

# SELF-DEALING TRANSACTIONS IN NONPROFIT CORPORATIONS

*Deborah A. DeMott\**

## INTRODUCTION

Should directors of nonprofit<sup>1</sup> corporations (“nonprofits”) be as free to self-deal as their counterparts are in for-profit business corporations? Will socially desirable consequences follow if standards common in the for-profit setting apply to directors’ self-dealing in the nonprofit context? This Article focuses on nonprofits organized for charitable or public purposes and deals much more briefly with nonprofits organized to provide mutual benefits for their members. The Article argues that, mutual benefit nonprofits aside, it is neither justifiable nor wise to import criteria that legitimize self-dealing from the for-profit setting to the nonprofit context. Part I examines the nature of nonprofits and reviews a number of recent controversial instances of self-dealing by nonprofit directors. Part II then analyzes the possible legal treatments of self-dealing in the nonprofit environment. Part III critiques in detail the treatment of self-dealing in the Revised Model Nonprofit Corporation Act (“RMNCA”). Finally, Part IV identifies the characteristics of directors’ service in the nonprofit environment that make the RMNCA approach problematic.

## I. NONPROFIT STRUCTURES AND ACTIVITIES

Private nonprofit corporations, which vary greatly in their size, purpose and sophistication, are collectively a significant force in the United States. Nonprofits are visible actors in

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\* Professor of Law, Duke University School of Law.

<sup>1</sup> This terminology, used in the Revised Model Nonprofit Corporation Act (“RMNCA”), is less precise than “Not-For-Profit,” the term used in the counterpart New York statute. Many corporations organized to conduct business on a for-profit basis become “nonprofits” because they do not generate net positive earnings.

many sectors, including health care, education and social welfare services.<sup>2</sup> As of 1990, revenues generated by nonprofits accounted for roughly fifteen percent of the nation's gross national product.<sup>3</sup> The defining difference between a nonprofit and a for-profit corporation is the nondistribution constraint, which prohibits a nonprofit corporation from paying dividends or otherwise distributing any part of its net income or earnings to the persons who control it.<sup>4</sup> A corollary of the nondistribution constraint is that members of a nonprofit (other than one organized for its members' mutual benefit) do not have a proprietary interest in the corporation comparable to the interest that shareholders have in a for-profit corporation.<sup>5</sup> Members of a mutual benefit corporation, in contrast, may receive distributions by selling their memberships to the corporation.<sup>6</sup> Some nonprofits that satisfy the Internal Revenue Code's criteria for income tax exemption<sup>7</sup> are eligible to receive tax-deductible

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<sup>2</sup> Nonprofits are concentrated in labor-intensive service industries, which have relatively low capital requirements. Religious groups are believed to predominate as founders of nonprofits because they "provide the organizational ability, the venture capital and, often, low-paid or volunteer labor as well." See ESTELLE JAMES & SUSAN ROSE-ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS* 50-51 (1986). Private philanthropy also plays an important role in supporting "experimental people and dissenting voices," whose projects are so controversial or idiosyncratic that neither government support nor for-profit investment is likely. See John G. Simon, *Charity and Dynasty Under the Federal Tax System*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 246, 254 (Susan Rose-Ackerman ed., 1986). Indeed, Professor Simon argues that broadly-supported nonprofits are less likely to support such projects than are narrowly-supported private foundations. *Id.* at 254-55. For a definition of private foundations, see *infra* note 19.

<sup>3</sup> See *Developments in the Law-Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1581 (1992) [hereinafter *Nonprofit Corporations*].

<sup>4</sup> See REV. MODEL NONPROFIT CORP. ACT § 13.01 (1987) [hereinafter R.M.N.C.A.].

<sup>5</sup> A further corollary is that in a merger transaction, nonprofit members do not have appraisal rights. See R.M.N.C.A. § 11.01 cmt. The RMNCA denies appraisal rights to members of *all* nonprofits, including mutual benefit corporations. The drafters' rationale is that even though mutual benefits' members may have an economic interest in the corporation, most memberships do not represent an investment that will generate a profit upon sale. *Id.*

<sup>6</sup> *Id.* § 13.02.

<sup>7</sup> Section 501(a) of the Internal Revenue Code limits the exemption from federal taxation of income to entities that meet certain specified criteria. I.R.C. § 501(a) (1988). In particular, § 501(c)(3) exempts entities organized solely for purposes that are "religious, charitable, scientific, testing for public safety, literary, or educational" as well as entities organized "to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals." I.R.C. § 501(c)(3). Subsections 501(c)(4)-(10) also exempt from taxation such entities as civic

contributions from donors.<sup>8</sup> Making a donation, however, does not necessarily make one a member. The corporation's organizational documents furnish the controlling criteria for membership.<sup>9</sup>

