attorney general involvement depends on the statute. In *Nathan Littauer Hospital v. Spitzer*,[71] a hospital wanted to restructure to create a sole member that, in turn, would adhere to directives for Catholic health care.[72] Abortion rights groups protested, and the attorney general asserted the right to intervene, based on his approval powers over the disposition of nonprofit corporate assets. The court ruled that the attorney general "has failed to offer any persuasive authority in support of the proposition that a change in the composition of Littauer's membership is the functional equivalent of a sale, lease, exchange or other disposition of corporate assets." The New York Court of Appeals denied the attorney general's appeal.[73] The Attorney General's website states: "Administratively, the Attorney General continues to insist that not-for-profit corporations that affiliate through a change of membership are disposing of control over the corporation, a substantial asset itself of the corporation, as well as control over the corporation's assets."[74]

c. Transporting trust doctrine to nonprofit corporation law

In sum, due to the lack of judicial precedence – and on the theory that charitable activities should be governed by the same legal standards regardless of its organizational form – trust law doctrine often finds its way into the administration of the law of nonprofit corporations. In practice, the differences between the organizational forms often diminish, because corporate donees must still obey any restrictions in a gift, and trust settlors typically waive strict trust standards. More broadly, particularly in States with a strict interpretation of the *cy pres* doctrine, the conservative desire to hew to the wishes of donors exerts its pull on regulators and courts throughout the life of all charities, trust and corporate.

B. Impediments to Attorney General's Monitoring and Enforcement Roles

Schizophrenia sometimes better characterizes States' approach towards regulation of charities: If under the common law, the attorney general seems untethered, under recent statutes and current practice, the attorney general seems alternately omnipotent and impotent. At the same time as we read press reports of aggressive attorneys general, we might be surprised to

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[70] Telephone conversation with Marion Fremont-Smith, November 1, 2002.

[71] 734 N.Y.S.2d 671 (N.Y. App. 2001).

[72] As to the duties of a sole corporate member of a nonprofit, see Dana Brakman Reiser, *Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care Systems*, 53 RUTGERS L. REV. 979 (2001).

[73] 98 N.Y.2d 602; 771 N.E.2d 835; 744 N.Y.S.2d 762 (2002).

[74] NYAG Outline, *supra* note __, at IV.D.3.c.

learn that legislatures typically have granted them few tools to provide effective oversight and enforcement. State budgets allocate insufficient resources, and with what they have, most attorneys general concentrate their charitable firepower on fraudulent and misleading fundraising.

Peter Swords and Harriet Bograd found that, as of 1996, only thirteen states had charities sections within the attorney generals' offices, of which eleven employed more than two full-time attorneys.[75] However, a simple head-count is misleading: "These thirteen states are home to about 55% of U.S. charities, with 62% of national charitable revenues."[76]

> The "integrated" state offices generally provide: registration and reporting systems for charities and for professional fundraisers; an enforcement program that includes inquiries, investigations, negotiations, and litigation to protect charitable assets and prevent fundraising abuse; educational programs to promote more responsible board governance and/or to prevent fundraising fraud; and oversight of charitable trusts or bequests. Some but not all of these offices also oversee certain structural changes such as mergers, dissolutions, or major transfers of assets. Many of these offices have self-sustaining budgets, supported by fairly modest registration and reporting fees.[77]

Variations occur across States in both statutes and court decisions as to the situations – such as will contests involving charitable trusts, *cy pres*, or sale of all or substantially all assets , merger or liquidation – in which the attorney general must be notified, give approval, or is a necessary or proper party.[78] Only 12 States have some form of registration.[79] New York State

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[75] Peter Swords and Harriet Bograd, Nonprofit Coordinating Committee of New York, "Nonprofit Accountability: Report and Recommendations" (Mar. 31, 1997), *available at* <http://www.charitychannel.com/forums/cyb-acc/resources/accrept.html>. *See also* Harriet Bograd, THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS 8-11 (Yale Univ. Program on Non-Profit Organizations, Working Paper No. 206).(Aug.1994) (finding that in 1994, over half the States apparently had only one part-time attorney or none assigned exclusively to charity cases; perhaps 10 states assigned five or more attorneys. Connecticut had four (a case load of 625 annual reports each), Massachusetts had seven (1,498 reports each), and New York had 17 (1,588 reports each)). California's website says: "the Attorney General has a small staff and limited financial resources to carry out charitable investigations." <http://caag.state.ca.us/charities/faq.htm#8> . [Insert data from NAAG studies and Michigan audit comparing attorney staffing in several States.]

[76] Swords & Bograd, "Nonprofit Accountability: Report and Recommendations," *supra* note __.

[77] *Id.*

[78] For a summary of these statutes, see FREMONT-SMITH (2002), table __. Note that where business corporation statutes require shareholder approval of such extraordinary events as merger or dissolution, nonprofit statutes often require the approval of members. Such a mechanism offers no check on the fundamental decisions of the fiduciaries of a charity lacking members – that is, most charities.

[79] Only eight States have adopted legislation requiring both registration and reporting from both charitable trusts and charitable nonprofit corporations: California, Illinois, Massachusetts, Michigan, New Hampshire, New

has one of the most comprehensive notice and oversight schemes.[80] Significantly, "in the vast majority of states there is no monitoring of dissolutions – and thus no oversight by a state official interested in preserving the assets of a terminating charity."[81] Parochialism can be found in the legislation of some of the States with merger legislation: "In some states the merger provisions require that the surviving corporation remain under the jurisdiction of the state in which the charity was originally organized. If the statutes of two States contain this requirement, merger is effectively prohibited."[82]

Not all of the lack of enforcement activity of charity officials can be blamed on poor resources. First, it might simply reflect a sector with relatively few problems.[83] Alternatively,

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York, Ohio, and Oregon. These States, however, cover the majority of American charities and charitable assets. The offices in these States maintain charity registries, review financial reports, investigate and prosecute breaches of trust, participate in court proceedings where the attorney general is a named party (such as *cy pres* and dissolution), and regulate charitable solicitations. (In addition, similar legislation in Rhode Island and South Carolina reaches charitable trusts, but not charities operating in corporate form., and Minnesota requires registration but not reporting) Fremont-Smith has found that several other States, even without mandatory registration and reporting statutes, conduct an active charities enforcement program: Connecticut, New Mexico, Pennsylvania, [. . .] Legislation expanding the attorney general's supervisory powers has been adopted in Massachusetts, "California, Ohio, Rhode Island, Iowa, Oregon, New Hampshire, Texas, and Michigan, although some are restricted to certain types of actions." FREMONT-SMITH (2002), chap. 6, at 65 (footnote citing an appendix deleted).

[80] The Not-for-Profit Corporation Law ("NPCL") "requires a not-for-profit corporation to obtain State Supreme Court approval, upon notice to the Attorney General, before it may (1) amend its purposes or powers (NPCL Article 8), (2) sell, transfer or otherwise dispose of all or substantially all of its assets (NPCL Article 5), (3) merge or consolidate (NPCL Article 9) or (4) dissolve (NPCL Article 10)." NYAG Outline, *supra* note __. The New York attorney general's website suggests:

> It is a common and better practice for organizations to provide the Attorney General with the terms and conditions of their proposed transaction in advance of the actual court filing. Such a procedure enables the Attorney General to review the transaction and raise concerns before the court application is finalized. When the court application is filed, the Attorney General may give a "no objection" endorsement or file objections. The Attorney General ensures that charitable assets are being protected and preserved for appropriate charitable purposes.

Id.

[81] FREMONT-SMITH (2002), *supra* note __, at 31.

[82] *Id.* at 32.

[83] According to a study by Peter Swords and Harriet Bograd, "no one has a precise picture of what abuses take place and the extent of the abuses," and State charity officials learn of abuses in one of three episodic ways:

> First, they may review the annual reports filed by nonprofits (rules vary from state to state as to exactly which groups, if any, must file). States vary widely in how intensely they review the filed reports, but clearly some review is done and from time to time these reports reveal problems. Second, in some states under various statutes charity officials must oversee certain transactions. These might include

some believe that no good can come from having an attorney general involved in "business" decisions of a charity, including structural decisions like change in purpose or sale of assets. As the assistant attorney general of Ohio recently wrote: "When charitable enforcement issues arise, many private sector practitioners seem to regard the state attorney general as an unwelcome and troublesome interloper."[84] Finally, the oversight that does occur might be of the "wrong" kind, overemphasizing filings, which provide objective and measurable signs of agency activity, while scrimping on investigating.[85] Even granting the lack of resources for this function, at some point we must concede that the public might not want to pay for more (or different) oversight than is occurring. When the matter becomes politically pressing or irresistible, the regulator seems to find the resources – and creative legal arguments.[86]

Marion Fremont-Smith finds that State legislatures have been spurred to action in the charitable arena "only after the attorney exerted strong support," and, once legislation is in place, "if the attorney general initiates changes, they will be adopted if he has a strong voice in the

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> incorporation, mergers, dissolution, transfers of substantially all assets, and charitable bequests; these reviews occasionally reveal problems. Finally, informants such as disgruntled employees, disaffected board members or employees, the general public, other government agencies, and the media are a major source of identifying problems. Indeed, a hard news story about some nonprofit abuse in the papers or an a T.V. almost forces state officials to investigate and become involved. Interestingly, our interviews with officials from the IRS also suggested informants and the media as a major source of leads to abuses.

Peter Swords and Harriet Bograd, "Accountability in the Nonprofit Sector: What Problems Are Addressed by State Regulators?" (Nonprofit Coordinating Committee of New York, revised Oct. 1996), *available at* <http://www.charitychannel.com/forums/cyb-acc/resources/ag_prob.html>.

[84] David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 FLA. J. L. & PUB. POL. 131, 133 n.2 (Spring 2002). Patton continues: "Much of this resistance results, no doubt, from an excusable ignorance on the part of many corporate practitioners regarding the history, tradition, and implications of charity trust law." *Id.*

[85] *See* Renee Irvin, "Nonprofit Accountability and State Regulation: Trading a Little Fraud for a Lot of Forms" (Sept. 2002 draft of paper to be presented at the November 2002 ARNOVA conference). [Expand]

[86] Nor does public enforcement necessarily provide the only reform. For example, a year-long *Chicago Tribune* investigation found that Save the Children Federation, which pioneered the heart-tugging child-sponsorship appeal, took money for children who were dead, and falsified correspondence to sponsors from children. The charity immediately appointed a former Watergate prosecutor and U.S. inspector general to monitor the promised benefits. Several states also investigated; in a settlement with Connecticut, Save the Children agreed to change its advertising to clarify that donations and government grants are pooled to fund worldwide development. Lisa Anderson, *Relentless Campaigns of Hollow Promises; Charity's Probe Finds Sponsors Funded at Least 24 Dead Children*, CHI. TRIB., Mar. 15, 1998, at 1; Lisa Anderson, *The Road to Reform; Save the Children Redirects Staffers to Closely Monitor Individual Cases*, CHI. TRIB., Dec. 31, 1998, at 1; <www.chicagotribune.com/ws/children/>. InterAction, a group of 162 nonprofits, adopted tougher standards for child sponsorship agencies (see <www.interaction.org/pvostandards/index.html>), and announced plans to hire outside evaluators to monitor compliance through checks of agency financial accounts and regular visits to their international field operations.

legislature, but not otherwise."[87] Indeed, the State attorneys general achieved significant success in obtaining statutes expanding the role of attorneys general (and the public) in nonprofit hospital and HMO conversions. (See Part II.C., below.)[88]

At the same time, we are unable to judge the level of charity oversight because few cases involving nonprofit fiduciary issues have reached the courts – often because of the concerns of charity fiduciaries as much as of the attorney general. Reform rather than punishment is generally the goal of the charity regulator, and board members as well prefer a chance to improve their behavior while avoiding embarrassment and personal liability. Settlements have traditionally been kept confidential,[89] although regulators are increasingly requiring disclosure where the transgression reflects more than a minor infraction by a single bad actor.[90] Thus it is impossible to determine how well government is doing to address malfeasance and misfeasance by charity fiduciaries.[91] Whether you regard the press as watchdog, sensationalist, or members of the prevailing social network, we know essentially the negative anecdotes we read in the newspaper.

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87 FREMONT-SMITH, *supra* note __, at 87.

88 Where the desire of attorneys general to protect the public from charity wrongdoing clashes with another social value, however, the legislature could favor the other policy. In a 1990 study entitled *State Attorneys General: Powers and Responsibilities*, the National Association of Attorneys General notes with unease "the movement to enact legislation designed to reduce the potential liability of directors and trustees." NAAG, STATES ATTORNEYS GENERAL, *supra* note __, at 193. Acknowledging the relationship of this topic to broader tort reform issues, NAAG cites with disapproval statutes that grant immunity from civil liability to uncompensated directors, trustees, and officers of nonprofit organizations for injury caused by their actions or omissions if undertaken in good faith, within the scope of his or her functions, and not wilful or wanton misconduct. *Id.*, citing to Connecticut's statute. (Congress passed a federal Volunteer Protection Act (1997), which preempts any State statute that offers less protection. These statutes are triggered when harm befalls a third party, and do not, by contrast, protect volunteer trustees or directors from suits by or on behalf of the charity, or by the attorney general, for breaches of fiduciary duty.) NAAG comments: "This is a departure from existing law governing trustees, who have always been held to a higher standard of care."

89 Even where reports of complaints are kept, Swords and Bograd found: "Often investigations of specific abuses are disposed of by settlement, in which the charity does not admit to having committed any abuse; thus the files do not show whether or not the allegations were found to be true." *Supra* note _.

90 Notably, in recent years, regulators conditioned settlement on disclosure by Boston University (Massachusetts), Adelphi University (New York), and the Kamehameha Schools/Bishop Estate (Internal Revenue Service). See, too, the numerous press releases on the New York attorney general's website, at <www.oag.state.ny.us/charities/press>. Moreover, prosecutions for embezzlement and other crimes are very public affairs. See discussion of Hale House in the Appendix, in connection with the discussion of the criminal prosecution in AHERF.

91 Separately, attorney general action might reflect a rivalry between a State's regulatory agencies. Depending on the industry in which it operates, a given nonprofit organization might be regulated by such agencies as the insurance commissioner, the department of health, education, or commerce, or the corporations commission.

Moreover, attorneys general might also be uninformed about their responsibilities in overseeing the charitable sector – or, as described in Part II, reluctant to carry them out. Several recent cases illustrate this problem. For example, an investigation by the staff of the Pennsylvania assembly into the spectacular collapse of the Foundation for New Era Philanthropy (see Appendix) found that the failings of the attorney general's office were not so much the fault of inadequate staffing as deference to a well-connected, charismatic founder.[92] Despite his claims of inadequate resources, the same charge could be made of the New York attorney general's failure to act sooner in the Hale House case.[93]

Indeed, it is not always possible to reach consensus over whether a particular case rises to the level of breach of fiduciary duty. As charity operations gone wrong constantly make front-page news, we need to ask ourselves whether the proper response is government enforcement action. The question of the "accountability" of charities is a hotly debated one in the philanthropic world today.[94] Equally important is the accountability of the regulator: Invisibility at the informal end of the regulatory spectrum makes it hard to judge the level and the effectiveness of regulators in influencing charity behavior – and whether regulators are motivated by their own or the public's interest. Perhaps State (and federal) regulators should be encouraged to issue reports of their own, describing their regulatory efforts, settlements, and judicial

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[92] JOINT STATE GOVERNMENT COMM'N, THE COLLAPSE OF THE FOUNDATION FOR NEW ERA PHILANTHROPY 49-50 (General Assembly of the Commonwealth of Pennsylvania 1995):

> "Of course, more quality employees can do more quality work; however, with this section enforcement was not a question of staffing.
>
> The Commonwealth's Office of Attorney General and Department of State learned of the foundation's existence and novel scheme approximately 23 months prior to the foundation's collapse. . . . Given the foundation's initial refusal and subsequent reluctance to comply with the Solicitation of Funds for Charitable Purposes Act along with a novel demand that potential grantees surrender funds to the foundation in order to receive a grant that could double these funds in six months, both should have been more vigilant. . . . [New Era founder John] Bennett became acquainted with and pursued multimillionaires; some people representing the traditional establishment fell into his confidence. A man with these references might have been too intimidating for regulators who should have been more aggressively curious.

[93] In defending New York State's delay in discovering and exposing the looting of Hale House (a children's shelter that attracted millions in donations) by its long-time executive director, "[attorney general] Mr. Spitzer said the charities bureau in his office was charged with helping charities comply with state requirements, rather than aggressively policing them. The bureau has only six accountants to oversee 40,000 charities, he said, and it still must rely on information kept on 3-by-5 index cards to track the organizations. Requests for the money to computerize the operation have been repeatedly rejected." Nina Bernstein, *Officials Overlooked Dire Signs at Charity*, N.Y. TIMES, Feb. 7, 2002, at __. Moreover, Hale House's founder was the executive director's mother, who "was elevated to sainthood" by Ronald Reagan and popular with other politicians. *Id.* (quoting the senior vice president for agency services at United Way).

[94] *See generally* Evelyn Brody, *Accountability and Public Trust, in* THE STATE OF NONPROFIT AMERICA (Lester Salamon, ed.) (Brookings Institution and Aspen Institute, forthcoming 2002).

outcomes.[95]

II. PAROCHIALISM AND PATERNALISM

The charitable sector fits oddly into traditional public/private distinctions. While charities represent privately held and managed assets, they perform public services. Furthermore, like other enterprises, they face government regulation. In tying these concepts together, the question becomes whose public can the State appropriately regulate a charity to serve, and who decides this question?

A. Geography Is Destiny

The seeming unconstrained powers of the attorney general, and the hazards of litigation for targeted charities, can induce attorneys general and courts to step over the line between oversight and management. The terms in the title of this Part II are, of course, pejorative. But they mean to suggest that one can objectively distinguish between appropriate and misguided prosecutorial, judicial, and legislative behavior.

Consider paternalism. One can appreciate the state's desire to eliminate "harmful" competition between charities – as one New York jurist put it, "I do not believe the public should have numerous groups soliciting funds when one well-recognized and well-operated organization is [already] seeking their contributions."[96] However, secretaries of state and courts no longer have the power to refuse to certify new nonprofits.[97] Nevertheless, the regulator still plays an important role in seeking to ensure the efficient and effective use of charitable resources. For example, as described in the Appendix, the New York attorney general prodded the September 11 charities into coordinating their relief efforts by creating a private database of resources and needs. More generally, many States attorneys general provide information for the public on wise giving to charity.

The flip side of meddling, reticence to monitor and investigate, might reflect a different kind of paternalism – the desire not to discourage charity managers from serving. But even here we find political considerations. Over 40 years ago, Kenneth Karst observed, "and this is by no means an indictment of our attorneys general, any high political official may be expected to approach rather cautiously the investigation of charges that respectable trustees are guilty of

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[95] See, for example, the yearly reports by the attorney general of Pennsylvania for 1997, 1998, and 1999-2000, at <www.attorneygeneral.gov>; [other examples].

[96] *In re Waldemar Cancer Research Ass'n, Inc.*, 205 Misc. 560, 130 N.Y.S.2d 426, 426-27 (Sup. Ct. 1954). For a discussion of this and other examples, see SILBER (2001), *supra* note __, at 62-63 and accompanying notes.

[97] See note 45, above.

wrongdoing or even mismanagement."[98]

Parochialism raises a different social concern. Attorneys general commonly administer the law by assuming that donors to an existing charity means those funds to "stick" to that community. However, State-level rivalry steals from other states, and intra-State moves usually provoke protests from the incumbent community.[99] See the Appendix for a discussion of the Terra Foundation, the Hershey Trust, and Health Midwest.[100] What is the proper role of the attorney general in these matters? Most important, when attorneys general act parochially, no State regulator exists whose interest it is to look out for the beneficiaries of a national or international charity. In terms of the national public interest, however, relocation could be a positive-sum game: A charity board might determine that the overall social benefit can be increased by moving the activities from a State with a low utility to a State with a higher one.

B. The Temptation of Charitable Investment Assets

Some of the more interesting cases of State enforcement relate to investment, rather than operating, assets of charities. Of course, investment assets are in a very real sense charitable assets, and not just for private foundations, whose only assets might be investments that produce grant income.[101]

1. The Role of Charitable Savings in the Political Economy

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[98] Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 478-79 (1960).

[99] Compare State business development efforts, where one State's loss is another's gain.

[100] See also the case involving the Museum of the American Indian, most of whose collection moved from New York to Maryland and Washington, D.C. when the Smithsonian rescued the financially troubled charity. Museum of the American Indian v. Huntington Free Library, 610 N.Y.S.2d 488 (1994), discussed in FISHMAN & SCHWARZ, *supra* note __, at 130-34.

In an earlier case, the New York attorney general opposed the move by the Sailor's Snug Harbor, a centuries-old retirement home for seamen, from Staten Island to North Carolina, where it would be operated in cooperation with Duke University. In the Matter of the Estate of Robert R. Randall, 338 N.Y.S.2d 269 (Surr. Ct. 1972). The surrogate court granted the charity's *cy pres* petition over the objection of the attorney general that the new site "is remote, that Sea Level is a very small community, that the town of Morehead City some 30 miles distant does not afford the opportunities available in New York City." The court countered by observing: "The average age of the residents is 77 years. Approximately 85% of these residents suffer from some sort of respiratory disease; 25% of them require intensive infirmary care, some are confined to wheel chairs. 75% of these residents were born in foreign countries and of the remaining 25%, most were born in the States other than New York. In recent years less than 15% of the residents of the Harbor lived in New York City at any one time before they entered the Harbor." *Id.* at 272-73.

[101] See, for example, the fascinating case of the Bishop Estate. Brody, *A Taxing Time for the Bishop Estate*, *supra* note __.

The wealth held in charitable endowments, like private wealth, must be invested somewhere, and by someone.[102] This is not to say that charities have performed the same function in all societies and at all times. A thousand years ago in England, the donor-charity relationship was basically a penitent-Church relationship, and charitable foundations enlarged the Church's landholdings. In the seventeenth and eighteenth centuries, secured loans made by charities provided entrepreneurial credit in cloth and market towns throughout England; in the same era, but on a small scale, Harvard made personal loans and mortgages. Historian Peter Dobkin Hall demonstrates how the nineteenth-century Boston Brahmins endowed and controlled the local colleges and universities in order to educate their sons in the professions, while, as trustees of those institutions, they invested the endowments in local businesses.[103] In the twentieth century, American would-be dynasties used private foundations to control family business enterprises. Moreover, foundations "provided a framework in which beneficiaries of family trusts could themselves become private fiduciaries, not of family fortunes, but of the public order in general."[104] Required to divest control of family businesses by the Tax Reform Act of 1969, the private foundations, along with other charities, now hold a fair-sized chunk of the equity and debt issues of publicly traded corporations.[105]

A serious imbalance of resources towards the nonprofit sector inevitably attracts attention.[106] Not that we will see a reprise of Henry VIII's dissolution of the monasteries, but a

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[102] The discussion in this paragraph comes from Brody, *Charitable Endowments*, *supra* note __.

[103] PETER DOBKIN HALL, INVENTING THE NONPROFIT SECTOR 182 (1992).

[104] GEORGE E. MARCUS WITH PETER DOBKIN HAL, LIVES IN TRUST: THE FORTUNES OF DYNASTIC FAMILIES IN LATE TWENTIETH-CENTURY AMERICA 69 (1992).

[105] The influence of any particular institutional investor on any particular company is no doubt much less, on average, than in the 19th century. For example, as of the mid-1990's, Harvard owned nearly 5,000 different securities, including U.S. stocks and bonds, foreign stocks and bonds, real estate, and private placements. Martin Baker, *Universities Are Often Smart Investors*, INT'L HERALD TRIB., Feb. 13, 1996, at "Special Report."

