Nonprofit Governance: A Practical Consideration of Possible Structures For Good Governance When Nonprofits Expand their Activities

Beverly M. Wolff
Nonprofit Forum
October 17, 2002

I. Introduction

During the 1990's – a period of great economic growth and declining government spending -- many nonprofits looked to expand in order to remain on par with or ahead of their perceived competition[1] and to capture new sources of revenues. The expansion that occurred was not only with regard to physical spaces, but also included expansion of boards and organizations' constituencies, as well as creating new programmatic and other ventures, and building new alliances. While the more recent economic downturn has no doubt derailed some planned expansion efforts, it has only further fueled the need for institutions of all sizes, to engage in more

[1] See, Emily A. Barman, Asserting Difference: The Strategic Response of Nonprofit Organizations to Competition, *Social Forces,* June 2002, 80 (4), 1191-1222 (The University of North Carolina Press), an article about the strategic response of a large United Way to a period of monopoly and a period of competition, wherein the author concludes that the effect of competition requires further empirical research, but also concluded that "the pressures of competition induce nonprofits... to seek to identify and fill distinct and different niches from one another.... To do so,...these nonprofits attempt to construct a hierarchy of comparison by which they come out on top. As a result, it seems likely that an organizational field characterized by competition will exhibit diversity across its organizational members. The field will become a fluid and shifting terrain, one in which nonprofits constantly negotiate and position themselves in relationship to one another. Id. at 1273.

outreach to new constituents and sources of revenues and to explore collaborations or consolidations with other institutions.[2]

Both of these activities – expansion of constituents, and ventures with other institutions - raise the question of what is the best governing structure for absorbing or creating such activities, which might include creating formal new groups such as affiliates or councils, or bringing organizations together, such as with a merger[3], or formal collaboration.

Organizations faced with the question of the appropriate governing structure or governance overview of the expanding institution, have not necessarily found the best structures or other controls, which has resulted in various problems and issues. These issues include: 1) contrary views of the organizations involved in a joint effort, or within one or both of the organizations, as to independence of the new or merged organization; 2) concern over ownership and maintenance of property; including the ensurance that the new activities will not undermine the good will, endowment, and other assets of the original institution (s); and 3) the lack of appropriate level of board oversight with regard to immediate and long term financial and other impacts of new ventures --i.e., the board is not appropriately apprised of the level of activities and the potential risks.

---

[2] See, Alair Townsend, *Responding to Cultural Shock,* Crain's (Oct. 7, 2002), p. 9, in which she notes that performing arts organization executives are speaking openly "about the desirability of having similar groups merge – a possibility that donors should encourage."

[3] As used herein the term merger includes mergers, acquisitions, and other consolidations.

The purpose of this article is to explore possible governance structures for improving board oversight in these circumstances and to elicit discussion on the advantages and disadvantages of such structures, starting with three suggested structures: 1) the use of a parent nonprofit as the sole corporate member of a subsidiary or the creation of a special membership group under the parent member, with specified authorities; 2) the use of licensing or contractual agreements; and 3) the use of a constitution to govern the multiple layers of an organization.[4]

Perhaps the easiest way to describe the problems and/or issues that may arise when organizations seek to expand at different levels is to do so with three fictional hypotheticals. (Any relationship to actual situations is purely coincidental.) I assume that each of you has seen variations on the themes presented.

II. Statement of the Issues

Hypothetical 1: Merger of Large and Small Organization

Facts: A large and prominent arts institution ("AI") merged with a smaller, programmatically but not financially successful, institution ("MI"). The legal

---

[4] Focusing on governance, this article does not consider other factors, which may impact structure, such as potential liability, separate accounting, etc. However, I will note that consolidated financials may create a positive form of oversight, in the absence of other appropriate oversight being in place.

Note also, that there is little guidance in law reviews or other publications on the pros and cons of the various structures from the point of view of good governance.

