The Nationalization of Nonprofit Governance Rules: A Good or Lousy Idea?

I. INTRODUCTION

In June of 2004 the Senate Finance Committee released a discussion draft prepared by its staff proposing reforms for the regulation of tax-exempt organizations. Among other things it proposed that there be established federal liability for breach by board members of their duty of care obligations and that boards be comprised of no less than three and no greater than fifteen members. These recommendations were contained under a heading entitled "G. Encourage Strong Governance and Best Practices for Exempt Organizations" and this part of the staff discussion draft is reproduced in the Appendix to this paper.

This part of the staff discussion draft proposed in effect the nationalization of some nonprofit governance rules.[1] This strikes me as a very bad idea and this paper asks whether nonprofit governance rules are best left to the states or whether they should be nationalized. Issues of federalism are raised and discussed, but, as I will shortly make clear, I make no claim to there being any constitutional impediments to such nationalization (nor for that matter do I claim to being anything more than a confused novice when it comes to constitutional analysis).

My focus in this paper is only on nonprofits whose activities and impact are solely intrastate and whose activities affect neither other states nor the citizens of other states. As an empirical matter I believe that in terms of numbers alone this describes the huge proportion of nonprofits. My concern is with purely local nonprofits that frequently have small staffs, perhaps only volunteers, and small budgets but which, if successful, can make a very positive difference to the communities in which they are located. Examples would include local libraries, local teenage counseling centers, local churches or local community development groups. Outside of my focus are nonprofit groups that operate in more than one state, either by having activities in other states or by having visitors, students, patients, audience members, etc., travel from other states to partake of their benefits.[2]

It should also note at the start that I am not excluding any nonprofit from national legislation designed to protect human and civil rights. I welcome national legislation prohibiting any nonprofit from discriminating on grounds of race, gender, age, sexual preference, etc.

At the start I want to address the argument that, as a purely logical matter, it can be justly said that everything affects everything else and so it is just not true that there are groups that have only intrastate impact. For our purposes I believe that the out-of-state impact of the kinds of groups that are my focus is so small as to be practically negligible. It is, of course, the case that most of these groups will purchase goods and in some case services from out-of state concerns, goods and services without which they could not operate. And it may be that from time to time an out-of-state resident visits them. But overwhelmingly these groups provide services just to the members of their communities,

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[1] The paper refers to tax exempt organizations but the reference is surely to the kinds of nonprofits that we meet to talk out.

their purposes are limited to serving just their communities and it is only the members of their communities that have any real interest in what they do or how they do it. A small community-based nonprofit in the northeast Catskills has about as much to do with the citizens of Oregon or Louisiana and it does with the citizens of Siberia.

It may be objected that I am making it too easy on myself by excluding the big nonprofits, many of which do in fact affect other states and their citizens. Some will argue that they are the only ones that really count. My answer is that this paper examines a relatively unexplored field and that by setting it up as I do, I can analyze the concepts involved unburdened by every real world concern and thus purchase a level of clarity about them that might not otherwise be gained. Perhaps if any of these ideas are sound they can at some future point be applied to a broader group of nonprofits. All of which is to say that this is an academic paper.

My argument then is not that all rules for nonprofit governance ought to be left to the states. I am happy to concede that for many nonprofits that operate throughout the country a good number of nonprofit governance rules might well be nationalized. Thus it would be consistent with my position that there be a set of national rules for some nonprofits but that such rules would not apply to the purely intrastate nonprofits, and as to the governance rules for that group of nonprofits, I would argue that their enactment ought to be left solely to the states. (Below I will discuss the circumstances when it makes good sense for there to be concurrent jurisdiction (both state and federal) over the same nonprofit subject matter.)

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[2] Little attention is given in this paper to nonprofits that solicit contributions in more than one state.

As should already be clear, much of my argument will be based on assertion that I am dealing only with local matters and I have already claimed that many of the rules that I will be discussing ought to be left to the states to provide. Inevitably the observation will arise that state lines are somewhat arbitrary jurisdictional limits: some are small, both in size and population and some are huge, and even the smaller states can be seen to be too large to provide all the advantages of localism. But it is states that make state laws in our system, including the laws we will be discussing, and whatever might be said about their size, there are many of them and they are obviously more local than the country taken as a whole.

As mentioned at the start, I make no claim in this paper that the authority of the U.S. Congress to regulate in this area is constrained by the Constitution. Surely for most of the nonprofits that we are interested in, virtually all of which enjoy tax exemption, it has the right to do so under the taxing power and this forecloses the issue for many of the rules regulating nonprofits that we will consider. There will be some rules, however, that may sensibly be said not to implicate the taxing power, e.g. a requirement for having board meetings open to the public. But even as to the national government legislating in areas of these kinds of rules, I make no claim that the constitution limits its authority to do so. I accept David Shapiro's conclusion, "that there is virtually no significant constitutional limit on the capacity of federal law to supercede state authority."[3] Shapiro goes ahead to admit that federal power may not be used to abolish a state without its

[3] David L. Shapiro, Federalism: a dialogue, 34 (1995) [hereinafter Shapiro]. It may not be too far off base to say that this is "the" book on the subject.

consent, but notes that "the assumption here is that while the federal government must leave the state with its boundaries … it may at the same time deprive the state of virtually all authority to regulate human affairs within those boundaries."[4]

Nevertheless, as we all know, huge areas of substantive legislative jurisdiction are left to the states. Shapiro notes:

> "While state political autonomy, and the subjects states may regulate free from any hazard of national control, have been narrowed in theory and in practice, it remains true that a remarkable proportion of the regulations that affect our daily lives – on such matters as the uses of property, education, local transportation, family relations, the definition of liability-creating civil and criminal conduct, and many others – continue as primarily the subject of state and local control." [5]

He admits that such matters could be shifted to national control and asks why this has not happened. He finds the answer in "the profound observation of Hart and Wechsler over forty years ago that federal law in this country is 'generally interstitial in its nature' …" [6]

[4] Id. at 34-5. Richard Briffault, writing in 1994, notes: "The combined effect of expansive contemporary interpretations of federal law-making power and the Supremacy clause's preemption of state laws that conflict with congressional enactments further narrows the scope of state law-making autonomy. The Constitution does not protect the states from federal displacement even with respect to matters that historically were primarily fields of state competence …" Briffault, "What About the 'Ism'?" Normative and Formal Concerns in Contemporary Federalism, 1301, 1341(1994) [hereinafter Briffault]. Both these writings were done before Lopez. Shapiro adds a postscript on Lopez noting that "the breadth of the various opinions for the five member majority suggest that the opinion may herald a significant change in the scope of congressional discretion, in exercising the commerce power, to preempt state regulation" and added that "it is difficult to tell at this early writing just what the generative force of the decision will be. Much will probably depend on the future make-up of the Court." Shapiro, supra note 3, at 141. His hunch at the time of writing the postscript was that "the impact of the decision on broader questions of federal power will be limited." Id. Of course, since that time Roberts and Alito have joined the Court.

[5] Shapiro, supra note 3, at 114. Richard Briffault notes that "the power to set rules that govern fundamental aspects of economic and social relations is left largely to the states." Briffault, supra note 4, at 1344. In comparing the authority of local governments to state governments, he lists the following fields as belonging to the states: contract, tort, property, the administration of justice, criminal law, [and] and family relationships. Id. at 1343.

[6] Herbert Wechsler said this on the subject in his famous federalism article: "National action has thus been regarded as exceptional in our polity, an intrusion to be justified by some necessity, the special rather than the ordinary case. This point of view cuts even deeper that the concept of the central government as one of granted, limited authority, and articulated in the Tenth Amendment. National power may be quite unquestioned in a given situation; those who advocate its exercise must nonetheless answer the preliminary

I need hardly confess to my fellow Forum members that I am hardly a scholar of constitutional law. But let me share with you my approach to these issues. First, as just noted, it is unarguable that there are massive amounts of substantive legislative jurisdiction that as a matter of fact remain with the states. Second, that there are few, if any, constitutional limits on the federal government moving into any field it chooses to. Third, the national government in fact has not occupied many of these areas of substantive legislative jurisdiction. It has chosen not to, not because it is constitutionally constrained, but almost certainly for some good policy reasons.[7] In many cases, I believe, that these reasons are the reasons that are advanced in support of a federal system.

I am going to argue that as a normative matter, in the limited circumstances I suppose, rules regarding the governance of nonprofit organizations should be left to the states, not because of any constitutional limit on the national government, but because from a policy

question why the matter should not be left to the states. Even when Congress acts, its tendency has been to frame enactments on an *ad hoc* basis to accomplish limited objectives, supplanting state-created norms only so far as may be necessary for the purpose. Indeed, with all the centralizing growth throughout the years, federal law is still a largely interstitial product, rarely occupying any field completely, building normally on legal relationships established by the states." Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 Colum. L. Rev. 543 (1954). Shapiro points outs that a note in Hart And Wechsler's The Federal Courts and the Federal System makes the same point and that subsequent editions of that case book (of which was an editor) "have barely altered the text of this brief note …[not because of inertia] but rather the editors' continuing acceptance of the accuracy and utility of the observation." Shapiro, supra note 8, note 22 at 114. Wechsler's article is famous for the point that the structure of the national government (state representatives and state electors at so many points, etc.) assures that the states' interests will not be trampled on. The point made above, and the one that Shapiro picks up on, seems in some ways more profound: namely, that as a matter of fact substantive legislative jurisdiction lies overwhelmingly with the states. That simply is a fact. They might also find a normative dimension to this state of affairs. Shapiro opines for example as follows: "Given the virtues of a federal system in which the starting point for the exercise of authority is at the state level (or lower), I think it is appropriate that the burden rest – as I believe it traditionally has - with those who advocate the exercise of national power." Shapiro, supra note 8, at 119.

standpoint, it makes good sense. I assume our goal is to have the best system of government possible and I believe that several of the policy arguments for federalism suggest that, given our goal of good government, it is best as a policy matter to leave the development and promulgation of many nonprofit governance rules to the states.

II. SOME VIRTUES OF FEDERALISM

In this part of the paper I briefly review some of the standard claims made for decentralization and federalism. As I have understood it, there appear to be two categories of argument: economic and political. The economic approach considers such matters as the economies and diseconomies of scale, the optimum provision of public goods, and race to the bottom and prisoner dilemma problems. David Shapiro's wonderful book, *Federalism: a dialogue*, [8] deals in large part with economic considerations.[9] My focus will be more on the political side of the issue.