[106] Of course, adding to charity resources is often regarded as superior to private wealth enhancement in the case of wrongdoing. For an unusual and extreme case of judicial activism, consider the 4-3 decision by the Ohio Supreme Court in Dardinger v. Anthem Blue Cross & Blue Shield, 2002 Ohio LEXIS 3081 (Dec. 20, 2002). A widower had won a $49 million punitive damage award (and $2.5 million of compensatory damages) against an insurance that refused to pay for treatment for his dying wife (it claimed the treatment was experimental). The court gave Dardinger the choice of a new trial or the remittitur of the punitive damages down to $30 million – with $20 million going to the Ohio State University for cancer research (after funding all the attorneys fees), into a fund name for the deceased wife. At no stage in the proceedings was this raised or considered, and the plaintiff had no say in the choice of charity or the charitable purpose. Nor does Ohio have a statute that permits or requires some of the punitive damages to be paid into a fund to benefit others. Dardinger is quoted as saying that he had already made charitable arrangements (and is now unsure of their effect), but that he would prefer to pay for patients whose insurance companies are denying treatment than for research. *Robert Dardinger Discusses His Lawsuit Against His Insurance Company*, THE EARLY SHOW, CBS NEWS TRANSCRIPTS, Dec. 30, 2002; Adam Liptak, *Court Dictates How to Spend Award*, N.Y. TIMES, Dec. 28, 2002. As of January 1, the composition of the Ohio supreme changed slightly, perhaps enough to have made a difference. Lee Leonard, *Ruling Highlights Court's Split*, COLUMBUS

revenue-hungry Congress cannot ignore the wealth held in the tax-exempt sector.[107] For example, an Executive Briefing Paper prepared by the National Association of College and University Business Officers warns: "Concern is rising on Capitol Hill regarding the propriety of nonprofit organizations taking part in large and risky business ventures such as the much-publicized buy-out of R.J.R. Nabisco. Five major colleges and universities, as well as the TIAA/CREF (the nation's largest pension fund [and tax-exempt as a section 501(c)(3) charity] were among the 70 investors in this project."[108] TIAA/CREF lost its federal tax exemption in 1997.[109]

Charity trust law being partly property law, the *cy pres* doctrine can be variously applied to preserve or alter current beneficiaries' expectations. Perhaps the poster child for a movement to liberalize the American *cy pres* doctrine would be the Buck Trust. Greatly simplifying, in 1975 Beryl Buck bequeathed $10 million worth of oil company stock to a trust for the benefit of the needy of Marin County, one of the richest in the country. Ten years later, when the stock had ballooned in value to $400 million, the trustee possessing distribution powers – the San Francisco Foundation – sought court approval to spend some of the income to benefit the greater San Francisco Bay area. The attorney general opposed on the ground that the original restriction was not impossible to carry out. The court agreed, and denied *cy pres* relief; the trustee resigned and was replaced.[110] Professor John Simon, contemplating the consequences of the Buck Trust case, cautions:

DISPATCH, Jan. 3, 2003.

[107] *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998); Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687 (1999).

[108] NACUBO EXECUTIVE BRIEFING PAPER: GOVERNMENT POLICY AND REGULATION 17 (1991).

[109] *See* I.R.C. § 501(m) (repealing exemption of organizations engaged in commercial-type insurance, such as Blue-Cross/Blue Shield (in 1986) and TIAA-CREF (in 1997)).

[110] In re Estate of Buck, No. 23259 (Cal. Super. Ct. 1986), *reprinted at* 21 U.S.F.L. REV. 691 (1987); *see also* Estate of Buck v. Marin Community Foundation, 35 Cal.Rptr. 2d 442, 443-44 (Cal. App. 1994):

> The petition for modification and the petition for removal of trustee were tried before the court beginning in February of 1986. After a six-month trial, the probate court issued a one hundred thirteen-page statement of decision. In its written decision, the probate court refused to apply the cy pres doctrine to modify the Marin-only restriction. The court reasoned that all of the Buck Trust income could be spent effectively and efficiently in Marin County. Moreover, the court found that the geographic restriction in the Buck Trust was "unequivocal."

See generally John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641 (1987); HARVEY P. DALE, THE BUCK TRUST (1987). Compare *United States v. Cerio*, 831 F. Supp. 530 (E.D. Va. 1993). In that case, the district court granted the *cy pres* petition of the Coast Guard Academy for a donated fund whose income was to be awarded each year to the graduating cadet with the highest grade in physics and chemistry. The income was so high that the Academy declared that it would refuse the gift unless the court permitted most of the income to be used for science fellowships and visitorships.

> It is not easy to maintain a favorable climate for such philanthropic and legislative assistance without public confidence in the fairness and equity of the philanthropy system. . . . Another season of public or legislative hostility is not out of the question for the charitable community, particularly if trustees are prevented from taking what is essentially a form of philanthropic self-regulation to cope with bizarre situations like this one. The perception of an adventitious windfall, from the Buck Trust, that lets the "rich get richer" – and that philanthropic mechanisms can do nothing to correct – could contribute to the apprehension that philanthropy, despite the tax "subsidy" it enjoys from the public at large, is an avenue to "welfare for the rich."[111]

2. Prudent Person and State Regulation

A trustee's duty of care includes the duty to make trust assets productive. Most states took many years to accept the "prudent investor" rule (for private as well as charitable trustees), which originated in the 1830 decision of Justice Putnam in Massachusetts.[112] The legislative and judicial quest to distinguish permissible "investing" from impermissible "speculating" led to extreme conservatism. Some courts and legislatures relied instead on "legal lists" – generally consisting of government bonds, and excluding both equities and debt issued by corporations as too risky – until, by the turn of the 19th century, trust companies had developed to provide "a rational, institutional base for legal and business experience in drafting, forming, managing and perpetuating long-term trusts."[113] In 1990, the American Law Institute adopted and promulgated a portion of the *Third Restatement of the Law of Trusts*, devoted exclusively to revisions in the Prudent Man Rule.[114]

Not coincidentally, though, legal lists that restrict investments to government bonds (among other approved securities) conveniently provided a source of funds for the public sector.[115] Describing the hazards of relying on the legislature to authorize particular investments, Professor Friedman observed: "It must have been clear to all where the impetus for these laws

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[111] Simon, *supra* note __, at 663.

[112] Harvard College v. Armory, 26 Mass. (9 Pick.) 446 (1830).

[113] Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 561 & 563 (1964).

[114] RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) (1992). The *Third Restatement* embodies modern portfolio theory in its amended Section 227: The general standard of prudent investment "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited to the trust."

[115] *See* John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1 AM. B. FOUND. RES. J. 1, 5 n.18 (1976); *see also* Roberto Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

arose. This was not a plain and narrow path but an invitation to corruption. The power to prescribe 'legals' was a power to control or at least to influence the flow of investment money."[116] Professor Friedman concluded that the Depression provided the spur to final repeal of legal lists: "One might seriously question . . . the social utility of rules which kept funds out of channels which might conceivably restore business confidence, enhance stock prices, and help get the country back on its feet."[117]

Section 389 of the *Third Restatement* provides: "In making decisions and taking actions with respect to the investment of trust funds, the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." However, charitable programs or purposes can conflict with investment policy. The *Third Restatement* would permit a charity to take "social considerations" into account only "to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust."[118] "Program-related investments" are made to advance a charitable purpose rather than to earn a financial return.[119] At the other extreme, a charity might divest or shun holdings in corporations whose activities clash with the charitable purpose. In the 1980's, institutions divested stock in companies doing business in South Africa;[120] some campus groups today call for divestiture from businesses in Israel. Mor broadly, some institutions apply screens or invest in "conscience funds" to avoid investments in stocks of companies producing tobacco, alcohol, and munitions.[121]

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[116] Friedman, *supra* note ___, at 562.

[117] *Id.* at 571. *See, e.g.*, WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND THE LORE OF ENDOWMENT FUNDS 7 (1969) (in 1939, Stanford University sought court approval to buy equities for an endowment that had been invested exclusively in fixed-income securities for 51 years).

[118] RESTATEMENT (THIRD) TRUSTS § 227 cmt. *c* (General requirements of loyalty and impartiality), at 13.

[119] Compare the debate over the Department of Labor's rules for "economically targeted investments" by pension funds. *See* DOL Interpretive Bull. 94-1, 59 FED. REG. 32606 (June 23, 1994), 29 C.F.R. 2509.94-1 (this would have been nullified by H.R. 1594, which passed the House on Sept. 12, 1995, but died with the 104th congress). *See generally* Alvin D. Lurie, *ETIs: A Scheme for the Rescue of City and Country With Pension Funds*, 5 CORNELL J. L. & PUB. POL. 315 (1996); Edward A. Zelinsky, *ETI, Phone the Department of Labor: Economically Targeted Investment, IB 94-1 and the Reincarnation of Industrial Policy*, 16 BERKELEY J. EMP. & LAB. L. 333 (1995).

[120] *See generally* RESTATEMENT (THIRD) OF TRUSTS § 227 Reporter's Note c (Loyalty) at 68-70 (discussing social investing cases and commentaries); Daniel R. Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988). *See also* Basich v. Board of Pensions, Evangelical Lutheran Church, 540 N.W.2d 82 (Minn. Ct. App. 1995) (the courts could not constitutionally interfere with the church's and pension board's policy, based on social and doctrinal grounds, to divest stock in companies doing business in South Africa).

[121] One wonders how far charities will take this "tainted money" concern – recall Shaw's Salvation Army

3. Private Foundations, Public Charities, and Diversification

Prudent investment generally includes a requirement to diversify.[122] Donors to charitable trusts and to corporate charities may direct the entity to retain an investment in particular assets, such as stock in the donor's business. Legislatures and courts have not yet unequivocally interpreted "charitable purpose" to exclude any right of a donor to require investment of charity assets in the donor's business – except for the narrow rules passed by Congress for "private foundations."

a. Private Foundations and Excess Business Holdings

At the federal level, several Congressional investigations during the 20th century cast suspicions on the motives and activities of private foundations – those narrowly supported, often family-controlled funds that financed charitable operations, but that did not themselves directly conduct a charitable program. During the American foundation world's direst moment, in 1969, Congress clarified existing ambiguity in the tax-exemption law by dividing section 501(c)(3) organizations into two types, "private foundations" and non-private foundations (colloquially referred to as public charities). An early proposal would simply have put a 40-year term limit on the life of any private foundation. The foundations were lucky to escape with just a minimum annual payout requirement, which has been low enough to allow most large foundations to grow in the real value of their endowments (well, until March 2000!).

The 1969 Act also prohibits a private foundation from owning more than 20 percent of any single business (35 percent if no party related to the donor or the trust owns any stock). Congress worried that if a donor could use his foundation to control the stock, the foundation would focus more on providing support for the company than on maximizing its charitable program. However, the percentages adopted in this "excess business holding" rule can allow effective control of publicly traded companies. (Moreover, the statute ignores any ownership interest not exceeding 2 percent of the company.) Thus, if the business is very large, a foundation can be 100 percent invested in it. (An undiversified portfolio might constitute a "jeopardy investment" subject to another private foundation tax, but the regulations ignore

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Major Barbara, and her repugnance at accepting a donation proffered by a wealthy distiller and arms merchant. George Bernard Shaw, *Preface* (1906), MAJOR BARBARA 25-26 (Penguin 1957).

[122] Section 227(b) of the *Restatement (Third) of Trusts (Prudent Investor Rule)* states: "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Comment *g* explains that in the absence of "special considerations making it prudent not to diversify in the particular trust situation," the overriding principles are prudent risk management and impartiality. See also section 229, comment *d* ("Effect of direction or authorization to retain"). Finally, section 389 states: "In making decisions and taking actions with respect to the investment of trust funds, the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." See also the Prudent Investor Act. See, for example, *Estate of Janes*, *infra* note __.

investments gratuitously received.) Recently,[123] the Robert W. Woodruff and the Joseph B. Whitehead Foundations of Atlanta – as well as Emory University – suffered from the decrease in the value of Coca-Cola's stock. Similarly, the Lilly Endowment's nearly exclusive investment in Eli Lilly stock at first looked smart, but the foundation lost 27 percent of its value in 1999 when the stock fell, and the Kellogg Foundation is only recently recovering (slightly) from a depressed share value. As of 2000, five of the six top foundations invested exclusively in a single stock. [Update.]

Not all undiversified foundations are required by their organizing documents or the gift instruments to maintain or concentrate their holdings in the founder's company stock. Perhaps diversification would be an unthinkable sign of disloyalty by the trustees, who – if not themselves family members – are probably close advisors to the donor's family or executives in the family business. Or, as in the Hershey case, the charity can be seen to "belong" to the community in which the business is located. As *The Wall Street Journal* reported: "Leaders of many old-line companies in the food, drug and newspaper industries enjoy the protection of long-dead founders, in the form of philanthropic foundations that represent a large bloc of friendly votes."[124]

However, the opposite could also happen, with such an arrangement boomeranging on the company. In a battle to stop Hewlett-Packard from approving a merger with Compaq Computer, the heirs of founders William Hewlett and David Packard announced that they would vote their own stock and that of their family foundations against the merger. This stock represented about 18 percent of the company, but the foundations' share percentages did not violate the excess business holdings rules. The Packard Foundation (owning 10.4 percent of H-P) was invested almost exclusively in stock of H-P (and an H-P spinoff); was H-P's largest shareholder; saw its endowment plunge from a peak of $18 billion to $6 billion in the prior year; and is led by Susan Packard Orr, the founder's daughter.[125] A source close to the foundation board told *The New York Times*: "The tough thing is that the board realized that this merger might be the right risk for the company, but it was too great a risk for the foundation to take."[126] (By contrast, the Hewlett Foundation has been engaging in regular sales of H-P stock as part of its program of diversification.[127])

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[123] Much of the data in this paragraph comes from Marina Dundjerski, *Billion-Dollar Growth at Big Funds*, CHRON. OF PHILANTHROPY, Feb. 24, 2000, at 1.

[124] David Bank, *H-P Case Illustrates Clout of Foundation Holders*, WALL ST. J., Dec. 24, 2001, at C1.

[125] Steve Lohr and Chris Gaither, *Hewlett-Packard Is Dealt a Blow on Compaq Deal*, N.Y. TIMES, Dec. 8, 2001, at A1.

[126] *Id.*

[127] Pui-Wing Tam and Molly Williams, *Hewlett Visits H-P Investors to Make Antimerger Case*, WALL ST. J., Jan. 7, 2002, at A15.

b. Supporting Organizations, Community Foundations, and Commercial Donor-Advised Funds

The prohibition on excess business holdings does not apply to public charities. Moreover, Congress and the Treasury Department exclude from the definition of "private foundations" three types of entities that resemble them.

i. Supporting Organizations

The statutory scheme that Congress wrote in 1969 deems certain types of 501(c)(3) organizations – including schools – as automatically public charities. But the Hershey Trust (discussed in the Appendix) is not itself a school; it is simply an endowment that supports a school. So Congress created a class of non-private foundations called "supporting organizations," and had the Hershey Trust in mind when it did so.[128]

One group of supporting organizations recently made news when the attorney general of New York persuaded them to dissolve and distribute their assets to their supported public charities. In this unusual case, seven supporting organizations were established by *Reader's Digest* founders DeWitt and Lila Wallace and funded with nonvoting stock of the company for the benefit of the Metropolitan Museum of Art, Lincoln Center, Colonial Williamsburg, and ten other charities.[129] In the 1990s, Reader's Digest stock plummeted and slashed its dividends; meanwhile, company executives dominated the supporting organizations' boards. The New York attorney general succeeded in obtaining the dissolution of the organizations; the beneficiary charities are now free to reinvest these holdings, worth a combined $1.7 billion.[130]

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[128] As later explained by the U.S. Tax Court:

> [T]he House and Senate reports further indicate that the purpose of section 509(a)(3) was limited, namely, to exclude from private foundation status, organizations which were theoretically separate from publicly supported organizations but were not thought of as private foundations because they were operated in close association with publicly supported organizations. The reports give, as examples of section 509(a)(3) organizations, religious organizations other than churches, the Hershey Trust (which is organized and operated for and in connection with a specific school), and university presses.

Quarrie v. Commissioner, 70 T.C. 182 (1978), *aff'd* 603 F.2d 1274 (7th Cir. 1979) (citing H. Rept. 91-413 (Part 1) 40-41 (1969), 1969-3 C.B. 200, 226-227; S. Rept. 91-552, 56-59 (1969), 1969-3 C.B. 423, 460-462; Conf. Rept. 91-782, 288-289 (1969), 1969-3 C.B. 644, 651; and 115 Cong. Rec. 37,514-37,515 (1969)).

[129] *See generally* Mark Rambler, Note, *Best Supporting Actor: Refining the 509(a)(3) Type 3 Charitable Organization*, 51 DUKE L.J. 1367 (2002).

[130] *See generally* Ralph Blumenthal, *13 Institutions Obtain Control of Vast Bequest*, N.Y. TIMES, May 4, 2001, at A1. For The Reader's Digest statement, "Wallace Funds Transfer $1.7 Billion to 13 Charitable Institutions," go to <http://www.wallacefunds.org/newsroom>. For the Attorney General's statement, "Spitzer Announces Resolution Involving $3.2 Billion Legacy Left by Founders of Reader's Digest; 13 Major Charities Including the Met, Sloan-Kettering, Colonial Williamsburg, Will Now Control Own Funds; Reorganization Also

ii. Community Trusts

Community trusts enjoy non-private foundation status because of a rule in the Treasury regulations that allow them to aggregate all the funds endowed by separate donors in order to meet the "public support" test.[131] To ensure ongoing public benefit and freedom from the "dead hand" of the donors, the regulations require community trusts to have "variance power" over each of the separate donated funds. This power superficially resembles a contractual *cy pres* power – except that the community trust need not ascertain or adhere to the donor's intent once the trust's governing body "in [its] sole judgment" determines that the original restriction is "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served. . . ."

This seeming broad discretion granted by the tax rules to the community trust's governing board was not recognized by the New York surrogate court in *Matter of Laura Spelman Rockefeller Memorial, et al.*[132] The trial court essentially ruled that the New York Community Trust jumped the gun when it decided that a change in circumstances had occurred that warranted the redirection of the Laura Spelman Rockefeller fund from the plaintiff beneficiary.[133] Surprisingly, the appellate division upheld the lower court's standard as "equitable and definable" (although it deprived the plaintiff of monetary satisfaction by ruling that it waited too long to sue).[134]

The attorney general had also asked the court to "impose an affirmative requirement for effective notice to the Attorney General, to ensure that the basic fairness inherent in judicial proceedings is not absent from the unilateral variance power's extrajudicial alternative," "noting that when charitable corporations seek to release restrictions after donors' deaths, they must

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Includes New, Independent Board for Wallace-Reader's Digest Foundation," go to <http://www.oag.state.ny.us/press/2001/may/may04a<uscore>01.html>.

Mark Sidel notes the uncomfortable position occupied by these supported charities during the process: "Comments by the recipient groups – some of which had complained earlier of investment and Reader's Digest stock sale restrictions – were considerably more muted, as the recipients tried to antagonize neither the Wallace Funds nor the Attorney General." Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 MICH. L. REV. 1312, 1323 n.35 (2002) (book review of NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM).

[131] Treas. Reg. § 1.170A-9(e)(11)(v)(B). Community foundations that take the corporate form are subject to different rules.

[132] Reprinted in *New York Law Journal*, Oct. 21, 1999.

[133] Judge Preminger, in this first construction of "variance power," ruled that the use "must be grounded in a change of circumstance that negatively affects the designated charity to such a degree that it would be likely to prompt a donor of the fund to redirect it."

[134] In re Application of the Community Service Society of New York, 713 N.Y.S.2d 712 (N.Y. App. Div. 2000).

petition the Supreme Court upon notice to the Attorney General pursuant to Not-for-Profit Corporation Law § 522(b)."[135] The appellate division, however, declined:

> In this case . . . Community Trust explicitly possessed the variance power pursuant to the terms of the Trust Resolution. While nothing prevented it from notifying the Attorney General, there is no requirement at law to do so . . . .
>
> . . . . The Attorney General's request that this Court craft a notice requirement would be better directed to the Legislature.[136]

iii. Commercial Donor-Advised Funds

[Add discussion of Fidelity Charitable Gift Fund, and failure of federal legislative proposal to conform rules for all donor-advised funds.]

C. Nonprofit Health-Care Conversion Statutes

A nonprofit hospital can be one of the largest charities in a community. Communities have been worrying about behind-closed-doors sales of nonprofit hospital assets: that the community might be short-changed either in the amount paid for the assets (and hence the funds available for future charity) or in quality and price of future, for-profit hospital services. Some also suspect conflicts of interest on the part of the nonprofit's trustees and officers, who might receive positions either in the new hospital management or the resulting foundation. In response, states began to adopt versions of a "Nonprofit Hospital Sale Act."[137] The National Association of Attorneys General ("NAAG") produced a model nonprofit health-care conversion statute in July

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135 *Id.* at 722.

136 *Id.*

137 See the Nonprofit Symposium Issue in the *Journal of Corporation Law* (1998) (introduction by Evelyn Brody and articles by Harvey Goldschmid, James Fishman, David Hyman, and John Colombo).

1998.[138] Today, [22] States have enacted such legislation.[139]

Typically, these conversion statutes require that the nonprofit hospital inform the attorney general of the terms of the proposed deal, and, after a public hearing, give the attorney general the right to disapprove it as against the public interest (disappointed parties may appeal to court).[140] As NAAG comments on the desirability of community input:

> An open process maximizes the public's confidence in the review process and reduces any concerns that these charitable assets are not being adequately protected. The role of the Attorney General's Office is to enforce the provisions of the charitable trust laws so as to fully protect the charitable assets for the benefit of the public. The charitable trust laws are built upon the principle that charitable trusts are not private business entities, like fast food franchises and indoor plumbing supply companies.[141]

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[138] Section 9.02 of NAAG's model statute provides: "Nothing in this Section shall be construed to limit the common law authority of the Attorney General and the [director of charitable trusts] to protect charitable trusts and charitable assets in this state." This section provides that a conversion transaction . . . entered into in violation of the statute "shall be null and void and each member of the governing board and the chief financial officers of the parties to the nonprofit healthcare conversion transaction may be subject to a civil penalty of up to $1,000,000, the amount to be determined by the [court of competent jurisdiction] in the county in which the nonprofit healthcare entity's assets to be transferred are located." Sec. 9.01. The penalties and remedies provided in the statute "are in addition to, and not a replacement for, any other civil or criminal actions which the Attorney General may take under either the common law or statutory law, including rescinding the nonprofit healthcare conversion transaction, granting injunctive relief or any combination of these and other remedies available under common law or statutory law." Sec. 9.01.

[139] Marion R. Fremont-Smith and Jonathan A. Lever, *State Regulation of Health Care Conversions and Conversion Foundations*, B.N.A. HEALTH L. REP., May 11, 2000, at 714.

[140] Section 2.01 of NAAG's model statute requires: "At the time of providing notice to the Attorney General [Court], the nonprofit healthcare entity shall provide the Attorney General [Court] with written certification that a copy of this statute has been given in its entirety to each member of the board of trustees of the nonprofit healthcare entity." Section 4.01 requires the attorney general to publish notice of the public meeting not only in the newspaper of the "affected community" and provided to the county board of supervisors, but also, "if applicable, to the city council of the city where the nonprofit healthcare entity's assets are to be transferred are located."

NAAG's model statute does not provide for an appeal of an adverse decision by the attorney general; however, its drafters commented: "With respect to judicial review, under most state Administrative Procedure Acts, arbitrary and capricious acts can be challenged. In addition, *mandamus* actions are available to parties aggrieved in this way." Memorandum from Christine Milliken, Executive Director and General Counsel, NAAG, to All Attorneys General, on "Comments to the Proposed Health Care Conversion Model Act," July 1998, at 4.

[141] NAAG, "Commentary to the Proposed Model Act for Nonprofit Healthcare Conversion Transactions," at 2. NAAG also observes: "Adoption of this statute will place significant demands upon the resources and staff of an Attorney General's office and consideration should be given to these additional demands." *Id.* See also Swords & Bograd: "These cases are complex and can require significant commitment of state officials' resources, and are complicated by the problem that too often the charity has not kept adequate records of restricted funds and restricted assets."

Typically, the parties must usually pay for the attorney general's costs of investigating the fairness of the deal, including expert appraisers. Legal problems remain because statutes define "hospital" and "conversion" differently, and political problems can arise if different state officials have overlapping jurisdictions.[142] NAAG emphasizes the importance of educating the legal and healthcare community on the attorney general's interpretation and procedures, adding: "The Attorney General should seek to reassure directors, not intimidate them or cause good individuals to avoid serving on governing boards."[143] In general, though, the process set forth in these statutes can make it even harder for a struggling nonprofit hospital to liquidate its assets and redeploy the proceeds to a more socially useful purpose.

