NONPROFIT FORUM

June 17, 1999

The Cornell Club
New York, New York

The For-Profitizing of the Nonprofit Sector: Corporate-Type Boards and the Gyroscope of Governance

by

J. David Seay, J.D.

Vice President, Secretary & Counsel
United Hospital Fund
New York, New York

The For-Profitizing of the Nonprofit Sector:

Corporate-Type Boards and the Gyroscope of Governance

Gyroscopes are instruments used in navigation equipment, such as a heading indicator on an airplane or a ship, designed to keep it on a true course. Being made by humans, however, such devices are not perfect, and tend to spin slightly forward in a motion called precession. Because of that tendency, they need periodically to be calibrated to the magnetic compass to maintain their accuracy and ensure the vehicle's travel on its true course. Governing boards of nonprofit entities are charged with the responsibility of hewing to the mission of the organization. They are in many respects the conscience or gyroscope of the enterprise, responsible for keeping the organization on its true course. And like man-made gyroscopes, they need calibrating from time to time to ensure that they operate properly.

Introduction

Many factors seem to be converging on the vast nonprofit sector in America, and some of them appear to be propelling some members of its family into new ventures and organizational forms which less resemble traditional notions of the nonprofit order and look more like their distant proprietary cousins. Governmental payment cutbacks, increased demand for services, competitive pressures from the for-profit sector and from other nonprofits have all intensified of late causing many nonprofit managers to scramble to innovate and to survive. And many have done so by adapting to the ways of business.

Indeed many nonprofits, in an effort to become more businesslike, have become businesses, leaving observers and community members scratching their heads and wondering whether they are still really nonprofits anymore and whether they continue to deserve the approbation and perquisites traditionally accorded charitable organizations, including tax exemption, lower postage rates, and the like. People are questioning whether such organizations have strayed from their missions and, even if they have not, whether too much of the management's time and attention has been diverted elsewhere.[1] From museum shops to health clubs, from for-profit subsidiaries to affinity credit cards, from joint ventures with for-profit companies to advertising campaigns and incentive compensation arrangements, the rush to emulate the commercial world is dizzying. Some scholars have suggested that the nation's charities should be divided into two types, the commercial and

---

[1] Ryan, William P., ***"The New Landscape for Nonprofits,"*** Harvard Business Review (Jan.-Feb. 1999).

the charitable, saying that only the "donative" nonprofits are truly deserving of special status.[2]

Management gurus are also on the scene preaching a number of new theories of management, organizational form, and governance. It has become particularly *au courant to* suggest to nonprofits that they adopt certain techniques from the for-profit sector in all aspects of their operations, including their governance structures and functions.[3]

Examples of all of the above can be seen in many quarters of the sector. By way of example and hypothetical discussion and analysis, this author chooses to begin this paper by looking at one particular area within the nonprofit world – health care, the largest single category of public charities in the country.[4] There are approximately 7,500 health system and hospital boards, and about 120,000 people sit on them.[5]

Consolidation within the health care sector is having dramatic effects on both the delivery of health care services and the institutions providing the services. Many forms of consolidation are being used, including loose affiliation agreements, memoranda of

---

[2] Hansmann, Henry, "***The Role of Nonprofit Enterprise,***" 89 Yale L.J. 835 (1980); and Colombo, John D. and Hall, Mark A., **The Charitable Tax Exemption**, Westview Press, Inc. (1995).
[3] Pointer, Dennis D. and Orlikoff, James E., **Board Work: Governing Nonprofit Health Care Organizations**, Jossey-Bass, San Francisco (1999).
[4] Bowen, William G., et al, **The Charitable Nonprofits**, Jossey-Bass, San Francisco, 1994, at p. 21.
[5] Pointer and Orlikoff, *supra*, at 1.

understanding, joint operating agreements, acquisitions, the use of subsidiaries and sole corporate member arrangements, parent holding companies, and full asset mergers, among others. Undertaken to achieve either structural or operational integration, or both, these types of consolidations in health care have been seen to involve all three classic types of integration under antitrust law: horizontal, vertical, and conglomerate integration. [6] Boards of directors in such organizations have fiduciary duties and responsibilities with respect to virtually all aspects of such transactions, including valuation and fair market value, due diligence and the use of timely and adequate information and data and the consideration of other potential alternative courses of action.[7]

This "nugget" examines trends in the governance of nonprofit organizations and the impact of some of those trends on mission and accountability. It suggests a reconsideration of the movement towards more "corporate" and less "community" governing boards.