There is, of course, a difference between decentralization and federalism. A unitary government can decentralize the administration of its governance, including letting localities make rules for local governance purposes. But the central, single government is the ultimate rulemaker and if it chooses can preempt any local rulemaking authority. In a federal system the local units have ultimate jurisdiction over at least some of the rules

[7] If, as Wechsler has taught us, the question to be asked is why the matter should not be left to the states, the implication is that in most cases there must be good reason.

[8] Shapiro, supra note 8, at 114

that it applies to its citizens. This distinction is elaborated on briefly at the end of Part III. Some of the advantages suggested in what follows apply just to centralization and some just to federalism and some to both systems.

A. Freedom

It is often said that a principal advantage of federalism is that it protects against tyranny and the many forms of government oppression.[10] Many in the late 18th Century feared a strong central government would be unresponsive to the freedoms and needs of local people and thus the tendency was to leave "as much of the power as possible to the states where genuine responsibility could exist."[11]

Madison, on the other hand, believed that the more capacious federal government protected best against tyranny. He feared that in the smaller states a majority of the interested (really self-interested), i.e., factions,[12] might well gain power and oppress the

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[9] There is much, of course, in Shapiro's book beside economic analysis.

[10] In Gregory v. Ashcroft, Justice O'Connor said: "Perhaps the principal benefit of the federalist system is a check on abuses of government power. ... Just as the separation and independence of the coordinate branches of the Federal Government serve to prevent the accumulation of excessive power in any one branch, a healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front." Gregory v. Ashcroft, 510 U.S. 452, 458 (1991) [hereinafter O'Connor].

[11] Herbert Storing, What the Anti-Federalists Were For, 18 (1981) [hereinafter Storing]. In his interesting piece on Federalism, Professor Rapacznyski observes: "The fear expressed rather generally at the time of the adoption of the Constitution was that the central government, ruling over a large territory and population, would be far removed from the people and would rely on a caste of bureaucrats and politicians, wielding an enormous governmental machine that could be turned against the interests of individuals and used to build a Romanlike empire." Rapacznyski, From Sovereignty to Process: The Jurisprudence of Federalism after Garcia, 1985 Sup. Ct. Rev, 341, 380-381 [hereinafter Rapaczynski].

[12] Madison defines the term faction as follows: "By a faction I understand a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passions, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interest of the community." Federalist No. 10 (Madison), in Jacob Cooke, ed., The Federalist, 57 (1961) [hereinafter No.10].

minority.[13] In contrast in the more extended federal government encompassing a multiplicity of interests, it would be less likely that an interested faction would gain power, presumably because any one faction would not be large enough to form a majority.[14] But even Madison saw virtue in having one level of government check the other. In Federalist 51 he notes that in a compound republic (one where power is divided between two distinct governments) that "[t]he different governments will control each other …. "[15]

[13] "The smaller society, the fewer probably will be the distinct parties and interests composing it; the fewer the distinct parties and interests, the more frequently will the majority be found of the same party; and the smaller the number of individuals composing the majority, and the smaller the compass within which they are placed, the more easily will they construct and execute their plans of oppression." No.10, supra note 12, at 63-64. Madison argues that the degree of security "may be presumed to depend on the extent of country and number of people comprehended under the same government." Federalist No. 51 (Madison), in Jacob Cooke, ed., The Federalist, 352 (1961) [hereinafter No. 51]. He then recommends this view: "Since it shews that in exact proportion as the territory of the union may be formed into more circumscribed confederacies or states, oppressive combinations of a majority will be facilitated, the best security under the republican form, for the rights of every class of citizens, will be diminished; …" Id.

[14] "In the extended republic of the United States, and among the great variety of interests, parties and sects which it embraces, a coalition of a majority of the whole society could seldom take place on any other principles than those of justice and the general good; …" No.51, supra note 13, at 352-353. "Whilst all authority in it [the federal republic of the United States] will be derived from and dependent on the society, the society itself will be broken into so many parts, interests and classes of citizens, that the rights of individuals or of the minority, will be in little danger from interested combinations of the majority." Id. at 351.

[15] Id. at 351. As Michael McConnell points out: "Madison himself did not view his argument as establishing the superiority of a consolidated national government; rather, he presented his famous argument about the tyranny of factions in favor of the intermediate, federalist solution of dual sovereignty. In Federalist 51, he underscored that 'the rights of the people' are best protected in a system in which 'two distinct governments,' federal and state, 'will control each other.' The diffusion of power, in and of itself, is protective of liberty." McConnell, Federalism: Evaluating the Founders' Design, 54 U. Chi. L. Rev, 1484, 1504 (1987) [hereinafter McConnell]. Samuel Beer tells it this way: "The argument which was foremost in the minds of the framers and which still holds the greatest promise as a rationale for states is the argument from liberty. …. While holding that the people at large on the on the larger jurisdiction were the best guardians of liberty, the nationalists also perceived that the central office-holders could become corrupt and oppressive. In this light, they too considered the states to be institutions for correcting deviations of the center. Madison emphatically sees the states performing this function as agents of the national will. That perception is clearest in his version of *divide et impera*, the tactic of the people at large using the states to mobilize national action against central misconduct. Each state has its separate tasks of governing 'the local and personal interest' of its citizens, in contrast with the 'the great and general interests' primarily entrusted to the federal government. It also has the crucial task of serving as the 'agent and trustee' of the people at large of the nations. The national will, as constituent sovereign, created the states and, as the governmental sovereign, uses them to protect the fundamental liberties of the individual. Reflecting the same principle of *divide et impera*, the federal government, moved by the national will, protects the minorities of the states against the danger of factious majorities. The federal system is interactive. While it separates the governing processes of the two levels on the principle of utility, it also integrates them

When first considered, it may seem fanciful to imagine a national or state law prescribing, for example, that nonprofit boards have audit committees as being the nose of the camel of tyranny slipping under the tent of liberty. But then we may remind ourselves of Harvey Dale's report on the new Russian nonprofit law that, if I recall his description properly, gives the Kremlin authority to arbitrarily extinguish a nonprofit's existence if it decides that it is no longer promoting the public interest, according to any standard it wishes to choose on the occasion of a particular execution. Russia today is at best a semi-democracy, so it is unlikely that Madison's argument from an extended republic would work there.

Does it work here? Madison was aware that the rulers pursuing their own interests, as distinguished from representing the classes of different classes of citizens, might sanction oppressive laws to satisfy their own ideological beliefs or notions of what they believe to be instrumentally optimal. In Federalist 51 he refers to "guarding the society against the oppression of its rulers."[16] For reasons that will be explored in subpart B below, it may

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politically for the protection of liberty." Samuel Beer, To Make A Nation: The Rediscovery of American Federalism 387-88 (1983) [hereinafter Beer].
Friedman puts it this way: "The point is that the states serve as an independent means of calling forth the voice of the people, if and when this is necessary. Despite well-meaning arguments about how the government operated best from the national level, the people's voice is not always heard there. The continued existence of the states ensures that there is an entirely separate forum in which the people can work to develop consensus." Friedman, Valuing Federalism, 82 Minn. L, Rev. 317, 403-404 (1997) [hereinafter Friedman]

[16] 351 On this topic McConnell observes: "Madison held that there are two different and distinct dangers inherent in republican government: the 'oppression of [the]… rulers' and the 'injustice of one part of the society against .. the other part.' The first concern is that government officials will rule in their own interest instead of the interest of the people. The second is that some persons, organized factions, will use the governmental powers to oppress others. Significantly, while Madison argued that the danger of faction is best met at the federal level [from the argument of the extended republic] … , he conceded that the danger of self-interested representation is best attacked at the state level. … Consequently, while powers most likely to be abused for factional advantage ought to be vested in the federal government, powers that

well be more likely that a wrong-headed proposal made by an overly passionate or myopic charity official could be headed off more easily at the state rather than the federal level where the effectiveness of any group of state guardians is diluted. But we should recall the firestorm of protest that erupted from guardians all over the country when the Reagan Administration proposed regulations under § 501(h) of the Code that would have pretty much gagged any attempts by nonprofits to lobby for chosen causes. As a result we have the highly functional and permissive § 501(h) regulations.[17]

B. Self-Government

One of the most obvious virtues of a decentralized system of rulemaking[18] derives from the strong probability that representatives in local rulemaking bodies are ordinarily on the scene and thus are better able to understand and are in a better position to respond to the local needs and problems to their constituents[19] than are representatives from the

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are most like to be abused by self-aggrandizing officials should be left in the states, where directs popular control is stronger." McConnell, supra note 15, at 1504.

[17] Treas. Reg. §§ 1.501(h)-1-3 (19XX)

[18] McConnell calls it "[t]he first, and most axiomatic advantage of decentralized government…" McConnell, supra note 15, at 1493.

[19] Friedman observes: "State and local governments work to protect the safety, health and welfare of their citizens. We all too often forget that governments exist for this very purpose. State and local governments are the ones that make myriad decisions that really matter to our lives. How many police shall there be, how shall they conduct themselves, and where shall they be stationed? Where shall schools be, and what shall they teach? Should we have light rail, or other means of assisting commuters?" Friedman, supra note 15, at 399. He wonders whether "these are questions better answered at the center, or even that they would be answered at all if authority over them was transferred [to the central government]." Id. at 401. Storing notes that in the founding era even Federalists accepted this position. He cites Fisher Ames for the proposition that: "The state governments represent the wishes, and feelings, and local interests of the people." Storing, supra note 11, at 11. He points out that for the Anti-Federalists even large states might be dysfunctional. "One problem is that in large, diverse states many significant differences in condition, interest and habit have to be ignored for the sake of uniform administration. . . . A national government would be compelled to impose a crude uniform rule on American diversity. …Behind the administrative defects of a large republic lie three fundamental considerations, bearing on the kind of government needed in a free society. Only a small republic can enjoy a voluntary attachment of the people to the government and a voluntary obedience to the laws. Only a small republic can secure genuine responsibility of the

community who spend most of their time far away in the halls of the central government. The point applies with all the more force to representatives from other communities who are sent to the central government from other locals.[20] Related to this advantage is the likelihood that local citizens are more likely to believe that such local representatives will better understand their needs and problems than central government representatives.[21] A

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government to the people. Only a small republic can form the kind of citizens who will maintain republican government. These claims are central to the Anti-Federalist position." Id. at 15-16. Having pointed out the Anti-Federalist endorsement of the principle that a republican government must rest on the confidence of the people, Strong notes: "But the Anti-Federalists denied that the simple expedient of having the people elect federal representatives was enough to secure their attachment. In a large republic the people 'will have no confidence in their legislature, suspect them of ambitious views, be jealous of every measure they adopt, and will not support the laws they pass.'" Id. at 16. He continues quoting Richard Lee (the Federal Farmer) "Within each state, 'opinion founded on the knowledge of those who govern, procures obedience without force. But remove the opinion which must fall with a knowledge of characters in so widely extended, and force becomes necessary to secure the purposes of civil government . . .'" Id. at 17. Expanding on the second characteristic of the small republic – to ensure a strict responsibility of the government to the people – and after noting that most Anti-Federalists admitted to the need of a representative system (as distinguished from a direct democracy), Storing continues: "The problem, then, was to keep the representatives responsible, in the rather narrow meaning of that term, that is, directly answerable to and dependent on their constituents …. Thus 'a full and equal representation is that which posseees the same interests, feelings, opinions, and views the people themselves would were they all assembled …' According to Melancton Smith, representatives 'should be a true picture of the people; possess the knowledge of their circumstances and their wants; sympathize in all their distresses, and be disposed to seek their true interests.' This describes state legislatures reasonably well, it was claimed, but the federal legislature could not even come close to being representative in this genuine sense, at least not without a sharp increase in its numbers." Id.