Should the deal be allowed to proceed, under the typical nonprofit hospital sale statute the resulting funds must be used for "health care purposes" in the community that the hospital served.[144] Moreover, some states are considering barring the old hospital trustees from controlling the board of the resulting foundation; in any event, foundation leaders recommend that new members be brought in to provide grant-making expertise and avoid potential conflicts of interest. NAAG recommends that "the Attorneys General should consider taking an active role in the drafting of the articles and bylaws [of the conversion foundation], the identification of the disadvantaged groups to be served, the defining of the charitable mission, and the critical selection of the members of the first governing board."[145] Not all trustees hew to the original charity's path. One Tennessee foundation that resulted from the sale of hospital assets determined that federal and State programs adequately met the needs of most uninsured patients, and so declared its intent to shift its focus to education, rather than health care, as its community's biggest concern.

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[142] NAAG's model statute contains an "optional" section 5.02 "for Attorneys General who deem it appropriate to also consider issues of health impact in their review." NAAG notes that if "adoption of this optional section is deemed to be inappropriate [because exceeding the scope of the attorney general's abilities and resources], it is strongly recommended that oversight for these issues be placed within an existing public health authority for review by that agency." NAAG, "Notes to the Proposed Model Act," at section 5.02.

[143] NAAG, "Notes to the Proposed Model Act," at section 6.01.

[144] Not all States have such a "back-end" *cy pres* requirement. NAAG notes that "if your state has . . . a cy pres statute [which requires court approval for such conversions], you must consider the options available: substituting the Attorney General for the court procedure and approval; requiring both court and Attorney General approval; or retaining only court approval." NAAG, "Notes to the Proposed Model Act," at section 2.01. NAAG also notes that its standard is more flexible than that of the *cy pres* statutes, "and how to proceed is a policy question for each state to decide." *Id.*

[145] NAAG, "Notes to the Proposed Model Act," at section 5.01(9). Section 5.01(9) lists as a factor for the Attorney General to consider in approving or disapproving the proposed conversion: "Whether any foundation established to hold the proceeds of the sale will be broadly based in the community and be representative of the affected community, taking into consideration the structure and governance of the foundation."

III. ASCERTAINING THE PROPER ROLE OF CHARITY ENFORCERS

This final Part seeks to set forth rules to guide the exercise of attorney general and court enforcement over charities, and highlights open issues.

A. Focus on Fiduciary Duties, Not Ends

Public oversight of charity activity could more properly be termed oversight of the activities of the charity fiduciaries. (The other primary focus of State interest relates to consumer-protection statutes that govern charitable solicitations, to prevent fraud and the diversion or waste of donated funds.[146] Researchers Peter Swords and Harriet Bograd find a disconnect between those who focus on one or the other of these two realms of State oversight.[147])

As Marion Fremont-Smith explains, the right of *parens patriae* enjoyed by the attorney general "does not include a right to regulate, or a right to direct either the day-to-day affairs of the charity or the action of the court."[148] After all, State attorneys general have no necessary expertise, much less the resources, to address the myriad concerns of the hundreds of thousands of charities that function in the United States today. A posting of frequently asked questions on the website of the attorney general of California nicely delineates between proper oversight and inappropriate interference: "The Attorney General investigates and audits charities to detect cases in which directors and trustees have mismanaged, diverted, or defrauded the charity. . . . The Attorney General does not review matters involving internal labor disputes, contested elections,

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

[147] "Many law professors and practitioners who specialize in nonprofit law focus on the themes listed here under 'protecting charitable assets.' On the other hand, professional fund-raisers, their attorneys and clients, and many journalists focus attention mainly on fund-raising issues. There seems to be little communication between the two camps." Swords & Bograd, *supra* note __. One official, commenting on a draft version of their paper, suggested: "you might want to point out that our offices spend considerable time on fund-raising problems because the public is outraged by misconduct in this area and demands that its public officials take enforcement action." *Id.*

[148] FREMONT-SMITH, chap. 6 (2002), at 2. *See, e.g.,* Midkiff V. Kobayashi, 507 P.2d 724 (Haw. 1973):

> The function of the attorney general, as parens patriae of charitable trusts, is to oversee the activities of the trustees to the end that the trust is performed and maintained in accordance with the provisions of the trust document, and to bring any abuse or deviation on the part of the trustees to the attention of the court for correction. * * * The authority of the attorney general over charitable trusts does not extend beyond the performance of that function. M. R. Fremont-Smith, *Foundations and Government,* 198 (1965). If a deviation from any trust provision is necessary in the interest of the trust, the power to authorize the deviation rests solely with the court. * * *

disagreements between directors and members over policy and procedures, and most legal actions between charities and third parties regarding contracts or torts."[149]

For example, New York has a statute providing: "The attorney general shall represent the beneficiaries of . . . dispositions [of property] for religious, charitable, educational or benevolent purposes and it shall be his duty to enforce the rights of such beneficiaries by appropriate proceedings in the courts."[150] In *Lefkowitz v. Lebensfeld*,[151] the New York attorney general invoked this statute to sue corporations whose preferred stock was owned by certain charities, seeking to compel the payment to the charities of dividend arrearages. The courts held that the attorney general has no authority to bring direct suit against third parties on behalf of charities. Declared the trial court: "[N]ot-for-profit corporations . . . have the right to prosecute an action in their own names for the protection of their ultimate beneficiaries . . ., and thus no need exists for the Attorney-General to act in their behalf."[152] The appellate division distinguished the situation where a restricted gift is made to a charitable corporation, where the attorney general has standing to enforce that restriction. By contrast, "a donor who has attached no conditions has no such expectation. He is, in effect, relying on the good will and judgment of the donee charity to utilize his gift in what the donee perceives to be the most appropriate manner."[153] Instead, the attorney general may, if warranted, proceed against the fiduciaries. "Standing to sue and supervisory powers are entirely separate legal principles."[154] The New York Court of Appeals affirmed: "[The statute] does not authorize a large scale incursion into the everyday affairs of charitable corporations. Indeed, in these circumstances, to confer standing upon the Attorney-General . . . would be to grant all but unlimited and uncontrolled power to act as the alter ego of the charitable organization."[155]

[149] Go to <http://caag.state.ca.us/charities/faq.htm>.

[150] NY EPTL § 8-8.1([subd] f).

[151] 415 N.E.2d 919 (N.Y. 1980).

[152] Lefkowitz v. Lebensfeld, 408 N.Y.S.2d 216 (Sup. Ct. 1978).

[153] 417 N.Y.S.2d 715, 720 (App. Div. 1979).

[154] *Id.* at 721.

[155] 415 N.E.2d at 921. *Compare* Estate of Janes, 681 N.E.2d 332 (N.Y. 1997) (permitting attorney general suit for breach of fiduciary duty by the trustee of a private trust with charitable remaindermen; holding it imprudent to retain a high concentration of Kodak stock in the estate – 71 percent – for seven years given the needs of the beneficiaries; and assessing damages for the value of the lost capital but not lost profits), *with* Commonwealth of Kentucky v. Ferguson, 327 S.W.2d 947, 948 (Ky. 1959) ("It is significant that no record has been produced of any attempt by an attorney general, during the entire 167 years of the Commonwealth, to intervene in the many contests about the validity and establishment of wills involving charities). Surprisingly, in this latter case, the court also commented:

If the present will is declared valid, bequests thereunder for the ultimate benefit of charity will be

Two California cases illustrate when enforcement action is appropriate. In *Horton v. Bradley*,[156] the appellate division declared: "We are cited no statutory or case law authority placing the Attorney General in a position of a super administrator of charities with control over, or right to participate in, the contractual undertakings of the charities. He has undoubted standing to seek redress in the courts of contracts entered into by charities which are collusive, tainted by fraud or which demonstrate any abuse of trust management." By contrast, in *Lynch v. John M. Redfield Foundation*,[157] the court upheld the attorney general's surcharging squabbling directors for permitting funds to accumulate in a noninterest-bearing account for five years while the charitable program fell dormant. While the facts suggested that the deadlock could be blamed on a single unreasonable director, the obligation of the others was to have sought instruction from the court.

While the imposition of monetary sanctions on the fiduciaries in *Redfield Foundation* was unusual, perhaps more such enforcement would be salutary. In recent years, all investors, including nonprofits, became more conscious of asset allocation. In the mid-1990s, the bull market drew in the smallest charity; foundations, due to their payout requirement, were particularly conscious of their net worth. Now, posting the first losses after years of positive investment returns, charities seem to be struggling to maintain their endowments – perhaps overly struggling. As of June 30, 2001, the Art Institute of Chicago had invested nearly $400 million of its $650 million endowment in lightly regulated "hedge funds," only to discover in the Fall that a $23 million investment had nearly vanished, and another $20 million was at similar risk. In a lawsuit, the museum complained that the hedge fund in which the loss occurred had promised that the museum "could not lose any of [its] investment, even in a declining market, unless the particular stocks in which the fund assets were invested fell in value by more than 30 percent," but that the fund could not divulge details of its "highly proprietary trading strategy."[158] The museum's finance committee included, among others, department-store heir Marshall Field; the chief executive of the Chicago Board of Trade; a former chairman of Sears, Roebuck; while a former chairman of Sara Lee Corporation and the current chairman of Hyatt Hotels Corporation also sit on the board. Commented trustee Field: "This is the risk of the game. And we lost. So

> nontaxable, and the state will be deprived of a substantial amount in inheritance tax revenue and in future taxes. Certainly, it was not the intention of the Legislature to place the Attorney General in the inconsistent position of being under the duty of seeking to establish the validity of a will when the state will benefit from its invalidity.

Id. at 949.

[156] 90 Cal. Rept. 66, 69 (App. Div. 1970).

[157] 9 Cal. App. 3d 293 (1970).

[158] Barbara Rose, *Museum Defends Investing Strategy*, CHI. TRIB., Dec. 12, 2001, Business section, at 1.

what?"[159]

B. Specific Powers of Attorneys General and Courts

In carrying out its supervisory role, the attorney general (or other designated State official), can investigate charges of improper charitable activities, view books and records, and subpoena witnesses. The courts, on motion of the attorney general or on their own, can "enjoin[] wrongful conduct, rescind[] or cancel[] a transfer of property, appointment of a receiver, replacement of a fiduciary, compel[] an accounting, redress of a breach or performance of fiduciary duties,"[160] dissolve a corporation, enforce restrictions in gifts, supervise indemnification awards, and surcharge fiduciaries for improperly received benefits.[161]

Because attorneys general lack the authority to unilaterally impose legal remedies, the courts can offer relief if the charity wants to litigate a position taken by the attorney general. By the same token, though, courts are not bound to accept a settlement reached between the attorney general and the charity.[162] The court, too has a proper realm.. While most charity regulation occurs in the lower courts, whose findings of fact are rarely reversed,[163] courts "may adjudicate only disputes brought to their attention by opposing parties and . . . they are confined to the issues raised by these parties."[164] Moreover, "where discretion is conferred upon a trustee of a charitable trust with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of that discretion."[165]

Availability of court review can curb inappropriate regulator zeal – or willingness to compromise – but even a process of court review still risks error by both the enforcer and the tribunal. More practically, attorneys general could not achieve the success they do in negotiating

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[159] Ianthe Jeanne Dugan, Thomas M. Vurton, and Carrick Mollenkamp, *Chicago Art Institute Learns Tough Lesson About Hedge Funds*, WALL ST. J., Feb. 1, 2002, at A1.

[160] EDITH L FISCH, CHARITIES AND CHARITABLE FOUNDATIONS § 712, at 549-50)1974).

[161] *See* FISHMAN AND SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 255-56 (2d ed. 2000).

[162] *See Fuller Trust, supra* note __.

[163] *Id.* at 4.

[164] Fremont-Smith identifies only two exceptions: where the charity fiduciaries seek "instruction" from the court, and, in some jurisdictions (and exercised rarely), where the court may exercise equity power to act under its own motion. FREMONT-SMITH (2002), *supra* note __, at 6-7. As a separate matter, courts in some States enjoy statutory authority, at the behest of proper parties, to dissolve nonprofit corporations that exceed their powers. *See* Revised Model Nonprofit Corporation Act § 14.30(a)(1) (proceeding brought by attorney general).

[165] *Restatement (Second) Trusts* (1959), § 382.

settlements unless the charity faces litigating in courts with views of State power similar to that of the attorney general's.

This leaves the problem of the attorney general who fails to act. Critics of the current limited standing rules urge greater powers in the hands of some outside party.[166] A few recent statutes set forth an expanded class of private persons with standing rights to bring derivative suits, such as a minimum number or percent of members. In addition, under the common law (and some statutes), any person granted "relator" status by the attorney general may initiate suit, which remains subject to control by the attorney general. But still no State has a general rule of donor standing.

A recent case in New York illustrates the frustration of some courts with this approach. In *Smithers v. St.Luke's-Roosevelt Hospital Center*,[167] an appellate court granted standing to a donor's widow – as a court-appointed representative of her husband's estate – to challenge the use of his restricted gift, despite an alternative arrangement approved by the attorney general. The three-judge majority opinion declared: "We conclude that the distinct but related interests of the donor and the Attorney General are best served by continuing to accord standing to donors to enforce the terms of their own gifts concurrent with the Attorney General's standing to enforce such gifts on behalf of the beneficiaries thereof."

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

The New York legislature had been considering granting standing to a donor to sue for breach of a restriction on a gift, but only upon notice to the attorney general.[168] The attorney general did not seek reintroduction of this bill, purportedly because of satisfaction with the

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[166] *Compare* Marion R. Fremont-Smith, *Enforceability and Sanctions*, "Governance of Nonprofit Organizations: Standards and Enforcement," Ninth Annual Conf., N.Y.U. Sch. of Law Program on Philanthropy and the Law (Oct. 1997), *with* Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998).

[167] 723 N.Y.S.2d 426 (App. Div. 2001).

[168] State of New York, Senate Bill 7805 (May 2, 2000), *available on LEXIS in* States library, NYTEXT file, 1999 NY S.B. 7805, new § 522(c) ("If a governing board disregards a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund, the donor may, on notice to the Attorney General, apply to the Supreme Court of the judicial district where the corporation has its office or principal place of carrying out the purposes for which it was formed for an order to enforce said restriction.").

holding in *Smithers*.[169]

C. Forum Shopping and Foreign Incorporation

As the Health Midwest case illustrates, a charity operating across State lines becomes subject to the jurisdiction of the State in which it has assets and solicits contributions. (See case 5 in the Appendix.) But the lines of jurisdiction are not clear, particularly over decisions by the board to make organic changes in purpose and governance.

Even for charities intending to operate in a single State, the desire to operate free of unreasonable governmental oversight has led savvy advisers to choose the State of incorporation carefully. New York practitioners, seeking to avoid the delays and involvement of the attorney general and the courts, routinely incorporate their nonprofit clients in Delaware (which does not have a separate nonprofit corporation statute).[170] Those starting a charity in California might be reluctant to submit to California's requirement that "not more than 49 percent of the persons serving on the board of any [nonprofit public benefit] corporation may be interested persons."[171] Typically, a foreign corporation (for-profit or nonprofit) must register to obtain a certificate of authority in States in which it operates.[172]

Under long-standing (although sometimes criticized) conflicts-of-law principles, the "internal affairs doctrine" holds that the law of the State of incorporation applies to regulate the intra-corporate matters of a foreign corporation authorized to transact business in the forum State.[173] Enshrined in the *Restatement (Second) of Conflicts-of-Law*, the doctrine has been

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[169] William Josephson, *Guiding Practitioners and Fiduciaries on Charities*, N.Y. L. J, Dec. 3, 2001, Outside Counsel, at 1 n.11 (Josephson is the chief of the Charities Bureau of the New York attorney general). *But see* In the Matter of Alaimo, 732 N.Y.S.2d 819 (N.Y. App. Div. 2001) ("Respondent, decedent's grandson and a person in whose honor the trust was created, lacks standing to challenge petitioners' administration of the trust [citations]. Rather, standing to enforce the trust or challenge petitioners' administration of it is restricted to the Attorney General.").

[170] *See* FISHMAN AND SCHWARZ (incorporators of charities operating in New York, which has a strict regulatory regime, prefer to incorporate in Delaware).

[171] Cal. Corp. Code § 5227(a). Subsection (b) defines "interested person" as either "[a]ny person currently being compensated by the corporation for services rendered to it within the previous 12 months . . . excluding any reasonable compensation paid to a director as director," or any specified family member of such a compensated person.

[172] *See generally* People v. Jewish Consumptives' Relief Society, 92 N.Y.S.2d 157 (N.Y. Super. 1949) ("most of the norms prescribed for doing business by commercial corporations appear to apply with equal validity to nonprofit corporations").

[173] Section 302 of the *Restatement (Second) of Conflicts of Laws* (1969), subsection 2, looks to the "local law of the state of incorporation . . ., except in the unusual case where . . . some other state has a more significant relationship to the occurrence and the parties. . . ." Comment *a* states:

adopted in the corporations code of over half the States.[174] However, a few States are particularly concerned about the "pseudo-foreign corporation" – the entity whose only ties to the State of incorporation is incorporation itself. California and New York, in particular, have adopted statutes applying much of their domestic corporate law to foreign corporations operating in-state that meet a threshold test.[175]

But the *Restatement* and these statutes explicitly do not apply to nonprofit corporations.[176] What, then, can we say about the level of authority that a State attorney general and courts wield over a foreign nonprofit corporation?[177] Case law is sparse. A California appeals court ruled: "The election and removal of officers are matters involving the internal affairs of a corporation,

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> Many of the matters that fall within the scope of the rule of this Section involve the "internal affairs" of a corporation . . . .
>
> Matters falling within the scope of the rule of this Section and which involve primarily a corporation's relationship to its shareholders include steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, . . ., the holding of directors and shareholders' meetings, methods of voting . . ., shareholders' rights to examine corporate records, charter and by-law amendments, mergers, consolidations and reorganizations . . .

See generally Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARV. L. REV. 1480 (2002).

174 *See* 4 MODEL BUS. CORP. ACT ANN. § 15.05 (3d ed. 1984 & 1997 Supp.) (identifying 26 State codes that contain an exception for the internal affairs of a foreign corporation doing business in the State).

175 I am grateful to Tom Silk for a helpful discussion of the California approach to the internal affairs doctrine.

176 The Introductory Note to Chapter 13 of the *Restatement (Second)* begins: "This Chapter deals with business corporations. It is concerned with the choice-of-law problems that arise when a business corporation extends its activities beyond the borders of the incorporating state. On the other hand, this Chapter does not deal with municipal or other public corporations or with nonprofit corporations, charitable or otherwise."

177 Space does not permit a full explanation of worthy enforcement action by the Hawaii attorney general against the self-dealing trustees of the Bishop Estate. *See generally*, Brody, *A Taxing Time for the Bishop Estate*, *supra* note __; Evelyn Brody, *Administrative Troubles for the Intermediate Sanctions Regime*, TAX NOTES, July 16, 2001, at 423. Relevant to our inquiry is the report that the Bishop Estate considered moving out of Hawaii in order to escape the oversight of the Hawaii attorney general – indeed, it contemplated and reforming in the Cheyenne River Sioux Reservation in South Dakota to get out from under IRS jurisdiction as well – but, as a trust, hesitated because of the necessity of obtaining court approval. *See* Interim Trustees' Trial Memorandum, In re Estate of Bishop, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999), at III.B.1 ("The Incumbent Trustee Investigated Moving KSBE's Domicile to Escape Oversight of their Activities By the Hawai`i State Courts, Legislature, and Executive Branch"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-10 (Dec. 16, 1999); Interim Trustees' Proposed Findings of Fact, Conclusions of Law and Order, In re Estate of Bishop, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) at ¶¶ 55-63 ("Possible Changes in Domicile and Tax Status"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-11 (Dec. 16, 1999). *See also* Rick Daysog, *Bishop Eyed Move to Dakota*, HONOLULU STAR-BULLETIN, Oct. 12, 1999, at A-1

and California courts generally apply the laws of the place of incorporation in such instances."[178] Nevertheless, the court went on to rule: "Where a charity has been organized by California residents, is located in this state and has all of its assets and most of its activity here, we believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law merely because the founders chose to incorporate elsewhere. Consequently, we hold that the law of California, to the extent it exists, is controlling."[179] "This holding, however, is not of great consequence because the differences between California and the District of Columbia law in the relevant areas are not so significant as to dictate opposite results in this case. Moreover, because the case presents issues which have not been definitively settled by the courts of California or of the District of Columbia, we shall have to seek guidance from the decisions of other jurisdictions as well."[180]

The high court of Maryland declined to become involved in a membership issue involving the NAACP, a foreign corporation, citing the internal affairs doctrine. Referring to the business corporation context, the court cited a definition by the U.S. Supreme Court: "the internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and

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[178] American Center for Education, Inc. v. Cavnar, 145 Cal. Rptr. 736, 742 (Cal. App. 1978). (If the charity takes the trust form, the court continued, it would be governed by the laws of the State in which the trust is administered: "Factors to be considered in determining the place of administration are the domiciles of the trustees, the physical location of the assets constituting the res of the trust, and the place in which the business of the trust is carried on." *Id.* 743 at (citation omitted).)

As for corporations formed in another county, compare a decision by the U.S. Supreme Court involving a Cuban bank, which argued that under the law of Cuba it would be viewed as a government instrumentality entitled to sovereign immunity. In First National City Bank v. Banco Para El Comercio, U.S. 462 U.S. 611 (1983), the Supreme Court declined to apply Cuban law, explaining:

> As a general matter, the law of the state of incorporation normally determines issue relating to the internal affairs of a corporation. Application of that body of law achieves the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation. See *Restatement (Second) of Conflict of Laws* § 302, Comments a & e (1971). *Cf.* Cort v. Ash, 422 U.S. 66, 84, 95 S. Ct. 2080, 2090, 45 L. Ed. 2d 26 (1975). Different conflicts principles apply, however, where the rights of third parties external to the corporation are at issue. See *Restatement (Second) of Conflicts of Laws, supra* § 301. To give conclusive effect to the law of the chartering state in determining whether the separate juridical status of its instrumentality should be respected would permit the state to violate with impunity the rights of third parties under international law while effectively insulating itself from liability in foreign courts. We decline to permit such a result.

Id., 103 S. Ct. at 2597.

[179] *Id.* at 743.

[180] *Id.* (footnote omitted).

shareholders – because otherwise a corporation could be faced with conflicting demands."[181] In conclusion, the court held:

> Applying these principles to the facts of the instant case, we first observe that the national NAACP is a foreign corporation. As such, applying the internal affairs doctrine, we decline to interfere with its internal management decisions. Moreover, even under Maryland corporations law, applying the business judgment rule, we would not interfere with the organization's decision because the NAACP did not engage in any fraud, arbitrariness, or bad faith.[182]

[EXPAND DISCUSSION.]

The decision to sell assets or move operations can be a matter for both the State of incorporation and the State of operation. The domestic attorney general will argue that, at the very least, that contributors to the domestic charity intended not only to further the purposes of the organization, but also to benefit those in the community in which the charity has been operating. Assuming that an attorney general could successfully assert oversight over donated assets, the next question is whether that oversight is severable. Assume, example, a nonprofit theater incorporated in Delaware and operating in Trenton, whose assets have resulted from a mix of contributions, government grants, and ticket sales. If the organization decides to move to Philadelphia, what authority does the attorney general wield over (1) the decision to sell the assets; (2) the decision to move the resulting funds to another State; and (3) the decision to devote those funds to a use other than as a theater? Apparently, while data are sparse, attorneys general seek to keep operations in the State, but would settle for keeping the entire net asset value in the hands of other State charities.[183] A charity willing to take the attorney general to

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[181] National Association for the Advancement of Colored People v. Golding, 679 A.2d 554, 559 (Md. 1996), *quoting* Edgar v. Mite Corp., 457 U.S. 624 (1982)). The Maryland court continued:

> We further explained the rationale for the doctrine in Condon v. Mutual Reserve Ass'n, 89 Md. 99, 42 A. 944 (1899), stating that:
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> > Our courts . . . can enforce no forfeiture of charter for violation of law, or removal of officers for misconduct; nor can they exercise authority over the corporate functions, the by-laws, nor the relations between the corporation and its members, arising out of, and depending upon, the law of its creation. These powers belong only to the State which created the corporation.
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> *Id.* at 116-17, 42 A. at 948. *Accord* Moore v. NAACP, 425 Pa. 204, 229 A.2d 477, 478-79 (1967) (upholding trial court's decision that it did not have jurisdiction over internal affairs of the NAACP, a New York corporation, and thus could not enjoin the NAACP from establishing additional chapters in Philadelphia).

