

# THE CHARITABLE FOUNDATION: ITS GOVERNANCE\*

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## INTRODUCTION

Private foundations have several characteristics that distinguish them from other charitable institutions: (1) they are generally dependent on a single donor (or family) for their funds and derive none of their financial support from broader based public fund raising; (2) they have a unique independence since they often retain contributions received as a capital fund and spend only the income which the capital fund earns; and (3) rather than operating charitable aid programs or research activities themselves, they usually make grants to other charities, institutions, or individuals to carry on such work. Thus, they are a relatively permanent, non-governmental source of floating capital endowment for alternative public purpose activities. This uniquely uncommitted endowment gives the private foundation its singular freedom to act, a freedom which is at once its greatest virtue and its most vulnerable vice.

The private foundations' independence, flexibility, and ability to respond to changing times and new problems<sup>1</sup> make these organizations perhaps the most valuable and most essential segment of the entire private nonprofit sector. No other private charitable institution or organizational structure seems so perfectly designed to respond to the changing needs of a democratic, pluralistic society.

Despite the apparent advantages of the private foundation, over a period of years it has been the object of more criticism than any other single area of private philanthropy. As a result, in recent years it has increasingly been placed in a less favorable position than other so-called publicly supported charities with regard to federal tax benefits.

There are several main explanations of what has led to the private foundation's susceptibility to criticism:

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1. These attributes have been described by the collective term "venture philanthropy."

(a) Contributions to private foundations come from wealthy families. Any controversy or criticism regarding such large concentrations of wealth in our society is easily transferable to the private foundations created with this wealth. Indeed, such criticism of the private foundation may actually be an expression of dislike for the institution of private property.<sup>2</sup>

(b) Large tax benefits are usually associated both with the creation and operation of foundations. These benefits lower the cost of charitable giving. However, as the burden of taxation becomes heavier, especially for the middle-income taxpayer, scapegoats are sought. The private foundation, having only a small, albeit wealthy, voting constituency is especially vulnerable to criticism in this regard due to its image as a tax haven for the wealthy.

(c) Some private foundations have been set up and operated for the private purposes of their donors; some pursue goals that have little if any relation to the public interest; still others have accumulated income while spending little on current charitable or public needs. These clear abuses of the tax benefits already received and of the public trust status of contributed funds have brought criticism to bear on all foundations and indeed on all philanthropy. Increased enforcement efforts and changes in the law, especially the Tax Reform Act of 1969, have done much to reduce the possibility of such abuses. But some, arguably needed, steps—such as ensuring gradual relinquishment of donor control—have yet to be taken. Furthermore, what some view as overly generous “grandfather” clauses—such as requirements in the 1969 Act for divestment of business control<sup>3</sup>—have weakened the reform. In any event the public image of the private foundation has been slow to change.

(d) If foundations are fulfilling their promised role, they exploit their unique independence by engaging in new, innovative, and often controversial activities. Because of this, foundations have from time to time been heavily criticized from all sides—by Republicans and Democrats, tax conservatives and tax liberals, populists and propertied interests. Such criticism is usually a sign of healthy vigor of the institution and will hopefully not be silenced.

(e) Many foundations—including those that may have performed their fiduciary obligations flawlessly, without self-dealing or private benefits—have nevertheless remained truly “private.” Generally speaking, this means that they are controlled by a small and self-perpetuating group consisting either of the donor and the donor’s family or of others who have gained control through their relationships to the original control group. Furthermore, foundations—even those that are not so closely controlled—have with few exceptions drawn their directors and chief personnel from a narrow and rela-

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2. See Liles & Blum, *Development of the Federal Tax Treatment of Charities*, 39 LAW & CONTEMP. PROB. no. 4, at 6 (1975).

3. See generally Worthy, *The Tax Reform Act of 1969: Consequences for Private Foundations*, 39 LAW & CONTEMP. PROB. no. 4, at 232 (1975).

tively homogeneous base. Many foundations also have been reluctant to disclose adequate information about their finances and activities, doing so only under the heaviest of criticism or because of government regulation.

Since private foundations are dependent on neither public fund raising nor public membership, it is not surprising that they have tended to exhibit characteristics of "privateness." Yet such uncontrolled, narrowly based power, especially when it enjoys the benefit of tax support, cannot be expected to be popular in our society. The few private foundations that have managed successfully to emerge from this stereotype and have progressed beyond this state of privateness might be well advised to refer to themselves as "charitable foundations" or "public foundations"—even though the effect is concededly cosmetic.<sup>4</sup>

The purpose of this paper is to examine current problems in the governance of private foundations, some of which have been summarized above, and to suggest possible solutions to help quiet the private foundations' critics without undermining the foundation's essential role. While directed at private foundations, much of what is discussed is also applicable to other charitable institutions that are similarly characterized by privateness or "non-publicness" and that also may share some of the alleged weaknesses of the foundations' governance structure.