Highly-publicized incidents of self-dealing by directors and executive officers have afflicted several well-known nonprofits in recent years. In the most visible incident, the United Way of America lent \$2.1 million in 1990 to a for-profit spinoff headed by the son of United Way's executive director. With the board's support, the executive director, who received \$463,000 annually in compensation, had previously created three for-profit spinoffs that performed services for the United Way and staffed them with friends and family members.<sup>10</sup> In a less-publicized incident in 1992, the San Diego National Sports Training Foundation, whose purpose was to build an Olympic training center, was reported to have spent \$6.2 million on contracts with firms run by the foundation's board members or officers.<sup>11</sup> In particular, the foundation hired a general contractor on the basis of a consultant's choice without putting the project up for bids. The general contractor, a firm controlled by one of the foundation's board members, had previously employed the consultant as the president of its San Diego division and was still making severance payments to him at the time he made his recommendation.<sup>12</sup> Finally, and most recently, the president of Boston University was reported to have received \$386,700 in connection with the University's 1989 sale of its stock interest in a medical diagnosis company to a third

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organizations, labor and agricultural organizations, pension plans, chambers of commerce and fraternal benefit societies.

<sup>8</sup> Section 170 of the Internal Revenue Code provides a deduction for charitable contributions; under I.R.C. §§ 170(c), § 501(c)(3), (1988), organizations are entitled to receive contributions that the donor may deduct from his or her income.

<sup>9</sup> R.M.N.C.A. § 6.01(a). No person may become a member without her consent. *Id.* § 6.01(b). It is possible to organize a nonprofit with *no* members. *Id.* § 6.03. Such a corporation would then operate with directors designated or appointed as provided in its by-laws or articles of incorporation, *see id.* § 8.04(b), with a self-perpetuating board, *see id.*, or with delegates authorized to make decisions. *See id.* § 6.40.

<sup>10</sup> *See* Felicity Barringer, *Charity Boards Learn to Be Skeptical*, N.Y. TIMES, Apr. 19, 1992, at A10.

<sup>11</sup> *See* Ralph Frammolino, *Foundation's Contracts Go to Firms with Ties to Officers*, L.A. TIMES, Dec. 13, 1992, at B1.

<sup>12</sup> *See id.*

party.<sup>13</sup> The University's trustees had previously granted the president options to buy shares in the company.<sup>14</sup>

To be sure, the merits of each of these transactions may in fact belie their problematic appearance. Such appearances, though, have significant consequences in the nonprofit sector. As of mid-March, results from the 1992-93 United Way campaign were down 3.3% from 1991-92 levels, despite continuing demand for the social welfare services provided by organizations funded by the United Way.<sup>15</sup> Although competing charitable providers reportedly view the United Way's plight as an opportunity,<sup>16</sup> another possible consequence would be fewer donations overall to the United Way and comparable organizations. Moreover, donors to charitable nonprofits trust the entity's management to use their contributions to further the entity's charitable purpose.<sup>17</sup> Donors' trust is undergirded by the nondistribution constraint,<sup>18</sup> but it is likely to be undermined both by visible instances of self-dealing and by suspicions that undetected self-dealing occurs. Trust is likely to be fragile when one receives no economic benefit in exchange for one's cash or property. Additionally, donors and prospective donors, having come to distrust one nonprofit, may distrust comparable organizations as well. In short, the negative reputational consequence of one organization's tolerance for self-dealing may not be confined solely to it.

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<sup>13</sup> Lawrence Ingrassia, *Boston University Targeted by State for Alleged Abuses*, WALL ST. J., Mar. 16, 1993, at B10. The Attorney General for Massachusetts announced that he will take action against alleged abuses and violations of University conflict-of-interest policies. The Attorney General also alleged that the University had willfully filed a false report with the state in which it failed to disclose the payment to its president. The University's President stated that he had returned the \$386,700 to the University and never received any benefit from its stock sale. *Id.*

<sup>14</sup> *See id.*

<sup>15</sup> *See* WALL ST. J., Mar. 18, 1993, at A1.

<sup>16</sup> *See id.*

<sup>17</sup> *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 847 (1980).

<sup>18</sup> Additionally, § 501(c)(3) of the Internal Revenue Code provides that no part of the net earnings of a tax-exempt organization may inure to the benefit of private individuals. *See generally* 1 MARILYN E. PHELAN, *NONPROFIT ENTERPRISES: LAW AND TAXATION* § 11A:02 (1985 & Supp. 1992) (analyzing forms of impermissible private inurement).