Lastly, note that nonprofits' expansion of activities through relationships with profit-making entities is beyond the scope of this article.

structure used to accomplish this was the creation of a new subsidiary 501 (c) (3) to house the activities of MI, with AI as the sole member of the new subsidiary ("SI"). This was accompanied by a merger agreement, which set forth certain terms and agreements regarding such matters as use of AI's name, staff issues, etc.

With the merger, a number of AI's Trustees have been placed on SI's board, which is otherwise comprised of former Trustees of MI. The former Executive Director of MI is the Director of SI (but is expected to retire in a few years). She is also a management staff member of AI and regularly attends senior staff meetings. AI is gradually taking control of SI's program content and property. SI has retained the name of MI, but is now identifying itself in advertising as an affiliate of AI.

Since the merger, it has become apparent that, although due diligence was done prior to the merger, many Trustees of AI did not know that there were certain large capital expenditures needed at SI, which MI hoped to achieve as part of the merger, but which are in direct conflict with the current capital needs of AI. SI's capital expenditure needs have been placed lower in priority than AI's needs. In addition, MI had hoped that its profile would be greatly enhanced by its affiliation with AI. While this has been somewhat true, there are many programs and activities that AI engages in without advertising the association. Moreover, recently AI has come to directly compete for the same audience as SI, without marketing the connection or encouraging the audience to attend both institutions. Another issue is the immediate extent of AI's control of SI's program content and timing.

Issues:

1. Is the organizational structure of the merger, with AI acting as the sole member of SI, the best structure for both AI and MI?

2. Is it unrealistic to expect that the problems presented could have been avoided in the agreement accompanying the merger given the lack of parity of the parties?

3. Should the imbalance of power between the two merging organizations be of concern to regulators?

4. Is there any structure or procedure, which would have provided better notice to the board of each merging institution as how the merged organizations would impact each other and would function?

Hypothetical 2: Arts Organization Creates International Group as Independent 501(c)(3)

Facts: Some years ago, a major arts institution ("A") decided that it wanted to gain international exposure and recognition by creating an international membership group that would come together once or twice a year in locations throughout the world, for purposes of exploring art masterpieces and exhibitions. Its targeted membership was major collectors throughout the world, many of whom were board members of similar organizations in their own country, who also had business or a residence in the city where A is located.

Several individuals were selected to act as catalysts in seeking membership and determining the appropriate organizational structure (hereinafter "organizing committee"). The organizing committee was adamant that if potential members felt that the group was under the auspices of or controlled by A, membership would be perceived as disloyalty to their own organizations. It was also perceived by the organizing committee and by A that a "Friends" type group would not have the necessary clout to elicit the hoped for level of member.

Consequently, A decided to create a separately incorporated 501(c)(3) which, for the purposes of this article shall be called A's International Group (hereinafter "AIG"). The only control that A had over AIG was, pursuant to a contract, the discretionary control over and the right to terminate the use of A's name in connection with the name and activities of AIG.[5] There was no specified overlap with respect to the boards of the two entities. In the event of dissolution of AIG, there was no provision for the assets to go to A; rather the bylaws simply provided that the state law of A would apply.

[5] While I was counsel to Pratt Institute a litigation ensued between the Institute and the Pratt Institute Engineering Alumni Association, a separately incorporated group which was created as a totally separate 501 (c) (3) with no role of Pratt Institute or its Board in the governance of the Association and no agreement as to use of the name Pratt or as to the use of any funds of the Association. The Association had property and wanted to undertake a fundraising drive that Pratt Institute believed was in direct conflict with its own fundraising plans. The Institute and Association unsuccessfully tried to resolve their differences. The Association finally declared that it was going to proceed with no input from the Institute and that any funds raised would benefit the Alumni and not the Institution. Pratt Institute commenced a state court action to enjoin the Associations continued use of its name. A state court judge held that the Association could appropriately continue to use the name Pratt, since it had used the name, independent of the Institution for over twenty years, without prior protestation from Pratt. (Opinion not reported.) A brief search surprisingly showed numerous cases between colleges or universities and their alumni associations. For an example, see Villanova University v. Villanova Alumni Educational Foundation, Inc., 123 F. Supp. 2d 293 (E.D. Pa. 2000) in which the University was granted a preliminary injunction against the defendant, which continued to use the University's marks, after an affiliation agreement between the parties expired.