## I

### LONG-RANGE STRATEGY

The grant-making private foundations will not continue to play an important role in American society unless it is determined that they are worth the price society must pay to sustain them. The "price" has two aspects—one monetary (tax incentives) and the other independence which, in effect, gives to private persons the right to appropriate monies that would otherwise be collected as taxes and appropriated by the legislature.<sup>5</sup> Presently foundations,

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4. Cf. the recommendation of the Commission on Private Philanthropy that a new category of "independent" foundation be established. See *GIVING IN AMERICA*, *infra* note 6, at 172. "Such organizations would enjoy the tax benefits of public charities in return for diminished influence on the foundation's board by the foundation's benefactor or by his or her family or business associates." Under the recommendation, governing boards of such foundations would be restricted to at most a minority representation by the donor, his family and associates. In return, such organizations would not be subject to the limitations on giving that now apply to private foundations, including the ceiling of 20 per cent of the giver's income that can be deducted from income taxes of gifts to private foundations, the restriction against endowment gifts from income of other foundations, and the exclusion from full eligibility to receive appreciated property that is deductible at market price. *Id.* at 173.

5. For example, a donor, in the 50 per cent marginal tax bracket, is able to give to the university of his choice one hundred dollars for each fifty dollars sacrifice in after-tax dollars. For a discussion of the effect this has on giving see Kirkwood & Mundel, *The Role of Tax Policy in Federal Support for Higher Education*, 39 *LAW & CONTEMP. PROB.* no. 4, at nn. 84, 85 (1975). The

notwithstanding the considerable progress of recent years, continue as noted above to enjoy a "precarious" image. Therefore a long range strategy must be developed to improve the image of the private foundation.

There clearly are limits to what can be done to lessen the political vulnerability of the private foundation. Once its public image has been tarnished it is very difficult for an institution or group to rid itself of such a stigma. This is especially so in the era of television communication when political success may depend on fifteen-second "spot" announcements. It is also an era in which it is quite fashionable to challenge existing institutions as being "irrelevant" or in need of "radical" change. On the other hand there would appear to be an appropriate strategy for the private foundation. Such a strategy should be based first and foremost on fulfilling the theoretical promise of the foundation to be the "cutting edge" of philanthropy, the sympathetic ear to the "voices in the wilderness," and the patron of pathfinders.

However, as a precondition to their ability to act with such independence, foundations must avoid making themselves easy targets for political criticism. Abuses, and the potential for abuse, must be dealt with forthrightly and promptly. Foundations as a group should be responsible first of all for playing a "watchdog role" over themselves. Furthermore, there is always the possibility that criticism of some charitable organizations will spill over to all charitable institutions. Thus equally important to this long range strategy is the willingness of foundations to take the lead in encouraging sound government regulation of all charity subject to the proviso that such regulation not interfere with their own vital independence or that of other charitable institutions. Foundations should be in the forefront of delineating for the public and for Congress those areas of all charitable activity that should be open to reasonable government regulation.<sup>6</sup> The limitations on self-dealing and

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other fifty dollars, tax savings, are monies which the donor is allowed effectively to designate to the university rather than paying directly to the government to be appropriated by the Congress. This latter element of present tax policy focuses on what is believed to be the central issue of foundation governance. The precise tradeoffs in terms of efficiency or equity of the tax (or other monetary) incentives to the donor and the desired level of total giving are beyond the scope of this paper, which will deal with only the second aspect: the "private appropriation"—or "private governance"—price that society may have to pay in order to sustain a desired level of giving to private foundations. This same non-monetary incentive may also be necessary in order to achieve and retain foundation independence and flexibility, the two characteristics that are believed to be their key values to society. The tradeoffs here are more delicately balanced, especially when independence and flexibility are at stake and a somewhat higher margin of safety may be called for than in the case of the monetary (tax) incentives.

6. The many independent studies sponsored by the Commission of Private Philanthropy and Public Needs are good examples of this potential role. For a list of these studies see *COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR* app. I (1975) [hereinafter cited as *GIVING IN AMERICA*]. The studies are to be published in a compendium by the Commission. The Commission also sponsored a "Donee" Group, a coalition of public interest, social action, and volunteer groups. This group published its report, *COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, PRIVATE PHILANTHROPY: VITAL AND INNOVATIVE? OR PASSIVE AND IRRELEVANT?* (1975) [hereinafter cited as *Donee Group Report*].

control-of-business provisions recommended in 1965 by the Treasury Department and enacted in 1969 should, under this strategy, have received strong and unqualified support by the foundation community. Similarly, foundations should be receptive to reasonable demands for disclosure and public accountability.<sup>7</sup>

However, it is not necessary—or *advisable*—that foundations and their supporters accept as permanent any unnecessary concessions to government regulation—such as the present tax benefit discriminations against gifts to foundations in favor of gifts to “public charities.”<sup>8</sup> Furthermore, an omnibus approach aimed at preventing all possible abuses is unwise if it risks the serious curtailment of the foundation’s independence and flexibility: to do so could ultimately lead to the destruction of the institution we seek to preserve.<sup>9</sup> Some criticisms, for example those relating to financial self-dealing should, and can be, and to a large extent have been, met by direct and rigorous government regulation. Unfounded criticisms—such as charges that foundations control the economy or are responsible for high income taxes—should be repudiated vociferously just as are such attacks on free speech, academic freedom, and an independent judiciary, three other important bulwarks of a free society. To deal with problems that fall somewhere in between, solutions are discussed below that would combine private regulation with semi-governmental controls or legitimacy-creating devices.