## II. NORMATIVE ALTERNATIVES TO REGULATE SELF-DEALING

In the charitable nonprofit environment, how should state organizational law treat self-dealing? Five basic possibilities emerge. The first would parallel the federal tax rules applicable to private foundations, which tend to be organizations supported for the most part by their founders or a small number of contributors.<sup>19</sup> This first approach would prohibit specifically defined acts of self-dealing entirely and impose a financial penalty on the self-dealer regardless of whether the self-dealer realized a profit or inflicted a loss on the corporation.<sup>20</sup>

A second approach, derived from the law of charitable trusts, would make all transactions tainted by self-dealing voidable at the election of the corporation, again regardless of whether such a transaction demonstrably benefitted the self-dealer or injured the corporation.<sup>21</sup> The justification for using the charitable trust standard is that, unlike a private trust, a charitable trust has a purpose but no specific beneficiaries. Thus, it lacks beneficiaries who could consent to the self-deal-

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<sup>19</sup> Under the Internal Revenue Code, private foundations are a residual category comprising all exempt organizations under § 501(c)(3) that are not public charities under § 509. Section 509 identifies organizations as public charities on the basis of the nature of their activities—such as religious, educational and medical research organizations—or, alternatively, on the basis of their support. Publicly supported organizations receive at least one-third of their normal support from governmental entities or from the general public. I.R.C. § 509 (1988).

<sup>20</sup> Under Internal Revenue Code § 4941, each act of self-dealing results in the imposition of an excise tax on the self-dealer of five percent of the amount involved. If the act is not corrected, the applicable rate is 200% of the amount involved. An initial 2.5% excise tax is also imposed on the foundation's manager if he knew the act to be self-dealing and willfully participated in it. Self-dealing for these purposes means specific, direct or indirect transactions between the private foundation and a "disqualified person," including substantial contributors, holders of more than twenty percent of voting power in the entity, foundation managers and government officials. *Id.* § 4941. Specified self-dealing transactions include sale and leasing agreements, loans and compensation payments to a disqualified person. In contrast, self-dealing by persons controlling public charities does not result in private inurement, which violates § 501(c)(3), if the transaction was at arm's length and the charity received fair market value from it.

Similarly, the Employee Retirement Income Security Act ("ERISA") prohibits defined acts of self-dealing involving employee benefit plans. *See* Employee Retirement Income Security Act § 406(b), 29 U.S.C. § 1106(b) (1988) [hereinafter ERISA]. Like Internal Revenue Code § 4941, ERISA imposes an exemplary civil penalty on self-dealers. *See* ERISA § 502(i), 29 U.S.C. § 1132(i) (1988).

<sup>21</sup> *See* 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 170 (4th ed. 1987).

ing, just as the nonprofit corporation lacks members with any proprietary interests.<sup>22</sup>

The third approach is based on the corporate law standard applicable to controlling shareholders who engage in self-dealing transactions with a corporation. This standard would make the transaction itself voidable unless its proponent establishes that the transaction was "intrinsically" or "entirely" fair to the corporation.<sup>23</sup> This fairness standard encompasses both the circumstances leading to and surrounding the transaction—including questions of timing and disclosure—as well as the transaction's economic terms, chiefly its price.<sup>24</sup> Separately, the self-dealer would be liable for any injury inflicted on the corporation.<sup>25</sup>

The fourth approach would permit nonprofit corporations to utilize the "safe harbor" or procedural approaches criticized in Professor Seligman's article.<sup>26</sup> A self-dealing transaction would not be voidable if directors who lacked an interest in the transaction had approved it after disclosure of the material facts of the transaction and the self-dealing director's interest.<sup>27</sup> The disinterested directors' decision, if challenged in litigation, would itself be evaluated against a nonprofit counterpart to the business judgment rule.<sup>28</sup>

Finally, one could require administrative approval of proposed self-dealing transactions, comparable to the SEC's statu-

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<sup>22</sup> If a nonprofit corporation is analogized to a trust, the court could consent to the transaction because the court may consent to a self-dealing transaction in a private trust if the trust beneficiaries are not competent to consent and the transaction is in their best interests. *See Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991).

<sup>23</sup> *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

<sup>24</sup> *See generally Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>25</sup> *See, e.g., Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403 (Del.), *cert. denied*, 488 U.S. 853 (1988).

<sup>26</sup> *See Joel Seligman, The New Corporate Law*, 59 BROOK. L. REV. 1, 9 (1993).

<sup>27</sup> *See R.M.N.C.A. § 8.31.*

<sup>28</sup> Even the drafters of the RMNCA characterize the approach in § 8.31 as something other than "the business rule." *See id.* at xxxvii. But the commentary to § 8.31 states that "[e]ven if the directors were wrong in believing that [the transaction] was fair, the transaction will not violate section 8.31 so long as the directors approved it in conformity with section 8.31 . . ." *Id.* § 8.31, cmt. *See also Oberly v. Kirby*, 592 A.2d 445, 462 (Del. 1991) ("A court cannot second-guess the wisdom of facially valid decisions made by charitable fiduciaries, any more than it can question the business judgment of the directors of a for-profit corporation.").

tory authority to approve proposed acts of self-dealing by investment companies.<sup>29</sup> Administrative review mechanisms, though, require a substantive standard against which the agency may assess the transaction.<sup>30</sup> As it happens, each of these approaches currently enjoys support. Historically, though, most courts in nonprofit self-dealing cases have applied either the standard derived from charitable trusts<sup>31</sup> or, acknowledging that the entity is a corporation and not a trust, closely and skeptically examined the merits of the transaction and the circumstances in its history.<sup>32</sup>

### III. SELF-DEALING IN THE REVISED MODEL NONPROFIT CORPORATION ACT

In contrast, the treatment of self-dealing in the RMNCA, released in 1987, adopts essentially the structure now typical in business corporation statutes. Under RMNCA section 8.31, a majority of disinterested directors may approve in advance a fellow director's proposed self-dealing if the material facts of the transaction and the director's interest are disclosed or known to the disinterested directors.<sup>33</sup> With such approval,

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<sup>29</sup> See Investment Company Act § 17(b), 15 U.S.C. § 80a-17(b) (1988).