[182] *Id.* at 562-63.

[183] *See, e.g.*, New Mexico Attorney General Madrid Press Release, *Attorney General Will Not Oppose the Sale of St. Joseph's Hospital*, July 19, 2002, available at <www.ago.state.nm.us/PIO/Archived_Press_Releases/2002/AGwillnotOpposeSaleofSt.JosephHospital.htm> (announcing the issuance of a "no objection" letter in the sale of St. Joseph Healthcare Systems by its member

court, though, should be able to move all assets (or their monetized value) in excess of those donations restricted for use within the State. This, of course, raises the question, discussed above, of when donations are so restricted.

C. The Role of D&O Insurance

Regulators or courts might intone tough-sounding legal standards while actually treating the charity fiduciary leniently in order not to discourage charity service.[184] In theory, "D&O" (director and officer) insurance policies, and State limits on indemnification of directors and officers by nonprofits, remain an important concern of fiduciaries. In theory, then, the fear of potentially high monetary liability discourages good directors from serving. At the same time, in practice, the desire to save directors from financial liability leads regulators and courts to degrade the legal standards by avoiding findings of liability.[185] The reporter of both the current California nonprofit law and the American Bar Association's revised model act observed that the law – out of concern that under a more exacting liability standard "very few sensible people would serve on the boards of nonprofit organizations" – allows volunteer directors "to almost be asleep at the gate."[186] Indeed, D&O policies currently are inexpensive.

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organization, Catholic Health Initiatives of Denver, to Ardent Health Services of Nashville, Tennessee). The press release stated:

> "St. Joseph's Hospital has had a 100 year tradition of service to unmet health needs in the Albuquerque area. That tradition will continue because Catholic Health Initiatives has agreed to use an estimated $21 million, *the net proceeds of the sale*, and an additional estimated $7 million from St. Joseph Foundation assets to serve the health needs of the people of Albuquerque and New Mexico. I appreciate the fact that Catholic Health Initiatives worked with my office and as a result New Mexico's charitable assets will remain in New Mexico," Madrid said.

Id. (emphasis added). The press release added that: "The exact mission and structure of the new [nonprofit] health ministry will be determined through a planning process that will include public input"; the "New Mexico Charitable Registrar of the Attorney General's office will have oversight of the new health ministry's planning process"; and the "governance board of the new health ministry will reflect the geographic, cultural and linguistic diversity of New Mexico."

[184] This paragraph is drawn from Brody, *Legal Framework for Nonprofit Organizations*.

[185] In one admittedly extreme case, a State court absolved the founder and dominating foundation manager of any breach of duty in running up a $300 million loss through poor investments by asserting that had he instead mismanaged his wealth before making the contribution, "would any one be so crazy and cruel as to assert a claim against him for his carelessness in not holding intact the fortune which he intended to bestow on others?" *George Pepperdine Foundation v. Pepperdine*, 271 P.2d 600 (Cal. App. 1954). While California later reversed this standard, the "*Pepperdine* attitude causes one of the larger difficulties in achieving effective supervision over charities." James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 413 (1987).

[186] Michael Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Organizations: The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE

This laxity might change. The existence of a D&O policy offers all of the parties except the insurance company a painless way to redress the financial harm to the charity. (Note, though, the observation by one editorial: "You cannot buy a policy that will insure against loss of public confidence."[187]) Evidently, attorneys general keep an eye on policy limits in negotiating a settlement. Consider the following spectacular examples:

- The attorney general of Hawaii settled a suit seeking to surcharge the highly compensated former trustees of the Bishop Estate for $25 million – the limit of the D&O policy. (Half of the amount went to cover attorneys fees for all parties, including the attorney general's office, with the rest going to the charity.)[188]

- In the resolution of the civil claims in the largest nonprofit bankruptcy in history; the Allegheny Health, Education and Research Foundation (AHERF) (discussed in the Appendix) – which had $1.5 billion in unpaid bills – the State of Pennsylvania and the parties settled for a total of almost $94 million (of which $24.5 million will go to the charity). About $56 million of this total will be paid by AHERF's D&O policy, which had already paid at least $12 million for the litigation. (AHERF had typically carried $50 million in D&O insurance, but in the months immediately prior to its bankruptcy filing, had purchased four times that coverage; the insurance companies asserted that the later policies were fraudulent.)

- The New York State Board of Regents removed and replaced 18 of Adelphi University's 19 trustees for acting "blindly, recklessly and heedlessly" in setting the unreasonable compensation paid to university president Peter Diamandopoulos.[189] The Regents also found that several trustees had conflicts of interest, and violated their duty of loyalty.[190] In settlement of the subsequent enforcement action brought by the New York attorney general, the former trustees agreed to reimburse the university about $1.6 million it paid in legal fees and other costs. The ousted trustees of Adelphi University, without

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WEST. RES. L. REV. 751, 772 (1988-1989).

[187] Editorial, *A Cancer Within Crime Against Charity Will Leave Deep Scars*, COLUMBUS DISPATCH, June 11, 2000, at 2B (referring to a comment by an officer of an embezzled charity that the loss would be covered by insurance).

[188] *See* Rick Daysog, *Ex-Trustees Settle With Kamehameha*, HONOLULU STAR-BULLETIN, Sept. 16, 2000, available at http://starbulletin.com 2000/09/16/news/story1.html; Stephen G. Greene, *Insurer to Pay $25 Million to Settle Dispute in Hawaii*, CHRON. PHILANTHROPY, Oct. 5, 2000.

[189] Panel of New York State Board of Regents, "Report and Recommendations After a Hearing to the Full Board of Regents," *in* The Committee to Save Adelphi, *et al.* v. Diamandopoulos, *et al.* at 26-33 (Albany, N.Y.: Feb. 5, 1997).

[190] *Id.* at 33-46.

admitting wrongdoing, agreed to pay Adelphi $1.23 million and assume over $400,000 in legal bills. The attorney general purported to prohibit the D&O policy from being the source of payment.[191] Unfortunately, the settlement document is a bare-bones recital of aggregate amounts owed, and provides no specific guidance on how the trustees were surcharged.[192]

- The California attorney general's office settled with three former employees of the Stanford University Bookstore over a charged "a pattern of speculative, unwise and unsound investments of the bookstore's internal procedures" resulting in losses of "approximately $1.7 million plus interest." Specifically, "The settlement provides that the defendants' Directors and Officers Insurance carrier will pay approximately $1 million in policy limits to the Attorney General's office. General Lungren will file a motion to seek reimbursement from the settlement for the taxpayers in the amount of $83,000, and return the remaining money to the bookstore for its charitable purposes."[193]

Private litigants, of course, have always looked to the defendants' insurance as a source of funds for third-party harms. It remains to be seen whether any States will also assert breach of fiduciary duty against officials in the Catholic Church for their role in assigning priests who committed sexual abuse of children.[194]

If investigations and settlements proliferate, D&O insurance companies could be forced to engage in underwriting, and to base lower premiums on improvements in governance

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[191] David M. Halbfinger, *Lawsuits Over Ouster of Adelphi Chief Are Settled*, N.Y. TIMES, Nov. 18, 1998, at B1.

[192] Compare William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAWYER 1287, [text after n.122] (2001): "In cases where the transaction cannot be undone, the court must conduct a director-by-director inquiry into which specific directors actually engaged in a breach of fiduciary duty sufficient to justify monetary liability."

[193] National Association of Attorneys General, *California – Stanford University Bookstore Employees*, CONSUMER PROTECTION REPORT, February 1995, Consumer Protection Cases; Deceptive Trade Practices, *available in* LEXIS, States library, NAAG file.

[194] Reports the *Boston Globe*, insurance coverage for the Boston Archdiocese against these third-party claims is not a certainty:

> Advisers to the archdiocese say church officials are uncertain what percentage of the clergy sexual abuse claims will be covered by insurance. Previous estimates had placed at about $40 million the amount of money that the archdiocese would have to pay out of its own coffers, in addition to the available insurance coverage.
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> However, that toll could rise as the Aetna and Kemper insurance companies, whose policies cover the archdiocese for the period in which most of the claims were made, are said to be balking at honoring many of the claims, according to advisers yesterday.

Stephen Kurkjian and Michael Rezendes, *Bankruptcy Filing Called Option for Archdiocese*, BOSTON GLOBE, Aug. 2, 2002, at __.

practices. Such a market solution could lead to a strengthening of fiduciaries standards, akin to the consequences of repeal of charitable immunity laws.

CONCLUSION

Proper State enforcement action over fiduciary decision-making reduces to a single rule: The role of the attorney general and courts is to guard against charity fiduciaries' wrongdoing, and not to interfere in decision-making carried out in good faith. Indeed, a State attorney general has the obligation to provide oversight of the charitable sector. To this end, an attorney general is vested with the authority to seek to correct breaches of fiduciary duty that have not otherwise been remedied by the board. However, the attorney general is not a "super" member of the board.

Complicating the issue, the talisman of donor intent seems to permeate decisions over all of a charity's activities, regardless of the other sources of charity assets, and how small a percentage of those assets might consist of donations. (It is sometimes also asserted that the public is entitled to a say over the use of the assets because of the indirect public contribution through tax exemption.) The law needs to clarify the extent to which donor intent can bind the charity beyond the immediate terms of the gift, and who gets to decide. That is, is a determination to alter the purposes of a charitable corporation a matter for the board, to be reviewed only for abuse of discretion?

Is there any way to take politics out of the mix? To what extent is it desirable to do so? Proposals have emerged from time to time to create a variously-conceived "charities board," either at the state level[195] or at the federal level.[196] Recently Joel Fleishman revisited this debate by urging:

> For the long-run good of the sector, we cannot continue to rely on an inadequately staffed and insufficiently powerful IRS, the vagaries of inadequately staffed and usually not-very-interested offices of state attorneys general which, in any event, have difficulty in policing a sector which routinely crosses state and national boundaries many times a day, the limited scope and vision of voluntary watchdog agencies, the new information-providing

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[195] *See* Karst, *supra* note __, at 476-83; Avner Ben-Ner, *Book Review: WHO BENEFITS FROM THE NONPROFIT SECTOR? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L. J. 731 (1994).

[196] *See* Filer Commission (Commission on Private Philanthropy and Public Needs), *Commentary on Commission Recommendations*, *in* FILER COMM'N RES. PAPERS Vol. 1, at 38 (U.S. Treas. Dept. 1977); *see also* David Ginsburg, Lee R. Marks and Ronald P. Wertheim, *Federal Oversight of Private Philanthropy*, *in id.* at Vol. 5, at 2640-2644; Adam Yarmolinsky and Marion R. Fremont-Smith, *Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy*, *in id.*. at Vol. 5, page 2857; Regina E. Herzlinger, *Can Public Trust in Nonprofits and Governments Be Restored?*, 74 HARVARD BUS. REV. 97 (1996).

organizations, and the investigatory, inflammatory press.[197]

However, creating a new body has risks of its own: Each regulator's particular priorities can lead to overregulation in some cases and underregulation in others.

[197] Joel L. Fleishman, *Philanthropy and Outcomes: Dilemmas in the Quest for Accountability, in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172 (Charles T. Clotfelter and Thomas Ehrlich, eds.) (1999). The closest we come to a national charity regulator is the Internal Revenue Service, although I note that the IRS focuses its resources on issues relating to the rules of tax-exemption; is generally indifferent to geographic location; and operates more as a bureaucracy than do those attorneys general who are more influenced by immediate political considerations.

APPENDIX: CHARITY ENFORCEMENT CASE STUDIES

CONTENTS

Management of Investment Assets

1. Hershey Trust
2. Boston Red Sox
3. Foundation for New Era Philanthropy

Change of Purpose

4. Terra Foundation and Museum
5. Health Midwest
6. AHERF
7. Empire Blue Cross

Fund Raising

8. American Red Cross

1. *In re Milton Hershey School Trust*

Hershey, Pennsylvania is a company town with a vengeance.[1] Perfumed with the aroma of roasting chocolate and festooned with Kiss-shaped hoods on the street lamps, the vision of Milton S. Hershey lives on in Hershey Foods Corporation, the Hershey Trust Company, Hershey Entertainment and Resorts Company – and the Milton Hershey School, which owns most of the foregoing. The school's decision to sell its multi-billion investment in the New York Stock

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[1] Steven Pearlstein, *A Bitter Feud Erupts Over Hershey Plant; Plan to Sell Candy Empire Divides a Company Town*, WASH. POST, Sept. 2, 2002, at A1: "Milton S. Hershey and his famous candy company not only provided residents with steady jobs and free medical care but also a swimming pool, theater, dance hall, zoo, parks, hockey arena and a junior college. He personally financed the school buildings and paid off the mortgages of every church. And Hershey-owned entities provided residents with subsidized electricity, water, phone and trolley service, and operated the town's newspaper, drug store, hotel and department store."

Exhange-listed food company provided a summer's worth of delight to headline writers, from "Blood and Chocolate" to "Judge Issues Hershey Bar" to eventual "meltdown," "kiss off," and "sweet" victory when the board retreated. All this from the Utopian community that Milton Hershey dreamed of having "no poverty, no nuisances, and no evil."[2]

In 1909, Milton and his wife Catherine created a trust for the founding of the Hershey Industrial School "for the residence and accommodation of poor white male orphans;"[3] the deed of trust required that the orphans be indentured to the school.[4] Over time, Milton Hershey's vision yielded to changing social and economic conditions, as reflected in a series of *cy pres* decisions. No longer only a vocational school, the now-named Milton Hershey School is open any "poor" child, regardless of race and sex, so long as at least one parent is unable to provide adequate care, and does not require the surrender of parental rights.[5] The 1990's produced a radical restructuring from a farm-based residential education to a centralized academic campus.[6] The school still offers free tuition, room and board, clothing and medical care. However, some

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[2] Quoted in JOËL GLENN BRENNER, THE EMPERORS OF CHOCOLATE: INSIDE THE SECRET WORLD OF HERSHEY AND MARS 89 (1999).

[3] Preamble to Trust Indenture, Milton S. Hershey, et us. to Hershey Trust Company, Hershey Industrial School (November 15, 1909), *available on the website of the Milton Hershey School Alumni Association at* <www.mhsaa.org/Lib/legal/HISDeed.htm>.

[4] Trust Indenture, § 15: "No orphans shall be admitted until the surviving parent, guardian, or other competent authority shall have given by indenture, release, relinquishment, or other lawful acquittance, . . . adequate power to the Managers . . . to enforce, in relation to each orphan, every proper restraint, and to prevent relatives, friends, or others from interfering with, or withdrawing such orphans from the institution."'

[5] See Second Restated Deed of Trust of the Milton Hershey School, Nov. 15, 1976, *available at* <www.mhsaa.org/Lib/Legal/MHSDeed.htm>. Section 13 now provides, in part:

> Consistent with the purposes of this deed, only a child deemed poor and healthy by the Managers, and who, in the opinion of the Managers, is not receiving adequate care from one of his or her natural parents, is of good character and behavior, has potential for scholastic achievement, and is likely to benefit from the program then offered by the school, in addition to meeting the other qualifications set forth herein, shall be admitted to the School.

[6] In 2000, former Pennsylvania governor and U.S. attorney general Richard Thornburgh, retained by the boards of the trust and the school, exonerated the boards from complaints brought by the Milton Hershey School Alumni Association that the boards failed to carry out the intent of Milton Hershey and otherwise breached their fiduciary duties. The 98-page report ("Independent Evaluation of Fiduciary Compliance: Findings and Conclusions of Special Counsel") and a separate 15-page summary, along with the Alumni Association's 19-page response (titled "Bias, Flaw, and Avoidance"), are available on the Alumni Association's website at <www.mhsaa.org/Lib/Legal.htm>.

dismayed alumni feel that even poverty is no longer required of applicants.[7]

Catherine Hershey died in 1915, and Milton Hershey died in 1945; they had no children. Shortly after his wife's death, Milton had transferred thousands of acres of land and all of his stock in the then-Hershey Chocolate Company (then valued at $60 million) in thrust for the school.[8] The trustees are limited to spending only the income, but are not directed to hold specific investments.[9] Stock in Hershey enterprises today makes up almost 60 percent of the Trust's assets.[10]

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[7] *See, e.g.*, David Olive, *the Failed Sale of Hershey Foods Suits its Spiritual Shareholders – The Townsfolk*, TORONTO STAR, Sept. 21, 2002, at C1 (quoting one complainant: "They've turned it into a damn prep school. Every time the trust does something controversial, like trying to sell the company, they say it's for the orphans. But it's not an orphanage any more. It's a very rich Ivy League school where the kids don't get dirt under their fingernails."). The Thornburgh report explains: "the Deed of Trust does not define 'poor,' so the Managers have approved a policy of limiting admission to students from families with incomes below 150 percent of the federal poverty index." *Supra* note __, at 84. On July 31, 2002 the Hershey School and Trust entered into a closing agreement with the attorney general, calling for, among other things, the school to adhere to this 150 percent cap. See <http://www.mhs-pa.org>, and click on "News."

[8] BRENNER, *supra* note __, at 134-35. Brenner continues:

> [I]t was five years before the press got wind of the donation. On November 9, 1923, *The New York Times* ran a front-page story detailing Hershey's philanthropy, creating a sensation throughout the business community. . . . At sixty-one, Milton Hershey was still very much alive, and yet he had given away virtually everything he owned.

Id. at 135.

[9] The deed of trust gives the trustee and the school's managers "full power and authority to invest all or any part" of the principal and unexpended income of the trust estate "in any securities which the Trustee and the Managers together may consider safe, . . . and neither the Trustee nor the Managers shall be held accountable for the exercise of its and their discretion, exercised in good faith . . . ." Trust Indenture, § 5. The 1976 amended and restated section continues:

> The Managers shall from time to time establish a general investment policy, and approval of investments shall be made pursuant to such policy and in conformity with this and other investment provisions of this deed, either by the Managers or by an investment committee appointed by the Managers and consisting solely of members of the Board of Managers in such number as the Managers may from time to time deem proper, having due regard for the investment expertise of potential members of the committee. The investment committee shall have such power as the Managers shall determine, to approve investments pursuant to the general investment policy of the Managers, but shall have no authority to deviate from that policy under any circumstances. The committee shall periodically report its actions to the Managers and the Managers shall keep themselves informed of the actions of the committee. The Managers shall have a veto power over any proposed action of the committee and may at any time, with or without notice, abolish, or alter the size or membership of, the committee and/or withdraw from the committee any part or all of the authority vested therein.

[10] As described in Part II.B.3, Congress had the Hershey Trust in mind when it wrote the rules in Internal Revenue Code section 509(a)(3) on "supporting organizations," and thus the Trust is not subject to the prohibition in section 4943 on "excess business holdings."

From the beginning, accumulation of income beyond the needs of the School concerned the boards. Meanwhile, "[i]n the years after Hershey's death, . . . the company and town slowly started to move apart."[11] "It was subtle at first, like when the company stopped providing the town's garbage pickup, snow removal and electricity."[12] In 1963, the Trust – with the attorney general consenting – obtained court approval to transfer $50 million from accumulated income to Penn State University to build a medical school in Hershey. Funding the medical center "completely changed the nature of the town. Suddenly, there were thousands of new residents who had nothing to do with the chocolate company and had little in common with the town's established citizenry."[13] "Many believed that if Milton Hershey were still in charge, that money would have been used to improve the two-year Hershey Junior College, which provided a free education to town residents and company employees"; instead, the junior college closed down.[14] The 1970 razing of the Cocoa Inn – the historic landmark that once served as the town's "drugstore, department store, bank, post office, restaurant and hotel" – confirmed "feelings that the Hershey enterprises no longer cared for the town as Milton Hershey had."[15] In subsequent years, the free park closed (to be replaced by a commercial theme park); factory tours were replaced with a simulation ride; and, in the community center, only the theater remained open to the public.[16]

Despite the Hershey Trust's wealth, in 1999 the Orphans Court denied a detailed *cy pres* application to spend $25 million a year out of accumulated and current income on an institute to train teachers in educating at-risk children, to be known as the Catherine Hershey Institute for Learning Development (CHILD).[17] The attorney general, who had initially supported the position, took the position in court that there had been no failure of the trust. The court found that: "Except in the late 1970's, the income from the fund has always exceeded the expenses of operating the School and at the close of the 1998 fiscal year, the amount of available accumulated income was 608 million dollars."[18] However, the court ruled that "[a]ny discretion

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[11] BRENNER, *supra* note __, at 264.

[12] *Id.*

[13] *Id.* at 265.

[14] *Id* at 264-65.

[15] *Id.* at 265

[16] *Id.* at 266-67. "In one stroke the town lost its bowling alley, indoor swimming pool, gymnasium, pool hall and party room." *Id.* at 267.

[17] *See* Reply Brief of Milton Hershey School and Hershey Trust Company to Brief of the Office of Attorney General, Oct. 21, 1999; Milton Hershey School, et al., Dauph. C.C.P. No. 712, year of 1963, Slip Op. (Dec. 7, 1999) (Judge Warren G. Morgan), *available at* <www.mhsaa.org/Lib/Legal.htm>.

[18] Adjudication, *supra* note __, at 5.

of the Board of Managers is servient to the dominant intent of the Hersheys to care for as many children at the School as the income will permit."[19] The court distinguished the 1963 *cy pres* proceeding by noting the attorney general's support of that earlier petition, and the absence of public notice, hearing and opinion in that matter.[20] In conclusion, "our [*cy pres*] discretion is not unfettered and, if exercised, must be within the limits of approximating the dominant intent of the Hersheys. The proposed Institute does not even come close."[21] (It was to this same judge, Warren G. Morgan, before which the Trust and the attorney general were to return in the summer of 2002.) Today, "even after spending $93,000 a year to educate, house, clothe, feed and nurture each of its 1,200 students, the school still has a reserve fund of more than $850 million from all the money it could not spend over the years."[22]

Diversification was another concern of the Trust. In 1980, 80 percent of the Trust's portfolio was in Hershey Foods stock.[23] A restructuring of the company that year created "A" shares (with one vote) and "B" shares (with 10 votes). Following four company buybacks in the 1990's, the Trust has whittled its Hershey Foods holdings down to 52 percent of its assets, representing 31 percent of the total stock and 77 percent of the voting shares. However, should the Trust's ownership drop below 15 percent of the company, the "B" shares would convert to "A" shares and the Trust would lose control of the company. The most recently available IRS Form 990 filed by the Milton Hershey School and School Trust, for the year ending July 31, 2001, values its Hershey Foods ownership at $2.6 billion.[24]

The attorney general's office, too, had concerns about lack of diversification. In 1999, the Pennsylvania legislature had adopted a version of the Uniform Prudent Investor Act, 20 Pa.

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[19] *Id.* at 7.

[20] *Id.* at 9.

[21] *Id.* at 15.

[22] Perlstein, *supra* note __. "In addition to three classroom buildings and modern library, the school boasts several theaters, a lavish gymnasium, a visual arts building and 120 group homes where 10 to 12 children live with full-time house parents. For vocational training there is an up-to-date television studio, a computerized printing and design shop, a mock hospital ward, and working dairy and vegetable farms. The school also operates its own in-patient infirmary, an extensive network of psychological services and a dental clinic with eight stations. And every student gets a laptop computer."

[23] Information in this paragraph comes from an interview of Robert Vowler, president and chief executive officer of the Hershey Trust Company, and A. John Gabig, chairman of the Milton Hershey School Trust board of directors, by the editorial board of the Harrisburg *Patriot-News. Why The Decision Was Made*, July 27, 2002, *available at* <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_05.html>.

[24] Available at <www.guidestar.com>. The Form 990 also reports 100 percent ownership of Hershey Trust Company (valued at $46 million), and a 100 percent common stock ownership of Hershey Entertainment & Resorts Company (valued at $6.6 million), in addition to other securities and real estate investments. Total investments assets are valued at nearly $4.7 billion.