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7. See, for example, the recommendation of the Commission on Private Philanthropy and Public Needs

that all tax exempt organizations be required to maintain “arms-length” business relationships with profit-making organizations or activities in which any principal of the exempt organization has a financial interest. . . . [And] that a system of federal regulation be established for interstate charitable solicitations and that intrastate solicitations be more effectively regulated by state governments.

GIVING IN AMERICA 24-25. The Commission also recommended that larger tax exempt organizations except churches and church-affiliates “be required to prepare and make readily available detailed annual reports on their finances, programs and priorities” and further that “larger grant-making organizations be required to hold annual public meetings to discuss their programs, priorities and contributions.” The Donee Group also recommended expanded public information requirements and annual public meetings. See Donee Group Report 21-23. In both cases the recommendations for disclosure and public accountability would expand the requirements now imposed on foundations and would extend them to cover almost all charitable organizations.

8. For a complete synopsis of these regulatory provisions see Worthy, *supra* note 3. See also Wadsworth, *Private Foundations and the Tax Reform Act of 1969*, 39 LAW & CONTEMP. PROB. no. 4, at 255 (1975).

9. Attempts to provide absolute assurance that dollars committed to private foundations will not be diverted to personal uses or spent in a narrow—*i.e.*, not truly public—and unresponsive way, will destroy the very reason for the existence of the private foundation. An essential and vital function of the private foundation in our society is to provide venture capital to initiate and support activities in new and controversial areas where government will not, or cannot, provide assistance. Under these circumstances, some degree of elitism is natural, some “slippage” will occur, and many mistakes will be made—just as all of these imperfections occur daily in governments, in private enterprise, and in publicly-supported charities.

If foundations have kept their own "skirts clean," they will then be in a position to carry out the more important part of a long range strategy of securing their recognition as vital to American society. This simply calls for the fulfillment of their promise. Foundations should be far more active in supporting through their grant-making process those ombudsman activities now permitted by law.<sup>10</sup> In this era when voters are called upon to decide on such complex matters as what degree of safety is required for nuclear power plants, how much military power does the United States require to defend itself, and what is appropriate economic policy to maintain full employment and avoid inflation, free press, town hall meetings, and academic freedom do not suffice. What are needed are extensive privately-supported research activities that will hopefully provide the necessary information for the press and others to disseminate. Similarly, in these days of almost overwhelming power of government, the protection of individual rights requires in many cases sustained and complex litigation that can be carried on only by public interest groups.

Moreover, foundations and their supporters must convince Congress that privately supported, nonprofit organizations are needed to counteract corporate and other private interest lobbies in federal, state, and local legislatures. These activities are now largely foreclosed to charitable organizations,<sup>11</sup> while business interests are afforded wide latitude to conduct non-grassroots lobbying with tax deductible dollars in matters connected with their business interests. If private foundations were permitted to make grants in support of lobbying activities, they would provide the requisite and vital counterforce to large government and its consequent private business lobbies.<sup>12</sup>

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10. Examples abound: consumer law firms which challenge unfair business practices in the courts; public auditors, such as Tax Analysts and Advocates—successful low-budget critics of the Internal Revenue Service, the Treasury Department, and the Congress, whose persistent and careful efforts led to the audit of President Nixon's tax returns; the Brookings Institute which presents in an objective, scholarly fashion alternative courses of action for governmental fiscal and economic policy.

To some extent both the Commission on Private Philanthropy and the Donee Group recognized the need to expand foundation grants in these areas. There was a difference of emphasis, however. The Donee Group Report states that "although the Commission recognizes the support of organizations such as these to be one of 'the enduring pragmatic functions seen for non-profit organizations,' it does not make recommendations to remedy the lack of support which these issues and organizations have received from the non-profit sector." Donee Group Report 5.

11. See Worthy, *supra* note 3; Wadsworth, *supra* note 8.

12. See the recommendation of the Commission on Private Philanthropy and Public Needs: "That non-profit organization, other than private foundations, be allowed the same freedom to attempt to influence legislation as are business corporations and trade associations, that toward this end Congress remove the current limitation on such activity by charitable groups eligible to receive tax-deductible gifts." GIVING IN AMERICA 26. See also the recommendations of the Donee Group Report 40.

## II

## SOME SPECIFIC RECOMMENDATIONS

## A. Areas of Appropriate Government Regulation

To maintain public confidence in the integrity of the management of private foundations, government regulation should be exercised in a reasonable manner to achieve:

- (a) prevention of self-dealing or other forms of private benefit;
- (b) prevention of "priveness" through full disclosure of foundation operations;
- (c) relative safety of foundation investments;
- (d) a balance between accumulation of capital and spending for present needs;
- (e) proper application of foundation funds, *e.g.*, avoidance of improprieties, such as giving for political purposes; and
- (f) to a limited extent, the prevention of "priveness" in the form of indefinite control by donors or donees over any particular foundation.

