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Peter Molk
University of Florida Levin College of Law, pmolk@law.ufl.edu

D. Daniel Sokol
University of Florida Levin College of Law., sokold@law.ufl.edu

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PETER MOLK
D. DANIEL SOKOL

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PETER MOLK*
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Abstract: The stakes for proper nonprofit governance are extremely high. Over 1.5 million nonprofits are registered with the Internal Revenue Service (IRS), collectively employing twelve million people and accounting for 5.6% of U.S. gross domestic profit. Yet whereas for-profit companies have significant checks on the behavior of boards and management, nonprofit firms lack many of the same types of internal and external governance control mechanisms. COVID-19 is just the latest shock to expose the lack of preparedness and capability of many nonprofit boards in fulfilling their essential governance functions. This Article contributes to the corporate governance literature by identifying aspects of nonprofit governance that create unnecessary risk to nonprofit entities and to society overall. Currently many governance failures that would be corrected in traditional for-profit entities go unaddressed among nonprofits. We make unique contributions to addressing these governance shortcomings by suggesting an enforcement reorientation by both public and private actors. Our novel solutions encompass disclosure, certification, oversight by state attorneys general, and federal actors.

INTRODUCTION

The size and scope of nonprofit enterprise is staggering. Nonprofits account for over a trillion dollars—or 5.6%—of U.S. gross domestic product,[1] employ twelve million people,[2] pay $670 billion in wages annually,[3] and pro-

* Associate Professor of Law, University of Florida Levin College of Law.

** Huber C. Hurst Eminent Scholar Chair in Law, Professor, University of Florida Levin College of Law, Affiliate Professor, University of Florida Warrington College of Business, and Senior Advisor, White & Case LLP.

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[1] *The Nonprofit Sector in Brief*, NAT'L CTR. FOR CHARITABLE STAT. (June 18, 2020), https://nccs.urban.org/project/nonprofit-sector-brief [https://perma.cc/XMC7-FK2C].

[2] *Business Employment Dynamics: Research Data on the Nonprofit Sector*, U.S. BUREAU OF LAB. STAT., https://www.bls.gov/bdm/nonprofits/nonprofits.htm [https://perma.cc/55FB-RPZT] (May 14, 2020).

vide immeasurable benefit to people's lives. Unfortunately, nonprofits' success can be accompanied by extreme cases of managerial misconduct. In one of the most famous examples, William Aramony, the longtime leader of the nonprofit United Way organization, served six years in federal prison after he was convicted of twenty-three felony charges.[4] His activity included using nonprofit funds to buy homes in New York City and Miami, to pay for limousine service and transatlantic business class flights, and to fund extramarital affairs in Paris, London, and Cairo.[5]

The past year has been a busy one for nonprofit governance issues. The New York Attorney General filed suit against the National Rifle Association (NRA), alleging self-dealing and fraud, including a $17 million post-employment contract for its head Wayne LaPierre, expensive clothing at Beverly Hills shops, and lavish foreign travel. These actions may help to explain how NRA leadership turned a $27.8 million surplus in 2015 into a $36.3 million net deficit in 2018.[6] The University of Southern California (USC) also was rocked by a series of highly publicized scandals. In one, wealthy parents sent checks to university accounts to secure admissions spots at the university as part of sports recruitment, leading to guilty pleas by parents and some USC officials to bribery charges.[7] At roughly the same time, USC also received allegations of discrimination against women by the then-dean of the business school, repeated sexual assaults by the campus gynecologist, allegations of potential self-dealing with the university by university board members,[8] and alleged associations between the dean of the medical school and criminal elements.[9]

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[3] *Id.*

[4] T. Rees Shapiro, *United Way Leader's Fraud Scandal Marred Charitable Legacy*, WASH. POST (Nov. 14, 2011), https://www.washingtonpost.com/local/obituaries/united-way-leaders-fraud-scandal-marred-charitable-legacy/2011/11/14/gIQALnwbMN_story.html [https://perma.cc/Q7HH-UQWY].