C.S. § 7201 *et seq.*, which provides in relevant part:

> § 7204 Diversification. Except as provided in section 7205 (relating to retention of inception assets), a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.
>
> § 7205 Retention of Inception Assets. A fiduciary, in the exercise of reasonable care, skill and caution, may retain any asset received in kind, even though the asset constitutes a disproportionally large share of the portfolio.

At a December 2001 meeting with the Hershey Trust, as part of discussions on a range of governance issues, an official in the attorney general's office suggested diversification. The trustees understood this to mean that in order to avoid exposure for breach of fiduciary duty, they should consider selling their controlling interest in Hershey Foods.

Several months later, in May 2002, the Hershey Trust rejected a proposal by Hershey Foods to buy back its remaining shares.[25] In July 2002, the Trust announced that it would explore selling its ownership in the company. "[T]he choice to us was either (go below) 15 percent and lose control, or to just sell it outright."[26] "Back in the early '70's, the price of Hershey Foods stock dropped considerably back when you had price wage controls from President Johnson. Hershey Foods, at that point, was more than 80 percent of the portfolio . . . . They cut their dividends and the trustees at the time had to sell real estate off to pay the bills of the Milton Hershey School. When you saw a precipitous drop in the population of the school from the early '70's in to the '80's, that was the reason."[27] Evidently, the Trust's board reached its decision to sell reluctantly: "Members of the board are graduates of this community. My heart is not in it, but my head is."[28]

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[25] According to the president of Hershey Trust, "The company's offer, which was to take us out of the entire holding completely, involved a long period of time – 3-5 years to take us out. And that involved to us, market risk, price risk.. . . In other words, the stock could have dropped down, and we would have been subject to the same market conditions we were trying to solve in the first place." *Why the Decision Was Made, supra* note __. Another reported reason was the fear that such a transaction would "require Hershey Foods to borrow money, putting the company at risk of a hostile takeover." Bill Sulon, *Kellogg to Hershey: Ownership is Grrrrreat!*, PATRIOT-NEWS, Sept. 15, 2002, *available at* <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_73.html>.

[26] *Why the Decision Was Made. supra* note __ (comment of Robert Vowler).

[27] *Id.*

[28] *Id.* (comment of the chairman of the board of the School Trust). He elaborated:

> When I came on board in 1996 and saw 52-55 percent of the assets in one security, the bells went

The possibly naive board (today, only 7 out of 17 live in Pennsylvania) was shocked by the explosive opposition.[29] "Derail the Sale" lawn signs and Internet petitions sprang up by workers fearful for their jobs. The Alumni Association re-mobilized. Members of the public were invited to affix their signatures to a petition to remove the trustees (go to www.removethetrustees.com). The board of supervisors of Derry Township voted to change the official name of the town to "Hershey." One resident complained: "I don't see why a town should be ruined so underprivileged kids can be privileged."[30] And the attorney general – the Republican candidate for governor – filed suit to halt any sale without court approval. When reminded that in the last year his office had pressed the Trust to diversify its holdings and remove conflicts of interest between the board of the school and other Hershey enterprises, he responded that he had not meant that they should sell the company.[31] Some trustees felt "betrayed at Fisher's emergence as the prime impediment to the sale, after his office privately encouraged it."[32]

The attorney general's petition asserted:

> 14. Any public sale of the controlling interest in Hershey Foods Corporation by the School Trust, *while likely to increase the value of the trust*, could also result in profound negative consequences for the Hershey community and surrounding areas, including, but not limited to, the closing and/or withdrawal of Hershey Foods Corporation from the local community together with a dramatic loss of the region's employment opportunities,

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> off. I said, what happens if that falls on my shift. I don't carry that kind of liability insurance.
>
> .... This was discussed over a period of time where we had to evaluate what the alternatives were – stock swap, sell on the open market..... [I]t was very, very hard for, particularly, the alumni to make that decision.....
>
> I don't think the kids that will come in here in the future, 25 years from now, should be subject to a decision that I made to keep a stock, when I don't know how that stock is going to do. And the only way I know how to handle that is to fully diversify.

[29] *See, e.g.*, Amy Barrett, *How Hershey Made a Big Chocolate Mess*, BUS. WEEK, Sept. 9, 2002.

[30] Quoted in Marc Levy, AP, at <www.philly.com/mld/philly/4 ...

[31] *See, e.g.*, Perlstein, Sept. 2, *supra* note __ ("In the past few years, in response to complaints by the alumni association, Fisher's office forced the changes in the makeup of the board. His office also pushed the trust to cut its traditional ties to other Hershey-related businesses and entities. As a result, only a handful of the 17 board members now live in town or have any connection to its major institutions."). See the closing agreement, cited in note __, above, and the attorney general's July 31, 2002, news release, "AG Fisher Reaches Agreement with Milton Hershey School to Restructure Its Operations and Admittance Policies," *available at* http://www.attorneygeneral.gov/press/release.cfm?p=3EAC5F90-ABAE-4ECC-BCE36F7225659B3F

[32] Brett Marcy and Jan Murphy, *Pennsylvania Official Urged Hershey Sale*, PATRIOT-NEWS, Aug. 23, 2002. The news story quotes Fisher: "They should have called me to check my position. They never hesitated to call before and come and meet with me . . . I'm at a loss as to how they got to where they are."

related businesses, and tax base.[33]

Invoking case law granting the attorney general authority "to inquire into the status, activities and functioning of public charities" and the view that "the ultimate beneficiary and real party in interest of all charitable trusts is the general public to whom the social and economic advantages of the trusts accrue," the petition declared:

> 18. Accordingly, the broad interests of the Attorney General necessarily entail protecting the public against any social and economic *disadvantages* which may be occasioned by the activities and functioning of public charities . . . .[34]

In the attorney general's view, this transaction "does not equate with the typical investment decisions that trustees make on a daily basis."[35] However, because "[e]xisting trust law requires a fiduciary to make decisions that are in the best interests of the charity trust,"[36] the "Attorney General is currently engaged in an expedited legislative effort to require that fiduciaries administering charitable trusts consider the impact of their investment decisions on the community."[37] The petition invokes the court's equity power "to protect and promote to the fullest extent possible as many of the competing interests as can be equitably achieved."[38]

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[33] Pennsylvania Attorney General, Petition for Citation for Rule to Show Cause Why a Proposed Sale of Trust Assets Constituting the Controlling Interest in Hershey Foods Corporation Should Not Be Conditioned Upon Court Approval, In re: Milton Hershey School Trust (Orphans' Court Div., Ct. Common Pleas, Dauphin County, Aug. 12, 2002), *available at.* <http://www.findlaw.com> (emphasis added).

[34] *Id.*, at ¶¶ 16-18 (emphasis in original).

[35] *Id.* at ¶19.

[36] *Id.* at ¶20.

[37] *Id.* at ¶21.

[38] *Id.* at ¶25 & 26. In later oral argument on appeal, a news story reported the following exchange between President Judge James Garner Colins and Deputy Attorney General Jerry Pappert:

> "What makes the attorney general's office better financial managers than the board of the Hershey Trust, and literally the worldwide experts they have hired as well?" Colins asked.
>
> Pappert replied: "Because we're managing different clients. We're managing the interests of the public, and we have an opportunity and a duty under the law to make sure that the ultimate beneficiary of the trust, the public, is not harmed."

Bill Sulon, *Attorneys Debate Role of Hershey Trust Co.*, THE PATRIOT-NEWS, Sept. 12, 2002, available at <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_68.html>. Pappert "added that the attorney general's office would 'absolutely' try to intervene even if an acquiring company chose to move Hershey operations elsewhere in the state." *Id.*

The Orphan's Court granted the attorney general's motion for a preliminary injunction on September 4, 2002.[39] Using such language as "pray tell" and "This needs looking into!", Judge Morgan explained that he told the parties –

> that we do not view our role in this matter . . . as "a passive instrument of the parties"; that the public interest in the controversy and this Court's inherent plenary powers of supervision over trusts may lead us to add to our consideration of the issues such facts not offered by the parties as might aid our determination; and we particularly referenced . . . judicial notice of adjudicative facts disclosed in . . . prior proceedings involving the Milton Hershey School Trust wherein the respondents here were the moving parties.[40]

Judge Morgan concluded the factual recitation by commenting that a competitive merger or acquisition process usually results in a bid price with a premium. "This leads the acquiring company to introduce management efficiencies . . . [that likely] will result in reduced work forces with a potential for plant location changes."[41]

The Orphans' Court began its discussion by ruling that "[p]roperty given to a charity is in a measure public property," the court held that "the Attorney General has the authority to inquire whether an exercise of a trustee's power, even if authorized under the trust instrument, in inimical to the public interest."[42] The court invoked its "broad visitorial and supervisory powers over charitable trusts": "The Court 'within its appointed orbit is exclusive, and therefore necessarily as extensive as the demands of justice.'"[43]

While the immediate issue was the preliminary injunction, the court also addressed the merits, declaring: "The business was not, during Mr. Hershey's life, is not now, nor foreseeably in financial difficulty, and the School, according to statements by officers of the Directors/Managers has ample funds in its accumulated income to carry out its purposes."[44] The court found lacking an "explanation why, if any need for funds exists for which a sale is necessary, it could not be met while still keeping control", raising the question "whether an

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[39] The opinion is reproduced at the end of the majority opinion in the appeal, In re: Milton Hershey School Trust, 2002 Pa. Commw. LEXIS 761 (Sept. 18, 2002).

[40] *Id* at 9-10.

[41] *Id.* at 14. Later in his opinion, Judge Morgan states: "We would add that this Court is not required to be blind and deaf to that which has been commonplace information to the public during the recent past period of numerous mergers and acquisitions of public companies." *Id.* at 19.

[42] *Id.* at 16.

[43] *Id.* at 16.

[44] *Id.* at 21.

immediate premium share price obtained in losing control is a reasonable trade-off for permanently retaining it."[45] The court concluded that a further investigation was warranted into whether a sale comports with Milton Hershey's intent, and whether "the act of . . . the Directors/Managers[] is so unreasonable as it relates to their duty to the School Trust that it amounts to a capriciousness that is an abuse of their discretion."[46] Dismissing the argument that a trustee is always to administer the trust solely for the benefit of its beneficiaries, the court wrote:

> The duties of a trustee and the Attorney General are concomitant in so far as assuring that the benefits of a charitable trust are delivered in accordance with the Settlor's intent; but because the socio-economic benefits of a charitable trust extend beyond the designated beneficiaries to the public itself; although ordinarily compatible with each other, the Attorney General has an added responsibility of assuring that compatibility.[47]

The Hershey Trust appealed to the Commonwealth Court, which on September 18, 2002, affirmed the grant of a preliminary injunction. The appellate court did not reach the merits of the Trust's arguments, but rather concluded: "A review of the record and Judge Morgan's opinion does not immediately convince us no apparently reasonable grounds exist to support the order as one that restores the status quo . . . before the issues raised by the parties are resolved [in court] . . ."[48] The court "direct[ed] that the Orphan's Court rule on the merits of the controversy expeditiously."[49] The vote was five to one (with one judge recusing himself).

Judge Pellgrini wrote a strong dissent. He "disagree[d] that the Attorney General has authority to become fully involved under a parens patriae theory to protect the 'public' regarding

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[45] *Id.* at 22. The court noted the 1999 *cy pres* proceeding "based on an allegation that there was a pro tanto failure of the School Trust because it had more accumulated income ($750,000,000) than it was ever going to need," and its denial of the petition "on the ground that the proposed Institute was not within the Settlors' intent." *Id.* at 25 n.4.

[46] *Id.* at 22-23. The court had earlier stated: "The symbiotic relationship among the School, the community, and the Company is common knowledge." *Id.* at 21. However, a subsequent filing by the Trust asserted that control of Hershey Foods could not have been an overriding interest to Milton Hershey because only the stock market crash of 1929 prevented him from merging Hershey Chocolate with the Kraft-Phenix Cheese Corporation and Colgate-Palmolive-Peet Corporation. Jack Sherzer, *Hershey Planned Merger in 1929*, PATRIO-NEWS, Sept. 10, 2002, *available at* <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_65.html>. As the news story quotes the trustees' filing: "[The deal] would have required the exchange of the shares of the Hershey Chocolate Company in the school trust for shares in the new company and would not have resulted in the school trust having voting control in the new company, clearly evidences that [Milton Hershey] did not intend to limit his fiduciaries in the exercise of their discretion in making trust investment decisions."

[47] Orphan's Court opinion, *supra* at 29.

[48] Commonwealth Court, *supra* note __, at 7.

[49] *Id.* at 8.

the proposed sale" prior to a decision by the trustees to sell. "If that were the case, then the Attorney General could become fully involved in the decision-making process of every charitable trust or, for that matter, every charity in Pennsylvania."[50] The preliminary injunction was not in accordance with law, he wrote, because nowhere in the Probate, Estate and Fiduciaries Code "is there any authority for the Attorney General to essentially act as co-trustee or comanager of the Trust and be part of the process leading up to a decision by the Trustees to take a certain action." Moreover, "for the Attorney General to properly exercise parens patriae powers, his concern must be on behalf of the public and tied to the express desires of the Trust settlor."[51] In sum, "[a]bsent a showing that the Trustee's actions are against the terms of the Trust or that the Trust provisions themselves are against public interest, the parens patriaes of the Attorney General do not apply."[52]

By coincidence, literally on the eve of this decision, two decisive events occurred. First, Hershey Foods received two offers for its stock, once of which, from gum manufacturer Wm. R. Wrigley, Jr. Co., totaled $12.5 billion in stock and cash, as well as a promise to maintain jobs in and support the Hershey community.[53] Second, the board of the Hershey Trust held a 10-hour meeting, at the end of which it voted 10-7 to abandon its exploration for a sale. The Trust asserted that the Wrigley offer failed to provide sufficient diversification, since the Trust would still have 36 percent of its assets in the new combined company.[54] One skeptic sensed rationalization: "If God had walked in and offered $110 a share, they still wouldn't have taken it."[55]

"Our cash cow is safe; we're feeling really great," was the reaction of one local leader, adding: "But there's still a lot of interest in getting rid of the Hershey trustees for ever trying this in the first place."[56] The attorney general was quoted as saying: "We did what we could to try to

[50] *Id.* at 32-33 (Pellegrini, J., dissenting).

[51] *Id.* at 38.

[52] *Id.* at 39.

[53] "In a moving presentation to the Hershey trust . . ., [William] Wrigley promised to uphold the company's commitment to the community. 'If you think it's hard for you to do what you're doing tonight, consider how hard it's been for me and my family to put someone else's name on the door of our company,' he said, a reference to the proposed new company's name, Wrigley-Hershey. . . ." Robert Frank & Sarah Ellison, *Controlling Trust Calls Off Sale of Hershey to Wrigley*, WALL ST. J., Sept. 19, 2002.

[54] *See, e.g.*, Sherri Day & Andrew Ross Sorkin, *Candy Giants Both Show New Faces in Failed Deal*, N.Y. TIMES, Sept. 19, 2002, at C1.

[55] *Id.*

[56] Francis X Clines, *Whiff of Chocolate, and the Sweet Smell of Success*, N.Y. TIMES, Sept. 18, 2002, at C6.

make sure people knew how hard it was going to be to buy Hershey Foods."[57] By contrast, Hershey Foods executives were furious. The company is viewed as weakened by the perception that it can never be sold,[58] and fears lawsuits over whether the Wrigley offer, which reflected a 42 percent premium on share price, should have been presented to shareholders.[59]

Hoping to put an end to the dispute, the Hershey Trust sent a letter to the attorney general declaring that the board "will not agree to any sale of the School Trust's controlling interest in Hershey Foods without the approval of the Dauphin County Orphans' court, following advance notice to the Office of the Attorney General."[60] The letter further says to Mr. Fisher: "We look forward to your ideas and support for our diversification efforts." A *Wall Street Journal* story commented, though, that "the trust's options for diversifying are limited as the company's management, which is now at loggerheads with the trust, is unlikely to be willing to offer a significant premium to buy back the trust's shares."[61]

The attorney general, however, still sought confirmation that the Hershey Trust, should it change its mind, must inform the office about a future sale, and whether the court must give its approval. On October 16, 2002, Judge Morgan issued a decree dismissing the case as moot.[62] However, the court noted, a future board could "ignore the resolutions and not disclose to the Attorney General, thereby evading judicial review of their action. Such deception would be an act of bad faith that would lead to removal of the Board members but in order to further resolve the Attorney General's concern we shall include in our Decree the provision for notice he requests."[63] The judge added the following "observations":

> The memorials of a good and generous man have not been well served by events surrounding this litigation. In this midstate area, Hershey is everybody's town; there is a shared pride in identifying with that community, its industry and the School, all founded

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[57] Quoted in Craig R. McCoy & Wendy Tanaka, *Hershey Trust Considered Two Bids Before Finally Deciding Not to Sell*, PHIL. INQUIRER, Sept. 19, 2002, business section.

[58] Robert Frank & Sarah Ellison, *Controlling Trust Calls Off Sale of Hershey to Wrigley*, WALL ST. J., Sept. 19, 2002.

[59] Pearlstein, *supra* note __.

[60] Hershey Trust chairman John Gabig, quoted in Sarah Ellison, *Hershey Foods' Controlling Trust Says It Has "No Intentions to Sell"*, WALL ST. J., Sept. 27, 2002, at B5.

[61] *Id.*

[62] Decree and Adjudication, In re Milton Hershey School Trust, Oct. 16, 2002, *available at* <http://www.friendsofhershey.org/documents/Judge%Morgan%27%20Decree%20%and%20Adjudication%2010-16-02.pdf>, at

[63] Adjudication, at 3.

> by Milton S. Hershey. . . . It appears to many that the Directors/Managers, whatever their skills and however well-intentioned their efforts, have become detached from [Milton Hershey's] philanthropic scheme, not the least significant reasons for this being that the membership of each Board is unusually large and the residences and daily lives of too many members are distant and disconnected from the charitable interests they serve. . . .[64]

Meanwhile, on October 9, 2002, the Pennsylvania senate passed – by a 48-1 vote – the bill sought by the attorney general.[65] Declared the senate majority leader, whose district includes 1,700 Hershey Foods employees: "We've all learned an important lesson here . . . We have to be active and protect our economic assets." On October 28, the house overwhelmingly approved the bill, and sent it to the governor, who signed it on November 6.[66]

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[64] *Id.* at 4.

[65] *See* Charles Thompson, *Future Hershey Sale Obstacles OK'd*, PATRIOT-NEWS, Oct. 10, 2002, *available at* <http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hershey_102.html>.

[66] H.B. 2060, *available in* LEXIS, States Library, PATEXT file, as 2001 PA H.B. 2060, amending section 7203 (Prudent Investor Rule) of Title 20 of the Pennsylvania Consolidated Statutes. The amendments read, in part:

> (c) Considerations in Making Investment and Management Decisions. – In making investment and management decisions, a fiduciary shall consider, among other things, to the extent relevant to the decision or action: * * *
>
> (6) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries, including, in the case of a charitable trust, the special relationship of the asset and its economic impact as a principal business enterprise on the community in which the beneficiary of the trust is located and the special value of the integration of the beneficiary's activities with the community where that asset is located; * * *
>
> (d) Requirements for Charitable Trusts Holding a Controlling Interest in Certain Publicly Traded Business Corporations. –
>
> (1) Notwithstanding any other legal requirement or process which may include court review of the activities of a charitable trust, a fiduciary for a charitable trust with beneficiaries at a principal location within this commonwealth holding a controlling interest in a publicly traded business corporation received as an asset from the settlor shall not consummate any investment or management decision executing a change in the trust's control of that corporation, by sale, merger, consolidation or otherwise, without:
>
> (i) Serving notice upon the attorney general at least 60 days prior to executing the change in control; and
>
> (ii) Directing that at least 30 days' prior notice of the execution of the change in control be provided by the corporation to employees of the publicly traded business corporation held by the trust who are located in this commonwealth.
>
> (2) In addition to any other power or duty provided by law, the attorney general also has the power to obtain judicial review pursuant to this subsection if the attorney general concludes that the fiduciary should be prevented from executing such a change in control.
>
> (3) In obtaining judicial approval under this subsection, the fiduciary must prove by clear and convincing evidence that executing the change in the trust's control of the corporation is necessary to maintain the economic viability of the corporation and prevent a significant diminution of trust assets or to avoid an impairment of the charitable purpose of the trust.

The previous day, Mike Fisher was resoundingly defeated in his bid for governor.[67] Nine days later, on November 14, 2002, ten of the Trustees (including all seven who voted in favor of the Wrigley bid) resigned, and four new members (including a former Pennsylvania attorney general) were appointing, leaving the board with a majority of local members.[68] Mike Fisher, who did not have to resign his position to run for governor, has two more years to serve as attorney general.

And what of the attorney general's goal to protect the town's jobs? Protectionism has its dangers. (Not that the Democratic candidate for mayor took the high road; he is running an ad declaring: "Can you believe Mike Fisher's bragging about saving Hershey? The truth? It was Fisher's office who told the Hershey board they should sell in the first place."[69]) One business columnist observed that Wrigley, which is not "a big player in the chocolate business," would have needed to keep the existing factories going. "And if at the same time the Hershey Trust had been able to free billions of dollars of capital, think what it could have done with the money."[70] Of course, this assumes that the Hershey Trust could get attorney general and court approval to spend the extra money.

2. Sale of the Boston Red Sox Sale.

The attorney general of Massachusetts actively participated in the 2002 sale of the Boston Red Sox, and claimed credit for obtaining an additional $30 million for charity after charging that the Bosox chose a low price from a particular bidder because of the influence of Major

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> (5) A fiduciary of a charitable trust with beneficiaries at a principal location within this commonwealth holding a controlling interest in a publicly traded business corporation received as an asset from the settlor shall not be subject to liability for the commercially reasonable sale of certain shares of the corporation not necessary to maintain control and for which no control premium is realized if the fiduciary reasonably determined that such sale was authorized in a manner consistent with the requirements of this section and other applicable provisions of this title.

67 With 99 percent of the vote counted on November 6, 2002, the *New York Times* reported 53 percent for Ed Rendell and 44 percent for Mike Fisher. Go to <http://www.nytimes.com/ref/elections2002/2002PA.html>

68 See Attorney General Mike Fisher Press Release, "AG Fisher Announces Reconstituted Hershey Trust Board; Says New Board Will Further Milton Hershey's Vision," Nov. 14, 2002, at <http://www.attorneygeneral.gov/releases/text/14Nov2002-ag_fisher_announces_reconstituted_hershey_trust_board;_says_.html>.

69 *See* AP, *A Look at Rendell's Hershey Foods Ad*, PATRIOT-NEWS, Oct. 10, 2002.

70 Avrum D. Lank, *Hershey Should Have Mimicked Milwaukee*, MILW. J. SENTINEL, Sept. 22, 2002, at 1D (describing the takeover of the Allen-Bradley Company, with the result that the "Bradley Foundation saw its endowment, and national influence, soar").

League Baseball.[71] The estate of Jean Yawkey, whose remainderman was the Yawkey Foundation,[72] owned a 53 percent general partner interest in Red Sox. John Harrington was both the Red Sox chief executive and the executive director of the Yawkey Foundation. The consent of a majority of the limited partners, who owned the other 47 percent, was required to sell the club.[73] While conceding that "[t]he trust set up by the Yawkeys to operate the ballclub and Fenway Park is private and its actions were not subject to our regulatory approval," the attorney general asserted "it is prudent to get the facts so we can determine whether the Yawkey Trust has appropriately discharged its fiduciary responsibility to the charities that stand to benefit from the sale of the team."[74]

As a result of the attorney general's pressure, the limited partners agreed to give $10 million from their share of sale proceeds to the Yawkey Foundation, and the buyers agreed to create a new $20 million charitable foundation. The $420 million proceeds from the Trust's share of the Red Sox sale made the Foundation the fourth-largest private foundation in Massachusetts.[75] Not all press coverage was favorable. Asked one editorial: "Why did Mr. Reilly declare a hands-off policy when the Boston-based O'Donnell group had the inside track but jump in with both feet when an out-of-town consortium got the upper hand?"[76]

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[71] Office of the Massachusetts Attorney General, Press Release, "AG Reilly Announces Agreement to Bring $30 Million More to Charities from Sale of Red Sox," Jan. 16, 2002, *available at* <http://www.ago.state.ma.us/txt/bosoxdeal.htm>:

> "This is a good day for the charities of this state," AG Reilly said. "My goal from the beginning has been to get more money for the charities that stood to benefit from this sale. Today, I am proud to say that we got that done. The limited partners and John Henry have stepped up to make charities in this state $30 million richer than they would have been under the original deal."