## B. Avoidance of Government Regulation

To preserve foundation independence and to allow foundations to carry out their missions, there should be no government regulation of the grant-making process itself. This includes both selection of areas of interest by a foundation and the actual making of grants to particular donees.

C. Areas of Experimentation With Different  
Regulatory Approaches

To encourage the continued growth of the private foundation while attempting to satisfy the justifiable demands for regulation, there should be experimentation with private regulation. The Financial Accounting Standards Board,<sup>13</sup> established by independent public accountants, and private regulatory boards with compulsory membership under state law, such as the State Bar of California,<sup>14</sup> can serve as possible models. These efforts might not bear significant fruit and could pave the way for direct government regulation of

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13. The Financial Accounting Standards Board is voluntarily financed on a long term basis by the ten largest accounting firms.

14. All practicing attorneys must maintain dues paying membership. The Bar in turn carries out, among many other activities, regulation of ethical practices of attorneys.

It is interesting to note that, effective January 1, 1976, California law requires that six non-attorneys be added to the California Bar's Board of Governors, apparently a first for any governing body of an American Bar. CAL. BUS. & PROF. CODE § 6013.5 (West Supp. 1976). The six lay persons will be appointed by the Governor of California subject to confirmation by the California Senate. The new law also requires two lay members each on the Committee of Bar Examiners and to the Disciplinary Board of the State Bar.

program selection and grant-making. Despite such drawbacks, however, the narrowness and the unresponsiveness of some private foundations demand such experimentation. Two of the principal goals of such experimentation should be to encourage the voluntary broadening of foundation management and greater foundation responsiveness to the controversial and changing needs of our society.<sup>15</sup>

#### D. Limits on Control But Not on Size

While it does not seem necessary, at present, to place any limits on the size or life of private foundations, there should be limits placed on the time during which a donor and related parties or donees may at first control, and later substantially influence, the conduct of the private foundation. To encourage new ideas and approaches, and to avoid prolonged control by persons falling outside the donor and related party group, it may also be necessary to place limits on the term of any single director.

#### E. Equal Tax Treatment for Foundations and Other Charitable Institutions

Finally, in order to promote the continued growth of private foundations and to eliminate their stigmatized status, the present tax distinctions between private foundations and other charities should be abolished. Donors to private foundations should be entitled to the same tax benefits now given to donors to other institutions; private foundations should not be subject to heavier taxes or auditing fees than other charitable organizations; and many of the existing prohibitions such as that against self-dealing and control of businesses now imposed on private foundations should logically and equitably be extended to all charitable institutions. Elimination of existing legal differences between private foundations and other charitable institutions is needed not only to remove an unfortunate stigma on foundations, and not only to eliminate the unwise distortion of charitable giving which such distinctions may

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15. Both the Commission on Private Philanthropy and the Donee Group strongly urge these two recommendations, the Commission by exhortation and the Donee Group "by law." The Commission feared that the latter would "undermine an important distinction between the voluntary sector and government." The Donee Group, impatient with exhortation, claimed that compulsory expansion of governing boards to include significant representation from the "general public," "non-profit agencies," and "in particular women and minorities" would "actually make philanthropy more pluralistic." Donee Group Report 19. Notwithstanding the Donee Group's claim, this concept of "pluralism" is not pluralism but is either "democratic representativeness" or "proportional representation," in either event an entirely different matter and, as noted by the Commission, essentially not distinguishable from government. Aside from definitional arguments, the Donee Group unfortunately makes the frequent mistake of those impatient with the pace of democratic progress when they confuse means and end. The Donee Group is concentrating on end results. However if they choose the means of forcing democratic or proportional representations on philanthropy they might just as well direct their efforts to government and do away with private philanthropy, having done away with its essential characteristics, namely, independence from such government interference.



create, but also because these existing distinctions themselves invite further discrimination, representing as they do a kind of legislative presumption of inferior status.

### III

#### AREAS OF POTENTIAL GOVERNMENT REGULATION: THE PROBLEM OF "PRIVATENESS"

##### A. Solicitation of Funds

By definition the private foundation obtains funds from a single donor or family. To require public funding or to otherwise restructure the support base would destroy the very nature of the private foundation. While there are admitted virtues to the contention that publicly supported charities must prove themselves continually in order to maintain a flow of donations, one of the unique aspects of the private foundation is its independence from such popular support. This makes the foundation less likely to be subject to public passions and prejudices of the moment than almost any other institution in our society. Even the wealthiest private university knows that "money [of its donors] talks." Therefore, any suggestions that foundations be required to solicit at least some funds from the public sector or perish is a route to "publicness" which should not be considered.

##### B. Selection and Composition of the Government Board Donor Control

Only a limited amount of direct governmental intervention can be safely brought to bear on the composition of governing boards of private foundations without destroying the independence of existing foundations and without negatively affecting the establishment of new foundations. Some objective legislative limits restricting only the scope and duration of donor—and donee—control may be tolerated. These legal minima could be supplemented by semiprivate mechanisms that would indirectly seek to accomplish goals not safely attainable through direct legislation or direct governmental regulation.