From the beginning, the membership drive was successful and AIG's membership and programs quickly surpassed A's expectations and enhanced A's international recognition. Over time, AIG raised funds for several of A's capital campaigns and AIG actually funded certain acquisitions, exhibitions and other programs at A, and endowed a special international program and gallery at A. Although not required, the president of AIG has always been either a trustee or the spouse of a trustee of A. AIG has a staff director and several administrative staff, who are also employees of A. In addition, the chair of AIG's board has become, under the bylaws of A, an ex officio trustee of A.

While overall, AIG would be considered a success from the point of view of expansion of constituency, in recent years a number of issues have arisen which call in doubt the lack of A's ability to manage or otherwise effect the activities of AIG. First, AIG has sought greater input into the international program of A than desired by A. Second, AIG has wanted to control the salaries of A's staff, who work on AIG matters, even though such salaries would be out of scale with A's other staff. Lastly, while in the past AIG has helped A in its capital campaigns by having its members pledge funds to the campaign, with a newly announced campaign, AIG has indicated that it wishes to create and maintain its own endowment, which while at a hefty number, is nowhere near as much as A had hoped to have raised by AIG from its members for A toward its capital campaign. Also, AIG does not wish to coordinate its fundraising with A's development staff and does not want A to separately solicit its members.

Issues:

1. This hypothetical raises the same issues as in the first hypothetical: how could this relationship have been better structured legally? A sub-question is whether A should have insisted on controlling certain of AIG's activities and assets. In hindsight, it is easy to suggest that the organizational structure of AIG should never have been created as a totally independent 501 (c) (3), with no controls by A over its activities and property. However, at the time of its formation and even today, it would not have been politic to either make A the sole member or to create AIG in such a way that there would always be major overlaps of the boards of both institutions.

2. In the absence of a formal legal control in the incorporating documents, or a contractual arrangement, is it realistic to expect that a special governing document, a constitution,[6] can be effective?

Hypothetical 3: Arts Institution Expands Nationally and Internationally Through a Number of Vehicles

Facts: Another arts organization (hereinafter "O") approaches global growth differently -- creating alliances, collaborations and other relationships with existing and new institutions abroad and in the United States. This has been accomplished through individual agreements, in a variety of forms including licensing, collaboration, and managing agreements. These agreements generally attempt to

[6] As used throughout, the term "constitution" shall been a governing document that augments the articles of incorporation and by-laws of an organization. The document may also be called a charter or have another title and may or may not require that it be ratified by an affiliating institution.

govern such matters as use of O's name, joint programs, responsibilities of each party and ownership of property, and appropriate sharing of revenues and/or expenses.

While many board members of O felt that this international focus and expansion could only improve the activities and good will of the original institution in the United States, certain board members and others were concerned that these activities would unduly stretch and/or undermine the management and financial capabilities of O, possibly putting in jeopardy its buildings, collection materials, and endowment. Questions were raised about whether a restructuring should occur to better protect the assets and good will of O from the new activities. Thought was given to creating a separate organization, whose board would oversee these new activities while separately preserving O's function and endowment.

Issues: Again the issues presented are variations of the same presented in the first two hypotheticals:

1. What measures can an institution take to ensure that it is adequately appraised of they risks to its assets as it expands? Are there specific structural mechanisms that could be used?
2. What are the pros and cons of licensing agreements and other contracts as a means of protecting O's good will and other assets?

III. Discussion of Issues and the Pros and Cons of Possible Governing Structure

A. Board Oversight In General

An overriding concern raised by all three hypotheticals is the adequacy of board oversight of expansion efforts. Although boards have a fiduciary responsibility to protect the assets of their organization, all too frequently boards are simply asked to approve mergers or other ventures, with only a broad outline of the major terms, and without specifics as to such important matters as long term protection of the use of the an organization's name or potential downside impact on other assets or programs of the organization.