[72] The legal name is the Yawkey Foundation II, to distinguish it from the Yawkey Foundation, established earlier under the will of Jean Yawkey's pre-deceased husband, Thomas R. Yawkey.

[73] Daniel Goldberg, attorney for the Yawkey Trust, described for Reilly the risks of reopening the auction, with the possibility of delays, fewer bids, and a lower price for charity. "He also implied [that delay would mean] . . . Harrington and general manager Dan Duquette would be running the Red Sox for another year or two, and outraged fans would blame Reilly." Kevin Cullen & Meg Vaillancourt, *Reilly, Sox Played Hardball Before Accord Divisions Were Deep Behind the Scenes*, BOS. GLOBE, Jan. 21, 2002, at A1.

[74] Massachusetts Office of Attorney General Press Release, *AG Reilly Seeks Facts on Proposed Sale of Red Sox*, December 21, 2001, *available at* <http://www.ago.state.ma.us/txt/bosox2.htm>.

[75] Peter J. Howe, *Harrington Blasts AG's Comments Calls Criticism of Mass. General Gift an "Insult"*, BOS. GLOBE, May 10, 2002, at D1.

[76] Editorial, *Reilly's Innings; Intervention in Red Sox Sale Remains Murky*, [WORCESTER] TELEGRAM & GAZETTE, Jan. 18, 2002, at A10. The editorial continued:

> Even after the $30 million shakedown, the sale price is still short, by tens of millions of dollars, of the flawed bids Mr. Reilly had been promoting. What happened to his demand that only the maximum

More of a potential deal breaker, though, was the attorney general's insistence that the Yawkey Foundation expand its board and make new policies and procedures subject to his office's review.[77] The attorney general initially wanted the ouster of John Harrington, but settled for diluting the influence of Red Sox insiders over future Foundation activity. Under the agreement, though, the attorney general cannot reject new board members, "even if he feels they are not qualified, and his advisory role will be limited to the selection of the five trustees to be named in the next six months. . . ."[78] Nevertheless, noting that other prominent Massachusetts foundations operate with just a few trustees, observers wondered "whether Reilly is setting a special standard for a high-profile trust, or raising the bar for all private foundations."[79] The *Globe* noted that "the attorney general's office has called for special governance agreements with foundations only where there has been evidence of mismanagement of the organizations or their money," and there "are no such allegations in the case of the Yawkey Foundation."[80]

Shortly before the scheduled arrival of the new board members, the Foundation made a $25 million grant to Massachusetts General Hospital (where Mrs. Yawkey received her medical care), a move that infuriated the attorney general. In an interview, Reilly charged that the gift was "an absolute violation of the spirit" of the agreement, elaborating: "It was handled in a secretive, clandestine manner, not in the way a foundation of this sort should be handling things.

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return for Yawkey Foundation charities would be acceptable?

> Adding to the mystery is the punishment meted out to the Red Sox chief executive. We carry no brief for John Harrington, but absent any evidence of illegality or some serious transgression, Mr. Reilly's insistence on his public humiliation smacks of malice.
>
> In sum, the precedent set by this tangled affair is anything but healthy for law enforcement.

See also a column by Joan Vennochi, *Politics and Egos Taint Red Sox Deal*, BOS. GLOBE, Jan. 17, 2002, at A13:

> Reilly, meanwhile, needed an exit strategy to justify his headline-grabbing interference in the sale of a private ballclub. He didn't have the jurisdiction to stop the deal, so he roughed up Harrington on the issue of the charitable foundation. It is interesting that in 1999, when Reilly last reviewed the handling of Jean R. Yawkey's estate and charitable foundations in the aftermath of a Herald report, he concluded that Harrington and the trustees "operated within the parameters."
>
> "As much as we like to think of [the Red Sox] as a public institution, they are a private business. It's a private trust, just like any you or I could set up," he said then in published remarks.
>
> At the end of the day, the trust may indeed be richer, but at what price? Was charity or vanity the burning cause?

[77] Cullen & Vaillancourt, *supra* note __; Office of Attorney General Press Release, *supra* note __ ("The governance agreement, an extraordinary agreement for a foundation of this size, is designed to ensure that the foundation operates appropriately in light of its enlarged funds").

[78] Greg Gatlin, *AG "Blinked" on Sox Deal*, BOS. HERALD, Jan. 18, 2002, at 25.

[79] Beth Healy, *Foundation Faces Greater Oversight AG Sets Bar Higher for Yawkey Trust than for Other Charities*, BOS. GLOBE, Jan. 18, at C1.

[80] *Id.*

It is undisciplined. They are spending money like drunken sailors. It is unworthy of a foundation to act in this way."[81] In response, the Foundation's executive director wrote to Reilly:

> "I trust you will never lose sight of the fact that the Yawkey Foundation is a private foundation – it has been funded entirely by Mrs. Yawkey's money. It does not raise funds from the public.
>
> "If Mrs. Yawkey were still alive, she would be directing her charitable gifts," Harrington said, adding that "the only difference is that the gifts you appear to object to were directed by the Trustees of her charitable Foundation, three of the four of whom she personally selected to carry out that task."[82]

With the appointment of six new trustees, including one recommended by the attorney general, the dispute has come to an end. "'All is well that ends well,' Reilly said, adding that he believes his 'goals have been accomplished.'"[83]

Meanwhile, declaring "that the extent of child sexual abuse by priests is 'shocking and appalling,' Attorney General Thomas F. Reilly has asked the Archdiocese of Boston for sweeping influence in the way the church recruits, trains, and monitors priests."[84] A Boston Globe column began: "Down, Boy. First, he wanted to run the Boston Red Sox. Now, he wants to run the Archdiocese of Boston."[85]

3. <u>Foundation for New Era Philanthropy</u>.

From a legal scholar's perspective, the unhappy saga of the Foundation for New Era

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[81] Joan Vennochi, *Reilly Cries Foul over Yawkey Gifts*, BOS. GLOBE, May 9, 2002, at A19.

[82] Howe, May 10, *supra* note __.

[83] Scott Van Voorhis, *Yawkey Charity Has New Trustees*, BOS. HERALD, May 31, 2002, at 29.

[84] Kevin Cullen, *Ag's Office Asks to Monitor Priests Issues Raised of Church-state Relationships*, BOS. GLOBE, May 8, 2002, at A1. "In an interview yesterday with The Boston Globe's editorial board, Reilly said his office's ambitious plan to have a say in the way the archdiocese hires its employees, and the way those employees interact with children, is needed, given the size, scope, and history of the problem within the metropolitan area's Catholic Church." *Id.* The story continued: "There is apparently no precedent for an attorney general having such involvement with a religious institution. But Reilly rejected suggestions that his office's role would amount to a violation of the constitutionally guaranteed separation of church and state. 'We have the authority,' he said. But when pressed to explain the legal authority he was citing, Reilly declined to elaborate." And: "Asked if the role he was seeking was beyond the jurisdiction of the attorney general, Reilly replied, 'We're very respectful of the fact that this is a religious institution that we're dealing with. We're also mindful of our responsibilities to protect children, to ensure that there are programs and a comprehensive set of programs in place that make children safe.'"

[85] Joan Vennochi, *An Overeager Clergy Watchdog*, BOS. GLOBE, May 12, 2002, at A12.

Philanthropy presents that rare case: a likely extraordinary breach of the duty of care – multiplied by the dozens – untainted by any hint of a breach of loyalty or complex business judgment.[86] The silence from the State regulators was deafening – apparently not a single one had the stomach to find charity trustees liable for the consequences of their gross negligence or nonfeasance.

The Wall Street Journal broke the story, with a May 15, 1995 cover story subtitled: "Some Say Matching Grants by New Era Foundation Resemble Ponzi Scheme."[87] Created by John Bennett in 1989, the Foundation for New Era Philanthropy had been inviting selected charities to contribute funds – but only for a short period. At the end of six months, New Era would return the "contributed" amount, plus a matching amount of money from anonymous donors.[88] The six-month deposit, New Era said, would generate income to defray operating expenses.

The *Journal* also reported that "suspicion is growing that the anonymous group of philanthropists who supposedly provide the matching funds doesn't really exist." Meanwhile, hundreds of millions of dollars had poured in from about 180 charities – as well as from about 150 individual donors, including such wealthy businessmen as John C. Whitehead (former co-chairman of Goldman Sachs), Laurance Rockefeller (brother of David), and John M. Templeton, Jr. (son of the mutual-funds manager), whose contributions to other charities were also to be doubled. Participating charities praised the program, and passed the word, because New Era had always come through as promised. New Era's 1989 contributions of $306,000 exploded to about $100 million in 1994.[89]

According to this first story, many of the participating charities claimed to have first conducted "'due diligence' checks on New Era through references and financial records, including tax returns...." The *Journal*, however, wondered why New Era's 1993 tax return declared income of only $33,788 on $41.3 million in contributions, which were supposed to be invested in Treasury bills and certificates of deposit. Furthermore, New Era showed only $31,821 in liabilities, describing funds received from other charities for doubling as contributions

[86] This discussion is drawn from Brody, *The Limits of Charity Fiduciary Law*.

[87] Steve Stecklow, *A Big Charity Faces Tough New Questions About Its Financing*, WALL ST. J., May 15, 1996, at A1.

[88] The article opened with a story about the University of Pennsylvania. After a trustee endorsed the program and Penn learned that two Philadelphia museums received double their money, Penn deposited $600,000, and, as promised, received back $1.2 million six months later. *Id.*

[89] The *Journal* compared that figure to the Rockefeller Foundation's 1994 grants of $95 million.

to itself.[90] Evidently, "[s]ome nonprofit groups seem concerned that if they raise too many questions about New Era they might lose the opportunity to participate." Albert Meyer, an accounting professor at Spring Arbor College, fought against his school's participating in this "Ponzi scheme," and wrote to the Internal Revenue Service, the Securities and Exchange Commission, and the Pennsylvania attorney general.[91] His unappreciative president stated, "I have indicated to [New Era's] Mr. Bennett that Albert's actions should in no way be interpreted as coming from Spring Arbor College." However, it was Meyer's tip that cut short the scheme.

The next day, the *Journal*'s page-one cascading headlines told it all: "Owing $500 Million, New Era Charity Seeks Refuge from Creditors: Mystery Donors Don't Exist, Founder Tells His Staff; Colleges Face Big Losses – A Hard Blow to Good Works."[92] Details emerged: The Coalition of Christian Colleges and Universities hoped to double $350,000; the Academy of Natural Sciences, in Philadelphia, had deposited $2.7 million – over one-tenth of its endowment. New Era's attorney asked the bankruptcy court to keep the list of creditors under seal; the court later declined to spare participants this publicity.[93]

The New Era matching-donation program began in the trusting world of churches and evangelical organizations, where founder John Bennett was prominent. John Templeton, a devout Christian, was so favorably impressed with Bennett that he invited him to serve as a director or trustee of 24 of the Templeton Funds – but the billionaire mutual-fund manager was falsely listed on tax filings as a New Era board member, and was not, as rumored, the mystery donor.[94] *The Wall Street Journal* observed: "New Era's matching program was glorious news to religious nonprofits, which often don't qualify for grants from major secular foundations....

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[90] Indeed, New Era's 1993 tax return was its first tax filing. Nor did New Era register with the Pennsylvania charities bureau until 1993. Steve Stecklow, *False Profit: How New Era's Boss Led Rich and Gullible Into a Web of Deceit*, WALL ST. J., May 19, 1995, at A1, A4.

[91] *See also* Barbara Carton, *Unlikely Hero: a Persistent Accountant Brought New Era's Problems to Light*, WALL ST. J., May 19, 1995, at B1 ("Mr. Meyer told his wife he was going to 'test the limits of tenure'").

[92] Steve Stecklow, *Owing $500 Million, New Era Charity Seeks Refuge from Creditors*, WALL ST. J., May 16, 1995, at A1.

[93] *See* Julie Stoiber & Daniel Rubin, *Bankruptcy Court Teeming with Lawyers*, PHILA. INQUIRER, May 19, 1995, at A23 (another lawyer at the proceeding paraphrased New Era's motion: "We don't want to embarrass all the executive directors who p—d their charities' money away"). Net amounts lost were much smaller.

[94] Stecklow, *False Profit*, *supra* note ___; Peter Dobrin, Suzanne Sataline & Thomas Ferrick, Jr., *New Era Played on Dire Need for Cash, and Nonprofits Swallowed Their Doubts*, PHILA. INQUIRER, May 21, 1995, at A1, A18 (said one college official, "I think the reason we and other organizations got sucked into this was that we all really believed that this organization was set up by Sir John Templeton to give away $1 billion. . . . We couldn't figure out where else the money was coming from."). Compare the requirement in the *Revised Model Nonprofit Corporation Act* that if the articles of incorporation name initial directors, they must sign the articles, because: "In nonprofit corporations incorporators sometimes name respected or famous individuals as directors in the hope that they will serve as directors." REV. MODEL NONPROFIT CORP. ACT, note 40, § 2.02(c) & off. cmt., at 60.

[S]ays Robert Andriga [of the Coalition of Christian Colleges], 'It's almost a gift from heaven, in a religious sense.'"[95]

The Pennsylvania attorney general quickly charged New Era with violating various state nonprofit and charitable solicitation laws.[96] However, as early as July 1993, the attorney general had received a suggestion to investigate New Era's matching program.[97] New Era had not yet registered with the charities bureau. After a meeting with the chief deputy attorney general, John Bennett registered New Era as a charity, but refused to register as a professional fundraiser, claiming he was merely offering "opportunities"; he also worried that he might have to disclose the names of his secret donors. According to the *Journal*, the attorney general's office closed its investigation because it could not find any complaining donors who lost money.[98] However, the charities bureau continued to receive questions about the legitimacy of the matching program, and began an inquiry in early May 1995 when New Era failed to file a properly audited financial statement.[99] A Pennsylvania legislative investigation found that both the attorney general's office and the department of state "should have been more vigilant" in the way they registered and tracked New Era, and concluded that current state law should have been sufficient to forestall the latter part of the fraud.[100]

A class of bilked charities soon filed suit in federal court against Bennett, New Era's accounting firm, and six people listed by Bennett as members of New Era's board. Some of the "winners" – those early participants that doubled their money, or that received matched donors' contributions – initially resisted voluntarily returning funds to help make whole those that lost money. In the end, charities lost as a net [$___] million.[101] In 1997, Bennett pleaded no contest

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[95] Stecklow, *False Profit*, *supra* note __.

[96] Gary Putka, *Pennsylvania to Freeze New Era Assets*, WALL ST. J., May 17, 1995, at A3.

[97] Stecklow, *False Profit*, *supra*, note ___, at A4.

[98] The SEC, as well, found its initial investigation hard going because of lack of cooperation from participants. Said one official: "We were trying to help them, and they didn't want any help, because they thought if we kept quiet they'd be able to double their money." G. Bruce Knecht & Jeffrey Taylor, *SEC Charges New Era, Bennett Defrauded Charities, Big Investors*, WALL ST. J., May 19, 1995, at A33.

[99] L. Stuart Ditzen & Robert Moran, *Judge Freezes Assets of Failed New Era Philanthropy*, PHILA. INQUIRER, May 18, 1995, at A1, A21.

[100] STAFF REP. TO THE GEN. ASSEMBLY OF THE COMMONWEALTH OF PENN, JOINT STATE GOVT. COMM'N, THE COLLAPSE OF THE FOUNDATION FOR NEW ERA PHILANTHROPY 50 (Nov. 1995).

[101] [Update data and cites.]

to federal charges of fraud and money laundering, and was sentenced to 12 years in prison.[102]

Turning from Bennett, the perpetrator, to the duped charities, what fiduciary obligations did their trustees and directors breach? Presumably none violated the duty of loyalty: rather, each was hoping that this was the golden goose that would keep the organization going. However, a violation of the separate duty of care occurs if the fiduciary fails to exercise the care of a reasonable, prudent person under the circumstances, in good faith and with due diligence.

As Professor Harvey Dale pointed out, the hard part of the fiduciary liability question is the conflation of fundraising and investing.[103] No trustee or director would have seriously entertained a double-your-money offer in the context of an investment return. But, after all, anonymous donors do exist. Does this mean, though, that the charitable solicitation business should be measured by a different standard from the one that applies to portfolio management? To use the old portfolio management standard, if anything was speculation as opposed to investment, this looked like it. Scoffed Robert Bothwell, executive director of the National Committee for Responsive Philanthropy: "what checks and balances do we have to make certain we give due consideration to reject this outlandish idea of matching grants from heaven?"[104]

What procedures would a defending fiduciary need to show he or she followed? The business judgment rule requires information gathering, studying, and deliberation. In looking at process, the unusual nature of the arrangement should bar a simple defense that "everybody was doing it."[105] Presumably scale is a factor: How important was the amount staked compared with

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[102] AP, *Foundation Chief Gets 12 Years*, N.Y. TIMES, Sept. 23, 1997, at A17; Steve Stecklow, *New Era's Bennett Gets 12-Year Sentence*, WALL ST. J., Sept. 23, 1997, at B12.

[103] Jennifer Moore, Amanda Roque & Grant Williams, *A Debacle for Charities' Credibility*, CHRON. OF PHILANANTHROPY, June 1, 1995, 1, 29 (Prof. Dale observed that the New Era scheme "mixed up for the charities the question of how to invest their assets with the question of how to get donations").

[104] *Id* at 29. Compounding the imprudence, some participants "were so tempted by the promises of matching funds that they borrowed the money to give to New Era, and have nothing to show but their debt." Sharon Walsh, *New Era Foundation: Red Flags, Red Ink, Red Faces*, WASH. POST, May 20, 1995, at A1.

[105] Mainstream organizations became involved when word of New Era's performance spread in the Philadelphia nonprofit community. "The city's cozy relationships between institutions became a double-edged sword," observed the *Journal*. "Because of lost money and crippled fund-raising efforts, the city is hoping that corporate leaders will pick up the slack from the New Era void. But many of the leaders are the same people who championed Mr. Bennett and now appear – in hindsight – to have used poor judgment." The *Philadelphia Inquirer* wondered: "[H]ow could these trustees, many of them so cautious, savvy and worldwise, still give the foundation their millions? . . . Boiled down, it was this: *They wanted to believe.*" Dobrin, et al., *Dire Need*, *supra* note ___. A lone Cassandra, the president of the Philadelphia Museum of Art became almost a social nuisance. As quoted in *The Wall Street Journal*, Robert Montgomery Scott would ask, "Show me the prospectus. Show me where the money would go.... I've been involved in raising money enough that I know there isn't a wide pool of anonymous donors." Power, *supra* note ___. After the scheme collapsed, Scott graciously said, "I feel like the person lucky enough to have missed the Titanic." B.J. Phillips, *Sophisticated Rich ... Rubes*, PHILA. INQUIRER, May 17, 1995, at C1.

the enterprise's overall budget? A director or trustee who failed to exercise judgment, by definition, falls out of the protection of the business judgement rule. With no question of divided loyalty, in the case of a corporate charity the burden would probably fall on the plaintiff to demonstrate that the director's behavior could not rationally have been in the best interests of the charity. Ironically, New Era president John Bennett made his initial reputation in the philanthropy world by running a training program for nonprofit managers.[106]

Of course, breach does not necessarily translate into liability. The next question becomes whether the fiduciary's action caused the loss, and the amount of that loss. Assuming these proof problems are overcome, what would the breaching fiduciaries be liable for if the organization cannot fully recover its loss from the bankruptcy estate of New Era? What happens if some of these charities are so weakened by losses that they themselves must file for bankruptcy? For those charities that are trusts, the *Third Restatement of Trusts* would measure damages based on the "total return (positive or negative) for other investments of the trust in question, or possibly that of portfolios of other trusts having comparable objectives and circumstances."[107] Observes Professor Halbach: "In theory, the extension is also appropriate to the traditionally avowed objective of restoring the trust estate and its beneficiaries to the position they would have been in had the trust been properly administered."[108]

Worst of all, if a charity sent funds to New Era more than once, will the transfers be viewed as separate transactions, so that the trustee cannot offset the eventual loss by the gains the charity earlier enjoyed? The commentary to the *Third Restatement* urges reducing the incentive for multiple breaches: "a trustee whose breach of trust has resulted in exceptional profits might be tempted later to take excessive risks if the prior success provided a degree of insulation from surcharge."[109]

If the fiduciaries are liable, can their organizations indemnify them? Can the charity's D&O liability policy cover this? Would they? Any charity that had enacted a monetary shield for directors who breach their duty of care could probably not obtain a money recovery unless the act were intentional or in bad faith, but a few statutes also exclude gross negligence. Finally, a court can abate or eliminate liability. In the case of a trust, the *Third Restatement* comments: "In the absence of a statute it would seem that a court of equity may have the power to excuse the trustee in whole or in part from liability where he has acted honestly and reasonably and ought

[106] Steve Stecklow, *New Era's Bennett Took Others' Millions; Now He's Giving Back*, WALL ST. J., Jan. 24, 1996, at A1.

[107] RESTATEMENT (THIRD) OF TRUSTS § 205 & cmt, at 155.

[108] Halbach, *supra* note __, at 1182 (citing to RESTATEMENT (THIRD) OF TRUSTS § 208 cmt. *a*, § 209 cmt. b, § 210 cmt. b, § 211). But see the rejection of the lost-profits measure of damages in *Estate of Janes*, *supra* note __.

[109] RESTATEMENT (THIRD) OF TRUSTS § 213 (Balancing Losses Against Profits), cmt. *f* (Factors determining whether breaches of trust are distinct), at 179.

fairly to be excused."[110]

We have no public information that any of the attorneys general supervising the defrauded charities brought suit against their fiduciaries – perhaps out of sympathy or perhaps out of worry about the political fallout. Perhaps if the Securities and Exchange Commission has decided to give a free pass to the outside directors of Enron, Tyco, and other publicly held corporations,[111] it should not surprise us to find the regulators of the charitable sector similarly desisting. It is unlikely that the beneficiaries, donors, or alumni (many were schools and colleges) could instead bring a derivative suit. Apparently, if they could they would: A survey conducted by the *Chronicle of Philanthropy* soon after the scandal broke found, among other things, that of wealthy donors across the country 60.1 percent "are very willing to take legal action against a charity's senior officers and trustees for mismanagement."[112]

Attorney general reluctance to charge fiduciaries exposes the nonprofit sector to repeated scandals due to disastrously inattentive governing boards. Consider the 1992 story of the United Way of America and the 2002 story of the United Way of the National Capital Area.

Contending for the top nonprofit story of the last decade is the exposure and disgrace of William Aramony, former long-time president of United Way of America.[113] The disclosure of his high salary and lavish perks provoked outrage.[114] The scandal triggered a rebellion in the ranks of the local (and independent) United Ways: initially, over half of the locals withheld their voluntary payments to the national.[115] The locals, in turn, braced for a falloff in contributions from the public.[116] Aramony insisted that his compensation fairly reflected his achievements, and the $29 million budget he supervised. The local United Ways, too, were satisfied that they got their money's worth from the national, through training and promotion.

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[110] RESTATEMENT (THIRD) OF TRUSTS § 205 cmt. *g* (Power of the court to excuse breaches of trust), at 227.

[111] *See* Scot J. Paltrow, *SEC Isn't Likely to Discipline Enron Board*, WALL ST. J., Sept. 25, 2002, at C1.

[112] Moore, et al., *supra* note ___, at 24 (box).

[113] This discussion is drawn from Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*. VILLANOVA LAW REVIEW 41: 433-504 (1996).

[114] Aramony received total compensation of $463,000 a year, flew the Concorde, and used chauffeured cars on his frequent trips to New York, where he stayed in a $430,000 condominium purchased primarily for his use by a subsidiary corporation. Charles E. Shepard, *Perks, Privileges and Power in a Nonprofit World*, WASH. POST, Feb. 16, 1992, at A1 & A38 [hereinafter Shepard, *Perks*].