---

[6] Peters, Gerald R., **Healthcare Integration: A Legal Manual for Constructing Integrated Organizations**, National Health Lawyers Association, Washington, D.C., 1995, p. 3 et seq.; and Pointer, *supra* at 13.
[7] Bryant, L. Edward, Jr., ***"Responsibilities of Directors of Not-for-Profit Corporations Faced with Sharing Control with Other Nonprofit Organizations in Health Industry Affiliations: A Commentary on Legal and Practical Realities,"*** 7 Annals of Health Law 139 (1998).

A Quasi-Hypothetical Example

Although loosely based on actual events, the following is a hypothetical discussion of consolidation trends recently observed among hospitals and systems in New York City. The first consolidation, a merger, of voluntary hospitals in recent times occurred in the late 1970s when two large Manhattan hospitals initiated a full asset merger, emerging with a unitary governing body. [8] In the intervening years, numerous other consolidating actions have been taken by many hospitals, resulting in some fairly large systems of hospitals and affiliated institutions. One such system was created by another large Manhattan academic medical center, which chose to use the sole corporate member/parent-subsidiary model of acquiring other, mostly smaller, hospitals for its growing system.

In that model, the to-be-acquired hospitals agreed to amend their by-laws to make themselves membership corporations under the Not-for-Profit Corporation Law (N-PCL), [9] each with one corporate member. That sole corporate member in each case was the acquiring hospital. Vestigial boards of trustees often remained at the acquired hospitals, albeit with significantly limited governing or merely advisory powers, and in any

---

[8] The United Hospital Fund of New York provided a planning grant to study the feasibility of merging Saint Luke's Hospital Center and The Roosevelt Hospital in 1978. The merger was completed the following year.

[9] New York Not-for-Profit Corporation Law (N-PCL), Sec. 601.

event the trustees of the acquiring hospital appointed those boards. The board of trustees of the acquiring hospital, in essence, became the ultimate legal governing body for it and all of its similarly acquired institutions. Thus one health "system" was created where a number of autonomous hospitals had been. Governing responsibility, in essence, was delegated up-stream to one board of trustees.

Similar consolidations were achieved by another hospital using the holding company model in which a new parent corporation was created to govern subsidiary corporations, which had hitherto been independent. Here, too, major powers of the subsidiaries were reserved to the parent board of trustees, which also controlled the membership of the subsidiary boards, and the acquiring hospital had majority control of the holding company's governing board. Each hospital remained "independent" in that each retained a board of trustees, albeit with subordinated authorities, and its own operating certificate under article 28 of the New York State Public Health Law [10] – as was the case in the immediately preceding example, as well. And thus another large health system was born, also with the real, legally cognizable governance responsibility delegated up-stream to one board of trustees.

In both cases, the governing boards were different in character and composition from the attributes of the many predecessor hospital boards. In one case the

[10] New York State, Public Health Law, Art. 28, and 10 NYC44 Part 405, et seq.

ultimate governing body was more "corporate" than what had preceded. That is to say, they were more professional – directors were selected less for their representing the communities served by the hospitals than for their own professional expertise. They were less diverse, had more insiders on them, and, above all, were much smaller in size than the more traditional nonprofit hospital board. The architects behind some of these new models were responding to such questions as "Can the larger, more diverse boards respond quickly enough to the decisions that are required in the rapidly evolving and more competitive health care environment?" And "Does the more market-oriented health care sector require more business-like governance?" Their answers were clearly "No" and "Yes," respectively.

The hypothetical example continues in a manner that has these two large systems themselves consolidating. Another holding company board is created under which these two systems are subsidiaries. This holding company board consists of three individuals: the president and CEO, the chief operating officer, and the chief financial officer of the corporation – each of whom had served in similar capacities with the larger and dominant of the two systems.

Query: Does anyone have a problem with this, and if so, why?

The foregoing is, of course, an extreme example. But it is an example of observed trends taken to an extreme. And both the Not-for-Profit Corporation Law and the Public Health Law in New York are permissive enough to allow the aforesaid example to occur. A public policy question is whether the laws governing these types of nonprofits should be changed to avoid such an occurrence. These trends call into question the status of traditional notions of autonomy, accountability, and checks-and-balances in the governance and operation of charitable nonprofit organizations.[11]

At present this trend may be only occurring in the large nonprofits – like the hospitals and perhaps the universities – where the pressure to behave more like a business is driven by the overwhelmingly large amounts of cash flowing through on tight margins and the need for enormous amounts of capital. If so, then these phenomena may relate to a relatively small number of nonprofits, but that has a disproportionate share of the nonprofit workforce. Two percent of New York City's 19,500 nonprofits employ 75% of the sector's workforce,[12] and these are largely the hospitals and universities. But there has been anecdotal evidence that in a number of smaller nonprofit organizations – in the arts and other areas – some of these trends have been seen. In any event it seems that such trends deserve a closer look.