[5] *Id.*

[6] Carol D. Leonnig & Tom Hamburger, *New York Attorney General Seeks to Dissolve NRA in Suit Accusing Gun Rights Group of Wide-Ranging Fraud and Self-dealing*, WASH. POST (Aug. 6, 2020), https://www.washingtonpost.com/politics/nra-lapierre-ny-attorney-general/2020/08/06/8e389794-d794-11ea-930e-d88518c57dcc_story.html [https://perma.cc/QFN3-FTYQ].

[7] Joel Rubin & Matthew Ormseth, *Admissions Scandal: Charged Parents Try to Drag USC into the Fray*, L.A. TIMES (Jan. 13, 2020), https://www.latimes.com/california/story/2020-01-13/college-admissions-scandal-parents-usc [https://perma.cc/EGV6-TETT].

[8] Marjorie Valbrun, *Does USC Need More Housecleaning?*, INSIDE HIGHER ED (May 21, 2019), https://www.insidehighered.com/news/2019/05/21/usc-board-trustees-undergo-major-changes-wake-recent-scandals [https://perma.cc/NA3Z-VWTL]. Self-dealing is not an uncommon feature in universities. *See* Paul Fain et al., *Divided Loyalties: One-Fourth of Private Colleges Do Business with Trustees' Companies. Whose Interests Come First?*, CHRON. OF HIGHER EDUC. (Mar. 14, 2010), https://www.chronicle.com/article/Divided-Loyalties-Conflicts/64629 [https://perma.cc/GW43-99NQ].

[9] Paul Pringle & Adam Elmahrek, *USC Had Many Warnings About Medical School Dean's Behavior but Took Little Action*, L.A. TIMES (Nov. 14, 2017), https://www.latimes.com/local/lanow/la-me-usc-dean-20171114-story.html [https://web.archive.org/web/20210203190659/https://www.latimes.com/local/lanow/la-me-usc-dean-20171114-story.html]. There has been a "global settlement." Vanessa Ro-

Of course, nonprofits are not the only organizational form to experience compliance problems. Leaders at for-profit organizations also engage in wrongdoing.[10] The key difference between the two, and which provides the launching-off point for this Article, is the set of legal mechanisms that exist to deter this type of failure. For-profit companies rely on robust oversight by boards of directors and shareholders to identify and deter managerial self-dealing of the type described above.[11] Nonprofits do not.[12] Instead, as exemplified in the United Way[13] and USC allegations,[14] nonprofits have boards that often engage in little meaningful duty of loyalty oversight, have no shareholders as a legal matter, and have barred other interested parties from being able to sue.[15] These differences can provide a fertile ground for nonprofit fraud.

Financial stresses exposed by COVID-19 only have exacerbated these governance differences between nonprofits and for-profits. Management at higher education and healthcare organizations in particular have been criticized for failing to plan for basic revenue disruptions of the type caused by COVID-19. For instance, as higher education became increasingly reliant on higher

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mo, *USC Agrees to $852 Million Settlement to End Sex Abuse Litigation*, NPR (Mar. 25, 2021), https://www.npr.org/2021/03/25/981435791/usc-agrees-852-million-settlement-to-end-sex-abuse-litigation [https://perma.cc/3RWA-63WP].

[10] *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1092 (2017); Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 652 (2010).

[11] Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1778 (2007); Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709, 723 (2019); Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2015 (2019).

[12] There is also a more robust ecosystem of external monitors (some more effective than others) in the for-profit setting than in the nonprofit setting. This includes the areas of certification and disclosure. *See infra* Part III.A. Private litigation against for-profits is also more robust. *See* C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 358 (2010); Claire E. Crutchley et al., *When Governance Fails: Naming Directors in Class Action Lawsuits*, 35 J. CORP. FIN. 81, 94 (2015). Public enforcement against for-profits is also more significant and robust. Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 209 (2009); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010).

[13] *See, e.g.*, Joan Beck, *United Way Scandal Could Embolden Many to Just Say No*, CHI. TRIB. (Apr. 9, 1992), https://www.chicagotribune.com/news/ct-xpm-1992-04-09-9202010652-story.html [https://perma.cc/G4ZT-9JGL] ("A significant part of the blame belongs to United Way's board of governors, who either did not know how Aramony was using contributors' money or had no objection.").