Friedman cites efficiency reasons for federalism: ". . . [W]hen power is diffused different governments can adopt a mix of policies that meet preferences of different citizens, thus maximizing the way in which government as a whole satisfies individual preferences." Friedman, supra note 15, at 387.

[20] McConnell, in commenting on the difficulty of national representatives to stay in touch with the local circumstances of their constituents, notes: "Moreover, if representatives to the national government are required to spend much of their time at the distant national capital, they are likely to lose touch with the sentiments of their constituents, and instead come to identify themselves with interests of the central governmental apparatus" McConnell, supra note 15, at 1510.

[21] McConnell, after noting that it was an article of faith for advocates of state autonomy that republicanism could only survive in a small jurisdiction and that one reason for this is that laws would be better enforced, then says: "Obedience to the law can arise from two different sources: fear of punishment and voluntary compliance. A republican government, which has a minimal coercive apparatus, must rely predominantly upon the latter. As Brutus explained, in a free republic 'the government must rest for its support upon the confidence and respect which the people have for their government and laws.' To advocates of decentralized government, this necessarily implied that the units of government must be small and close to the people. 'The confidence which the people have in their rulers, in a free republic,' according to Brutus, 'arises from their knowing them, from being responsible to them for their conduct, and from the power they have of displacing them when they misbehave.' Unfortunately, this confidence is impossible in a country the size of the United States.

The different parts of so extensive a country could not possibly be made acquainted with the conduct of their representatives, nor be informed of the reasons upon which measures were founded. The consequences will be, they will have no confidence in their legislature, suspect them of ambitious views, be further advantage is the near certain fact that local citizens have better access to and influence over such local representatives in their making rules than they do over central government representatives.[22] For this reason, we may also suppose that local citizens will be more likely to comport with enacted laws. And perhaps most important of all, because of their access to rulemakers and thus their participation in the rulemaking process, local citizens will feel empowered as self-governing citizens.[23] Finally many of these advantages of decentralization transfer to arguments in favor of a federalist structure when it is accepted that local rulemakers should have the final say over certain rules and that those who elect the local rulemakers should be sure that those who they elect will have the final say on such rules.

Related to the point about self-governing, Rapaczynski discusses a model of participatory government which views political activity as a good in itself and not instrumentally as a way of simply working out an acceptable distribution of goods amongst the various classes of society so as to satisfy their preferences. He notes that the founders' emphasis

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jealous or every measure they adopt, and will not support the laws they pass." McConnell, supra note 15, at 1508

[22] Friedman lists accountability as a virtue of federalism. "Accountability entails more than periodic elections. Officials, elected and appointed, should be available for public comment, anger, approval, suggestions, and ideas about the course of public affairs. They should be accessible, by phone, fax, by e-mail. Of course, the fewer layers of staff one has to go through the better . . . . From this perspective, it is obvious that federalism provides for broadened accountability. Officials at the local level are likelier to be available, and thus are likelier to be held accountable. Local officials actually responsible for making policy live in the localities where the impact of their policies are felt." Friedman, supra note 15, at 395.

[23] In her catalogue of the advantages of a federalist structure of joint sovereigns, Justice O'Connor includes that such a structure "assures a decentralized government that will be more sensitive to the diverse needs of a heterogeneous society; [and] it increases opportunity for citizen involvement in democratic processes; …" O'Connor, supra note 10, at 458. McConnell in discussing the republican virtue of public spiritedness – a motivation to be as concerned for the good of the community as one's self-interest – notes: "First, public spiritedness is a product of participation in deliberation over the public good. If citizens are actively engaged in the public debate they will have more of a stake in the community. The federal government is too distant and its compass too vast to permit extensive participation by ordinary citizens in its policy formations. By necessity, decision-making will be delegated to agents. But as they are cut off from active

on republican virtues involved a belief that the good life involved "a commitment to a political community and participation in a process by which individuals shape in common the mode of life they are going to share. … It should then be by no means surprising if, given the limited possibility of direct participation on the national level, the Framers envisaged the states, particularly their subdivisions, as the most fertile grounds for the development of the alternative political processes, responsive to the need for participatory forms of political life."[24] He concludes that "the principles of federalism provide an … independent reason for protecting the autonomy of the political process of local governments … [by] .. "protecting a different form of political space that the national government is very unlikely to provide."[25]

C. A Laboratory for Social and Economic Experiments

We come now to idea that the federalist structure advances the public good by providing the condition pursuant to which various states in effect experiment with various solutions to social problems making it more likely that an optimum solution available for everyone

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participation in the commonwealth, the citizens will become less attached to it and more inclined to attend to their private affairs." McConnell, supra note 15, at 1510.

[24] Rapacznski, supra note 11, at 401.

[25] Rapacznski, supra note 11, at 404. "If one of the primary functions, within the federalist framework, of state-run institutions is to provide the public space for participatory politics, then from this point of view federalism does not conceive the division between state and national governments as a way of parceling out 'sovereignty' – the control over substantive fields of regulation - but rather as a way of preserving alternative modes of decision making. Naturally, the vitality of the participatory state institutions depends in part on the types of substantive decisions that are left for the states. Should the federal government preempt them from most fields that touch directly on the life of local communities, the states would become empty shells within which no meaningful activity could take place." Id

Friedman echoes Rapacznski's point: "States, and their substate local governments, are closer to the people and provide an opportunity for greater citizen involvement in the functional process of self government." Friedman, supra note 15, at 389. He expands the point: "But a single-minded focus on voter turnout misses the point that participation can and should stretch well beyond electoral participation. The fact is that many Americans can call their state and local officials on the phone - and do – and have those phones calls returned by the actual officeholder, not a staffer tallying opinions in a polite voice. The fact is that countless citizens attend city council and state legislative sessions, watching to see some matter of interest will emerge than would be the case with a unitary government where there is only one experimenter with the likelihood that its solution would be less desirable than the best solution of a number of experimenters.[26] So it might be claimed that in requiring nonprofit board to have an audit committee one state might mandate that nonprofit groups have audit committees while another might not.[27] And then the argument runs that after each state has had opportunity to see how its system works or does not work, it will become apparent which one does best.[28] This is surely an attractive contention and particularly for all of us who are used to making a similar claim in support of nonprofits. But alas it does not work. All these "laboratory" advantages might just as well materialize in the context of a unitary government that decentralized its governance

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resolved. The fact is that interest groups at the state and local level all tend to be more grass roots, less mechanized, and more responsive to the efforts of concerned individuals." Id. at 391.

[26] In her catalogue of advantages of the federalist structure, Justice O'Connor claims that this advantage "allows for more innovation and experimentation in government." O'Connor, supra note 10, at 458. When it is discussed, Brandies' dictum is invariably cited which states: "[I]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." New State Ice. Co. v Liebman, 285 U.S. 262, 311 (1932)(Brandeis, J. dissenting). After observing that Madison in Federalist No. 56 predicted that states could come to serve as models for federal legislation, Beer points out that: "In his American Commonwealth, first published in 1888, James Bryce made a similar point when he observed that 'federalism enables a people to try experiments which could not safely be tried in a large centralized country.' Bryce was thinking about imitation among the states, but as federal regulatory legislation grew, state experience often served as a model for Congressional action. This capacity was characterized in the concept of 'laboratories for experimentation,' given wide circulation by Justice Holmes and Brandeis in later years." Beer, supra note 15, at 306.

McConnell, after observing that "A consolidated national government has all the drawbacks of a monopoly: it stifles choice and lacks the goad of competition." goes on to observe that: "Lower levels of government are more likely to depart from established consensus simply because they are smaller and more numerous. Elementary statistical theory holds that a greater number of independent observations will produce more instances of deviation from the mean. If innovation is desirable, it follows that decentralization is desirable. This statistical proposition is strengthened, moreover, by the political reality that a smaller unit of government is more likely to have a population with preferences that depart from the majority. It is, therefore, more likely to try to a approach that could not command a national majority." McConnell, supra note 15, at 1498. This good point has little to do with federalism. As will be noted in the text, it is probably more apt for a decentralized than a federal system of government.

[27] See Part IV B. 1. below.

[28]Friedman wonders whether "innovation" might have been a better word than Brandeis' "experimentation" and then goes on to say: "Indeed, the best model to describe what is at stake here may be an understanding of innovation as an evolutionary process. Countless states and local governments remote from one another but facing similar problems, develop numerous twists on solving them. At conferences,

allowing, say, a number of different districts to experiment with audit committee requirements. Indeed, the argument might work better in this context since once enough information was available to determine which system worked best, the unitary government could impose it by a uniform law that applied to everyone everywhere. In contrast in a true federal system, a recalcitrant state might stubbornly retain its less-than-optimum audit committee rule despite overwhelming evidence of its inferiority.

I am certainly not claiming that the "laboratory" argument has no merit. States do benefit from each other's experience. Model laws, and the like, may well reflect the best solutions. These virtues, however, have nothing to do with federalism qua federalism where the power to make rules is given local governments, not because the more governments there are trying to solve problems, the more likely that good solutions will emerge, but rather because the power is given to local governments because as to the rules in question they are the bodies that ought to have the last word on their enactment.[29]

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and through observation, governments learn of techniques employed elsewhere. The ones that seem sensible, that work, survive; many others die on the vine." Friedman, supra note 14, at 399-400.