[11] Ilchman, Warren F. and Burlingame, Dwight F., ***"Accountability in a Changing Philanthropic Environment,"*** in **Philanthropy and the Nonprofit Sector in a Changing America**, Clotfelter, Charles T. and Ehrlich, Thomas, eds., Indiana Univ. Press (1999).
[12] Nonprofit Coordinating Committee of New York, **The Nonprofit Sector in New York City**, New York (1992) at i.

No one seems to be talking about these trends, even at a time when boards and directors are coming under increasing public scrutiny within an enforcement framework where there is really very little oversight.[13] Goldschmid has observed that "...in contrast to the for-profit world, the law plays little role, other than aspirational, in assuring accountability in the nonprofit sector,"[14] and Kurtz has made similar observations.[15] Dale has noted a trend of increasing application of the laws of business corporations to nonprofit organizations, moving away from the traditional ties to trust law, and treating nonprofits more like for-profits with respect to the legal duties and responsibilities of directors,[16] while Fremont-Smith points out that significant differences remain between the two forms.[17]

For purposes of this discussion, six attributes of the more "corporate" board are described and discussed, although not all six are necessarily required for the admittedly nebulous definition. These six characteristics are boards that are ***more***

[13] Fishman, James J., ***"The Development of Nonprofit Corporation Law and an Agenda for Reform,"*** 34 Emory L.J., 617, 669 (1985).
[14] Goldschmid, Harvey J., ***"The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms,"*** *Journal of Corporation Law, summer 1998, at 632,* and presented at National Center on Philanthropy and the Law conference, New York, October 30 – 31, 1997.
[15] Kurtz, Daniel L., **Board Liability: Guide for Nonprofit Directors**, The Association of the Bar of the City of New York, Moyer Bell Limited, Mt. Kisco, NY, 1988, p 78 et seq.,
[16] Dale, Harvey P., ***"Advising Directors and Trustees on Risks and Opportunities,"*** C875 ALI-ABA 57 (1993).
[17] Fremont-Smith, Marion R., ***"The Role of Government Regulation in the Creation and Operation of Conversion Foundations,"*** 23 EOTR 1, at 37 et seq.; ***"Enforceability and Sanctions in Governance of Nonprofit Organizations: Standards and Enforcement,"*** New York Univ. School of Law, Nat'l. Center on Philanthropy and the Law Symposium (1997).

professional, paid, less community-representative, less diverse, more insiders, and smaller. Each will be addressed in turn.

More Professional Directors

Nonprofit boards need to have members with varying types of professional expertise. Individuals with financial acumen and accounting and legal expertise can obviously bring their talents to the nonprofit organization. Larger nonprofits, such as hospitals and universities, it can be argued, are so complex and intricate that merely delegating such skills to the staff or to outside firms and consultants is not sufficient to meet the needs of an increasingly demanding set of decisions in the boardroom. Smaller nonprofits may find such professional talent even more valuable, given their budgets and the cost of such skills at either the staff or outside level. And even when such expertise is delegated or purchased, it may be a good idea to have people on the board who can review and oversee the products of such work.

In some of the emerging "corporate" type nonprofit boards, however, there is a greater reliance upon directors selected for their individual professional skills and their potential contribution of just those skills to the organization. Sole-criterion selection often typifies board recruitment profiles and can lead to a board with some good professional talent but with little overall understanding or appreciation of the mission, stakeholders, and goals of the organization.[18]

There is a school of thought that says nonprofit trustees should be sought for far more than just a set of skills that the organization can purchase or delegate. Governance calls for a different set of abilities that may or may not include professional or other specific talents. The former chairman of the board of Adelphi University brought insurance skills to that boardroom and the university, of course, had insurance needs. Other attributes, it turned out, were missing.

Trustees are supposed to bring something even more valuable to the board table: judgment -- judgment and an understanding of the organization's mission and an appreciation of how mission can be operationalized in contemporary and ever-changing times.[19] Bowen points out that a *critical attribute* is sometimes overlooked or under-valued in board selection and composition: "a genuine understanding of the mission of the organization, combined with empathy and commitment."[20] He adds that more than specific professional skills, "in constructing boards, there is a special need for members who are

---

[18] Pointer and Orlikoff, *supra,* at 153.
[19] ***Todd v. Citizens Gas Co.,*** 46 F. 2d 855, 865 (7th Cir. 1931), *cert. Denied, 283 U.S. 852,* ***Eastern Kentucky Welfare Rights Organization v. Simon,*** 506 F.2d 1278, 1288 (D.C.Cir. 1974); Clark, Carolyn C., "***New York Healthcare Nonprofits: Regulation of the Merger and Conversion Process,***" Conference on Health Care Conversion Foundations: Protecting the Public Interest, The State Capitol, Albany (Draft Dated April 20, 1999).
[20] Bowen, William G., **Inside the Boardroom: Governance by Directors and Trustees**, John Wiley & Sons, Inc., New York, 1994, p. 51.