<sup>30</sup> Under the Investment Company Act, for example, the Securities Exchange Commission must exempt a proposed self-dealing transaction from the prohibition on defined acts of self-dealing between the investment company and any affiliated person, promoter, or principal underwriter if evidence establishes that "the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned," and that the transaction is consistent with the stated policy of each investment company involved and with the general purposes of the statute. *Id.* §§ 17(b)(1)-(3), 15 U.S.C. §§ 80a-17(b)(1)-(3).

<sup>31</sup> See Ronald A. Brand, *Investment Duties of Trustees of Charitable Trusts and Directors of Nonprofit Corporations: Applying the Law to Investments that Acknowledge Social and Moral Concerns*, 1986 ARIZ. ST. L.J. 631, 658-59.

<sup>32</sup> *Id.* at 659. See also *Oberly*, 592 A.2d at 468 n.17 (judicial review of disinterested directors' decision to approve self-dealing transaction would be "more searching" for a charitable corporation than a for-profit business corporation, based on the special duty of fiduciaries of a charitable corporation to protect and advance its charitable purpose).

<sup>33</sup> R.M.N.C.A. § 8.31(b)(1)(i)(ii). The RMNCA states that

A transaction in which a director of a public benefit corporation has a conflict of interest may be approved in advance by the vote of the board of directors or a committee of the board if the material facts of the transaction are disclosed or known to the board or committee of the board; and the directors approving the transaction in good faith reason-

then, the transaction is not voidable by the corporation. Additionally, and in contrast with many business corporation statutes, the approval immunizes the self-dealing director from any individual liability arising from the transaction.<sup>34</sup> Moreover, the disinterested directors who approve the transaction under section 8.31 need not comprise a majority of the entire board.<sup>35</sup>

Under RMNCA section 8.31, the statutory standard for directors' approval of self-dealing transactions is whether "the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation."<sup>36</sup> This standard closely resembles the comparable statutory standard applicable to all acts of directors in for-profit business corporations, but with one variation. Under the Revised Model Business Corporation Act, directors of for-profit corporations, in discharging any duty, must act in good faith and in a manner they reasonably believe to be in their corporation's best interests.<sup>37</sup> Under the RMNCA, when nonprofit directors approve a self-dealing transaction, the central question is whether the directors in good faith reasonably believed the transaction to be fair to the corporation, not whether it was fair. If financially disinterested directors enjoy, in this context as elsewhere, a presumption that they acted in good faith and in the corporation's best interests,<sup>38</sup> the plaintiff would have the burden of showing that the directors did not in good faith have such a reasonable belief. In operation, then, RMNCA section

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ably believe that the transaction is fair to the corporation.

*Id.*

<sup>34</sup> In contrast, New York Not-For-Profit Corporation Law § 715 does not address the question of the self-dealer's individual liability. N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1970 & Supp. 1993).

<sup>35</sup> RMNCA § 8.31(e) states that "a conflict of interest transaction is authorized, approved, or ratified, if it receives the affirmative vote of a majority of the directors on the board or on the committee, who have no direct or indirect interest in the transaction . . . ."

<sup>36</sup> *Id.* § 8.31(b) (standard for public benefit and religious corporations). If the corporation is a mutual benefit nonprofit, the directors need not act in advance of the transaction and the "good faith . . . reasonable basis" standard is inapplicable.

<sup>37</sup> See R.M.N.C.A. § 8.30 (1988). Section 8.30(a) states: "A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation."

<sup>38</sup> See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).



8.31 closely resembles the business judgment approach described in Professor Seligman's article.<sup>39</sup> Whether this shift away from most jurisdictions' present law is justifiable depends on the assumption one makes about the care and competence with which nonprofit directors discharge their duties.