Plainly, the governing boards of foundations must be nondemocratic. They must remain so if they are to provide any alternative to the political establishment. This necessarily involves a certain risk of "narrowness." Yet, for foundations to play a significant role they must be prepared to respond to changing times and needs. They must therefore continuously seek to broaden their outlook either through changes in their staffs or their boards or at least through the scope and outlook of their grant-making programs. In sum, they must endeavor to act in a "public" and "responsive" fashion (even though such concepts are not amenable to precise definition) or their future will sim-

ply not be secure. More importantly, unless they so behave they will not fulfill the promise of their role as an independent source of power on the frontiers of charity, probing new and controversial causes, to ever give new strength and vitality to a democratic society and to challenge the democratic majority and the conventional wisdom.

Furthermore, if any single factor preponderates in subjecting foundations to political criticism, it is the image of nondemocratic control by the donor or his surrogates. Donor control or substantial influence on a board creates, at least, apparent possibilities for selfish operation and self-dealing. The rules promulgated by the Tax Reform Act of 1969,<sup>16</sup> extensive as they are, have not eliminated this possibility. One of the key elements of the Tax Reform Act of 1969 is section 4943 which imposes a penalty tax on certain excess business holdings and which is designed to prevent foundation control of business. Section 4943 was recommended by the Treasury Department and adopted by the Congress on the theory that foundation control of business can be harmful because, among other reasons, it affords the opportunity for very subtle and difficult to detect forms of self-dealing. It was for similar reasons that the 1965 Treasury Department Report recommended that control of foundations by donors be limited to a twenty-five year period:<sup>17</sup>

It [the proposed limit on donor control] would limit the time period within which abuses could occur through the exercise of substantial donor influence; and, by assuring the donor that his actions would ultimately be subject to independent review it would tend to protect the foundation from abuse even during its first 25 years. By enabling independent private parties to evaluate the performance and potentiality of the foundation after 25 years of operation and granting them power to terminate the organization, then or later, the measure would provide a method for eliminating foundation[s] which have doubtful or minimal utility. Finally, in broadening the base of foundation management, the recommendation would bring fresh views to the foundation's councils, combat parochialism, and augment the flexibility of the organization in responding to social needs and changes.<sup>18</sup>

The Congress did not act affirmatively on this recommendation. However, for the reason above cited, the same kind of recommendation is made here.

More specifically, the recommendation has two main parts: (1) adopt a gradual reduction of donor and related-party presence on the board, and (2)

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16. The Tax Reform Act of 1969, Pub. L. No. 91-172, 85 Stat. 487, added chapter 42, sections 4940-48 to the Internal Revenue Code of 1954, which rival in their complexity such notable areas of the Internal Revenue Code as subpart F dealing with "tax haven" corporations and, more recently, the provision of the Employees Retirement Income Security Act of 1974, 88 Stat. 829 (codified in scattered sections of 5, 18, 26, 31, 42 U.S.C.). These rules provide a comprehensive pattern of prohibitions and control of foundation behavior enforced through a series of sanctions in the form of severe penalty taxes.

17. U.S. DEP'T OF TREASURY, 89TH CONG., 1ST SESS., REPORT ON PRIVATE FOUNDATIONS 57 (Comm. Print 1965).

18. *Id.*

limit the term of any person other than the donor. Substantial donees<sup>19</sup> of the foundation and essentially nonindependent persons such as direct or indirect employees, attorneys, accountants, and bankers of the donor or his family should also be included within the related party category. Since the details of such a recommendation cannot be derived from pure logic but must be based on a subjective balancing of objectives, the rules sketched out below are suggestions to demonstrate the kind of details that implementation of the main recommendations would entail.<sup>20</sup>

Slightly different rules would be needed for inter vivos contributions and for contributions made on the death of the donor. In the case of a donor who created a foundation and funded it during his lifetime, the donor himself could be allowed to remain on the foundation board for his lifetime. This would leave unimpaired a significant motivation for the formation of foundations by wealthy donors. On the other hand the make-up of the board should be limited as follows in the case of such inter vivos foundations:

(a) "Control" of the board by the donor and related parties should be eliminated after a relatively short period of time such as, *e.g.*, 7½ years. Persons within the "donor group" should be defined even more broadly than the category of "disqualified persons" under existing law and, in particular, to include substantial donees of the foundation. "Control" could be defined as the ability to cause the foundation to act (normally evidenced by more than 50 per cent of the voting power of the board or other governing body).

(b) After relinquishing control, the donor group as defined above would be allowed "substantial influence" on the board for another period of 7½ years. "Substantial influence" could be defined as more than 20 per cent, but

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19. Defined as a donee that received more than five per cent of the foundation's total grants for the year or for the last "x" number of years.