[29] Richard Briffault in his "Ism" paper (see note 4 above) takes a different approach to federalism and argues that the federal structure established by the Constitution guarantees that states remain political centers that provide important alternatives for federal decision-making. He argues that the design of the constitutional system "…assures that the states will be a factor in the political calculus, and that states will remain political centers that provide important alternatives to the national government for public decision making." Briffault, supra note 4, at 1351. He describes such features of the constitutional system as follows: "[t]he states have fixed boundaries, their borders cannot be changed without their consent. They have territorial integrity; no other state or other subnational government overlaps the boundary of any other sate. The states serve as constituent elements in the structure of our national government. The states have inherent law-making capacity: they can enact laws, regulate, and raise and spend money without having to secure authority from any other level of government." Id. at 1305-1306. His main thesis is that the courts when confronted with federalism issues should not focus on the values of federalism (the 'isms') such as increasing the opportunities for political participation or keeping government close to the people, since these are essentially political questions and ought to be left to the political process. Rather, when these questions come up, courts should consider "…the impact of national action on the capacity of the states to be independent lawmakers and alternative power centers within the federal framework." Id. at 1502. He barely discusses why it is a good idea to have states as alternative power centers. On a stoop outside of the Bloomingdale Music School on 103rd street this past Sunday, he explained that his point was not normative but simply rested on the fact that this is the way things are. One wonders what happened to Madison's

III. WHY MANY NONPROFIT GOVERNANCE LAWS SHOULD BE LEFT TO THE STATES

In this section I offer what I believe are the reasons that support the proposition that the provision (development and enactment) of a good part of the rules for nonprofit governance ought to be left to the states and not nationalized. Many of these reasons will reflect the justifications for federalism described in Part II.

To begin, let us recall the context in which I set our inquiry. I am limiting its scope to the activities of nonprofits that operate solely intrastate and have virtually no impact on other states or their citizens. This immediately suggests that those from other states have in fact no justifiable interest in such activities and thus presumably little office to assert legislative authority over them.[30] The converse of this point suggests that only those on the scene ought to make rules for governing such nonprofits. If a group of people join together to conduct activities that are designed to provide benefits solely to the people of their community[31] and in fact only provide direct benefits to such people,[32] and if such

plainly normative idea that the different governments will control each other and thus provide a double security to the rights of the people.

[30] Of course, everyone presumptively has an interest in the exemption from federal taxation of any group, since the result of an illegitimate exemption logically tends towards an increase in their taxes. But the focus here is not on exemption from federal taxes but rather on rules by which nonprofits are directed to govern themselves.

It might also be said that we all should care about the well-being of our fellow American citizens no matter where they are located, but such noble sentiments hardly warrant people in one place officiously providing rules for people in another place who have absolutely no impact on them other than being objects of their tender concern.

[31] There is an ambiguity to the term "community." I have in mind a state, but of course the same point applies to a county or district or any other kind of local subdivision.

[32] That benefits provided to people in one jurisdiction place might also indirectly benefit people in other jurisdictions (externalities) will always be true. Taking care of an elderly woman in New York benefits her

activities have virtually no effect on anyone that is not part of their community, the claim is that only they or their representatives ought to have the final word on making rules that govern those activities.[33]

All of this is particularly the case where different conditions and different preferences of citizens in different places are likely to give rise to a diversity of rules.[34] As suggested in Part II, local rulemakers know best about local conditions and needs and local preferences and thus their responses to such circumstances and dispositions are a likely to be more apt than the responses of rulemakers far away. It is more likely that rulemakers who live in the community will have more genuine concern and interest in their community and its problems than those who live far away or than those who feel beholden to those who live far away.[35] As also suggested in Part II, it is likely that such rulemakers will be perceived by those in the community to whom their rules apply as having greater concern for the community with the probable result that such community folk in turn will be more likely to accept the rules of their local rulemakers than rules imposed from afar. Furthermore, local citizens, who perhaps know best about local conditions and whose preferences it is that counts, are more likely to have access (input) to local rulemakers (e.g., state legislators) than they are to their representatives in a

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children and grandchildren in Arizona. This suggests the Hegelian logic that everything affects everything else, which, as noted above, is a piece of logic that for purposes of this paper I reject.

[33] Keep in mind that my claim only extends to the particular activity. Other jurisdictions may have authority to tax the activity or to seize its property or to impose rules on the use of drugs or to impose environmental rules, etc., but when it comes to the activity itself, say running a homeless shelter for local residents, my claim is that as a normative matter only the jurisdiction in question should have the authority to make rules governing that activity.

[34] Even where a possible rule is unaffected by local conditions or preferences (e.g., that board of directors must have at least one member), in the circumstances supposed – a rule applying to activities that have virtually no extra state impact - its development ought to occur at the local level.

[35] I have in mind here an agent from a central government that has been assigned to work in a local district.

distant place (e.g., Washington). Preferences will be expressed; preferences will be heard and preferences will be responded to. Local citizens' participation in the development of rules will also make it more likely that they will accept the rules enacted.

More fundamentally, and related to the last point, are considerations of self-government.[36] If self-government is thought to be a value itself, an ultimate end and not just an instrumental value, it follows that people ought to be able to decide how to run things for themselves and not have those who are not part of their community decide for them. Because so many rules and regulations are enacted and promulgated at the local level, it has to be the case that many more are involved with the development of such rules than would be the case if there was just one central rule making body. And thus self-government is promoted by federalism.

Who are the people I have been writing about? I have in mind primarily state legislators, the Attorneys General and their assistants and local nonprofit advocacy groups like the Nonprofit Coordinating Committee of New York (NPCC). NPCC represents the nonprofits of New York. NPCC stands for the local citizens referred to above. NPCC is intimately aware of the conditions in which New York nonprofits function. So is the Charities Bureau of the New York Attorney General's office. NPCC has considered virtually all of the proposed nonprofit governance bills introduced in the past twenty years and, when it thought appropriate, has advocated for change or elimination.[37] Lest I

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[36] Self-government was discussed at Part II C. above

[37] For the past seven years or so, NPCC has worked closely with the New York Charities Bureau in developing nonprofit governance bills and it is widely accepted that the final product of these joint efforts

be considered overly jingoistic, it must be said that various nonprofit bar association committees function very much like NPCC. Further, as is known, over the past twenty years or so a large number of nonprofit advocacy groups have been established in states across the country and many of them participate like NPCC in the development of nonprofit governance rules in their states.[38] I am sure the same can be said for many nonprofit bar association committees.

Edwin Rubin and Malcolm Feeley argue in an important paper that federalism is dead and that all the putative virtues accorded to it flow from decentralization.[39] In their view, decentralization is a managerial concept designed to promote effective management by locating administrators close to the those being regulated, thus achieving the advantages commonly claimed for federalism: knowledge of local circumstances, responsiveness to community members, etc. The difference between the two systems lies, of course, in who has the last word over the subject being regulated: under decentralization the central government, under federalism the local government. Rubin and Feeley claim that federalism makes sense only where there are normative disagreements or value differences between the government units and not where the differences are merely instrumental.[40] This seems wrong to me. Both federal and state administrators regulating corporate governance can share the same values (e.g., that boards function effectively) and yet differ instrumentally on the best ways to achieve those values. In

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are bills that better meet the needs of both the regulators and the regulated than the first versions initially published by the AG's office.

[38] Recalling the point about the virtues of self-governance made above, it is clear to me that many more of my colleagues have been able to participate in the development of nonprofit governance rules than would be the case if the only medium for doing was, for example, the Independent Sector in Washington.

[39] Rubin & Feeley, Federalism: Some notes on a National Neurosis, 41 UCLA L. Rev. 903 (1994).

circumstances where the corporations being regulated have no impact beyond the geographical limits of the states in which they are operating, it seems entirely appropriate, as suggested, that such states would have the last word on their regulation. And this would be so even if there was complete agreement between the national and state governments on the value underlying the rule in question. It would be quite possible for a National Charities Bureau to establish district bureaus in the various localities around the country and allow them to develop and experiment with nonprofit governance rules and perhaps for a while everything would go along as described above. But at some time the central bureau might very well decide that enough experimentation had taken place and impose one rule on everyone. In these circumstances, the autonomy of those districts that opposed the uniform rule would be compromised. They would not have had the last word. My claim is that in the context I have posited, they should. Thus, the claims I make are federalist claims.

IV. A CONSIDERATION OF SOME NONPROFIT GOVERNANCE LAWS

In this final part of the paper, I consider several existing nonprofit governance rules regarding which states differ. They can be divided into two types. One group involves rules that would seem to have little, if anything, to do with maintaining the legitimacy of an organization's tax exemption and thus do not implicate the national government's taxing power. These kinds of rules I argue should be subject solely to state jurisdiction. The other type deals with rules that directly involve the finances of nonprofits and thus

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[40] "Purely instrumental disagreements can be resolved with a unitary system because the criteria for judgment are shared by those or imposed on those within the system." Id. at 912.

would likely fall under the jurisdiction of the Internal Revenue Service (IRS) and the taxing power, if national government chose to exercise such jurisdiction. As I will argue below, in many instances it makes sense for there to be both federal and state rules over the same matters, i.e., concurrent jurisdiction.

A. State Only Rules

In this subpart, I consider nonprofit governance rules that seem to me do not cover subjects or activities that would fall under the national government's taxing power and thus in my view are rules that ought to be left solely to the states. After a somewhat extended analysis of spending standards, I briefly discuss a number of other such rules.

1. Spending Standards for Endowment Funds

As is well known, the National Conference of Commissioners on Uniform State Laws (Commissioners) adopted the Uniform Management of Institutional Funds Act (UMIFA) in 1972. The Act provides standards for the managing, investment and spending of funds of charitable corporations.[41] It has been adopted by over 45 states.[42] For those states that have adopted UMIFA, its standards apply in assessing whether a board has met its duty of care regarding investment decisions, etc.

[41] "UMIFA applies to corporate charities, but it is not clear whether it applies to charitable trusts, although the statue explicitly does not apply to charitable trusts administered by noncharitable trustees (such as banks)." American Law Institute, Principles of the Law of Nonprofit Organizations 256 (Discussion Draft, April, 6, 2006) [hereinafter Principles].
[42] "UMIFA has been adopted in all jurisdictions, except Alaska, Arizona, Pennsylvania and South Dakota." Id.

The Commissioners are now revising UMIFA. The new act will be called the Uniform Prudent Management of Institutional Funds Act (UPMIFA).[43] Section 4 of the new Act relates to expenditures from endowment funds.[44] Section 4 (a) provides:

> Subject to the intent of a donor expressed in a gift instrument [and to subsection (d)], an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. … In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider [a number of factors].[45]

[43] Perhaps the most significant change made by UPMIF is its abandonment of UMIFA's historic dollar value. The problems with this approach were ably canvassed by the paper Harvey Dale delivered to the Forum earlier this year entitled " Prudence Perverted: Politics, Perceptions, and Pressures." [hereinafter after Dale]. UPMIFA also narrows decision making to particular endowments (focusing on the fact that endowments endure over time) while UMIFA had decision makers consider the institution at large. The Principles note: "A welcome portion of UPMIFA is devoted to conforming the investment standards of corporate charities to the Uniform Prudent Investor Act." Principles, supra note 41, at 256. The Uniform Prudent Investment Act applies to trusts.