knowledgeable about he characteristic functions and problems of the particular enterprise in question."[21] Trustees' fiduciary duties of care include the often-difficult task of ascertaining, over time, the mission of the organization and its interpretation in changed circumstances.[22] And trustees must actually act to use their judgment in all such matters. The traditional protections of the business judgment rule may provide no safe harbor unless a director actually exercises judgment.[23]

Kurtz and Goldschmid both note the authority of boards to delegate certain responsibilities and skills and to rely on outsiders for many of these talents, [24] suggesting a dichotomy or separation between two distinct types of activities. There are certain specific technical and professional talents and skills on the one hand, which boards may or may not have among their own members, and on the other hand there are the types of decisions and actions boards must make and take in any event. The former may be delegated without fear of liability while the latter cannot. The former may be a necessary but not sufficient predicate to responsible governance behavior. Thus the issue is more complex than just "professional" directors versus other types. However, it is a trend that should be noted and taken into consideration when reform of nonprofit governance is considered.

---

[21] Bowen, **Inside the Boardroom**, supra, at 53
[22] ***Queen of Angels Hospital v. Younger***, 136 Cal. Rptr. 36 (Cal. Ct. App. 1977), and Ono, Naomi, ***"Boards of Directors Under Fire: An Examination of Nonprofit Board Duties in the Health Care Environment,"*** 7 Annals of Health Law 107 (1998).
[23] Brody, Evelyn, ***"The Limits of Charity Fiduciary Law,"*** 57 Md. L. Rev. 1400 (1998).
[24] Kurtz, *supra,* at 8 et seq., and Goldschmid, *supra.*

Paid Directors

Ira Millstein and other experts in corporate governance have said that directors of nonprofit organizations should be compensated for their time and talent serving on nonprofit boards. [25] As the argument goes, paying them is one way to get nonprofit directors' attention and get them to truly value their time spent governing the organization, giving it the same attention they give their own businesses and service on corporate boards. Many nonprofit managers and scholars have spoken of a culture difference within many nonprofit boards where otherwise skilled and consummate businessmen and professionals behave quite differently than they do in their usual lines of business or professions.[26] The United Way of America board during the Aramony years had on it some of the best and brightest of corporate America, and yet it seems as if they checked all their talent at the door of that room. [27] Some would say that was, in part, because they were not compensated for their service, adding to a looser, less rigorous and less accountable governance environment. It is unclear, however, whether the issue of compensation had any direct bearing on what happened at United Way of America.

---

[25] Millstein, Ira M., partner, Weil, Gotshal & Manges LLP, presentation at United Hospital Fund Trustee Leadership Briefing ***"Lessons from For-Profit Governance: Responsibilities in the Hospital Boardroom,"*** New York, February 19, 1998.
[26] Kurtz, *supra*, and Bowen, **Inside the Boardroom**, *supra*.
[27] Goldschmid, *supra*.

There are others who take the more traditional view that nonprofit directors should not be paid, and that this is one way in which nonprofit boards are supposed to be different from corporate boards. What sense does it make to pay a director for her service, only to turn around and solicit her for charitable contributions in amounts that may equal or even exceed her director's fees? And then there is the notion that the very essence of the American nonprofit sector is its voluntary nature. Some would inquire, in what sense can an organization be called voluntary when its governing board is paid? Of course there can be other volunteers for the organization and there can be voluntary donations and other contributions. But it has been suggested that the role of governance is situated on such a basic plane that all organizational direction and culture emanate therefrom. And historically, nonprofit directors have not been compensated, except for directors of private foundations, [28] although there is increasing anecdotal evidence that this is changing.

Oleck has observed that at least one state prohibits the compensation of trustees of charitable corporations,[29] and New York prohibits compensation of either members or directors of community mental health services and mental retardation services companies.[30] The compensation of trustees, at least at certain types of charitable organizations, is an issue deserving further scrutiny.

---

[28] Kurtz, *supra,* at 6.
[29] Oleck, Howard L., **Nonprofit Corporations, Organizations, and Associations**, 4th ed., Prentice Hall, Inc., New Jersey (1980), at 619-20; and Ohio Rev. Code Sec. 1713.30.
[30] NY Ment. Hyg. L. Sec. 75.15; 27 NYCRR 75.