20. In this regard compare the recommendations of Senator Edward Kennedy, the Donee Group, and the Commission. It is the recommendation of Senator Edward Kennedy that, after the first twenty-five years of existence of the foundation, the creator and members of his family be limited to 25 per cent of the membership of the managing board of the foundation. In the case of organizations in existence for more than ten years, the period would be fifteen years from the effective date of the new law. 122 CONG. REC. 3755 (daily ed. March 18, 1976). Senator Kennedy noted that

[a]lthough the recent [Commission on Philanthropy] study did not make any specific recommendations to restrict donor control of private foundations, the above proposal is consistent with its statement that Congress examine the issue. The Commission did espouse "the general view that openness and accessibility are as important for donor-controlled foundations as for other philanthropic, non-profit organizations. If, in any particular organization, relinquishing a degree of donor control serves to further the cause of greater accessibility, then the course should, we feel, be positively pursued."

*Id.* at 3764. While Senator Kennedy's recommendation would move more slowly than that recommended herein, the impatient Donee Group recommended that the governing boards of all foundations be required by law "to have no less than ⅓ public members immediately and no less than ⅔ public members after 5 years. Public members would be defined negatively to eliminate donors, their relatives and business associates." Donee Group Report 17.

less than 50 per cent, of the voting power of the board. Thereafter, only less than substantial influence would be permitted.

(c) In any event, the terms of all persons serving on the board (except the principal donor) would be limited to a period of no more than five years, with no possibility of reappointment. In some cases, this might result in the elimination of donor control and substantial influence over a shorter period than required above.

In the case of foundations which are substantially created by testamentary gifts, the following should apply:

(a) So that the donor has some assurance that his charitable goals will be carried out, it might be reasonable to allow his immediate family to control the foundation for the same 7½-year period specified for inter vivos foundations. The "immediate family" would be limited to the donor's spouse, children, and grandchildren.

(b) There appears to be no compelling policy reason to allow other, more remote, donor-related parties (such as his attorneys, accountants, or business employees) to control the foundation after the donor's death or to play any substantial role in assisting the immediate family in its initial control role. Therefore, during the initial 7½-year period these other disqualified persons could serve, along with the immediate family in the capacity of a control group, but should themselves be limited to no more than 20 per cent of the board.

(c) After the initial 7½-year period following the donor's death and the creation of the foundation, the donor's family together with other disqualified parties would be allowed no more than substantial influence (more than 20 per cent, but less than 50 per cent, of voting power) on the board for another 7½ years. Thereafter, only less than substantial influence would be permitted.

(d) The terms of all board members would be limited to one five-year term with the possible exception of the donor's spouse, children, and grandchildren who, as surrogates of the donor, might be allowed to serve more than five years (perhaps ten years) but not a lifetime. In any event, this exception should not be used to circumvent the provisions requiring no control after 7½ years and no more than substantial influence after fifteen years.

These periods of permitted donor control and substantial influence should be sufficiently generous so as not to interfere significantly with the principal donor's motivation to impress a desired character on a foundation, and thus should not lessen the donor's incentives to create and fund the foundation. And yet, these limits are an objective and enforceable way of dealing with one pressing aspect of the need to achieve publicness for foundations. Alone, they will not ensure publicness, but at least they are an attempt to ameliorate one aspect of privateness. Such governmental regulation need not be an incursion on the foundation's independence: it merely limits the control of the foundation by one exclusive private group.

In addition to these suggestions for the gradual elimination of donor control and substantial influence over a fifteen-year period, strong anti-self-dealing, anti-business control, and anti-accumulation rules (as contained in the Tax Reform Act of 1969) must be maintained. Full disclosure of foundation finances, grant-making procedures and results would also significantly improve foundation publicness.

#### IV

##### PRIVATE OR SEMI-GOVERNMENTAL REGULATION OF BOARD COMPOSITION AND CONDUCT

Direct governmental regulation of the selection and composition of the board is generally inconsistent with the desired pluralistic and independent nature of the foundation. While all of the recommendations in the preceding section would go a long way toward removing some of the actual and political weaknesses and vulnerabilities of the private foundation, it would still be susceptible to the charge that foundations are non-public and non-responsive even when they are not controlled by the donor (or parties related in some way to the donor). These could be allegations that the composition of foundation boards is narrow in origin, background, outlook, and interests; that they are elitist, unimaginative, and unsystematic in setting priorities; that they are not accessible to some groups. Such characteristics, and especially the fact that they are not democratically representative, are not necessarily faults. Indeed, these characteristics may be virtues, since a foundation whose directors were chosen like legislators would present no real alternative to governmental support.

However, if it could be shown that these characteristics limit the foundation's very ability to respond to public needs or its ability to provide a real alternative to public sector support, then such privateness would be not only a political disadvantage, but also diametrically in opposition to the avowed goals of the foundation in our society. Policy alternatives in this regard might be to:

(a) dismiss the charges as minor imperfections which should be ignored since they will cure themselves over time and cannot be handled through any kind of regulation without seriously damaging the foundation;

(b) accept the charges as serious but limit their correction to non-governmental methods of regulation, perhaps, with minimal intervention in providing "legitimacy" to otherwise private regulators; or

(c) treat the charges as serious and risk the damage that might ensue from direct governmental regulation.