[115] Charles E. Shepard, *United Way of America Adopts New Ethics Rules, Safeguards*, WASH. POST, June 26, 1992, at A2 [hereinafter Shepard, *Safeguards*]; Wendy Melillo, *Community-Wide Giving Launched 105 years Ago*, WASH. POST, Feb. 16, 1992, at A39.

[116] Shepard, *Perks*, *supra* note __, at A38.

Then came the bombshell: A multi-count indictment charged Aramony with fraudulently diverting hundreds of thousands of dollars to personal use, and filing false tax returns. Aramony argued that the board was fully aware of his activities. After an entire week of deliberation, a jury convicted Aramony on 25 counts.[117] He received a seven-year prison term, and was released from prison in October 2001.[118]

A *Washington Post* editorial turned from the chief executive to the board of directors: "Where was UWA's board while its staff was flying the Concorde to Europe? The board has traditionally been composed largely of leading figures from the corporate world – people who brought prestige to it, but put little time into it."[119] In fact, the United Way resembles corporate America because it was created by corporate America, receiving most of its funding from workplace payroll deductions. This "corporate" mentality, however, explains why the board failed to anticipate the public revulsion to high salaries. Indeed, Aramony once quipped, "A cardinal rule . . . is that you never put anyone on your Board who makes less than you do."[120]

According to the website of New York attorney general's office:

> Beginning in 1992, the Attorney General began investigating news reports of the misappropriation and mismanagement of charitable funds at the United Way of America ("United Way"). When new management took over at United Way in 1995, the Attorney General and United Way entered into an Assurance of Discontinuance that required certain corporate governance reforms at the agency. Separately, the Attorney General sued two former United Way officers for alleged breach of fiduciary duty, seeking, inter alia, recovery of funds misappropriated from United Way. In July 1998, the court held that the Attorney General had standing to sue these officers for losses suffered by the not-for-profit entity as a result of their breaches of fiduciary duty, and granted the Attorney General's motion for partial summary judgment on the issue of liability based on the two officers' criminal convictions.[121]

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[117] Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than $600,000*, N.Y. TIMES, Apr. 4, 1995, §1, at 1.

[118] AP, *High Life Sends Ex-United Way Boss to Prison*, CHI. TRIB., June 23, 1995, §1, at 3; *see* Matthew Sinclair, *William Aramony is Back on the Street*, NON-PROFIT TIMES, Mar. 1, 2002, at 1.

[119] Editorial, *United Way's Breach of Trust*, WASH. POST, Apr. 7, 1992, at A24. The organization adopted a code of ethics requiring more local representation on the board, and created new committees on ethics, budget and finance, compensation and personnel, services and membership. Shepard, *Safeguards*, *supra* note __.

[120] JOHN S. GLASER, THE UNITED WAY SCANDAL 114 (1994).

[121] NYAG Outline, *supra* note _, at II.F.4.b (citing to Vacco v. Aramony, N.Y.L.J., Aug. 7, 1998, p. 21 (Sup. Ct. N.Y. County July 13, 1998).

Incorporated in the District of Columbia, the United Way of the National Capital Area is subject to oversight on the District's Corporation Counsel, but no report has emerged of any enforcement action by that office. Everyone else, though, seems to have jumped in – from the Department of Labor (to investigate a possibly illegal anticipation of retirement benefits by a UWNCA executive) to the business sector (worried about participating in the upcoming federal Combined Federal Campaign in the absence of reforms). [Expand.] Under the pledge to "Leaders Vow to Earn Back Public Trust While Serving Community Needs," the organization published a task force report in September 2002[122]

4. Terra Museum's Possible Move Out of State.[123]

In September 2000, a rift arose within the board of the foundation that operates the Terra Museum, which houses a modest collection of American impressionist art. The widow of the founder and her allies (including former senator Alan Simpson) wanted to discuss moving the assets of the struggling Chicago museum to Washington, D.C.., perhaps to combine with the Corcoran Museum. Before any vote could occur, two directors – prominent Chicago businessmen – brought suit to block a move, charging that its proponents were breaching their fiduciary duties.

Filing a complaint on the side of the plaintiffs, and asserting jurisdiction under the Illinois Charitable Trust Act, the attorney general sought to read into the purposes of the corporation the desire to benefit primarily "the people of Illinois."[124] (The articles of incorporation contained no geographic restriction; moreover, the Terra Foundation operates a sister museum in Giverny, France). During the course of the litigation, the defendant directors charged, the attorney general brought pressure to bear on two individual directors to switch their votes and support keeping the

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[122] <http://www.unitedwaynca.org/pdf/completereportb.pdf>.

[123] I was retained as an advisor to the Terra Foundation defendants in July 2001.

[124] The Illinois attorney general's office has in one other recently publicly reported instance made the same demand. As the *Chicago Tribune* reported on the settlement reached with the Regenstein Foundation:

> "The fact that the new directors lived elsewhere had concerned the state attorney general's office, which intervened in the case and insisted the settlement say that most of the money would be disbursed here.
>
> "'We're happy to get it *locked in* for the Chicagoland area,' said Assistant Atty. Gen. Floyd Perkins. He noted that his office has intervened in another case to prevent the Terra Museum of American Art on Michigan Avenue from moving out of town."

J. Linn Allen, *Foundation Truce a Boon for Charities*, CHI. TRIB., Apr. 28, 2001, at 14 (emphasis added).

assets in Chicago.[125] Indeed, a settlement ensued when a majority of directors voted to obligate all current board members to step down; to require, for at least 25 years, that a majority of the board be residents of Illinois; and to prohibit the assets from leaving the State for 50 years.[126] The defendants, however, have filed an appeal of the court's acceptance of the settlement.[127]

The new board members took office in September 2002, headed by Marshall Field V.[128] The foundation's primary concern is whether to attempt to build its endowment and stay

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[125] The defendants unsuccessfully sought recourse in federal court. In Terra Foundation for the Arts v. Perkins, 151 F. Supp. 2d 931 (N.D. Ill. 2001), the district court rejected their claim that the attorney general violated their constitutional rights:

> [T]he conduct being induced (a changed vote) is not itself unlawful . . . . Essentially the plaintiffs argue that Mr. Perkins used his undoubtedly legitimate authority to name Dr. Stebbins in a complaint and to investigate Dr. Marshall's school in order to get them to do something lawful, which the plaintiffs argue will have unfortunate effects. If the directors had just changed their minds, the plaintiffs would just have to live with it. What difference, as far as their status as potential § 1983 defendants goes, does it make if they changed their votes because of the inducements by Mr. Perkins?

As a threshold matter, the court also rejected plaintiffs' assertion that federal court protection is needed against (elected) State judges:

> Moreover, there is no reason to think that the plaintiffs require the special protections of federal court even though the state is a party to the state court action. The only basis that the plaintiffs give for thinking there may be a problem with the state court is that the very able state court judge is elected. That is not a reason to think that she cannot fairly resolve charges of misconduct made against the state and its officers, such as Mr. Perkins.

[126] See *Joint Press Release re Buntrock et. al. v. Terra Foundation, et. al.*, PR Newswire, July 26, 2001:

> The plaintiffs and the Foundation are pleased to announce that a settlement has been reached and adopted by the Court.
> The settlement will preserve the public's access, here in Chicago, to The Terra Foundation's collection for no less than 50 years.
> The Foundation will continue to manage its affairs, to operate its museum and programs in Giverny, France, and to promote understanding of and appreciation for American art. The Attorney General is satisfied that the settlement upholds the interests of the people of the State of Illinois. The plaintiffs and the Foundation are pleased that a settlement could be reached.
> The plaintiffs and the Foundation have agreed to let this statement stand alone. No further statements are to be made.

See also Alan G. Artner, *Terra Founder's Deeds May Not Reflect Desires*, CHI. TRIB., Feb. 25, 2001, at 1; Jon Yates, *Judge to OK Museum Accord*, CHI. TRIB., July 25, 2001, Metro section, at 1.

[127] *Lawsuit Challenges Museum Settlement*, CHIC. TRIB., Aug. 1, 2001, Metro section, at 4.

[128] *See* Jerry Mullman, *Terra Explores Art of Mag Mile Move; Relocating Is Cheaper than Revamp*, CRAIN'S CHI. BUS., Sept. 16, 2002, at 1 ("Mr. Field, along with four other board members, was appointed last year by Attorney General Jim Ryan's office, which monitors the running of charities and non-profits, after it weighed in on the Terra controversy. Subsequently, Mr. Field selected the other 10 directors.").

independent, or, alternatively to merge its $100 million Illinois collection with the Art Institute of Chicago or the University of Chicago's Alfred Smart Museum of Art. (The foundation would retain control over its $200 million endowment and the Giverny museum.) The new board is also worried about a decision by Chicago's Commission on Landmarks to give preliminary landmark protection to the Michigan Avenue building housing the museum ; this could limit the foundation's options if it wants to sell the building.[129]

5. Health Midwest.

In the Fall of 2002, the for-profit Tennessee-based chain HCA, Inc. – formerly known as Columbia/HCA – submitted a winning bid of $1.125 billion to acquire Health Midwest. HCA has also agreed to invest an additional $450 million in capital improvements, at least maintain Health Midwest's level of indigent care, and keep existing hospitals open. Explained a spokesman for Health Midwest: "Nonprofits are at a decided disadvantage at acquiring necessary capital to expand and strengthen themselves. . .. Our board of directors decided the only responsible way to proceed would be to listen to offers from for-profit companies."[130] Owning seven hospitals, leasing two, and managing four, Health Midwest is Kansas City's largest hospital system, treating one in three area patients.[131] The acquisition is HCA's largest.

As has happened with many nonprofit hospital conversions, the fight has then shifted to the question of what to do with the sale proceeds, which must remain in the charitable sector. In this case, an expected $700-800 million will fund one or more "conversion foundations," "sparking a philanthropic tug of war between advocates of indigent health care and proponents of life sciences research."[132]

Complicating matters is that Midwest Health must contend not just with one attorney general but two, given that the 14-hospital, multi-community system operates within a 150-mile radius of Kansas City, straddling Missouri and Kansas. Health Midwest brought suit to clarify the jurisdiction of both attorneys general. The attorneys general's answers were severe.

Missouri attorney general Jay Nixon counter-claimed by moving to dissolve Health Midwest as a nonprofit corporation and remove its board for abandoning the entities' charitable

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[129] Jon Yates, *Terra Fight Set for New Chapter; 11 to Leave Board, but Art Museum's Fate Still Unclear*, CHI. TRIB., Sept. 6, 2002, Metro § at 1.

[130] Richard Williamson, *HCA, Midwest Come Together for $1.6 Billion Deal*, BOND BUYER, Oct. 17, 2002, at 3.

[131] Vince Galloro, *Some Loose Ends; HCA Deal Worries Missouri Attorney Genearl*, MODERN HEALTHCARE, Nov. 25, 2002, at 12.

[132] Paul Wenske and Julius A. Karash, *Rival Interests Jockey for Access to Proceeds from Health Midwest Sale*, KANSAS CITY STAR, ____, 2002.

purpose in agreeing to a sale to a proprietary buyer.[133] Declared the attorney general: "The Attorney General of Missouri may bring an action for removal of directors of a public benefit corporation . . . when the directors have engaged in a gross abuse of authority or discretion with respect to the corporation, including a breach of their fiduciary duties owed to the corporation and the people it exists to serve, and removal is in the best interests of the corporation."[134] As an affirmative defense, the Missouri attorney general stated:

> WHEREFORE, Plaintiff's Petition should be dismissed under the doctrine of laches and estoppel because, having enjoyed the benefits of non-profit, charitable status since its inception, and having conceded the Attorney General's authority and sought his review and approval, Health Midwest may not now challenge that authority or seek to prevent a determination on their proposal which the Attorney General has not yet made . . . .[135]

Carla Stovall, attorney general of Kansas – where Health Midwest operates two subsidiaries and manages a county hospital – similarly reacted angrily to Health Midwest's declaratory judgment suit. She issued a press release stating: "It is unconscionable for Health Midwest to waste money belonging to the citizens of the two states in filing this lawsuit, and to deny those same people the ability to benefit from or have any say in this proposed sale. The Health Midwest board members have the arrogance to believe that this money is theirs, when in reality it belongs to the people of Kansas and Missouri. . . ."[136] In her answer, she raises several counter-claims, including (1) a petition for the conduct of a judicial cy pres proceeding; and (2) the removal of the directors, and the appointment of a receiver to take over the charitable assets in a quo warrento proceeding due to ultra vires acts by a nonprofit corporation.[137] Moreover, she

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[133] "By disposing of the very facilities it exists to 'establish, operate and maintain,' Health Midwest has put itself in a position in which it can no longer carry out or fulfill its purpose." [Missouri] Attorney General's Answer, Counterclaims, and Cross-Claims to Plaintiff's Petition for Declaratory Judgment, ¶ 98, in Health Midwest v. Nixon, Case No. 02CV326118, filed Dec. 5, 2002. *See also* Office of Missouri Attorney General Press Release, "Nixon Asks Court to Dissolve Health Midwest," Dec. 5, 2002, *available at* <www.ago.state.mo.us/newsrls/2002/120502b.htm>. The attorney general's answer characterizes Health Midwest's suit as "an unconscionable waste of corporate assets." Answer, *supra*, ¶¶ 73 & 75.

[134] Answer, *supra* note __, at ¶ 102.

[135] Answer, *supra* note __, at ¶ 76.

[136] Kansas Attorney General Press Release, "Stovall Responds to Health Midwest Lawsuit," Nov. 27, 2002, *available at* <www.ink.org/public/ksag/con...ses/2002news/hca_lawsuit_react.htm>.

[137] Answer, Counterclaim, and Cross Claim of Defendant Carla J. Stovall in Her Official Capacity as the Attorney General of the State of Kansas, in Health Midwest v. Stovall, Count III, IV and V, filed Dec. 10, 2002, *available at* <www.ksag.org/contents/litigation/hmcounter.pdf>. Kansas Attorney General Press Release, "Stovall Files Counter-Suit Against Health Midwest," Dec. 11, 2002, *available at* <www.ink.org/public/ksag/con...ses/2002news/hm_countersuit.htm>.

asks for a jury trial.[138]

Attorney general Stovall's counterclaim declares:

> 17. The Kansas assets of Health Midwest, which are vested in Kansas tax exempt not-for-profit corporations are the property of the people of the state of Kansas. Any proceeds from the sale of any Kansas assets are property of the people of the State of Kansas and no person or entity can divest, alienate or exercise dominion over these assets without specific Judicial approval.[139]

She asserts that Health Midwest has "waived the right to contest the authority of the Kansas Attorney General to review the transaction" by, for example, providing such a right in their bylaws; through statements to that effect made by its general counsel at board meetings; and through a term in the asset purchase agreement giving the Kansas attorney general the right to request a delay the closing date of this transaction.[140]

Finally, Stovall's counterclaim also includes her own proposal for a post-closing foundation, with a 15-person board appointed by her.[141] Yielding to criticism, Health Midwest subsequently proposed two conversion foundation, one for each State, and to prorate the sale proceeds 80 percent to the Missouri foundation and 20 percent to the Kansas foundation in accordance with current operations. However, under Health Midwest's modified proposal, a common 25-person board would govern both foundations. According to Health Midwest's memorandum describing the structure and governance of the foundations:

> Attorney General Jurisdiction. Because a separate entity will be chartered in each state, each Attorney General will be able to assert such jurisdiction as permitted by laws of their respective states over the entity chartered in his or her respective state.[142]

However, the Missouri and Kansas attorneys general continue to contest the authority of the Health Midwest board to structure the foundation boards and determine how the funds will be

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[138] *Id.* at p. 53.

[139] *Id.* at ¶ 17.

[140] *Id.* at ¶ 10.

[141] *Id.* at Count VIII, ¶¶ 74 through79.

[142] Health Midwest, "Structure and Governance for Foundations," Dec. 19, 2002, at 2, *available on the Missouri attorney general's website at* <www.ago.state.mo.us/health/index.html>. As a separate matter, 10 existing foundations that support the Health Midwest system could continue to operate independently if they choose. *Id.* at 6; *see* M. Steele Brown, *Some Health Midwest Foundations Consider Independence After Sale*, BUS. J. OF K.C., Jan. 3, 2002, *available at* <kansascity.bizjournals.com/kansascity/stories/2003/01/06/story7.html>.

used. Nor do separate statewide foundations address concerns of how and where within Health Midwest's current operating area the funds should be expended: "Kansas City officials want [the sales proceeds] spent only in the central city. The mayor of adjacent Independence, Mo., has his own detailed plan for spending some of it in the suburbs."[143]

Out of fear that the attorneys general's wrangling over the foundations will delay the financially-needed sale, a third of Health Midwest's physicians took out an ad in the Kansas City Star in December 2002 supporting the transaction.[144] Kansas's Carla Stovell, however, told the press that she wants Health Midwest executives to pay over half of their closing bonuses to the charitable foundations, and has asked for experts to determine the percentage of the sales proceeds that should go to each state's foundation.[145] While Stovall was ending her term, incoming attorney general Phill Kline reaffirmed Stovall's position that the Health Midwest board should be replaced.[146] Nor does Missouri attorney general Jay Nixon seem moved, telling the editorial board of the *Kansas City Star* he does not feel bound to settle by the called-for March 30, 2003 closing date.[147] He charges Health Midwest with having filed suit in order to keep sale documents secret, commenting: "It's a stunning thought that Health Midwest would think that public documents in the hands of the attorney general are not public."[148] However, neither Health Midwest nor the Kansas attorney general's office respond to Nixon's comment, having been made subject to a January 9 gag order imposed by a Johnson County district judge to further mediation talks.[149]

6. The AHERF Bankruptcy: Civil and Criminal.

Occasionally, a charity "borrows" from the principal of an endowment or other restricted

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[143] Bill Lewis, *HCA Finds "Tough Crowd" in K.C.*, THE TENNESSEEAN, Nov. 22, 2002, at E1.

[144] Mike Norbut, *Physicians Back HCA Purchase of Nonprofit Hospital Chain*, AMNEWS, Jan. 20, 2003, *available at* <www.ama-assn.org/sci-pubs/amnews/avantgo/content/bb0120.htm>.

[145] *Attorney General Negotiating with Health Midwest*, KNOZNEWS, Jan. 10, 2003, *available at* <www.knoxnews.com/kns/state/article/0,1406,KNS_348_1665869,00.html>.

[146] M. Steele Brown, *New AG Kline: He'll Stay Course on Sale to HCA*, BUS. J. OF K.C., Jan. 13, 2003, *available at* <kansascity.bizjournals.com/kansascity/stories/2003/01/13/story2.html>.

[147] Paul Wenske, *Nixon Says He Doesn't Feel Pressure for Quick Health Midwest Settlement*, KANSAS CITY STAR, posted Jan. 15, 2003.

[148] Quoted in id.

[149] *Id.*

gift in order to cover operations.[150] Legally, such a transaction is analyzed as an investment of endowment assets: If such a loan is not prohibited by the gift document, would it be prudent for the charity to invest these funds this way, taking into account the security of the investment and the expected financial return? (Putting the question this way suggests that the answer would often be no.) One might expect, moreover, that these situations arise where the transaction is motivated by financial distress, and so if donor-designated purposes could be jeopardized, court permission might be required.[151]

Early 2002 brought a resolution of the civil claims in the largest nonprofit bankruptcy in history; the Allegheny Health, Education and Research Foundation (AHERF), which supported a Pennsylvania-wide umbrella system of health care institutions, had left $1.5 billion in unpaid bills. The State and the parties settled for an agreed total of almost $94 million (of which $24.5 million will go to the charity). About $56 million of this total will be paid by AHERF's directors and officers' insurance policy, which had already paid at least $12 million for the litigation.[152]

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[150] An indirect version of such a transaction can be quite profitable: Where the charity can earn a market return on its endowment but borrow from the public by issuing tax-exempt bonds, the charity benefits from the spread. The charity must be take care that it does not secure the bonds with its endowment, or else the Internal Revenue Code would require the charity to refund the "arbitrage" profits to the federal government. In practice, a charity will seek a favorable bond rating by granting a security interest, either in real estate or in the income stream from the real estate. *See* Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997).

[151] *See e.g.*, National Association of Attorneys General, *Connecticut -Windham Community Memorial Hospital*, CONSUMER PROTECTION REP., June 1997, section: Charitable Trusts and Solicitations; at 10:

> Connecticut Attorney General Richard Blumenthal recently announced that he has reached a settlement with the Windham Community Memorial Hospital to resolve allegations that the hospital improperly used more than $1.8 million in funds it received in donations. The money was taken from endowment funds and used to help finance construction of a $23 million building addition and the day-to-day operations of the hospital, actions that were contrary to the purposes for which donors gave the money. Under the various terms of the gifts to the hospital, only the income generated from the endowments, not the endowment itself, was to be spent and with regard to some of the gifts, only for certain specified purposes.
>
> The agreement ends a two-year investigation by General Blumenthal's Office and requires Windham Hospital to return all of the money, $1,800,702 to the endowment funds plus $144,316 in interest. The agreement allows the hospital to make the payments through 2002, with additional interest of $91,314 accruing until all payments are made. . . . By entering into the agreement, the hospital does not admit any wrongdoing. . . .
>
> The lawsuit alleged that in 1988 the hospital's legal counsel sent a letter to Dr. Fred Hyde, then President and Chief Executive Officer of Windham Hospital, advising that only income and net appreciation from the endowment funds could be spent, not the endowments. However, both in 1991 and 1992 the hospital's directors voted to use the endowment funds for ongoing operations and construction financing. The Attorney General's office represents the public interest in protecting any gifts intended for public or charitable purposes.

[152] AHERF had typically carried $50 million in D&O insurance, but in the months immediately prior to its bankruptcy filing, had purchased four times that coverage; the insurance companies asserted that the later policies were fraudulent. Cinda Becker, *Settling Down; AHERF to Pay $93.7 Million to Creditors, Trusts*, MODERN

By contrast, in *In the Matter of Estate of Othmer*[153] the New York surrogate court applied *cy pres* to permit a hospital to use a sufficient portion of an income-only fund to secure nearly $90 million in new debt that would implement strategic capital projects and provide working capital. The court cited dramatic changes in the health care industry since 1995 (notably the growth in managed care, the deregulation of the private sector hospital rate-setting system, the reduction in Medicare reimbursements, and the shift from higher-paying in-patient care to lower-paying ambulatory care). The hospital's bankruptcy and closure, concluded the judge, would frustrate the general charitable purpose of the donors, while the income on the funds was not sufficient to fund long-term operations. The judge cited both the changed circumstances and the "exponential growth" of the donors' assets in approving the recovery plan. "In conclusion, the court finds that LICH has met the three required tests for application of the cy pres doctrine under EPTL 8-1.1. For that reason and also in reliance on the Attorney General's support of the relief requested, the court grants LICH's cy pres petition in its entirety."[154]

Returning to AHERF, the attorney general of Pennsylvania also obtained an unprecedented criminal indictment against AHERF's former chief executive, chief financial officer, and general counsel. The indictment charged that the officers invaded the endowments and restricted charitable gifts in order to maintain general charitable operations, and by so doing they committed Thefts by Failure to Make Required Disposition of Funds Received (a felony); Misapplications of Entrusted Funds (a misdemeanor); and conspiracy to do the same. In May 2002, after a preliminary hearing that lasted for months, the judge narrowed the charges against the chief executive to several hundred allegedly misapplied restricted gifts (apparently some $50 million), and dismissed all charges against the former chief financial officer and the former general counsel (the judge threw out the conspiracy charges, since the chief executive cannot conspire with himself).[155] On August 29, 2002, Abdelhak pleaded no contest to a single misdemeanor of misapplication of entrusted funds, and received a sentence of 11-½ to 23 months (he is expected to serve several months). A week earlier, the attorney general's press release acknowledges, the court had "dismissed felony theft charges against Abdelhak, saying he did not use the endowment money for his own personal gain."[156]

HEALTHCARE, Jan. 21, 2002, at 14.

[153] 710 N.Y.S.2d 848 (Surrogate's Court of New York, 2000).

[154] *Id.* at 853.