Less Community Representative Directors

As already mentioned, the move towards more professional directors often comes at the price of having fewer directors selected for their ability to represent, in a broad sense, the community or communities served by the organization. This can be exacerbated as the boards shrink in size. And nonprofits achieving their exempt status as community benefit organizations, it can be argued, need a board-level awareness of and understanding of the unique community needs and characteristics of the communities served by the institution. The concept of "moral ownership" has been used to describe the kind of allegiance the board should owe to the institution's primary stakeholders,[31]and it is a concept readily grasped by community residents. Although it is not, *a priori* impossible for individuals from outside the community to be able to do good things in the community, there may be a sense of "ownership," enhanced loyalty, and therefore improved accountability associated with community trustees. This also may hold true where the communities served, rather than geographical, are among one or more of the arts, sciences, or other areas in which nonprofit organizations operate. Certainly, traditional

---

[31] Carver, John, **Boards that Make a Difference: A New Design for Leadership in Nonprofit and Public Organizations,** Jossey-Bass, San Francisco (1990), at 17.

notions of the checks-and-balances and accountability of nonprofit organizations have included broadly representative governing boards.

However, others would counter that in some highly competitive and rapidly consolidating areas within the sector, such as health care, the utility of a community-representative board is diminished by modern circumstances. A case in point may be the regional or national nonprofit health system such as Catholic Health Initiatives based in Denver, Colorado. This is a $5+ Billion operation with over 100 hospitals and other health care facilities in many states around the country. A "community" board may make no sense there, except in the sense that there are representatives from among the various communities on the governing board. The urge is strong, though, to build a board of national health care experts in such cases, relying on vestigial local boards in advisory capacities. The Henry Ford Health System in Detroit is another example where the ultimate governing authority is, by design, less community-representative than the hospital boards of yore.[32] These enterprises have become so large, complex, and geographically dispersed that governing boards must adapt to a different set of demands than did the local boards before them. New models are required to adequately discharge their own fiduciary responsibilities as well as to serve those institutions. Or maybe just a new or refined definition of community is required. In any event, the issue of less community

---

[32] Warden, Gail L., CEO, Henry Ford Health System, presentation at United Hospital Fund Trustee Leadership Briefing, ***"Creating Health Systems for the 21st Century: The Roles of Trustees, Management, and Physicians in Health Care Integration,"*** New York, November 9, 1998.

representative governing bodies is also a modern trend. It, too, should be re-examined when changes in laws and policies concerning nonprofit governance changes are discussed.

Less Diverse Boards

Less diverse boards are probably not the result of a conscious decision in developing a governance structure. Rather, it is likely the unintended consequence and logical result of some of the other trends already discussed. In this context diversity includes but is not limited to its more traditional definition of inclusion of minorities, persons of color, and cultural representation. It also includes the broader notion of community and communities already discussed, and it includes representation among management, practitioners, such as physicians in the health care context, employees, persons served, donors, and many other stakeholders of the organization. This describes an egalitarian approach to nonprofit governance that has probably been more the exception rather than the rule, at least with hospitals and other larger organizations. A more elite form was often chosen; only now the social and class elitism is perhaps yielding to a form of commercial and business elitism on these nonprofit boards.

Diversity in governance can also mean diversity of viewpoint, opinion, and perspective among individual trustees. In this sense the organization is benefited by a breadth of judgment and avoids a narrowness of focus that can be damaging at the governance level. Of course focus is important in both management and governance when pursuing mission, but a too narrow focus in arriving at or interpreting mission in changing times can rob an organization of opportunities which otherwise may be missed. The duty of obedience imposed upon trustees requires that they exercise their judgment in ascertaining what the organization's mission requires at any given time, and differences of opinion can spark litigation over the correct interpretation.[33] And the burden on directors to ensure that adequate information systems and reporting exist to give them a wide array of information to inform their judgment and decisions is increasing.[34]

In the emerging context of conversions of nonprofit health care organizations to for-profit status, a number of states have adopted varying statutes providing a framework for regulatory oversight of such activities. Included in some of the statutes are requirements that boards of the charitable entities receiving the charitable assets resulting from the conversion be diverse and "...be broadly based in and representative of the community...."[35]

---

[33] ***Commonwealth of Pennsylvania v. Barnes Foundation,*** 398 Pa. 158, A.2d 500 (1960).

[34] ***In Re Caremark International, Inc. Derivative Litigation,*** 698 A.2d 959 (1997), and Gruner, Richard S., ***"Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond,"*** 995 PLI 57 (1997).

[35] Fremont-Smith, *supra,* ***"The Role of Government Regulation...,"*** at 48-49.

Thus, diversity can be seen as a mechanism to promote accountability of nonprofit boards, and to the extent that it does, trends towards less diverse boards may not be in the public's interest.