The first course involves no action other than defensive argumentation and possibly vague exhortations to foundations to "do better." Little more can

be said about this first alternative which involves a complex balancing of questions such as the political strength of the foundation and the seriousness with which one views governmental or private intrusion into this area. A realistic assessment would reject this "do-nothing" position as neither necessary for the preservation of the most vital aspects of foundations nor politically safe. Certainly no one would argue that there are *no* limits on who may be a fiduciary. For example, it would probably not be problematical if government were to provide that the following persons could not sit on a board: a minor, an alien, a convicted felon, an elected government official, a major supplier of services to the foundation, or a repeating and willful, self-dealing board member.<sup>21</sup> Limits on the terms of fiduciaries and on the extent and duration of donor control are surely more serious matters but are still relatively mechanical regulations which need not involve direct governmental intrusion into foundation decision-making. The third alternative must be rejected outright as simply inconsistent with the *raison d'être* of the foundation.

The second alternative, limited private regulations, seems superficially attractive; however, the problems with this approach are also serious:

(a) How could a private regulatory body be endowed with the "legitimacy" or enforcement sanctions necessary to make it effective?

(b) How could it obtain independence from the persons and institutions it regulates?

(c) Could it set any uniform and objective standards for behavior that would be useful and sensible?

As previously noted the Financial Accounting Standards Board in the accounting field is one possible model for self regulation. However, the process of setting standards is extremely difficult in the foundation area. There is no single standard for correct behavior in program selection, grant-making, or in board composition for a foundation, perhaps because foundations must be pluralistic in such respects—that is, promotive of differences, not uniformity. Moreover, even if regulations could be devised, there are no ready-made sanctions for failure to comply in the foundation area as there are in the accounting field. The American Institute of Certified Public Accountants can, as part of its rules of ethics, require its members not to certify statements which are contrary to the standards set by the Financial Accounting Standards Board. Furthermore, certain government agencies such as the Securities and Exchange Commission have also adopted certain of these standards thereby legitimizing them. In view of the lack of possible uniform standards, it is difficult to conceive of similar sanctions in the foundation field. Finally, it should be noted that there are already serious criticisms of the FASB which raise

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21. While these latter rules are undoubtedly less objectionable even to the most ardent opponent of government interference, it must be stated that it is not here suggested evidence that such persons are today sitting on boards.

questions about its ability to act independently enough to fend off direct government regulation. Nor would any California lawyer be completely sanguine about the success of the California State Bar as a model of effective semi-private regulation.

Nevertheless, because the charges of foundation privateness and narrowness are serious, such semi-private models must be considered and something like a Foundation Evaluation Board should be tried, at least on an experimental basis. Such a board could be given financial independence in several ways. It is conceivable that the largest foundations might agree to fund the activities of a Foundation Evaluation Board over an extended period, such as ten years. This would allow for the appointment to the board on a full-time, long range basis of capable and independent persons. Their tenure could be sufficiently long—five to seven years, for example—to provide them with true independence. The financing could also provide for adequate staffing.

An alternative financing method would be to combine private regulation with some form of governmental participation in order to provide legitimacy. Such a course might require that all private foundations register with the Foundation Evaluation Board solely for the purpose of paying a certain amount of dues per year. Government could also help by making it mandatory to supply the board with needed data. Even if nothing further were done this would provide such a Foundation Evaluation Board with more prestige, legitimacy, and independence than if it were merely funded by the ten or twenty largest foundations.

While it would be relatively easy to provide some degree of independence through financing and tenure, selecting the board members of a Foundation Evaluation Board would pose more serious problems. Here one could conceive of a variety of sources of appointments that would guarantee a modicum of independence. Some members might be selected by the foundations themselves; others by the Secretaries of the Treasury and Health, Education, and Welfare; still others by various associations of charitable organizations.

An adequately funded and legitimized board with adequate staff could develop, over an experimental period of ten years, useful functions for itself that would meet some of the challenges in this area. For example, it could draft standards for the fair and prompt processing of applications and for publicizing the areas of foundation interest and results of the award process; it could systematically gather information about the composition of foundation boards and key staff personnel; it could encourage both of the areas of foundation concern and of governing board composition.

Setting up a board of this nature could pave the way for an eventual takeover of its functions by a government agency. Moreover, the very criticisms raised by this board might be used by some critics of private foundations as further evidence of the need to curtail or eliminate the foundation as

we know it today. However, it is believed that these dangers are, on balance, worth risking in view of the dangers of a "do nothing" policy.<sup>22</sup>

## V

### COMMUNITY FOUNDATIONS: AN INAPPROPRIATE MODEL

Another possible policy alternative might be modeled on regulations now being developed by the Internal Revenue Service which would establish criteria to determine whether "community foundations" will be treated under the existing tax laws as publicly supported charities rather than private foundations.<sup>23</sup> Many of these community foundations receive substantial amounts of their support from a limited number of donors and cannot meet the usual test for publicly supported charities. However, the comparison between them and private foundations does not hold up under close analysis, and this alternative is probably inappropriate in the foundation sphere. Community foundations are essentially local institutions; they obtain funds from the general public, generally engage in rather noncontroversial charity programs of a local nature, and even where there is controversy, there is often a tendency to move toward a consensus basis. Any effort to implement this kind of approach for private foundations would come dangerously close