No doubt, where a separate legal entity is being created to house the new activities, many board members assume that they can rely simply on the creation of such an entity to guarantee protection of their own organization's assets. The hypotheticals and reality show that this is not the case.

While one might stop here and say that all of the issues presented could simply be solved by better oversight as is required by the duty of care and loyalty, I am not sanguine that this is a viable reality. We continually see examples of lack of oversight, perhaps the most recent being at The United Way of the National Capital Area, which is being investigated by a federal grand jury regarding accusations of mismanagement and misconduct. When questions were raised as to the payout of the departing executive director's contract, they prompted statements such as: "The board didn't even know the contract existed..." and "Several board members had asked to see the contract over the past year and a half but...they had been refused..."[7]

Proper board oversight should include a review of key terms and an examination of the potential impact of any major contract or other arrangement, rather than delegating these matters to a committee or to staff, without adequate reports back. It has been suggested that a board in a merger situation should be subject to a more rigorous standard of care than for ordinary actions, similar to the standard imposed on business corporations.[8] To determine if this is advisable or necessary, it is useful to first examine whether oversight can be enhanced by the use of an appropriate governance structure.

B. Parent Organization Acting as Sole Corporate Member or Parent as a Member with an Additional Class of Members

Use of a subsidiary where the parent organization acts as the sole member has generally been regarded as the best way to protect the interest of a founding organization, when creating new ventures. This however, may not be a viable solution where the social politics, such as in Hypothetical 2, are strong. Moreover, a recent law review article adds fuel to the premise that such a legal arrangement may not adequately protect the interests of the subsidiary. *See* Dana Brakman Reiser,

[7] "Washington United Way to Select New Board," The New York Times, Friday October 4, 2002, p A18.
[8] *See,* Garry W. Jenkins, The Powerful Possibilities of Nonprofit Mergers: Supporting Strategic Consolidation Through Law and Public Policy, 74 S. Cal. L. Rev. 1089, at 1125-1126.

Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care Systems, 53 Rutgers Law Review 979, wherein the author points out that "because the law does not impose fiduciary duties on members, a PASCM [Parent Corporation Acting as the Sole Corporate Member] can make decisions for its subsidiary solely in service of the goals and interests of the parent, and without considering the impact of those decisions on the subsidiary or its beneficiaries."[9]

Reiser makes a number of other points relevant to the issues at hand. She suggests that a variation of the PASCM structure might be used, to protect other interests than those of the parent company, by creating two classes of members in a subsidiary: the parent organization member, and an additional class of members which would have control over certain specified operational matters ("dual member subsidiary").[10] To me, a dual member subsidiary is an appealing way for power to be shared in a new subsidiary; it would put the issues on the table at the earliest stages of development of the subsidiary and would avoid some of the problems with Reiser's other suggestions discussed below. However, use of a dual member subsidiary would seemingly only be effective if election to its board, which, unlike the members, has fiduciary responsibility to the subsidiary, were either determined by a vote of both classes of member or if each class elected half of the board.

[9] *Id.* Reiser
[10] *Id.* at note 61.

While Reiser recognizes that certain legal mechanisms exist, such as donor restrictions on assets, which in effect "protect the donated assets of the subsidiary from outright looting by the parent,"[11] she notes that because a PASCM elects the directors of and makes decisions for the subsidiary, accountability becomes more difficult to trace than in a typical freestanding nonprofit.[12]

The main premise of Reiser's article is that to avoid the uncontrolled use of a subsidiary to serve the purposes of a PASCM, without concern for the interests of the subsidiary, courts, regulators, and/or legislators[13] should impose fiduciary duties on the PASCM. The author suggests that three models for doing so be considered: 1) the director model, 2) the wholly - owned subsidiary model, and 3) the controlling shareholder model.