[44] The draft Act defines the term "endowment fund" as follows: "'Endowment fund' means an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of a gift instrument. The term does not include assets of an institution designated by the institution as an endowment fund for its own use." UPMIFA §2 (2). The Drafting Committee elaborates: "The term 'endowment fund' includes funds that may last in perpetuity but also funds that are created to last for a fixed term of year or until the institution achieves a specified objective." UPMIFA §2 comment.

[45] UPMIFA §2 The factors are: (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution. Id.

Subsection (d) creates a kind of safe harbor and it is up to each state as to whether to include it or not.[46] It provides:

> [(d) The appropriation for expenditure in any year of an amount greater than seven percent of the fair market value of the endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period not less than three nor more than five years immediately preceding the year in which the appropriation for expenditure was made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the endowment fund will be calculated for the period of time the endowment fund has been in existence. This subsection does not:(1) limit the authority to make expenditures as permitted under law other than this [act] or the gift instrument; and (2) create a presumption of prudence for the appropriation for expenditure of an amount less than or equal to seven percent of the fair market value of the endowment fund.][47]

In their comments on this subsection, the Drafting Committee included a discussion of the advantages and disadvantages of including the rebuttable presumption of imprudence in legislation. They note that:

> …the presumption of imprudence may serve to assure donors that the spending from an endowment fund will be limited. …Those in favor of the presumption of imprudence argued that the presumption will curb the temptation a charity might have to spend endowment too rapidly. Although the presumption would be rebuttable, and spending above the identified percentage might, in some years

[46] "Each enacting state should make its own determination as to whether to include the presumption when the state enacts UPMIFA." UPMIFA §4 comment.

[47] UPMIFA §4 (d).

> and for some charities, be prudent, institutions will likely be reluctant to authorize spending above seven percent, in addition, the presumption will give the attorney general guidance in enforcing the prudence standard.[48]

The Drafting Committee also offers arguments it heard against the presumption:

> A fixed percentage in the statute might be perceived as a safe harbor and could lead institutions to spend more than is prudent. Although the provision should not imply that spending below seven percent will be considered prudent, some charities might interpret the statute that way. Decision makers might be pressured to spend more than is prudent, or might be willing to make spending decisions without adequate analysis.
> Perhaps the biggest problem with including the presumption in the statute is the difficulty of picking a number that will be appropriate given the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under current economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflations, seven percent may be too low.[49]

Then as noted, and significantly for this paper, the Drafting Committee states: "Each enacting state should make its own determination as to whether to include the presumption when the state enacts UPMIFA."[50]

So here we have an example of where states may differ. Some legislatures may wish to adopt the 7% presumption of imprudence for the reasons given in the Drafting Committee's comments set out above. In addition, Forum member Dale has suggested that some attorneys general staff "desire a bright-line test to make it easier for them to intervene to deter over-spending."[51] On the other side legislatures might be persuaded by

[48] UPMIFA §4 comment.
[49] Id.
[50] UPMIFA §4 comment.
[51] Dale, supra note 43, at 41. In a recent conversation with David Ormstedt, formerly with Connecticut's Attorney General's charity division, he agreed that the presumption would make the attorney general's job easier. But for David there was a more important reason. In his long years of experience, he had observed

the reasons against the presumption, both those of the Drafting Committee set out above and Dale's recent devastating criticisms and perhaps others.[52]

One can easily imagine a state whose legislators sense that a good number of the nonprofits in their jurisdiction are managed by people who are unsophisticated and inexperienced in the management of money. They might worry that recipients of endowment funds might be tempted to engage in unreflective "spending frolics" in disregard of donors' temporal intents. Such legislators might also think that potential donors share their concern and thus will be moved to limit their endowment gifts to institutions that they perceive as employing experienced money managers. Such a possibility might be seen as threatening the growth of a diverse charitable sector in that state.

On the other hand, some state legislators may believe that most of those who handle charitable funds in their state are sophisticated and knowledgeable about current investment and spending theories and thus that the straight prudence is both appropriate and adequate and is better suited to attract endowment gifts in their state to a diverse groups of nonprofits.

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a good number of nonprofits that had received endowments whose managers were very unsophisticated about the management of money and who, upon receiving an endowment gift, had little hesitation about spending it down with great enthusiasm and with little concern for its future, albeit to achieve the goals of the gift. He felt that the 7% rule might act as a check on their eagerness and cause them to pause and reflect before seriously depleting the fund.

[52] Dales criticisms are found at pages 41-44 of his paper. See, Dale, supra note 43, at 41-44.

Can anyone say that in view of the unchallengeable correctness of one of these approaches, local conditions and preferences make no difference in choosing which rule to adopt? Should this decision be taken away from the states in favor of a uniform rule? And, assuming that prudent investing of charitable funds is a matter for the national government, who by the way is to say that it would get it right?

2. Other State Only Rules

Here I briefly consider a few nonprofit governance rules that I believe do not no fall under the national government's taxing power and thus in my view are rules that ought to be left solely to the states. (As to these rules, I do not know whether there are any such laws existing or proposed. The time and exhaustion factors have kicked in. I am pretty sure, however that there could be such laws.)

It might be proposed, for example, that a nonprofit board have no more than 15 members.[53] Many states require at least three members and Delaware only one. Should there be one uniform, national rule on this subject? Forum member Small in a paper first delivered to this forum and now published with Michael Klausner, has reviewed some reasons why nonprofit boards can be very large (adding members to help with fundraising, legal, real estate, public relations, investment and accounting advice and advice and services more directly related to the organization's mission).[54] Bill Bowen suggests that: "The size of for-profit boards should normally fall within a range of, say,

[53] The Senate Finance Committee's staff discussion draft makes just such a proposal. See Appendix.

10 to 15 members; many nonprofit boards should be larger – in the range of, say, 12 to 30, with ever larger sizes justified in some circumstances."[55] He observes that boards with too few members run "the risk of being insufficiently diverse in the range of backgrounds, experiences, and perspectives " and may become "overly dependent on one or two people."[56] He notes, "that boards can be too large to function effectively."[57] While he likes 15 for for-profit boards, he notes that nonprofit boards "tend to be larger – *much* larger in some cases."[58]

Some then will argue that functional effectiveness requires a limit on nonprofit board size. Others will claim that the reality of the nonprofit world requires large boards for fundraising and constituency reasons. Can anyone say who is absolutely right about this? Why shouldn't each state be able to decide for itself and strike its own balance between functional effectiveness and recognition of the wider realities of nonprofit viability?[59]

Some might suggest that nonprofit board members have absolute term limits. Most state laws do not require this. Here the tension is between assuring fresh blood on the board, clearing off dead wood and having many people in the community serve on boards on the

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[54] Klausner & Small, Failing to Govern? The Reality of Nonprofit Boards, Stanford Social innovation Review Spring 2005

[55] William Bowen, Inside the Boardroom, 40 (New York 1994).

[56] Id. at 40-41.

[57] Id. at 41. He continues: "It is obviously far harder to achieve a genuinely interactive mode of discussion and decision making when the board becomes too large." Id.

[58] Id. at 43. "There are two reasons why nonprofit boards are often large. First, many have to satisfy a wider range of constituents than do for-profit boards; therefore they are likely to have a greater need for diversity … A second consideration is the need to include major donors and those able to solicit contributions on the boards of many nonprofits. Clear tradeoffs are made: Some boards knowingly become larger than they believe they should be because of the high priority given to fund-raising." Id at 42-44.

[59] As board size has something to do with effectiveness and as one of the areas in which boards ought to be effective is in assuring that, for example, funds are not siphoned off into improper hands, it might be argued that board size falls under the jurisdiction of the federal tax authorities. Maybe so. I think this is a stretch.

one hand and on the other hand keeping experienced people on the board that many believe are essential to the successful functioning of the organization. Who can say there ought to be one uniform, national answer to this question? Why shouldn't each state answer it for itself?

It has been proposed that nonprofit board meetings be open to the public.[60] Here the conflict is between hyper-accountability and the inevitable inhibition of genuine discussion between board members when outsiders are listening. What warrant is there for a uniform, national rule covering this matter? Why shouldn't each state decide the question for itself?

Finally some states prohibit loans to board members[61] and many do not. Some states may have had experiences with many and severe abuses regarding loans to board members. Others in a context where perhaps it is difficult to attract people to nonprofit boards may believe that the ability to make such loans is important for attracting and keeping board members. Should there be a uniform, national rule about this?

B. Concurrent Jurisdiction

We now consider two nonprofit governance rules for which there are reasons supporting the legislative authority of both the federal and state governments. One, the requirement of an audit committee, deals with the effectiveness of an organization's financial controls

[60] Jon Pratt of the Minnesota nonprofit state association and I used to argue about this.
[61] See N-PCL §716.

and an organization's financial disclosure responsibilities, and the other deals with interested party transactions.

We begin with the audit committee rules. A system that is designed to insure that funds are not siphoned off improperly helps assure that moneys are not allocated in ways which very likely make them and the organization from which they are taken taxable, in such circumstances where, because the transfer is not likely to be known about, they almost certainly will not be taxed. A good audit process also promotes these goals. And of course, the development of a system designed to produce the disclosure of adequate financial information is key to assuring that a tax-exempt organization remains properly tax exempt. Thus, there are good reasons for Congress under the taxing power to have jurisdiction over the subject of audit committees. Some of the same reasons justify Congressional jurisdiction over self-dealing rules. In fact § 4958 of the Internal Revenue Code (Code) is such a rule.

States also have an interest in the same rules. Aside from supporting their taxing power, states want nonprofits operating within their borders to succeed and flourish and consequently have an interest in systems designed to inhibit funds from being improperly diverted from the support of a nonprofit organization's public benefit purposes and transferred into private hands. In cases where nonprofits' impact is solely intrastate (as is the focus of this paper), it is only the states in question that have a concern for their flourishing. [62]

[62] It may be argued that the national government is also concerned that American charities flourish. And this may very well be so for charities that operate nationally. But the claim does not work for nonprofits

While the subject matter and activities are largely identical (bad financial management and improper siphoning of charitable funds), the national and state government purposes for regulating in these areas are quite different. The national government is primarily concerned to protect its tax base,[63] and the state governments are primarily concerned that their nonprofits succeed in providing public benefits. With different ground purposes, it is likely and appropriate that different rules will develop.