More Inside Directors

Traditionally, there have been no employees of nonprofit organizations on their own boards, with the exception of the top paid individual, such as executive director, president, or whatever term is used.[36] Sometimes those individuals served without vote, and in other cases were allowed to vote. Such individuals can be valuable sources of information and judgment on a board, given their intimate knowledge of the organization and its field of operation. The law even ascribes higher duties to them based on such information and knowledge.[37]

In some of the hospital consolidations referred to at the outset, the holding company boards are appearing to have increasing numbers of insiders on them. There is anecdotal evidence that in some cases three or more paid corporate officers, including the president/CEO, executive vice president/COO, and the vice president/CFO serve on the

---

[36] Kurtz, *supra* at. 6; and Bjorklund, Victoria, Fishman, James J., and Kurtz, Daniel L, **New York Nonprofit Law and Practice: With Tax Analysis**, Michie Law Publishers, Virginia (1997).
[37] Kurtz, *supra* at 27.

governing board. In addition, there is also a trend towards having more physicians on hospital/holding company boards. Even if those physicians are not employed by the hospital by salary, but are private attending physicians with hospital privileges, it can be argued that they are still insiders for purposes of governance category. And of course the effects of this trend, as in all of the ones herein discussed, is exacerbated when the board is smaller in size.

The law has recognized that certain directors can be classified as "interested directors," to use the terminology of the model nonprofit corporation act,[38] or "disqualified persons," to use the term adopted under the new intermediate sanctions regulations recently promulgated by the Internal Revenue Service.[39] These are directors who have a personal or other financial interest in a transaction being considered by the board on which they sit. They should, therefore, be disqualified from participating in that decision, due to their conflict of interest. Common law also has long-recognized that directors can have real, potential, or apparent conflicts of interest, and has provided sanctions in cases of abuse.[40] Portions of or entire boards of trustees have even been replaced in extreme cases where the behavior was most egregious, and there is a growing

---

[38] **Revised Model Nonprofit Corporation Act (RMNCA)**, The Committee on Nonprofit Corporations, Section of Corporation, Banking, and Business Law, American Bar Association, exposure draft, May 1986.
[39] Taxpayer Bill of Rights 2 (1996), Internal Revenue Code, 26 U.S.C. 4958, REG-246256-96 (1998).
[40] ***Stern v. Lucy Webb Hayes National Training School,*** 367 F. Supp. 536 (D.D.C. 1973), 381 F. Supp. 10003 (D.D.C. 1974); ***Blankenship v. Boyle,*** 329 F. Supp. 1089, ***Fowle Memorial Hospital Co. v. Nicholson,*** 189 N.C. 44, 126 S.E. 94 (1925).

awareness and concern about charitable trustees, abuses of authority, and conflicts of interest.[41] Further, case law has long recognized that directors committing fraud, self-dealing, misappropriation of corporate opportunities, improper diversion of corporate assets, and pursuing personal interests versus the welfare of the corporation violate the duty of loyalty, and that neglect, mismanagement and improper (but disinterested) decision making by directors are breaches of the duty of care owed to the corporation.[42] The ***Adelphi*** case uncovered numerous examples of breaches of both the duty of care and the duty of loyalty.[43]

There are a number of circumstances when inside directors, whether they are executive employees of a hospital or system or physicians earning their livelihood there, have more or less "built in"conflicts of interest. The most obvious type involves the setting of their own executive compensation.[44] However, I suggest that the range of potential conflicts is much wider and subtler than that example. Inside directors have a personal, professional, and financial relationship to the hospital or other nonprofit

---

[41] ***"Trustees Ousted in Hawaii,"*** *Chronicle of Philanthropy,* Vol. XI, No. 15, May 20, 1999; ***In the Matter of the Estate of Beryl H. Buck, Deceased,*** No. 23259 (August 15, 1986); Letter of Agreement between the Commonwealth of Massachusetts, Office of the Attorney General and Dr. G. B. Metcalf, Chairman and on behalf of Trustees of Boston University (November 16, 1993); ***Committee to Save Adelphi, et al v. Diamandopoulos, et al***, Bd. Of Regents of the Univ. of the State of N.Y. (Feb. 5, 1997); and Fishman, James J. & Stephen Schwartz, **Cases and Materials on Nonprofit Organizations** (re the Adelphi University case), Foundation Press (1995).

[42] Goldschmid, *supra*, at 646; Hopkins, Bruce R., **The Law of Tax-Exempt Organizations**, 6th ed. (1992).

[43] ***Committee to Save Adelphi***, *supra,* and Goldschmid, *supra*, at 647

[44] ***Boston Children's Heart Foundation, Inc. v. Nadal-Ginard***, 73 F. 3d 429 (1st Cir. 1996), ***Application of J. Stanley Baker v. Henry Glass & Co.***, 140 Misc. 2d 836, 531 N.Y.S. 2d 746.

organization that no other outside director has. Some examination of these types of relationships alongside the concepts of "interested" or "disqualified" directors is in order.