The first, or director model, would work as follows:

> "Such a stylized Director Model would define a fiduciary duty for PASCM's as if the PASCM entity were a director, and would subject the PASCM to the typical duties imposed on such directors. Under this Model, courts would evaluate actions taken by a PASCM with respect to a subsidiary for violations of the duty of care and loyalty. As in the director context, duty of loyalty challenges would be the most prominent enforcement vehicle. If a PASCM makes a decision for its subsidiary, in which the PASCM also has an interest, it would be deemed to be operating under a conflict. The decision could be approved or validated through procedures analogous to those applied in interested transaction statutes.[14]

[11] *Id.* at note 67, citing Evelyn Brody, *The Limits of Charity Fiduciary Law,* 57 MD. L. REV. 1400, 1465-67 (1998).
[12] *Id.* at 992.
[13] In my view, it is unlikely that a court would undertake to impose the constructions the author suggests on a non-profit PASCM and that any change in fiduciary responsibility would require legislation.
[14] *Id.* at 1003.

Since interested transaction provisions in the not-for-profit laws usually require a showing of fairness for a transaction. Reiser suggest that defining "fairness" in the context of a PASCM could best be done "with reference to the system of which both entities have chosen to become a part."[15]

With respect to the wholly owned subsidiary model, Reiser notes that courts have generally, with few exceptions, not enforced any duty of the parent to the subsidiary, so that the fiduciary responsibility is solely to the parent. *Id.* at 1005-1009 and 1017-1018. [Note: I do not know why the author included this model, as it effectively provides no guidance as to any possible change in fiduciary duty for the not-for-profit PASCM.)]

Reiser favors the third or controlling shareholder model, noting that the "beneficiaries" of the PASCM's subsidiary are similar to the minority shareholders in that just as those shareholders have a potential mechanism in a derivative lawsuit, the beneficiaries have potential enforcement, to ensure that their interests are protected, through the state attorney general. *Id. at 1009-1013* and 1018-19.

In my view, there are several problems with suggesting that a PASCM be held to the same accountability as under a controlling shareholder model. First, the beneficiaries who have standing with regard to a subsidiary non-profit may be different than the parties that are concerned about a transaction or the general operation of the non-profit. Take for example the newly created subsidiary created by

[15] *Id.* at 1016-1017.

the merger in hypothetical 1. There, arguably the most concerned parties as to any actions by the PASCM would be the original directors of the merged organization, MI, now serving on the board of the new subsidiary, SI, and perhaps the executive director of SI, formerly the executive director of MI. It is doubtful, however, that a court would define these individuals as beneficiaries; rather the beneficiaries would be either donors to MI or possibly the broader community that uses its services. This would provide some oversight, and Reiser argues that it "would filter out less threatening PASCM actions from court review,"[16] but query whether this would be adequate.

Second, and closely related to the first, is the problem of the attorney general having to be the moving party in any action on behalf of the beneficiaries. As we have so often discussed in the Forum, most states just do not have the resources for this type of oversight.

Third, a change in fiduciary responsibility of PASCMs could effect certain types of subsidiaries which, unlike those in my hypotheticals, are created solely for the benefit of the parent, e.g., a non-profit real estate holding company subsidiary or publishing subsidiary, where the PASCM should not have to take into consideration what is best for the subsidiary, which could vary from the best interests of the parent (such as purchasing property at a higher cost than comparable property because of its proximity to the parent) since there is no doubt that the activities of the subsidiary are

---

[16] *Id.* at 1019 and 994, where here premise is that if matters regarding internal conflicts of an institution were resolved in court this would be too burdensome on the PASCM.

solely to benefit the PASCM and should be only for its best interest. This result would be unfortunate.

Given the reasons set forth above, in my view, the imposition of fiduciary responsibilities on a nonprofit parent, would only work if the nonprofit law were revised to separately recognize at least two types of non-profit subsidiaries: 1) a dual member subsidiary, where the parent would have a fiduciary responsibility to both the parent and the subsidiary and the other members would have a fiduciary duty to the subsidiary, which would be utilized when the interest of another merging entity exists; and 2) a wholly owned subsidiary with a PASCM, where there would be no duty other than to the PASCM, to be utilized where there are no interests of a second entity, or former second entity as in a merger, to be protected.