#### IV. CHARACTERISTICS OF NONPROFIT DIRECTORS

There is ample reason to believe that the overall quality of directors' performance in the nonprofit sector is less than in publicly-traded, for-profit business corporations. First, because they do not issue publicly-traded investment securities, nonprofits are not subject to the extensive disclosure requirements, enforcement machinery and private litigation detailed in Professor Seligman's article.<sup>40</sup> Nonprofit directors thus make decisions in a less transparent environment and information about their decisions is not regularly exposed to the scrutiny of a broad audience. Their decisions on self-dealing questions typically become visible only in the wake of scandal.<sup>41</sup>

Second, apart from private foundations, the risk of attracting the wrath of the Internal Revenue Service does not operate as a deterrent to self-dealing that is comparable to the impact of the disclosure requirements described by Professor Seligman. Under section 501(c)(3) of the Internal Revenue Code, no part of an entity's net earnings may inure to the benefit of a private individual.<sup>42</sup> If a tax-exempt charitable corporation violates the general prohibition on private inurement through self-dealing, the penalty is loss of tax-exempt status. This penalizes the corporation's patrons and donors but does not necessarily penalize the self-dealers.<sup>43</sup> Additionally,

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<sup>39</sup> See Seligman, *supra* note 26, at 14.

<sup>40</sup> Indeed, Congress expressly exempted from the requirements of the Securities Act of 1933 ("Securities Act") securities issued by nonprofits organized for specified purposes. Securities Act of 1933 § 3(a)(4), 15 U.S.C. § 77(c)(a)(4) (1988). A comparable exemption applies to the registration requirement imposed by § 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). See Securities Exchange Act of 1934 § 12(g)(2)(D), 15 U.S.C. § 78l(g)(2)(D). Such exempt issuers are subject neither to the periodic reporting requirements imposed by § 13, which apply only to issuers of securities registered under § 12, nor to the proxy rules under § 14.

<sup>41</sup> See *supra* notes 10-14 and accompanying text.

<sup>42</sup> I.R.C. § 501(c)(3); see *supra* note 18.

<sup>43</sup> See Hansmann, *supra* note 17, at 874; *Nonprofit Corporations*, *supra* note 3,

the IRS's enforcement resources are limited.<sup>44</sup> Relatedly, states' attorneys general, who have standing to investigate and to sue to challenge nonprofit managers' abuses, have limited resources as well.<sup>45</sup>

Third, directors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment. Most nonprofits do not compensate their directors directly.<sup>46</sup> Board members often join because they believe in an organization's mission and contribute to it with financial donations. They depend heavily on organization management to set the board's agenda and provide information to the board. Many large nonprofits also have relatively large boards.<sup>47</sup> Some actors in this environment reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal.<sup>48</sup> Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organization.<sup>49</sup>

In this environment—one not characterized by skepticism and analytical rigor,<sup>50</sup> the "reasonable belief" standard in

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at 1601. Arguably, in extreme cases, self-dealing may also raise questions as to whether the corporation is being operated exclusively for its eligible purpose under § 501(c)(3).

<sup>44</sup> See Hansmann, *supra* note 17, at 874 (noting IRS lacks "particula[r] zea[l]" in this area).

<sup>45</sup> *Id.* at 873-74.

<sup>46</sup> Standards adopted by the National Charities Information Bureau ("NCIB") provide that a philanthropic organization should not pay fees to its directors for serving on its board, although participation costs (such as travel) may be paid. NCIB, STANDARDS IN PHILANTHROPY 1f (1991). The NCIB interprets the "no-fee" standard to encompass a corollary standard that "[s]ituations where board members derive financial benefits from board service should be avoided." *Id.*

<sup>47</sup> United Way of America, for example, has thirty-four members on its board. See Barringer, *supra* note 10, at A10.

<sup>48</sup> See Frammolino, *supra* note 11, at B1 (reporting view of nonprofit's vice-president that self-dealing director, having made a financial contribution, was entitled to receive contract to act as general contractor for construction project).

<sup>49</sup> The drafters of the RMNCA state that "[t]he Model Act recognizes that many individuals are elected to nonprofit boards because of their ability to enter into or cause an affiliate to enter into a transaction with and for the benefit of the corporation." R.M.N.C.A. § 8.31 official cmt. 1. Separately, the drafters acknowledge that the statute's "underlying philosophy" is "contrary to the strict trust concept that interested directors can never obtain a profit when dealing with their corporation." *Id.* official cmt. 6.

<sup>50</sup> In some sectors nonprofit boards are also visibly homogeneous. Reportedly,

RMNCA section 8.31 becomes a charade. So long as directors have some "reasonable basis" to believe a proposed self-dealing transaction to be fair, the transaction is not voidable and the self-dealing director is not personally liable. Nonprofit boardrooms seem to be inhospitable venues for challenges to the opinions of fellow directors and the internal and external experts the directors may retain. Note that the statutory standard requires only a belief as to fairness—a concept defined in the official comment as having the earmarks of an arm's length bargain<sup>51</sup>—not a belief that the transaction has the *best* or most advantageous terms available to the corporation under the circumstances. The drafters' failure to embrace a more exacting definition of fairness is especially troublesome. For example, a transaction may exhibit the earmarks of an arm's length bargain by having terms that evidence negotiation, and yet fall short of the best deal available.<sup>52</sup> That is, a transaction may have terms that are respectable but not noticeably attractive or beneficial to the nonprofit corporation. In any event, the dispositive question under the statute is whether the directors reasonably believed the transaction to be fair, not whether a court concludes that its terms bear indicia of arm's length bargaining.