The Model Act provides an optional section limiting to 49% the number of interested directors, thus resulting in a requirement of a disinterested majority.[45] According to Kurtz, only California has enacted a statutory requirement for a disinterested majority.[46] In New York the Not-for-Profit Corporation statute is silent on the issue, but certain provisions in the Public Health Law dealing with the establishment of hospitals, for example, prohibits directors with a financial interest from voting on any matters involving their interest.[47] But that regulation goes on to define financial interest as "…an aggregate beneficial equity interest of 10 percent or more."[48] No amount of salary or other income is covered by the definition. One can argue that a financial interest of 100% of one's salary is also substantial for these purposes. Boards can act with greater independence the fewer insider director they have, and when the directors have no such interests, there is less likelihood of conflicts between self interest and the best interests of the organization.[49]

Receiving one's livelihood and, in essence, one's professional career from an organization has a powerful effect on executives' incentives and behaviors, especially

---

[45] RMNCA Sec. 8.13.
[46] Kurtz, *supra* at p. 7, note 11; Cal. Corp. Code Sec. 5227.
[47] 10 N.Y. ADC 610.4, 10 NYCRR 610.4
[48] See Note 43 *supra,* at Sec. 610.4 (a) (2).
[49] Bjorklund, *supra,* at 341.

given the growing use of incentive compensation arrangements in hospitals and systems which often attempt to link pay to bottom-line performance. But many of the decisions a board must make may not always be in the best interests of one's career or salary. Short and long-range strategic decisions about the future of the organization, a decision to cut back services, reduce compensation, lay-off employees, or even to close the institution can all run counter to a paid employee's own interests. If that person is also a director charged with making those decisions, the conflicts come to the fore. If all of the directors are insiders the problem is compounded nearly to the point of impossibility. "The object…is to ensure that a majority of the directors of public benefit corporations do not have a built in conflict of interest. Directors who receive compensation from a corporation constantly make decisions which directly or indirectly affect their compensation. Thus they are not completely free to decide dispassionately how to allocate a corporation's resources and what is in the corporation's best interest."[50]

Composition of a board of directors therefore, can be very important – and at times perhaps even determinative – in matters relating to conflicts of interest, self-dealing, and other abuses of trust. Some nonprofit boards can be composed of token members controlled by in-house director employees, in contrast to most large for-profit corporations.[51] These problems "…are more likely with a weak board dominated by one

[50] RMNCA, Sec. 8.13, Comments.
[51] Fishman, James J., *supra,* Emory L.J., at 674.

or a small group of individuals who, as full-time officers and/or employees, have a financial interest in the organization (even if limited to their salaries and related benefits). The board should consist predominantly of individuals who are financially disinterested."[52]

In this area, with the potential for abuse, the relative laxity of the law as an accountability vehicle,[53] and the permissiveness of the laws in many states, such as New York, it seems only reasonable to call into question the continued reliance upon the existing statutory framework. Perhaps the public interest, and the nonprofit sector itself, would be better served by adopting a stricter requirement with regard both to inside directors, specifically, and interested directors more broadly.

Smaller Boards

It has already been pointed out that each of the five preceding attributes is exacerbated as board size decreases. In many states, such as New York, nonprofit boards may be as small as three,[54] but some states require a minimum of five directors.[55] The model act also sets the minimum at three.[56] One state even permits a "board" of one.[57]

---

[52] Kurtz, *supra,* at 64. and Bjorklund, *supra* at 400.
[53] Kurtz, *supra,* at xi; Bjorklund, *supra,* at 387; and Goldschmid, *supra,* at 1.
[54] NPCL, Sec. 702.
[55] Oleck, *supra,* at 597.
[56] RMNCA, Sec. 8.03(a).
[57] Cal. Corp. Code, Sec. 5151(a); and Oleck, *supra,* at 597.

In the rapidly evolving and more competitive nature of the nonprofit sector, and especially within health care, there is increasing pressure to make decisions more quickly in order to respond effectively to market changes. There is a growing view that the traditional, larger nonprofit board is just too large and too cumbersome in its decision-making ability to function efficiently and effectively in this new environment.[58] What is needed, the thinking goes, is for the nonprofits to look to and emulate their for-profit cousins, and pare the board down to a "leaner and meaner" governing structure modeled more on the corporate governance model. This, as has been noted herein, includes boards with fewer directors.

Certainly the argument can be made that some of the hospital boards resulting from some of the mergers in New York are extremes in the other direction. There are at least two such entities in the New York metropolitan area whose boards each include over one hundred trustees. It is difficult to imagine how boards of such size can function effectively without wholesale delegation of duties to committees and management. In fact more than one commentator has suggested that such large boards are also subject to being dominated by a small subset of individuals, often insiders.[59]

---

[58] Millstein, *supra*, and Pointer and Orlikoff, *supra*.