In conclusion, the use of a dual member subsidiary, either with a fiduciary responsibility to the subsidiary created by a change of law, as described above, or without the change in law, but with the second class of members having meaningful responsibilities, including a significant role in the election of the board, as described earlier,[17] could have resolved many of the issues involved in each hypothetical. For example, in the situation where a non-profit creates a splinter group that has clout, as in hypothetical 2, it is much more likely that the group would have accepted a PASCM if there where a fiduciary responsibility to the group. The group also might have considered a separate, if effective, category of membership in a dual member

[17] See discussion *supra* at p. 12.

subsidiary, without this fiduciary responsibility, rather than requiring that AIG be created as a totally independent organization.

Similarly, in the third hypothetical, where a non-profit is in an expansionist mode, and there is concern about protecting existing assets and programs, a PASCM might be used, if a super-structure were created over the original entity, so that the original entity became a subsidiary, with the super structure as its PASCM. This might be an attractive way to preserve the original entity's current assets, if either there were a fiduciary responsibility to the subsidiary by the PASCM, or if the subsidiary had a class of members with well-defined authority.

Since it is unlikely that the courts or legislature will be quick to modify existing law to create the broader fiduciary responsibility, one is left with the questions of whether the current type of dual member subsidiary alone would suffice to provide governance control, should it be provided by other mechanisms, or should it be provided by a combination of both.

C. Use of Licensing, Affiliate, or Management Agreement or Other Form of Contract

On initial consideration, it would seem that a formal written agreement should be an efficient and judicious way to describe and/or proscribe the anticipated terms between the parties as a nonprofit takes on new ventures. An agreement can either be used as the sole document outlining the relationship and responsibilities of the parties or could work in tandem with incorporating documents of a newly created entity and have the potential for resolving most issues between the parties.[18]

There are a number of advantages to using contracts, which include that they require the clear delineation of terms at the outset and are relatively simple to modify over time. In addition, as the initiating organization continues to expand into newer ventures, there is the ability to easily change structures and terms for different parties as the nonprofit's experience and clout expands and its needs change. Lastly, there is clear standing for both parties to raise breach of contract issues in court, unless the parties have agreed to an alternative dispute resolution mechanisms or other waiver of such rights.

There are also certain disadvantages. First, governing boards are not necessarily aware of the terms of the agreements, although this could be avoided either a) by including in the contract the requirement that it be ratified by the boards of each organization; or b) by a particular organization adopting a requirement that all contracts of a certain nature, duration or size be either i) standard in form with any changes in key terms approved by the board, or ii) individually pre-approved by a vote of the board.

[18] For an example of an short and good form of affiliation contract, *see* Oleck, The Law of Associations, § 416, at 1244-1250, which presents a "Form of Affiliation Contract" between a university and its separate nonprofit foundation, which sets forth detailed requirements for the foundation to coordinate all fundraising matters with the university, which includes: that for all gifts where the principal received is for a lawful University, said funds shall be immediately turned over to the university, and specifies investment practices for all gifts where income only comes to the university. It also details certain requirements of the university to provide space and services.

All too frequently, boards do not use the procedures just described, except for the acquisition of real estate or for certain investment actions. However, the same reasons these procedures are used for those types of transactions, i.e., that they are material to the financials of the institution, should equally apply to the types of significant new ventures discussed in this paper.

Perhaps the culprit here is the delegation of authority to contract, frequently found in nonprofit by-laws, which provide for certain officers or staff to sign contracts on behalf of the organization, which can result in certain contracts being executed without appropriate board review. Another culprit may be the auditors who will look to the minutes of board meetings to ascertain that the board appropriately authorized certain actions that have an immediate financial effect, but may not question other actions taken without appropriate board approval, which may have dramatic long-term financial or other material affect on the organization.