There are also regulatory reasons to support concurrent jurisdiction. In many cases the national government may have little, if any, interest in local nonprofits (they may be too small to bother about) whereas a state might. For example, state regulators may perceive a pattern of abuses by small nonprofits that it believes is beginning to affect the welfare of its citizens. Because state regulators are on the scene and have a level of concern that bureaucrats far away are less likely to have,[64] they are more likely to identify the problem than federal agents. If state regulators are going to enforce a rule, for many of the reasons set out in Part III above, it is better that they and their legislators have the last word in its creation.

On the subject of concurrent jurisdiction, a word should be said about preemption, Congress's ability to supercede state laws in areas over which it has regulatory

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whose only impact is intrastate. In the way that the federal government has no real interest in the success and flourishing of a local sanitation department, it has no interest in the success and flourishing of a purely local nonprofit.

[63] See preceding note

[64] Agents working for a central government bureau assigned to local districts are also less likely to have a level of concern equal to that of state regulators.

authority.[65] Barry Friedman has described the working of the preemption doctrine this way:

> "Generally speaking, the Supreme Court applies a three-part test in order to determine if a state law as been displaced. First, the Court looks to congressional enactments to see if Congress has been explicit in its desire to preempt. Second, in the absence of express preemption, the Court ascertains whether there is a direct conflict between the exercise of state and federal authority. Third, even if there is no direct conflict and no express preemption, the Court might find that state regulatory authority is preempted because it is clear from the pattern of federal enactment that Congress has 'occupied the field.'"[66]

My sense is that if the national government moves into the field of nonprofit governance, many of the laws it might enact will not conflict with the exercise of state authority in the field and there will surely be no pattern of federal enactment to suggest that Congress has occupied the field. Thus if Congress legislates in the field it will have to confront the question of whether there are sound policy reasons for it to expressly state its intention to preempt. Depending on the legislation, in many cases I believe for the reasons advanced in this paper in support of federalism, that in this narrow field it would not be good policy to expressly preempt.

1. Audit Committees

We now consider audit committees. Since the for-profit scandals that gave rise to Sarbanes Oxley, there have been several state proposals regarding audit committees including an audit committee requirement that is now law. Audit committees are board

[65] "When Congress exercises a granted power, the federal law may supercede state laws and preempt state authority because of the operation of the supremacy clause of Art. VI." G. Gunther & K Sullivan, Constitutional Law (thirteenth edition), 337 (1997)
[66] Friedman, supra at note 15, at 344.

committees[67] that generally are charged with the duty of overseeing the audit process (including hiring and overseeing any external auditor)[68] and making sure that adequate financial controls are in place. Critical to the adequate functioning of such committees is the requirement that, in order to assure their objectivity, its members have no personal interest or stake in the organization other than an aspiration that it achieves its charitable purposes.

There follows an analysis of three state-law approaches to nonprofit audit committees.

First, a state may have no requirement for audit committees.[69]

A second approach is exemplified by California which in 2004 passed a law that requires that a board of any nonprofit that receives $2 million or more in gross revenues each year establish an audit committee whose members shall have no material financial interest in

[67] Below it will be observed that some proposals for audit committees do not require that all its members be board members, but audit committees are established by the board and assume delegated responsibility of and for the board.

[68] Some organizations are so small that no audit process is required or presumably takes place. For example, New York law does not require any kind of audit process for groups with revenues of $100,000 or less.

[69] While I have not researched the various state laws on this subject, I am fairly certain that this is the case for most states. While Forum member Freemont-Smith's great book notes that the New York Attorney General has proposed legislation requiring an audit committee (discussed below), there is no mention of any other state requirement. M. Freemont-Smith, Governing Nonprofit Organizations 110, 435 (2004). (As noted, this book was published in 2004 and as will be seen below there has been some new legislation on the subject.) Forum member Brody's Principles, issued in April of this year, dealing with committees and delegation, notes that: "Increasingly, state statutes might mandate certain committees (such as an executive committee or an audit committee) and their composition (such as only independent directors for members of the audit and nominating committees). American Law Institute, Principles of the Law of Nonprofit Organizations 72 (Discussion Draft, April, 6, 2006) [hereinafter Principles]. Nonetheless, I think it is fair to assume that enough states do *not* require audit committees to posit that one option is not to require such committees.

any entity doing business with corporation.[70] In addition, members must not include the staff, including the president or chief executive officer and the treasurer or chief financial officer. It may include those who are not members of the board of directors. The law provides that if the corporation has a finance committee, it must be separate from the audit committee and while members of the finance committee can serve on the audit committee, the chairperson of the audit committee may not be a member of the finance committee and members of the finance committee must make up less than one-half of the membership of the audit committee.[71]

A third approach is represented in bills proposed in New York and Massachusetts. In 2005 the New York Attorney General proposed a bill that would encourage but not require nonprofit boards of groups with gross revenues in excess of $250,000 to establish audit committees.[72] It would amend §712 (Executive committees and other committees) of New York's Not-For-Profit Corporation Law (N-PCL), by adding a new paragraph (g) that would require the board of certain nonprofits[73] to designate from among its members an audit committee consisting of three or more directors, unless the certificate of incorporation or by-laws of the organization prohibit the appointment of an audit

[70] Cal. Govt. Code §12586 (e)(2)
[71] The law requires that: "Subject to the supervision of the board of directors, the audit committee shall be responsible for recommending to the board of directors the retention and termination of the independent auditor and may negotiate the independent auditor's compensation on behalf of the board of directors. The audit committee shall confer with the auditor to satisfy its members that the financial affairs of the corporation are in order, shall review and determine whether to accept the audit, shall assure that any nonaudit services performed by the auditing firm conform with the standards for auditor independence referred to in paragraph (1), and shall approve performance of nonaudit services by the auditing firm." id
[72] NY Attorney General's Legislative Program Bill # 68-05 (S – 5235; A – 7825).
[73] It would apply to any corporation whose financial statements are audited by a public accountant or that accrues in any fiscal year gross revenue and support of at last $2 million.

committee.[74] In the latter case, the board is required to perform the functions of the audit committee. The proposed law expressly states that each member of the audit committee shall be a disinterested[75] member of the board of directors.

Finally, legislation, containing an audit committee requirement, has recently been proposed by the Attorney General of Massachusetts.[76] Under the law[77], public charities required to file audited financial statements must have an audit committee[78] of at least three persons. The committee may include persons who are not members of the board so

[74] The proposed law provides: "(2) The audit committee (or the entire [sic] board of directors in the case of any corporation whose certificate of incorporation or by-laws prohibit the appointment of an audit committee) shall be directly responsible for the appointment, compensation, and oversight of the work of any public accountant or public accounting firm employed by that corporation (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such public accountant or public accounting firm shall report directly to the audit committee (or the entire [sic] board, in the case of corporations whose certificate of incorporation of by-laws prohibit the appointment of an audit committee)." Id. at subparagraph (2).

[75] It states that no member "other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee [shall]: (a) accept any consulting fee, advisory fee, or other compensation or other benefits form the corporation; or (B) have participated in any other interested party transactions within the meaning of section 715 (Interested directors and officers), with in the previous year." Id at subparagraph (3). The law further provides: "(4) Each audit committee, or the entire board of directors [sic] in the case of any corporation whose certificate of incorporation or by-laws prohibit the appointment of an audit committee, shall establish the procedures for: (A) the receipt, retention, and treatment of complaints received by the corporation regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the corporation of concerns regarding questionable accounting, auditing or other financial matters." Id at subparagraph (4)

[76] The legislation, entitled "An Act to Promote the Financial Integrity of Public Charities," was initially introduced last year, but resubmitted on April 14, 2006 to the co-chairs of the legislative Committee on Consumer Protection and Professional Licensure.

[77] The Act will amend Chapter 123 of the General Laws by adding Section 8P.

[78] The Act requires the audit committee, subject to the supervision of the board, to be responsible for making recommendations to the board concerning: "(a) the selection, retention, and termination of the independent auditor, (b) the compensation of the auditor, (c) measures to ensure that the internal controls are documented by management and evaluated as part of the audit, (d) the process by which the audit committee shall review the audit and the management letter, if any, with the auditor and work with the auditor and management to resolve any issues of concern arising from the audit or the management letter or recommend resolution to the board and (e) measures to ensure that any non-audit services provided by the audit firm conform with the required standards of independence required in section eight F." Id. at proposed Section 8P. The Act also requires the audit committee to report to the board on the results of the audit (prior to the board's consideration of and action on the independent auditor's report). Id.

long as the majority of audit committee members is made up by board members.[79] The board of a charity may designate its finance committee or other permanent board committee to perform the audit committee function, so long as it is in compliance with all the audit committee membership requirements outlined above.

Among these three approaches to requiring an audit committee, we find a continuum running from the least restrictive – no requirement at all - to the most demanding – California's unqualified requirement of an audit committee. In between are Massachusetts and New York that do not require an audit committee but, in the absence of such a committee, mandate that the function of an audit committee be carried out by the board or a board committee. The latter approach appears to recognize the fact that many nonprofits have small boards, and perhaps only a very few members that are financially informed, making it difficult to staff an additional committee charged with financial responsibilities. In contrast, California not only mandates an audit committee but also provides that members of the finance committee must make up less that one-half of the membership of the audit committee and that the chairperson of the finance committee may not serve on the audit committee.

[79] The composition of an audit committee also must satisfy the following factors concerning independence: (a) members may not be employees of the charity; (b) members may not receive compensation in excess of the standard compensation, if any received by all trustees of members of the board in exchange for their services as trustees of board member; (c) no member shall have any material financial interest in any entity doing significant business with the public charity; and (d) no member shall have engaged in any related party transactions within the three years preceding appointment to the audit committee. See proposed section 8P

These approaches which require audit committees, or that an audit function is done, do not impose such requirements on organizations with revenues of less than a stated amount. This, no doubt, reflects recognition that there is no strong need for audit committee-type oversight for organizations with small amounts of income. Massachusetts's proposed requirement kicks in for groups with gross revenues of more than $100,000, New York's proposed requirement for groups with gross revenues over $250,000 and California's requirement for groups with gross revenues of more than $2,000,000. So we note threshold differences among the various state approaches. We have already identified differences between mandating an audit committee, requiring in lieu of an audit committee that audit committee functions be performed by a board or a board committee and having no audit committee-type oversight required at all.[80]

Presupposing, as I think we must, that the responsibilities of an audit committee fall under a nonprofit board's duty of care obligations, a policy which lets each nonprofit board itself decide how best to carry out such duties – whether by establishing an audit committee, having the functions be carried out by the finance committee or by the board as a whole – seems sensible enough.[81] On the other hand, if a state has had many incidences or fraud of near-fraud taking place because of, for example, lack of independence on the part of those who have financial oversight responsibilities, then in this context it might make sense to mandate an audit committee. It strikes me as also reasonable for a state to clearly articulate the audit committee function and in effect to

[80] There are other differences between these approaches, such as whether non-board members can serve on an audit committee, but I am going to limit myself to these two differences.

expressly build it in to a board's duty of care obligations, but leave it up to each board to decide for itself how best to carry out these duties.