[59] Oleck, *supra*, and Taft., S., ***"Control of Foundations and Other Nonprofit Corporations,"*** 18 Clev. St. L. Rev. 478 (1969).

Clearly, a "just right" balance is what is needed, even in the absence of agreement on what it should be.[60] However, it is also difficult to imagine the public's interest in having any nonprofit organized and operated with a board of only three persons, especially when coupled with laws permitting unlimited numbers of inside directors. Perhaps it is time for those states with the three-director minimum to reconsider the wisdom of their statutes in this area.

Conclusion and Recommendations for Reform

The desire to be more efficient in nonprofit governance structure, composition, and operation can be understood, especially in a rapidly evolving marketplace that is becoming increasingly competitive. The tendency to want a governing board that is nimble and can make quick decisions is natural in such circumstances. However, quick fixes to achieve efficiency may come at the price of accountability, public understanding and support, and political protections. It is the conclusion of this "nugget" that the gyroscope of governance has precessed somewhat and some calibration or reform is needed in the laws and policies covering nonprofit governance. These changes are needed to promote or enhance the accountability of nonprofit, charitable organizations to

[60] Pointer and Orlikoff, *supra,* at 134.

the public and the various constituencies, communities, beneficiaries, and other stakeholders of these organizations. The trend towards more corporate-style boards and away from the more traditional nonprofit governance model may not be in the public interest or even in the best long-term interests of nonprofit institutions.

Some of the changes by their nature are difficult to implement by statute or regulation, and can best be made by organizations themselves voluntarily. The concepts of having community-representative boards, broadly defined, and more rather than less diverse governing bodies may not be amenable to legislative solutions, although the inclusion of such language in statutes and regulations would give some badly needed guidance in this area.

Some of the other attributes of the more corporate board are more amenable to regulatory oversight, and indeed are already regulated, albeit loosely, in some cases. For example, it is herein recommended that Ohio prohibition[61] of compensating trustees of charitable organizations be adopted by New York and other states. However, given the deeply rooted tradition of compensating trustees of private foundations, a more practical recommendation may be to limit the prohibition to public charities and perhaps 501(c)(4) organizations.

---

[61] See Note 29, *supra*.

Similarly, it is recommended that the statutory minimum number of directors, in New York and elsewhere where it is permissively low, be raised to five. Although the difference between three and five may not be numerically significant, its impact can be substantial in the character, composition, and conduct of a nonprofit governing board.

And finally, with regard to inside directors and other interested directors, it is recommended that New York and other states adopt the model act's optional section that requires decisions to be made by a disinterested majority of a nonprofit's governing board. Further, short of an outright ban of inside directors, some consideration should be given to fixing a statutory maximum number or percentage of inside directors allowed on the boards of nonprofit, charitable organizations. As discussed before, due to the inherent nature of their interests in the organization itself and the built-in conflicts associated with them, it would be unwise to legally permit significant numbers of such directors. One option would be to require that they serve without vote. Another would be for them to be statutorily defined as interested or disqualified directors for certain specified or all purposes.

Intermediate sanction regulations will likely have a significant effect on governance behavior in the subset of self-dealing situations and conflicts of interest the regulation was designed to address. It, alone, cannot address all types of potential director misconduct, and in any event, it remains to be seen just how pervasive their effect will be and to what extent compliance is achieved in an environment where enforcement resources are scarce.

Numerous voices for various reforms of the nonprofit sector have been heard in recent years. There have been calls for increasing the classes of person with standing to sue directors and officers of nonprofit organizations, using relators to enhance the role and reach of the attorneys general, increasing public involvement and letting "sunshine" into the affairs of nonprofits, lessening the complex dissolution and other arcane features in certain state regulatory schemes, using the Form 990 as a tool for enhanced disclosure and better oversight and accountability of nonprofits, and other suggested improvements, all designed to make the sector better and more accountable.[62] This nugget in its own modest way attempts to join those voices calling for careful calibration of the gyroscope of nonprofit governance in an effort to keep the sector on a true course.

---

[62] Fleishman, Joel L., ***"Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform,"*** chapt. 8 in ***Philanthropy and the Nonprofit Sector...***, *supra.;* Goldschmid, *supra;* Clark, *supra;* Fishman, *supra;* and Swords, Peter DeL., ***"The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits,"*** 51 Tax Lawyer 571 (1998).

The author wishes to acknowledge with appreciation the research assistance in the development of this paper provided by Mr. David Weisberg. Mr. Weisberg is a 1999 graduate of the Benjamin N. Cardozo School of Law of Yeshiva University in New York. He worked at the United Hospital Fund of New York in 1998 and 1999 under an Albert Schweitzer Fellowship from the Harvard University School of Public Health.