Additionally, with new ventures governed solely by contracts, board oversight is not simply a matter of one-time approval, but rather may require ongoing monitoring. In my opinion, boards need more guidance and perhaps more stringent by-law provisions pertaining to monitoring contracts and an organization's contract authorization policies.

Another disadvantage is that, perhaps to avoid unnecessary controversy, often contracts do not appropriately deal with messy issues such as the division of assets once the contract is terminated or otherwise ends. This can be of particular concern where the property is unique, such as questions of ultimate ownership of works of art or other unique property either held by a new entity or a joint venture. Again, one can argue that this would not occur if there were appropriate board oversight.

A final disadvantage is the flipside of an advantage mentioned earlier -- the flexibility to change or negotiate the terms of the contract could be a detriment depending on the idiosyncrasies of the other contracting party.

The described disadvantages of reliance on agreements as the sole instrument for creating new ventures, has lead to the exploration of the possible use of a constitution as a means of eliminating some of the oversight and negotiation issues discussed.

D. Use of a Constitution or Other Governance Document to Articulate Governance Issues for Associated Activities

Certain large organizations use a constitution,[19] which may or may not be ratified by its affiliates, and which impose restrictions on activities of subsidiaries or

[19] When using the term "constitution" here (as also defined in footnote 6, *supra*,) I refer to a document, which defines and sets forth relationships not normally dealt with in by-laws, as distinguished from a constitution which is merely super bylaws, which spells out such things as membership, number of trustees and officers which are normally set forth in by-laws, Examples of the later are the by-laws of The Metropolitan Museum of Art and Museum of Natural History, both of which are available upon request from the institutions.

Note also that other institutions use by-laws to set forth relationships that might just as well be set forth in a constitution. For example New York University uses its By-laws to define the relationship, election of Board other affiliates. Such a document may provide a governance aid to the expanding institution.[20] A constitution[21] provides a vehicle, which allows the organization to set forth at the outset its principles and place legally enforceable restrictions on its subsidiaries and affiliates with regard to their activities and property. [22]

---

members (controlled by the University), reporting requirements, and property ownership by the University and its unincorporated affiliates: its Medical Schools and the Institute of Fine Arts.

[20] Note: I had hoped to find guidance in the constitutions of such large multi-faceted organizations as Girls, Inc., or the Red Cross but was disappointed to find that many such larger institutions are not satisfied with their governance structure. In 1997, at the conference of the National Center on Nonprofit Boards, it was determined that many large national federations like the American National Red Cross and the Boy Scouts of America, most of which have a dual and complex governance structure, of a national board and a national membership, which functions differently from the traditional nonprofit model, reported "confusion, conflict or concern about how to govern their organizations effectively. *See* Governance of National Federated Organizations, Aspen Institute, WP 99.003 (1999) at 1 and 33. As a result of this 1997 determination, the Aspen Institute undertook a study of such federated organizations and issues of governance.

Among the conclusions cited in the Aspen Institute study were: 1) "In many cases it was difficult to determine the consequences to local affiliates that choose to disaffiliate.... In a few cases disaffiliation has raised complex legal questions which are currently being tested in the courts." *Id.*, at 12. 2) The governing structures ranged from those in which the board had complete power and membership (in 22 percent of the organizations), "to organizations in which the membership could make policy on its own or even overrule the board. *Id.* at 15. 3) Differences between formal governance procedures and current practices were noted in a sizeable number of organizations that submitted information or were interviewed. *Id.* at 18. 4) Forty percent of those surveyed (20 institutions) said there were governance conflicts between the board and members. *Id.* at 21. 5) Many organizations had affiliate staff or board members on the national board and the author noted that this raised issues of conflicts of interest with regard to the duty of loyalty to the affiliate and conflicts of interests as to fundraising and policy-making. *Id.* at 30. The study concluded that there was no one size fit all solution.

Note that none of the institutions surveyed in the Aspen report used a constitution as a governance vehicle.