[155] Cinda Becker, 2002, *Settling Down; AHERF to Pay $93.7 Million to Creditors, Trusts*, MODERN HEALTHCARE, Jan. 21, 2002, at 14.

[156] [Pennsylvania] Office of Attorney General Mike Fisher, Press Release: "AG Fisher: Former AHERF Official Pleads to Raiding Endowments; Ceo Sentenced to 11 to 23 Months," Aug. 29, 2002, available at <www.attorneygeneral.gov/releases/text/29Aug2002-ag_fisher-_former_aherf_official_pleads_to_raiding_endowment.html >.

Compare a more traditional criminal proceeding – one involving self-dealing. In 2002, the New York attorney general obtained a 72-count indictment against Lorraine Hale, the self-dealing former executive director of Hale House, a home for the children of drug-addicted mothers. Separate from these counts of falsifying business records, forgery, grand larceny, and tax evasion, the attorney general brought a civil forfeiture action seeing restitution of over $1 million.[157] In July 2002, Lorraine Hale pleaded guilty to a single count of larceny and agreed "to turn over approximately $118,000 worth of assets to Hale House, all of which had been seized in the forfeiture proceedings, and have judgments entered against [her and her husband] for the balance of the stolen funds."[158] Lorraine Hale received five years' probation, and is permitted to remain in the Scarsdale house owned by the charity, at the charity's expense.[159] In response to criticism of that Hale would serve no jail time, the *Daily News* (which broke the story and kept up pressure on it) wrote:

> Zachary Carter, the former Brooklyn U.S. attorney whom Spitzer brought in as Hale House's new board president, said he thought the plea agreement was fair. "When you consider how far Lorraine Hale has fallen – to be the toast of the town in some circles, to a convicted felon in the twilight of her life, that is not an insignificant event," Carter said.[160]

Sniffed the *Daily News* in an editorial after the sentencing: "You can thank their plea deal with state Attorney General Eliot Spitzer. This is justice? No, it's a disgrace."[161]

Meanwhile, an investigation by a newly-appointed board of directors found that Dr. Hale had created a phony board (including a fictitious board member), falsified board minutes, and forged signatures.[162] "We've got to get some living people on this board," Dr. Hale was reported

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157 New York Attorney General Press Release, "Lorraine Hale and Husband Indicted for Stealing Hale House Funds" (Feb. 6, 2002), *available at* <www.oag.state.ny.us/press/2002/feb/feb06b_02.html>.

158 New York Attorney General Press Release, "Former Hale House Director Pleads Guilty to Felony Charges Involving the Misappropriation of Charitable Funds" (July 3, 2002), *available at* <http://www.oag.state.ny.us/press/2002/jul/jul03a_02.html>.

159 Heidi Evans and Dave Saltonstall, *Hale & Hubby Avoid Big House, Must Pay 769G*, N.Y. DAILY NEWS, Oct. 25, 2002, at 20. Lorraine Hale and her husband were also ordered to repay $769,000 (although the couple pleads destitution), and are barred from future service with another charity.

160 Heidi Evans, *Hale Guilty in 1M Theft*, N.Y. DAILY NEWS, July 4, 2002, at 6.

161 Editorial, *Getting Away With It*, N.Y. DAILY NEWS, Oct. 25, 2002, at 54.

162 Terry Pristin and Nina Bernstein, *Ex-Head of Hale House and Husband Charged With Theft*, N.Y. TIMES, Feb. 6, 2002, at B1.

to have once commented.[163] In defending New York State's delay in discovering and exposing the looting of Hale House by its long-time executive director, the attorney general pleaded lack of resources; as in the New Era story, however, as big an impediment might have been the power of the charismatic, politically connected leadership.[164]

7. The Empire Blue Cross Conversion.

After legislative changes that removed preferences for nonprofit health insurers and other competitive changes, the large New York heath-insurance nonprofit Empire Blue Cross Blue Shield sought to convert to for-profit status. Beginning in 1996, the Empire board negotiated with the attorney general and the department of insurance over the form of such a transaction. Consistent with one typical form of conversion in other States, Empire proposed creating a new for-profit insurance company whose stock would be held 100 percent by a new nonprofit "conversion foundation," which would then sell off shares of stock over time in order to diversify its assets and raise funds for making grants. From 1997 through 1999, the attorney general and the insurance department held public hearings on Empire's proposal. "Over 130 community organizations endorsed a set of principles calling for an independent, community-responsive foundation to be established with Empire's nonprofit assets in the event the conversion were permitted. Empire drafted a conversion petition largely consistent with these principles and outlined its plan to use the assets generated by the conversion to expand access to health insurance and health care for the medically underserved."[165]

At a May 2000, health care conference, Attorney General Eliot Spitzer described his role as "determining whether a particular conversion proposal properly protects the public interest," and outlined changes that he obtained to the Empire plan.[166] In April 2001, Empire issued a press release describing that the new "independent charitable foundation that would be created as part of its proposed plan to restructure as a for-profit company is estimated to be at least $1 billion." The foundation "would be dedicated to providing funds to expand access to more affordable health insurance coverage for those New Yorkers who need it the most: children, the elderly and individuals who purchase their own coverage." Michael Stocker, MD, President and CEO of Empire stated in the release: "Historically, Empire has provided coverage to these New Yorkers when they could not afford coverage elsewhere. Dedicating the charitable value of Empire to

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[163] Heidi Evans and Dave Saltonstall, *Lorraine Hale's $1.3 Million Slush Fund*, DAILY NEWS, Aug. 8, 2001, News section, at 2.

[164] See Part II, *supra* note __.

[165] Consumers Union, Press Release, "Advocates Blast Amended Empire Blue Cross Conversion Plan, Urge Ny Department of Insurance to Reject For-Profit Bid," Aug. 5, 2002, *available at* . . . .

[166] "Remarks by Attorney General Eliot Spitzer, Empire State Report Health Care Conference," May 24, 2000.

this population is consistent with the historical mission of the company."[167]

However, because of opposition from health care unions and hospitals, legislation to authorize the conversion remained stalled for years. Finally, in early 2002, the State legislature authorized the conversion as part of a multi-billion dollar health care package,[168] in which 95 percent of the proceeds from Empire's initial public offering would be appropriated for State budgetary purposes,[169] and only 5 percent deposited in a "conversion foundation" for the health care needs of the poor. "The deal was protested as a shallow attempt by Pataki to curry favor with a 200,000-member union headed by Dennis Rivera, one of the most powerful labor leaders in the state and one of its most influential Hispanic figures. Pataki, indeed, later received the union's endorsement for his re-election bid."[170]

None of the traditional parties complained about this removal of $1-$2 billion[171] in value from the nonprofit to the public sector. Apparently, the Empire board has its eyes on its future operations as a for-profit business (they would no longer have controlled the conversion proceeds in any case). The attorney general's motives for not opposing the result are unknown, although Eliot Spitzer has a reputation for being politically ambitious.[172] Consumer groups were furious,

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[167] Empire Blue Cross Press Release, "$1 Billion to Care for the Uninsured Provided by New Charitable Foundation," April 2, 2001.

[168] On January 25, 2002, the Governor signed Chapter 1 of the Laws of 2002, codified as N.Y. Insurance Law § 4301(j) (amended) (McKinney 2002) (permitting certain not-for-profit health care corporations to convert to for-profit corporations) and N.Y. Insurance Law § 7317 (McKinney 2002) (establishing the process and standards for the superintendent of insurance's review and approval of a proposed conversion plan).

[169] The legislation designates 95 percent of the stock to fund "work-force recruitment and retention." According to the Consumers Union complaint:

> 82. The remaining 95% of the conversion proceeds is treated as a Public Asset and required to be deposited in a "Public Asset Fund" managed by a five member board appointed by the Governor, Senate Majority Leader and Speaker of the Assembly, and paid over to the Director of the Budget for deposit in a Tobacco Control and Insurance Initiatives Pool, from which in excess of $700 million dollars, more than two thirds of the anticipated value of Empire, is required to be paid to hospitals, nursing homes and certain personal care agencies to fund pay raises for their nonmanagerial health care workers over a three year term.

[170] Staff, *The Empire "Heist"*, JOURNAL NEWS, Aug. 31, 2002, OPINION, pg. 8B. *See also* Elizabeth Greene and Meg Sommerfeld, *$1-Billion Conversion Plan Draws Criticism in N.Y.*, CHRON. PHILANTHROPY, Jan. 24, 2002, at 25. *See also* James C. McKinley, *Before Bill Move in Albany, 3 Leaders Cut Deals in Secret*, N.Y. TIMES, Oct. 21, 2002, at A1.

[171] According to the plaintiffs' reply memorandum filed October 28, 2002, at page 7, the "intended stock sale prices, as of October 21, 2002, would value the company at between $1.7 billion and $2 billion."

[172] The governor's insurance commissioner commented: "What you would have had is 12 to 15 board members appointed by the attorney general doling out money as they see fit. . . . Now what you have is the duly elected members of the Legislature, who represent districts all across the state, determining what the health care

but face the threshold issue of whether they lack standing – indeed, under the legislation, the courts are deprived of jurisdiction to enjoin the transaction, as explained below.

On June 18, 2002, Empire filed an amended plan of conversion with the New York State Department of Insurance for approval to convert from a not-for-profit health service corporation to a for-profit accident and health insurance company.[173]

Consumers Union complained, among other things, that this "plan would spend 95% of Empire BCBS's resources over three years, instead of establishing a permanent endowment to continue Empire's charitable mission. If instead all the funds were put in a health care foundation, the foundation could award $50 million in grants to expand health access and coverage per year in perpetuity."[174]

In comments filed with the superintendent of the department of insurance, the attorney general again focused on issues of maximizing the value of Empire's stock.[175] Referring back to the earlier conversion contemplated under the Not-for-Profit Corporations Law, the attorney general asserted that "the Empire Conversion Legislation is apparently silent, as is Empire's Amended Plan, with respect to shareholder rights and other protections of the kind we pursued under Empire's former proposal." Accordingly, the attorney general concluded, the department

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purposes should be." A spokesman for the attorney general claimed "unusual circumstances," and denied that this action "sets rock-solid precedent." Andrew Metz, *Conversion's Missed Chance*, NEWSDAY, Jan. 20, 2002, at A8.

[173] The department held hearings on the 2002 plan in August. Empire's website carries a set of "frequently asked questions," which include:

22. <u>What happened to the proposal of the Charitable Foundation in 1999?</u> The proposed restructuring of Empire as a for-profit corporation as described in the plan of restructuring that was filed with New York State in 1999 and approved by the Superintendent of Insurance on December 29, 1999 never took place. Therefore, the charitable foundation referenced in the 1999 Plan was not created. The New York State legislation passed earlier this year provides specific requirements regarding the transfer of the value of Empire HealthChoice, Inc. They differ from what was proposed in 1999. They do not involve the creation of a charitable foundation like the one discussed in 1999 but instead require the creation of the "Fund" and the "Foundation," which . . . will be established by the State of NY pursuant to N.Y. Ins. Law § 7317(e) and § 7317(k)(1), which were adopted by the NYS legislature in January 2002.

23. <u>Why does the "Fund" get 95% of the assets and proceedings?</u> The New York legislation passed in January 2002 specifies the percentage distributions that will go to each of the Fund and Foundation. This legislation is found at N.Y. Ins. Law § 4301(j) and § 7317.

Go to <http://www.empireblue.com/about_empire/publicaffairs/forprofit_conversion_hearing_qa.shtml>.

[174] Consumers Union, Press Release, "Advocates Blast Amended Empire Blue Cross Conversion Plan, Urge Ny Department of Insurance to Reject For-Profit Bid," Aug. 5, 2002, *avaiilable at* . . . .

[175] Letter from Eliot Spitzer, New York Attorney General, to George V. Serio, Superintendent, New York State Department of Insurance, regarding Empire Blue Cross and Blue Shield, August 2, 2002.

of insurance "should approve a conversion plan only if it is accompanied by sufficient shareholder rights and other protections which will ensure that the fair market value is not substantially diminished, and the statutory mandate to 'maximize the value of the public asset' is achieved." The attorney general does not comment on the percentages allocated to the State and to the foundation.

Unsatisfied with this course of events, Consumers Union and other parties filed a lawsuit in August 2002 seeking a permanent injunction prohibiting the conversion or, in the alternative, requiring all conversion proceeds to be paid to a foundation that will carry on Empire's charitable mission.[176] The plaintiffs charge the legislature with engaging in an unconstitutional taking of private property without just compensation and other constitutional violations. As to the actions of the board, the complaint charges "In their eagerness to secure for-profit status, however, Empire's directors have now chosen to acquiesce in the State's taking of Empire's charitable assets. They have thus violated the duties of loyalty, obedience and care which they owe to Empire and its charitable mission."[177] As to the actions of the attorney general, the complaint charges: "the Attorney General has declined to challenge the Legislation, the actions of Empire's Board, or the taking of Empire's assets by the State."[178]

On September 20, 2002, the attorney general (on behalf of the State defendants) and

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[176] Consumers Union of U.S., Inc., *et al.* v. State of New York *et al.* N.Y. Supreme Court, N.Y. County. It is unclear what the grounds are for the plaintiffs' standing. The complaint asserts: "Upon information and belief, no member of the Board of Directors, no appointed member of the corporation, and no public official with authority to require that Empire's Directors act in accord with their fiduciary duty to the corporation, including the office of the Attorney General, has challenged or will challenge the Amended Plan of Conversion as inconsistent with their fiduciary duties." ¶ 141.

[177] Complaint, ¶ 3. Specifically, the complaint also charges:

> 92. Empire's Board of Directors has not, since 1999, considered whether use of any proceeds of sale of stock in a restructured or converted Empire for purposes other than those proposed in its Restructuring Plan, including those purposes provided for in the Legislation and Amended Plan of Conversion, would be consistent with the corporate purposes of Empire. Instead, the Board of Directors wrote to the Governor and leaders of the Legislature in August, 2001, saying that appropriate use of the proceeds of Empire's conversion was "not an issue that Empire can resolve," and suggested creating a foundation without a specific mission, letting the foundation board decide how to divide the proceeds.

and:

> 143. Empire's Directors abdicated and breached their fiduciary duties of care, loyalty and obedience by, inter alia: (i) abandoning the Restructuring Plan which the Board originated in 1997 as best meeting its fiduciary obligations and then pursued through 5 years of regulatory hearings and approvals; (ii) asking the Legislature to substitute its judgment in determining the disposition of Empire's assets; and (iii) ignoring requests to exercise its fiduciary duty and instead simply acquiescing in the Legislature's taking of Empire's value for purposes other than carrying out Empire's mission.

[178] ¶ 97.

Empire filed a motion to dismiss, on the grounds that the plaintiffs lack standing and have failed to state a cause of action. On the merits, the attorney general's memorandum in support of its motion quoted the legislation to show that the provisions of the act preempt the ordinary process for adopting and approving the disposition of nonprofit assets:

> Notwithstanding any other provision of law, the superintendent's approval of the conversion transaction shall constitute final approval of the transaction and no other authorizations or approvals shall be required. Notwithstanding any other provision of law, sole jurisdiction for any challenge of the superintendent's final determination regarding the conversion transaction shall rest with the New York supreme court and shall be commended within thirty days of the superintendent's final determination. *Judicial review shall be limited to a determination as to whether the superintendent acted in an arbitrary and capricious manner with respect to reaching a determination.*[179]

As to the plaintiffs' charge of an unconstitutional taking, the attorney general replied that "the conversion by Empire from a non-profit to a for-profit entity does not result in a state taking of anything: it is a voluntary, discretionary decision by those responsible for Empire – the board of directors."[180] Moreover, Empire's memorandum asserts that the board is insulated from a charge of breach of duty by the statute: "if the Superintendent approves the amended plan of conversion, New York Insurance Law § 7317(f)(ii) effectively declares that the board's decision to authorize the conversion cannot constitute a breach of fiduciary duty *as a matter of law.*"[181]

In their reply brief, the plaintiffs declared:

> It is ironic that the AG cites its own role as "parens patrieae" and protector of charitable assets as a basis for denying plaintiffs' standing in this cases. . . . Indeed, the unusual circumstances of this case – where the AG has been legislatively defrocked of its

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[179] N.Y. Ins. L. § 7317(f)(i) (emphasis added).

[180] Attorney General's memorandum at 29.

[181] Empire's memorandum in support of its motion to dismiss, at 25 (emphasis in original). Specifically, the statute provides that compliance with the new act –

> shall be deemed to constitute compliance with and shall supercede [sic] all such other legal requirements, including, but not limited to, statutory, common law and any other requirements relating to not-for-profit corporations and fiduciary requirements applicable to the board of directors of any company filing a plan pursuant to this section. In addition, and not in limitation of the foregoing, a transaction approved by the superintendent shall be deemed for all purposes to be a transaction that is fair and reasonable to an applicant, and the use of proceeds as described herein shall be deemed for all purposes to be a use for a purpose that is consistent with and as near as may be to the purposes for which the applicant was originally organized and subsequently operated.

N.Y. Ins. L. § 7317(f)(ii).

> parens patriae robe and has been saddled with an irreconcilable conflict of interest by virtue of its statutory obligation to defend legislative enactments – provide an additional basis for plaintiffs' standing. With the AG removed from its customary office as protector of the public's (as opposed to the government's) interest in charitable property, and the Directors walking away from their fiduciary role, no one but plaintiffs remain to stand up for Empire and the charitable mission of its assets.[182]

The plaintiffs refined their "takings" argument by characterizing the legislation as an "unconstitutional condition," in which New York State granted the Empire board's desire to convert to for-profit status on condition that it surrender nearly all of its assets.[183] "When the Directors have been left with no option but to sell Empire's charitable soul in order to save its commercial enterprise skin, this hardly makes their forfeiture 'voluntary.'"[184]

In other States where nonprofit health-care conversions have occurred, the process has been almost as politicized. See the discussion in Part II. The New York result is extreme in the amount that will wind up in public coffers for current expenses.[185]

8. American Red Cross and Donor Intent

The flood of charitable giving after the September 21, 2001 terrorist attacks on the United States led to a spectacular demonstration of both the legal and political pressures to enforce perceived donor expectations over the use of contributed funds. The 250 new organizations formed to handle the outpouring of contributions, along with existing major charities like the Red Cross and the Salvation Army, found themselves tripping over each other, unable to ensure that the more than $1.5 billion in contributions was being distributed responsibly. The American Red Cross succeeded in attracting most of the dollars contributed for this effort, and deposited them into a separate "Liberty Fund."

It soon transpired that Red Cross chief executive Bernardine Healy intended to devote a large portion of this fund to the improvement of the organization's infrastructure, for overhead,

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[182] Memorandum of Law in Opposition to Defendants' Motion to Dismiss, Oct. 29, 2002.

[183] *Id.* at 36, n. 32 (quoting Dolan v. City of Tigart, 512 U.S. 374 316-17 (1994).

[184] *Id.* at 36.

[185] See the Consumers Union chart "Efforts by State Governments to Control Conversion Foundations' Assets" (summarizing completed or proposed transactions in Colorado, Delaware, Kansas, Kentucky, Maryland, New Hampshire, New Jersey, New Mexico, and Virginia). The *New York Times* reported, however, that a private lawsuit has few legal precedents: "In one case, consumer organizations sued Blue Cross and Blue Shield of Georgia and the state insurance commissioner after the health plan converted to a for-profit. In a settlement in 1998, the conversion went ahead but the health plan agreed to give some assets to a public health foundation." Milt Freudenheim, *Suit Attacks Plan to Change Blue Cross Status*, N.Y. TIMES, Aug. 21, 2002, at B2.

and to address the needs of future terrorist events. Adverse public reaction led to charges that the charity was misleading donors, and forced the board of the Red Cross to demand Healy's resignation.[186] A congressional body held hearings into the performance of September 11 philanthropies.[187] At that hearing, New York attorney general Eliot Spitzer declared:

> [T]he charities that have been entrusted with these funds must spend them in a manner that fulfills the will of the donors. Most importantly, the donations made specifically in response to the September 11 attacks must be used exclusively for the benefit of those who have suffered as a result of those attacks. In particular, the indication by the American Red Cross that up to $260 million of the newly-established "Liberty Fund" will not be used directly for the victims of the September 11th attacks is unacceptable.[188]

Shortly thereafter, the Red Cross promised to spend the balance of the principal of the Liberty Fund on the victims and their families, and named former Senator George Mitchell to develop a plan of distribution. Accepting Mitchell's recommendation that "recipients of these monies are in the best position to assess their own immediate and long-term needs," the Red Cross announced that 90 percent of the nearly $1 billion raised would be disbursed by the first anniversary of the attacks.[189]

This decision, which essentially views the Red Cross as a financial conduit from the donors to the victims' families, was not necessarily what the attorney general had in mind. As he wrote in his testimony:

> [P]rograms must be carefully designed and funds prudently managed so they remain available to meet evolving needs. The charities cannot and should not spend all of the

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[186] This finding was echoed in the August 2002 report on the American Red Cross posted by the Better Business Bureau's Wise Giving Alliance, a charity rating agency. See <www.give.org/reports/arc.asp>. In June 2002, the Red Cross announced "a new system of affirmative confirmation and acknowledgment to ensure donations are directed as intended." Go to <www.redcross.org/press/disaster/ds_pr/020605dsfunds.html>. "The program is called Donor DIRECT which stands for D(onor) I(ntent) RE(cognition), C(onfirmation) and T(rust)." *Id.*

[187] *See* "List of Witnesses to Appear Before Committee on Ways and Means Subcommittee on Oversight on Response by Charitable Organizations to Recent Terrorist Attacks," <waysandmeans.house.gov/oversite/107cong/ov-7wit.htm>, with links to prepared statements.

[188] Statement of the Hon. Eliot Spitzer, New York Attorney General, "Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means," Hearing on Response by Charitable Organizations to the Recent Terrorist Attacks (Nov. 8, 2001), *available at* <http://waysandmeans.house.gov/oversite/107cong/11-8-01/11-8spit.htm>.

[189] See <www.redcross.org/press/disaster/ds_pr/020130libertyfund.html>. The Red Cross slightly reduced this percentage when it unexpectedly continued to receive another couple of hundred million dollars. It also expressed concern about jeopardizing its tax exemption by distributing living expenses to families that had no financial need. See Quarterly Report on the Liberty Fund (through July 31, 2002).

money immediately. A coordinated process by which the charities account for their progress will demonstrate that they are fulfilling their mission and remaining faithful to their public trust.

If the Red Cross – which, after all, specializes in ameliorating the immediate effects of disasters – was not in the best position to administer a long-term fund, the attorney general could have supported a *cy pres* or deviation plan to transfer an appropriate portion of the Liberty Fund to charities more experienced in long-term assistance.[190]

As for his role of ensuring the wise use of charitable resources, the attorney general commendably prodded the September 11 charities into privately coordinating their relief efforts by creating a combined data base.[191]

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[190] The Red Cross' stance led to reports that the Red Cross to some degree was throwing its money at those who might not need charitable assistance. A Red Cross spokesperson, reported *The Wall Street Journal*, said "the extended maintenance funds are being offered 'based on need' and notes that every person has his own idea of what constitutes an emergency. If the offer exceeds the need, 'it's up to the individual not to accept it. . . . We're not in a position to judge." (Chaker 2002.) The *New York Times* quoted one resident as trying to save the Red Cross from itself: "I could just sense that the organization would give [the money] to someone else who didn't need it, so . . . I said I will take it. And I'm donating it. It's like regifting." Joyce Purnick, *Take the Cash. You're Making Us Look Bad*, N.Y. TIMES, Feb. 11, 2002, at B1. The day after this story broke, the Red Cross "clarified" its policy that residents and workers in the area in lower Manhattan are entitled only for documented aid. *Red Cross Alters Guidelines for Awarding Disaster Relief*, WALL ST. J., Feb. 8, 2002, at B12. Aside from the legal issues, a charity seen to bestowing disaster relief on the financially well-off might have trouble raising funds from the general public in the future.

[191] It appeared from press reports that the attorney general initially sought public involvement, if not control, over such a database, but yielded to charities' concerns over confidentiality. For a description of an umbrella group for the major New York human services charities, see the webpage on the New York attorney general's website, at <http://www.wtcrelief.info/Charities/Information/pages/News.jsp?newsID=9 (posted December 14, 2001)>.