As to threshold differences, it is hard for me to see that there is one right answer for everyone. Different states have different views. Massachusetts, for example, with its long history of prudent money management, may have been inclined to impose audit-type requirements even on small groups with little revenue. California, on the other hand, with perhaps sunnier and more laid-back attitudes about money, uses a higher threshold.[82]

So we come to the question of whether there should be one uniform rule or whether this is best left up to each state. This is an interesting question since the national government has clear authority to legislate in this area and, as suggested above, there are justifiable reasons for it to do so, namely, to protect the integrity of federal tax exemptions. So this is a rule for which there could well be concurrent jurisdiction. The federal rules would necessarily establish the minimum requirements and it would be pointless for a state to impose requirements that were looser that the federal rule.[83] On the other hand, it would make at least logical sense for a state to impose requirements that were stricter than the federal requirements. In this latter case, the issue would be whether the federal law

[82] The threshold, having been met, California, as we have seem, get tough and mandates an audit committee with strict rules designed to assure independence.

[83] For example, if a national law mandated an audit committee, it wouldn't make much sense for a state to have a rule without such requirement for the groups to which the federal law applied. (Of course, a state might have such a rule to assure its nonprofits that "whatever problems you might have with the feds on this score, you won't have them with us." But that seems silly.)

should be drafted in such a way as to preempt state laws on the subject. For many of these reasons that have been developed in this paper, this might be bad policy.[84]

2. Interested Party Transactions

This section addresses interested party transactions and the duty of loyalty. I shall principally consider § 715 of the N-PCL and a proposed version of the same statute. Presently § 715 of the N-PCL provides in effect that no transaction between a director and his corporation shall be voidable if the interested director discloses in good faith the material facts as to his interest and the transaction is approved by disinterested directors by a sufficient vote for such purposes without counting his vote.[85] On the face of it, this appears to mean that if an interested director and the corporation on whose board he serves enters into a transaction which is unfair and unreasonable to the corporation, the transaction will not be voidable, and a fortiori no remedy will lie against an interested director, just so long as the interested director discloses his interest in the transaction (but discloses nothing about the material facts of the transaction). New York courts interpreting a similar statute under the Business Corporation Law have ruled that in such

[84] If for example the federal threshold was $500,000, why shouldn't Massachusetts be able to have a lower one?

[85] In more detail, the law provides: "No contract or other transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, firm, [etc.] in which one or more of its directors or officers are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors or officer or officers are present at the meeting of the board, or committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose: (1) If the material facts as to such director's or officer's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the board or committee, and the board or committee authorizes such contract or transaction by a vote sufficient for such purpose without counting the vote or votes of such interested director or officer; or (2) [covering a membership corporation]." N-PCL §715(a)(1) and (2).

cases where there has been the required disclosure and a transaction has been properly approved by disinterested directors, a challenge still lies and the challenger must prove that the approving directors breached the business judgment rule in approving the transaction.[86] This, of course, is a standard favorable to the transaction and difficult to meet. Presumably in a nonprofit context, New York courts would proceed in a similar way. (There are, though, no nonprofit cases in New Yrok that have done this.) What is clear, however, is that, if the proper disclosure procedures have been followed and disinterested approval has been gained, the burden is on the party who would challenge the transaction to establish a basis for upsetting it, etc.[87]

In the spring of 2005 the New York Attorney General filed a proposal to amend N-PCL § 715 along with other proposals to amend the N-PCL. The beginning (first sentence) of the proposed § 715 is virtually the same as the beginning of the present § 715. And then the big changes come. It continues by providing in effect that any interested party transaction may be voided or *modified* by the corporation or *the attorney general* and certain remedies shall be available to the corporation or the attorney general unless the interested director, and any approving director, shall establish affirmatively that such transaction was fair and reasonable as to the corporation at the time of the transaction. It

[86] Of course, if a challenger can show that there was inadequate disclosure or that the approving board members were not disinterested or both, then the burden shifts to the challenged to show that the transaction was fair to the corporation. If there has been adequate disclosure and the approving board members were disinterested and if the challenger can establish that there was no rational basis for the approving board's approval (it having been ately informed as to the transaction), then the burden shifts to the proponents of the transaction to prove that it is nonetheless fair to the corporation.
[87] If the interested director did not disclose or if there was no disinterested approval, then the transaction may be challenged by the corporation and the Attorney General, and, unless the interested director establishes affirmatively that the transaction was fair and reasonable to the corporation at the time it was authorized, it may be voided. N-PCL § 715(b). Any action against board members who approved the

goes ahead to provide that an interested party transaction shall be presumed to be fair and reasonable if in effect Code section 4958's rebuttable presumption procedure plus is followed, namely, that the transaction: (1) is approved in advance by the board by a vote sufficient for such purposes without counting the vote of the interested director and the material facts of the transaction and such director's interest therein were disclosed in good faith to the board; (2) the board obtained and relied upon appropriate data as to comparability; and (3) the board adequately documented the basis of approving the transaction at the time of such approval,which documentation includes a number of items (see footnote below).[88]

If the interested director or approving director fail to meet his burden, the corporation of the attorney general may void or modify the transaction (unless such action would hurt the corporation) and may seek to recover from the interested director restitution in

transaction would presumably be brought under N-PCL § 717 (and N-PCL § 720) as a duty of care violation.

[88] The proposed § 715(B) provides in part: "An interested party contract or transaction within the meaning of paragraph (A) … shall be presumed to be fair and reasonable to the corporation, if the following conditions are satisfied: (1) the contract [or] transaction was approved in advance by the board or committee entitled to vote thereon and the members, if any, entitled to vote thereon, by a vote sufficient for such purpose without, in the case of a board or committee vote, counting the vote or votes of such interested director or officer, and the material facts as to such contract [or] transaction …and such director's or officer's interest therein were disclosed in good faith or otherwise known to the board or committee or members, if any, entitled to vote thereon; and (3) the board or committee adequately documented the basis for approval of the contract [or] transaction at the time of such approval, which documentation shall include: (A) the terms of the contract [or] transaction, that was approved and the date it was approved; (B) the members of the board or committee who were present during discussion of the contract [or] transaction, that was approved and those who voted on it; (C) the comparability data obtained and relied upon by the board or committee and a description of how the data was obtained; and (D) any action taken by the interested director or officer with respect to consideration of the contract [or] transaction."

amounts equivalent to remedies that would be available to the IRS together with interest.[89]

In contrast to the present § 715, the proposed § 715 puts the burden of proof expressly on the interested director and approving directors and provides specific remedies for failing to meet the burden which are expressly available to both the corporation and the Attorney General. These remedies include voiding or modifying the transaction and collecting restitution in an amount available to the IRS under § 4958 of the Code.

We see then two critically different approaches to interested party transactions. Perhaps it is arguable that under the present New York rule, if the proper disclosure and disinterested approval have been attained, that puts an end to it: the transaction walks. [90] Whether (as I do not believe) a court would refuse to consider a challenge to an interested party transaction on the grounds that it was unfair to the corporation if proper disclosure

[89] In more detail, § 715(C) provides in part: "If the interested director or officer or approving director fails to meet his burden under paragraph (A), the corporation or the attorney general may void or modify the contract or transaction, unless such voidance or modification would place the corporation in a position worse than that in which it would be if the contract or transaction were not voided or modified. In addition, if the interested director or officer or approving director fails to meet the burden under paragraph (A) … regardless of whether or not the corporation is subject to section 4958 of the code, and regardless of whether or not the internal revenue service pursues its remedies, the corporation or the attorney general may seek to recover from the interested director or officer or approving director, respectively, restitution in amounts equivalent to the remedies that would be available to the internal revenue service from an interested director or officer or approving director of a corporation subject to said section … together with interest at the rate pursuant to section 5004 of the civil practice law and rules on any such amounts."

[90] And perhaps other interested party transaction rules work the same way. Forum member Brody, after commenting on a number of similar rules covering interested party transactions, has suggested: "In general, such a transaction will be reviewed for substantive fairness only in the absence of a process of requiring decisionmaking by disinterested fiduciaries. Some states always require the transaction to be fair to the charity; other states use the fairness test as an alternative to disinterested approval." Principles, supra note 69, at 235.

and disinterested approval has occurred,[91] it is clear that some rules put the burden of proof on whoever challenges the transaction,[92] and others, like the proposed New York rule, put it on the parties to the interested transaction.

In addition to the burden of proof issue, there is the question of what standard of judicial review should be applied to these interested party transactions. Forum member Goldschmid, in an earlier paper for this forum, which has now been published, has observed, " If for-profit precedents are used, most states, it appears, would apply the business judgment rule – and its highly deferential rationally believes test - to judicial review of these transactions."[93] He recommends, "… when there has been proper disclosure with respect to an interested transaction … followed by disinterested approval, the highly deferential rationally believes test of the business judgment rule should not be the standard for judicial review. A fairness test, or at a minimum the ALI's intermediate test, should provide the applicable standard for review."[94] Goldschmid's proposal is, of course, tougher on interested party transactions. Here then is another example upon which states may differ so far as taking a more or less lenient approach to these transactions.

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[91] The Principles itself allows for the challenger to prove a breach of the duty of loyalty under § 375(b)(2) if the challenged transaction meets the requirements of § 330(c) regarding disclosure and distressed approval. Id. at 429.

[92] First the challenger will try to show that there was inadequate disclosure or the approving board was not disinterested. If successful, the burden will shift to those supporting the transaction. If unsuccessful the challenger will be put to establishing that the approving board failed to meet the applicable standard of review for these cases, which today in almost every case will be the business judgment rule.

[93] Goldschmid, The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problem, and Proposed Reforms, 23 J. Corp. L.631, 648 (1998) [hereinafter Goldschmid].

[94] Id. at 650-651. So far as I am aware, no state has adopted or proposed a judicial standard for review for these transactions more rigorous than the business judgment rule. It is not clear to me that the Principles take a position on this issue. In her comments Forum member Brody notes that: Marion Fremont-Smith believes that of all the suggestions to reform duty of loyalty, Goldschmid is 'the most balanced and likely to gain acceptance.'" Principles, supra note 69, at 442.