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22. The Donee Group, evidencing a rather short memory considering the relatively recent Watergate experience, criticized the Report of the Commission on Private Philanthropy because "fear of government pervades the Report." Donee Group Report 14. Even were not the experiences of Watergate so fresh in our memories, it should be easy to recall that the basic reason for philanthropy, and in particular for the private foundation, is as an alternative to government. Fear of government intervention is thus quite sensible. The Donee Group also criticized the Commission for excessive confidence in self regulation. The Donee Group dimly remembered Watergate when it recommended the removal of the supervisory function regarding exempt organizations from the IRS and the creation of a new, independent regulatory commission with a presidentially appointed board reflecting all elements of private philanthropy, including donees. It forgets that Watergates can reach even such agencies as the SEC. It also recommended a permanent standing committee in the House and Senate having oversight responsibility over such an agency.

The Commission recommended that a permanent national commission on the nonprofit sector be established by Congress whose role would be to continue, in effect, the work of the Commission on Philanthropy itself. One half of the commissions's membership would be named by the President, subject to Senate confirmation, and the other half by the presidential appointees themselves. Funding for the commission would come half from government, half from private sources. See Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, U. SO. CAL. 1968 TAX INST. 27, 77.

23. This approach would begin with a government definition of "publicness," dependent on a variety of factors. There would be several ways in which a private foundation might satisfy the requirements that it be "public." For example, possible factors would include: the extent to which the foundation's directors are chosen by outside agencies, such as public officials or groups of donees; the extent to which the foundation seeks to raise outside funds; and the extent to which a foundation formally chooses its board members from different fields and different representative groups, such as clergymen, educators, civic leaders, or university officials. See Proposed Treas. Reg. § 1.170A-9(e)(10)-(19), 36 Fed. Reg. 19598 (1971) and Proposed Treas. Reg. § 1.507-2(a)(8), 36 Fed. Reg. 19601 (1971).



to either democratizing them, which would undermine their role as an independent alternative, or would commit their funds to ongoing activities such as are the endowments of operating charities, which would seriously undermine the foundation's flexibility.

## VI

### LIMITATIONS ON MINIMUM OR MAXIMUM SIZE

Many critics claim that government-imposed limitations on foundation size—either on a minimum or a maximum basis—should exist. Some contend that foundations that are too small are apt to abuse their public trust since they are too numerous and too difficult to police. Furthermore it is argued that they are not apt to do useful work in view of their limited funds and limited staffing. While this is a question of competing alternatives, many small foundations *have* been useful and *have* played an important role in the general scheme of foundation affairs. It appears most unwise to extinguish the opportunity for small, but varied, pluralism without serious evidence that the government is indeed unable to police such foundations and that indeed they are wasteful. No such evidence is as yet available. In fact, government regulation already imposed by the Tax Reform Act of 1969 has proven to be too expensive and onerous for many small foundations, so much so that many have been terminated and it is suspected that new ones have not been formed in view of the new requirements.<sup>24</sup>

As to maximum size, some would contend that it is unwise to give as much power to a single board as is now held, for example, by the board of the Ford Foundation. In view of the fact that many of the largest foundations have performed better than average, these charges are probably not substantial. There is no evidence that large foundations have acted less adventurously than the average medium-size foundations, nor that they have stifled or molded research to the detriment of the pluralism we seek. It would seem that we need more, not less, large foundations at the present time. Furthermore, it seems that like good wines, foundations also improve with age; generally the "horror" examples of the Treasury 1965 report and others are not the Carnegie and other "mature" foundations. If the previously discussed recommendations for regulating foundations are carried out, there would be no cogent reasons to limit the size of foundations nor to limit their life or duration.

### CONCLUSIONS

Since by definition the private foundation normally obtains its funds from a single donor or family, to require public support or to change in any way

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24. See Worthy, *supra* note 3.

this source of funding would be to destroy the very nature of the private foundation. To require such publicness is not a feasible or desirable alternative for the foundation as we know it. While little government regulation can be safely brought to bear in the area of choosing the governing board and management of a foundation without destroying its independence and without adversely affecting the creation of new foundations, some modest limits for restricting the scope and duration of donor control and influence might well be incorporated. The benefits from such limits appear to outweigh the possible risks of such action *or non-action*.

Moreover, governmental regulation could possibly play a role in the manner in which the board and key staff govern the foundation. A board essentially performs two major functions: first, it manages the foundation's funds and oversees budgetary planning; second, it selects areas of program interest and determines who will receive individual grants. Government can directly regulate the first function without detriment to the foundation's role. On the other hand, the very heart of the foundation is its independence in selecting areas in which grants will be made and in making the individual grants, and these must be kept free of government regulation and should be subjected, at most, to systematic, privately supported or semi-governmental evaluation and criticism.