These vulnerabilities are especially evident when a charitable nonprofit (like a hospital) sells all its assets to a for-profit corporation controlled by directors of the nonprofit.<sup>53</sup> Statutes

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as of a decade ago the majority of trustees of art museums were graduates of Ivy League colleges over sixty years of age. See Gordon H. Marsh, *Governance of Non-Profit Organizations: An Appropriate Standard of Conduct for Trustees and Directors of Museums and Other Cultural Institutions*, 85 DICK. L. REV. 607, 612 n.23 (1981).

<sup>51</sup> R.M.N.C.A. § 8.31 official cmt. 2a.

<sup>52</sup> In marked contrast, under the counterpart California statute, the self-dealing director or other proponent of the transaction would have the burden of establishing three elements: (1) that the transaction was fair and reasonable to the corporation at the time it entered into the transaction; (2) that the corporation entered into the transaction for its own benefit; and (3) either that a majority of the corporation's board of directors "in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances," or that in fact with reasonable effort the corporation could not have obtained a more advantageous arrangement. See CAL. CORP. CODE § 5233(d)(2) (West 1990). Alternatively, before or after its consummation the transaction may be approved by the attorney general or the court in an action in which the attorney general is an indispensable party. *Id.* § 5233(d)(1).

<sup>53</sup> See James F. Peltz, *Lawmaker's Plans Could Make HMO Buyout Costly*, L.A.

governing nonprofit corporations require the net proceeds from the asset sale, upon dissolution of the nonprofit, to be transferred to another eligible charitable nonprofit.<sup>54</sup> Terminal self-dealing transactions consistently are likely to be afflicted with a bias toward undervaluation of the nonprofit's assets because, dollar for dollar, undervaluation enhances the prospective profitability of the for-profit purchaser.

Directors of the selling nonprofit are, analytically, in a position comparable to for-profit directors who evaluate a management buy-out ("MBO") proposal. Reflecting on a decade in which disinterested directors, acting as committees, reviewed management buy-out proposals, Delaware's Chancellor—whose court adjudicated most challenges to MBOs—confessed to having "a painful awareness of the ways in which the [disinterested director] device may be subverted and rendered less than useful."<sup>55</sup> Long-standing deference to management may lead to passive acquiescence when management proposes to buy the entity. Events are vulnerable to stage-management by professional advisors, who may be tempted to substitute "theatre" for facilitating the provision of "informed, energetic and committed" service by directors to their shareholders.<sup>56</sup> If in the MBO setting directors were, at times, less than optimal representatives of their shareholders' interests, one would have similar concerns in the nonprofit setting.

But one's concerns are deepened by the differences between profits and nonprofits. In some nonprofit sale transactions, the selling nonprofit's directors have taken the position that they need not evaluate the fairness of the sale price in light of probable third party offers.<sup>57</sup> Indeed, by definition all

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TIMES, Oct. 8, 1991, § D, at 9A (describing proposed sale of nonprofit HMO to for-profit corporation controlled by nonprofit's directors).

<sup>54</sup> See R.M.N.C.A. § 14.06(a)(6). If the nonprofit corporation does not dissolve, in theory it could use the sale proceeds to buy another operating asset (like a hospital), sell that asset in a second self-dealing transaction, and then repeat its purchase and subsequent sale until it has no more assets. In practice, sales of this sort are closely scrutinized by the IRS, which has retroactively revoked nonprofits' tax exempt status when related-party purchasers buy assets at an undervalued price and subsequently resell them for a large profit. See Peltz, *supra* note 53, at 9A.

<sup>55</sup> William T. Allen, *Independent Directors In MBO Transactions: Are They Fact or Fantasy*, 45 BUS. LAW. 2055, 2056 (1990).

<sup>56</sup> *Id.* at 2062.

<sup>57</sup> See Peltz, *supra* note 53, at 9A.

transactions for control in nonprofit corporations are negotiated transactions. In this context, permitting disputes over self-dealing to focus solely on whether directors have some reasonable basis to believe any given price is fair is unlikely to deter probable and predictable abuses. Cases concerning for-profit corporations recognize that self-dealing parties are apt to behave differently, as are the directors who approve the transaction, when all parties know at the outset that a court will independently assess its merits if litigation subsequently impugns the transaction.<sup>58</sup> Moreover, nonprofit members lack statutorily mandated appraisal rights, a significant protection in some types of transactions for for-profit shareholders.<sup>59</sup>

For these reasons, in the nonprofit context, a self-dealing transaction should be voidable unless the transaction's proponents can affirmatively establish its fairness to the corporation at the time of the transaction. Separately, the fact that disinterested directors have approved the transaction should not in itself exonerate the self-dealer from liability to the corporation. These standards, which are also applicable to self-dealing controlling shareholders, are more likely to deter problematic conduct than the approach adopted by the RMNCA because they envision judicial review of the merits of self-dealing transactions.