At a general level we see then some states that take a more lenient view and others a less lenient view to interested party transactions. There are good reasons in support of both approaches. As to the more lenient approach, frequently an interested party transaction between, for example, a board member and the corporation on which she serves will be favorable (and fortiori fair) to the corporation. If a board member was aware that, if challenged, she would have the burden of proof to establish the fairness of the transaction, she might very well decide not to go forward with the deal and her corporation (and presumably the public) would be less well off than they might have been. Forum member Jim Fishman's great casebook puts it this way:

> "In many situations, interested transactions are a healthy necessity. They may provide access to resources unavailable from the marketplace. The financial status of the nonprofit organization may be so poor that market sources of credit, supplies and services are unattainable. A loan of money goods, or services may be obtainable only from a director, an individual concerned with the organization's welfare."[95]

On the other hand, as the same useful source notes: "Conflict of interest, divided loyalties, and transactions among directors, officers, and charitable organizations abound in the nonprofit sector. Breaches of loyalty are not only much easier to

[95] J. Fishman & S. Schwarz, Nonprofit Organizations, (Second Edition), 192 (2000). In considering an absolute prohibition against interested party transactions, it is said: "Would not a total prohibition against any conflicts of interest by nonprofits be too severe by carrying in its swath useful interested transactions that nonprofits, particularly smaller ones, need to survive? An absolute ban ignores the reality of much of the charitable sector. Many nonprofit organizations must engage in transactions with board members in order to survive. Generally, few people have as much interest in the welfare of the nonprofit or understand it better than its directors. Self-dealing transactions can be efficient for the organization. The transaction costs are low. Interested directors may be able to lend money or provide services or do business with a nonprofit at a lower rate, because they know the organization best. Because the organization may not be able to obtain equivalent goods in the marketplace, these benign transactions may be the only source." Id. at 226

identify than breaches of care, they are more prevalent."[96] Goldschmid, after confessing his reservations about the effectiveness of board governance among many nonprofits, observes: "Of even greater concern are recent well-publicized scandals in the duty of loyalty area. Improper self-dealing and other duty of loyalty violations threaten to undermine the trust and goodwill necessary for the nonprofit sector to function successfully."[97]

And, of course, the question occurs again: should there be one uniform national rule or is it better to leave it up to the states to decide? In this case we have the value of promoting useful transactions between board members and the nonprofit corporations on which they serve against the value of assuring that the charitable sector is not disadvantaged by unscrupulous insiders. Might it not be that some states have mostly small nonprofits that need all the help they can get so that precluding help from their board members would be unfortunate, while other states have a large number of nonprofits with high revenues and substantial assets and a history of insider abuse? Why shouldn't each state decide for itself how it wants to strike the balance? Where is the need for national uniformity?

As suggested above, in so far as a particular interested party transaction is covered by §4958 of the Code, there may be concurrent jurisdiction over the matter. But there remains room for differences. In an action brought under §4958, the burden would presumably be on the challenger-IRS. Under the proposed New York rule, as noted, it is on the challenged. It is likely that there may be instances where the IRS will not

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[96] Id. at 190.
[97] Goldschmid, supra note 71, at 633.

challenge a transaction but a state might and, for many of the reasons suggested in this paper, it is appropriate that that state prosecutes the case under its own rule. Even where there is joint prosecution by the IRS and a state against the same interested party transaction, for similar reasons, it is appropriate that different rules be applied to the two cases. For example, in defending a disinterested board's approval of an interested party transaction, the amount of information and the extent of data regarding comparable transactions would presumably be less demanding under the business judgment rule than under Code section §4958's rebuttable resumption standard. On the other hand, if a state was to adopt a tougher fairness test, as recommended by Professor Goldschmid,[98] the defense of a disinterested board approval of an interested party transaction might be tougher. Again, what warrant is there for a uniform rule?

V

By limiting my focus to nonprofits that operate in only one state (and only solicit funds from the citizens of that state), I have avoided the problems arising from nonprofits being subject to the different rules of different jurisdictions. Forum members Chisholm and Grumbach have discussed some of these issues in recent papers for the Forum. The burdens on nonprofits that solicit contributions in many states and the correlative virtues of having one registration and annual reporting form have been talked about for ages. But I have bit off more than I can chew and my paper has grown fat, so perhaps we are all lucky that I have made it easier on myself.

[98] See supra note 93.

Appendix

Part G. of June 2004 Senate Finance Committee Staff Discussion Draft

G. Encourage Strong Governance and Best practices for Exempt Organizations

1.Board Duties

A charitable organization shall be managed by its board of directors or trustees (in the case of a charitable trust)[99]. In performing duties, a Board member has to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the mission, goals, and purposes of the corporation. An individual who has financial skills or expertise has a duty to use such skills or expertise. Federal liability for breach of these duties would be established.
Any compensation consultant to the charity must be hired by and report to the board, and must be independent. Compensation for all management positions must be approved annually and in advance unless there is no change in compensation other than an inf1ation adjustment. Compensation arrangements must be explained and justified and publicly disclosed (with such explanation) in a manner that can be understood by an individual with a basic business background.
. The Board must establish basic organizational and management policies and procedures of organization and review any proposed deviations.
. The Board must establish, review, and approve program objectives and performance measures and, review and approve significant transactions.
. The Board must review and approve the auditing and accounting principles and practices used in preparing the organization's financial statements and must retain and replace the organization's independent auditor. An independent auditor must be hired by the Board and each such auditor may be retained only five years.
. The Board must review and approve the organization's budget and financial objectives; as well as significant investments, joint ventures, and business transactions.
. The Board must oversee the conduct of the corporation's business and evaluate whether the business is being properly managed.
. The Board must establish a conflicts of interest policy (which would be required to be disclosed with the 990), and require a summary of conf1icts determinations made during the 990 reporting year.
. The Board must establish and oversee a compliance program to address regulatory and liability concerns.

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[99] The duties of a board that are described in this paper would also be the duties of a trustee for a charitable trust.

The Board must establish procedures to address complaints and prevent retaliation against whistleblowers.[100]

All of these requirements must be confirmed on the Form 990. Relaxation of certain of these rules might be appropriate for smaller tax exempt organizations.

2. Board Composition

Board shall be comprised of no less than three members and no greater than fifteen. No more than one member may be directly or indirectly compensated by the organization. Compensated members may not serve as the board's chair or treasurer.[101] For public charities, at least one board member or one-fifth of the Board must be independent. A higher number of independent board members might be required in limited cases. An independent member would be defined as free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments.

3. Board/Officer Removal

Prohibition on services. Any individual that is not permitted to serve on the board of a publicly traded company due to Federal, State (or exchange) law may not serve on the board of an exempt organization. Any individual that has been criminally convicted of a Federal or State charge of fraud, or similar offense, may not serve on the board or as an officer of an exempt organization for 5 years after the conviction. Any individual who has been convicted of a crime under the laws enforced by the Federal Trade Commission, U.S. Postal Service or State Attorney General for actions related to service as an officer or director of a tax exempt organization (or the crime arose from an organization that falsely presented itself as a tax exempt organization) may not serve as an officer/director for a tax exempt organization for 5 years. An organization or its officers/members that knowingly retained a person who is not so permitted to serve such organization would be subject to penalty.[102]

IRS Authority. The IRS would have the authority to require the removal of any board member, officer, or employee of an exempt organization who has been found to have violated self-dealing rules, conf1icts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation laws. The IRS may require that such individual may not serve on any other exempt organization for a period of years. An

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[100] See The Sarbanes-Oxley Act and Implications for Nonprofit Organizations, Board Source and Independent Sector (2003)(useful discussion of provisions of whistleb1ower protections and other provisions of Sarbanes-Oxley and nonprofit organizations).

[101]See generally, BBB Standard 4, ECFA Standard 2.

[102] See generally Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002, Fremont-Smith and Kosaras, 42 Exempt Organization Tax Review 25 (2003) (noting the number of repeat offenders in the survey) and Where the Law Ends: the Social Control of Corporate Behavior, C. Stone, 148-189 (1975) (advantages of suspension in corporate world).

organization that knowingly retained a person who is not so permitted to serve would lose tax exempt status or be subject to a lesser penalty.

4. Government encouragement of best practices.

Grant-Making and Contracts. In determining the recipients of Federal government grants and contracts to tax exempt organizations, the responsible Federal government agency issuing the grant or contract would be required to give favorable consideration to organizations that are accredited by IRS designated entities that establish best practices for tax exempt organizations. The IRS would annually determine those organizations, with a preference for organizations that perform an independent review of accredited organizations and that audit applications for accreditation.[103]

Combined Federal Campaign. The IRS, in consultation with OPM, will establish best practices/governance requirements/accreditation for charities participating in the Combined Federal Campaign (CFC). The IRS will ensure that the best practices/governance requirements for the CFC are uniform nationwide in order to encourage charities to participate in the CFC.

5. Accreditation.

There would be an authorization of $10 million to the IRS to support accreditation of charities nationwide, in States, as well as accreditation of charities of particular classes (e.g. private foundations, land conservation groups, etc.). The IRS can initiate its own accreditation efforts as well as solicit requests. Priority would be given to proposals with matching dollars. The IRS would have the authority to contract with tax exempt organizations that would create and manage an accreditation program to establish best practices and give accreditation to members that meet best practices and review organizations on an ongoing basis for compliance. Such organizations could require dues by members to meet costs; and contract authority to review member information and take corrective action. The IRS would have the authority to base charitable status or authority of a charity to accept charitable donations on whether an organization is accredited.[104] The proposal should encourage accreditation that is already taking place at the state level(e.g. Maryland, Ohio, Pennsylvania, Georgia and Louisiana) in particular classes (nonprofit hospitals, zoos and universities already subject to accreditation).[105]

6. Establish prudent investor rules

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[103] Compare with the Administration's proposed Millennium Challenge Account (MCA) which uses independent ratings (ex. Freedom House for Civil Liberties) for determining countries that will receive support. Treasury Under Secretary John Taylor Testimony before the Senate Committee on Foreign Relations, March 4, 2003 (www.treas.gov/press/release/js80.htm).

[104] See Nonprofit Compensation and the Market, Frumkin and Andre-Clark, 21 Hawaii L. Rev. 425, 476 (Winter 1999)(general discussion about accreditation).

[105] See Standards for Excellence Institute (www.stanardsfor excleenceinstitute.org)(discussion of accreditation efforts in states).

A prudent investor rule would apply to investment activities of charitable organizations. Many States apply a prudent investor standard to non-profit entities incorporated in the Sate; such State standards would inform the development of a Federal standard.[106]

[106] See Fremont-Smith at 454 (pressing need for adoption of the Prudent Investor rule as eh standard for

compliance).