[22] Courts have upheld constitutional provisions, which require the consent of the parent organization, *see*, National Grange v. O'Sullivan Grange, 35 Wash. App. 444, 667 P. 2d 1105 (Wash. Ct. App. 1983), or require that property be held on behalf of the parent organization, *see,* Phillips v. Perrin, 253 Or. 540, 450 P. 2d 767 (1969). *See also,* James J. Fishman and Stephen Schwarz, Nonprofit Organizations, p. 131-132, citing these cases and others (Foundation Press, 2nd Edition, 2000). *And see,* International Brotherhood of Boilermakers, etc. v. Local Lodge D747 of the Cement, Lime, Gypsum and Allied Workers..., 673 F. Supp 199 (W.D. Texas, 1987) where an action for preliminary injunction to prevent the local from disposing of its assets was granted based on a constitutional provision of the International that, in the circumstances before the court "...all books, records, properties, funds and assets owned or held by the lodge shall become the property of the International."

Note that in the absence of a constitution or contractual provision providing for ownership or distribution of property to the parent or national organization, courts faced with dissolution have not given the property to the national organization. *See,* Matter of Multiple Sclerosis Service Organization, Inc., 107 A.D 2d 538 (N.Y. Ct. of Appeals. 1986) also cited in Nonprofit Organizations, *supra*, at 124-129. *See also,* York v. First Presbyterian Church, 474 NE2d 716 (5th Dist, Ill. 1984), cert den. 106 S. Ct. 183, wherein the national council was not entitled to take over local church property when the local church had withdrawn from the national council prior to an amendment to the council's constitution creating an express trust in such property.

An example of such a constitution is that of Presbyterian Church (U.S.A.) ("Church USA"), which sets forth the principles and powers of the individual presbyteries and synods, and has specific provisions that all property is held in trust for the benefit of the church and that any property used contrary to the constitution, or held by an individual church that is formally dissolved by procedures provided in the constitution, shall be transferred or sold as provided by the presbytery.[23]

A constitution normally would be approved by the board of the organization prior to it being put to use. This presumably accomplishes two things: 1) board oversight; and 2) it eliminates alterations or negotiations with the subordinate organizations. The later assumes that the creating organization will have the power to impose the terms of the constitution on any merging institution(s). This may not be the case. Moreover, while a constitution is an attractive vehicle for setting forth policies and key practices, query whether it is an appropriate document to also set forth many of the smaller issues usually included in contracts.

---

[23] See The Form of Government, The Book of Order, part II of the Constitution of the Presbyterian Church, available at www. pcusa.org/org/constitution.htm. A charter, which is usually ratified by the member, can serve the same purpose. *See,* Associations Operations, The Law of Associations (Matthew Bender & Co.) §2.21[7] which sets forth a sample charter that specifies such matters as the right to use the chartering institution's name, a statement of the legal relationship of the parties, reporting, and termination. I envision that a constitution would also deal with use of each other's property, and authority and/or restrictions on fundraising.

Note: research did not uncover any sample constitutions, which were as detailed as many affiliate or other licensing agreements tend to be, but there would seen to be no reason why all key terms could not be dealt with in a constitution.

V. Conclusion

Having considered the options and issues just presented, one might conclude that selecting one structure over another -- legal structure, contract, or constitution -- is a matter of form over substance. The key here, as was discerned earlier, is board oversight. If, the law were changed to hold boards that are considering merger to a higher standard of care, such as with a business judgment rule, this alone would solve many of the oversight issues. Alternatively, if dual categories of subsidiary nonprofits, where the parent was required to weigh the interests of any merging institution, this too would solve many issues. In the absence of either of these and/or as added protection, structure does matter and, in my view, a good structure will most likely call on several of the mechanisms discussed.

My bias is for a legal structure for the subsidiary, which imposes the greatest fidiuary duty available under current law, augmented by the use of a constitution, to protect the creating organizations assets and property, as this would, in my view, best serve the public interests. But, I also recognize that there is no one solution for every situation and that there are times when contracts would be appropriate. If utilized, I would generally think they should be used in tandem with a changed legal structure. The area of board governance and appropriate structure merits more analysis.