Would more draconian approaches, if adopted generally, be preferable to judicial review of the fairness of the transaction? Some scholars have advocated extending the tax treatment of self-dealing in private foundations to all tax-exempt charitable nonprofits.<sup>60</sup> The private foundation rules impose an excise tax, calculated as a percentage of the amount involved in the transaction, on the self-dealer and, in some instances, on the foundation manager.<sup>61</sup> The tax applies without regard to

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<sup>58</sup> See, e.g., *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 939 (Del. 1985) (majority shareholder, prior to initiating merger negotiations to merge subsidiary with itself, was aware of inevitability of litigation challenging merger; terms of merger transaction and majority's conduct in dealing with minority shareholders satisfied applicable standard of entire fairness).

<sup>59</sup> See R.M.N.C.A. § 11.01 official cmt.

<sup>60</sup> See, e.g., Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 569-70 (1981).

<sup>61</sup> See *supra* note 20. Reportedly the private foundation standard created by Internal Revenue Code § 4941 caused the Rockefeller Foundation to spend two million dollars to move out of its offices in Rockefeller Center, even though it paid

whether the self-dealer in fact profited or the foundation in fact lost due to the transaction.<sup>62</sup> Some self-dealing, though, is truly benevolent. It is not unusual for directors of small nonprofits to sell goods and services to the nonprofit at below-market prices. In short, the private foundation rules—generated by tax-driven concerns for tax exempts that lack broad support—would be an over-deterrent if applied generally.<sup>63</sup> Similarly, the treatment of self-dealing that typifies the law of charitable trusts would deny nonprofits the benefit of fairly priced transactions if any party with standing to sue objected to the transaction.<sup>64</sup> To require advance administrative approval of all self-dealing transactions seems cumbersome. In any event, requiring such review does not in itself establish the standard to be applied by the reviewing agency. Additionally, not all states have the budget resources to develop the requisite administrative expertise, which is likely to vary in its nature given the diverse population of nonprofits.<sup>65</sup> Moreover, many nonprofits by definition support activity that is too idiosyncratic or controversial to attract

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the Center a regular rate of rent—a fact readily susceptible of verification in New York City's commercial real estate market. See *Discussant Remarks and Audience Questions*, 39 CASE W. RES. L. REV. 765, 770 (1988-89) (remarks of Professor John G. Simon).

<sup>62</sup> See *supra* note 20.

<sup>63</sup> Acknowledging the risk of over-deterrence, Professor Hansmann suggests that the grasp of the private foundation rules may be avoided by restructuring some types of transactions. Thus, a furniture store owner who serves as a director of a day care center ordinarily would be prohibited from selling much-needed furniture to the center at a below-market price. The director could, however, guarantee a third party's extension of credit to the center, enabling it to buy the furniture because the guarantee would be a "gift," which is not a prohibited act of self-dealing. See Hansmann, *supra* note 60, at 571-72.

This line of reasoning is flawed. If the center buys the furniture in an arm's length transaction, it presumably will pay the market price. Additionally, arm's length parties do not extend credit for free. Thus, the center will obviously pay more for furniture bought on credit than it would in a self-dealing transaction priced below-market. Even if the director gives the center the difference between the prices plus the cost of credit financing, the furniture still would cost more.

<sup>64</sup> See Brand, *supra* note 31, at 661-62 (advocating adoption of charitable trust standard for nonprofit corporations).

<sup>65</sup> See Daniel L. Kurtz, *Safeguarding the Mission: The Duties and Liabilities of Officers and Directors*, in COMMITTEE ON CONTINUING PROFESSIONAL EDUC., ALI-ABA NOT-FOR-PROFIT ORGANIZATIONS: THE CHALLENGE OF GOVERNANCE IN AN ERA OF RETRENCHMENT 15, 41 (1992) (noting "[a] chronic lack of resources for enforcement by public agencies").

funding from either for-profit or governmental sources. A blanket requirement of administrative approval creates the risk that the agency will subject transactions to especially close scrutiny when the nonprofit supports unpopular activities.

## CONCLUSION

Apart from these basic questions concerning self-dealing, other subsidiary issues in the nonprofit context warrant reflection. Fiduciary norms are neither self-executing nor self-enforcing. One might wonder whether litigation as a vehicle to enforce fiduciary norms is presently as effective as it might be and, if not, how its impact could be enhanced. At present, standing to sue is typically restricted to the corporation and a state's attorney general,<sup>66</sup> some statutes, like the RMNCA,<sup>67</sup> and some courts in the absence of statutory authorization,<sup>68</sup> additionally permit members to sue derivatively on the corporation's behalf. Perhaps standing should be expanded by statute to encompass non-members who are substantial financial donors to the corporation.<sup>69</sup> Relatedly, would the nonprofit sector as a whole benefit from enhanced reporting obligations, including mandatory disclosure of self-dealing transactions?<sup>70</sup> To be sure, if answered generally in the affirmative, each of these questions poses subsidiary questions of implementation.<sup>71</sup>

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<sup>66</sup> See DEBORAH A. DEMOTT, *SHAREHOLDER DERIVATIVE ACTIONS* § 2:04 (1987 & Supp. 1992).

<sup>67</sup> R.M.N.C.A. § 6.30; N.Y. NOT-FOR-PROFIT CORP. LAW § 623 (McKinney 1970 & Supp. 1993); CAL. CORP. CODE §§ 57106, 7710 (West 1990) (all authorizing member derivative suits in public benefit and mutual benefit corporations, but not in religious corporations).

<sup>68</sup> See DEMOTT, *supra* note 66, § 2:04.

<sup>69</sup> Some courts recognize the right of a donor or the donor's heirs to sue to enforce the purposes of a restricted gift. See, e.g., *Denckla v. Independence Found.*, 193 A.2d 538 (Del. 1963). This principle of standing could support legislative expansion of standing beyond members to non-profit corporations' donors on the theory that such donors give to further the organization's charitable purposes and not to subsidize unfair self-dealing.

<sup>70</sup> See *Nonprofit Corporations*, *supra* note 3, at 1607 (observing that expanded standing alone will not increase the information available to prospective plaintiffs' attorneys, "the primary force behind any enforcement action").

<sup>71</sup> Expanding the standing doctrine would raise a number of questions. To reduce the risk of non-meritorious and frivolous litigation, it may be justifiable to restrict standing to sue to substantial donors, but doing so seems blatantly inequalitarian. Moreover, dollar for dollar, a wealthy donor's contribution costs that

Such concerns aside, it is foolish to import for-profit norms respecting self-dealing generally into the nonprofit context. Governance mechanisms are so much weaker in the nonprofit sector that loose controls on self-dealing create unacceptably high risks of misconduct. Such misconduct, if it becomes visible, has reputational consequences unlikely to be restricted to

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donor less than the contribution of a less wealthy donor. A separate question concerns the type of action that might be authorized. As noted above, *see supra* notes 62-64 and accompanying text, present authority addresses derivative actions brought by members and actions brought by attorneys general on behalf of the nonprofit itself. Should donors, additionally, be able to assert *individual* claims if the nonprofit engages in unfair self-dealing transactions? Donors might argue that such self-dealing in economic fact constitutes personal inurement to those benefiting from the self-dealing, personal inurement subsidized by their donations. A secondary, more procedurally oriented question is the feasibility of a donor class action consolidating such individual claims. A potential roadblock, however, to maintaining such an action under Federal Rule of Civil Procedure 23 is that donors may well differ in the relief they seek; some may wish to enjoin or void the self-dealing transactions, while others may desire the return of all or part of their donation. This roadblock, though, could be overcome if the court is willing to create subclasses among the donors at the remedial phase of the litigation. In any event, a more substantive problem is that self-dealing transactions are generally understood to injure the corporation itself, not its members or, in this context, its donors.

Enhancing mandatory disclosure by nonprofits poses three questions: disclosure of what, to whom and at what cost? A good starting point for the content of the disclosure would be SEC's Regulation S-K, Items 401-04, which encompass the corporation's executive compensation and self-dealing transactions. 17 C.F.R. §§ 229.401-404 (1992). The cost of preparing accurate disclosure documents, even if their distribution is limited to an administrative agency or to substantial donors, is a factor to consider. Closely related questions concern the constitutionality of such disclosure mandates. The Supreme Court treats the *solicitation* of charitable contributions as a form of speech protected by the First Amendment. *See Riley v. National Fed. of the Blind*, 487 U.S. 781, 789 (1988). In *Riley*, the Court subjected to exacting scrutiny a state statute requiring charitable foundations to disclose to persons they solicit the percentage of contributions they collected during the prior twelve months that were actually turned over to the charity. The Court held that this requirement of "compelled speech" was unduly burdensome to solicitors and tailored insufficiently narrowly to achieve the state's objectives. *Id.* at 798. Arguably, compelling retrospective disclosure about the *use* to which an organization has put its assets is quite different from point-of-solicitation disclosure. Moreover, *Riley* acknowledges that a state *itself* may constitutionally publish the financial disclosure form it requires fundraisers to file, and it may "vigorously enforce its antifraud laws to prohibit professional fundraisers from obtaining money on false pretenses or by making false statements." *Id.* at 800. *Riley* aside, beyond the making of false statements, fraud conventionally encompasses making half-true statements, knowingly failing to correct a misleading impression created by a statement and, in some situations, failing to disclose information going to a basic assumption that is not reasonably available to the other party to a transaction. *See RESTATEMENT (SECOND) OF TORTS* § 551 (1977).



a particular nonprofit. Betrayed once, donors' altruism may be jeopardized and all nonprofits will suffer as a result. At present, the inhibitions to self-dealing in for-profits created by disclosure mandated by the federal securities laws are not paralleled in the nonprofit environment. Consequently, there is no effective substitute for independent judicial review of the merits of self-dealing transactions in nonprofits.