[14] Some blamed the then-president, Max Nikias, for creating a weak compliance culture in which wrongdoing was not reported. Valbrun, *supra* note 8. We note that universities may be different from many other nonprofits because of the more active role for some stakeholders in governance (faculty, for example, and state-level legislatures in the case of public universities), but universities still tend to have less monitoring than publicly traded for-profits.

[15] For additional discussion of these problems, see *infra* Part II.

tuition and enrolling international students,[16] many nonprofits appeared slow to engage with the basic issue of planning for revenue disruptions from these sources.[17] These organizations now find themselves in the unpleasant position of scrambling for solutions in response to COVID-initiated enrollment declines.[18] In healthcare, hospitals, most of whose revenue comes from profitable elective procedures,[19] have found that their main source of revenue has dried up during COVID-19 lockdowns, requiring them to administer expensive treatment[20] to COVID-19 patients with little anticipated revenue in exchange.[21]

Again, nonprofits are not the sole organizational form to experience these problems. Some for-profit organizations likewise failed to anticipate economic disruptions of the type and magnitude caused by COVID-19. Yet the response among for-profits is different. Among for-profits, unhappy shareholders have greeted many of these basic governance failures with class-action lawsuits.[22] But nonprofits, because of differences in legal regimes, face little sanction out-

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[16] *See* Eva Bogaty & Kendra M. Smith, *Moody's: US Higher Education Outlook Revised to Stable as Revenues Stabilize*, MOODY'S INVS. SERV. (July 20, 2015), https://www.moodys.com/research/Moodys-US-higher-education-outlook-revised-to-stable-as-revenues--PR_330530 [https://perma.cc/PN8S-RTB6].

[17] Caroline Spiezio, *Fall LL.M. Enrollment Expected to Plummet, Bruising Law School Finances*, REUTERS (July 22, 2020), https://www.reuters.com/article/lawyer-coronavirus-llm/fall-llm-enrollment-expected-to-plummet-bruising-law-school-finances-idUSL2N2ER20A [https://perma.cc/32AC-AXA4].

[18] Dick Startz, *University Finances and COVID-19: Different Schools, Different Risks*, BROOKINGS INST. (June 18, 2020), https://www.brookings.edu/blog/brown-center-chalkboard/2020/06/18/university-finances-and-covid-19-different-schools-different-risks/ [https://perma.cc/K3KS-BWYL].

[19] *See, e.g.*, Adrian Diaz et al., *The COVID-19 Pandemic and Rural Hospitals—Adding Insult to Injury*, HEALTH AFFS.: HEALTH AFFS. BLOG (May 3, 2020), https://www.healthaffairs.org/do/10.1377/hblog20200429.583513/full/ [https://perma.cc/A9RZ-922G] (describing how hospitals, particularly those in rural areas, rely upon elective surgery to return margins to supplement high-cost/low return procedures, such as caring for COVID-19 patients).

[20] The Kaiser Family Foundation estimates a cost of twenty thousand dollars for treatment of a COVID-19 patient. Matthew Rae et al., *Potential Costs of COVID-19 Treatment for People with Employer Coverage*, PETERSON-KFF HEALTH SYS. TRACKER (Mar. 13, 2020), https://www.healthsystemtracker.org/brief/potential-costs-of-coronavirus-treatment-for-people-with-employer-coverage/ [https://perma.cc/S6DZ-GFQ5]. This cost rises to over eighty-eight thousand dollars per patient for patients that require the support of a ventilator. *Id.*

[21] Diaz et al., *supra* note 19 ("While hospitals are canceling profitable elective surgeries to make way for costly patients with COVID-19, they also have higher staffing and supply costs with no way to predict reimbursement.").

[22] *See, e.g.*, Kevin LaCroix, *Securities Suit Alleges Cybersecurity Company Misrepresented COVID-19 Impact*, D&O DIARY (June 11, 2020), https://www.dandodiary.com/2020/06/articles/coronavirus/securities-suit-alleges-cybersecurity-company-misrepresented-covid-19-impact/ [https://perma.cc/F65Z-UUJS]; Kevin LaCroix, *Shareholder Files State Court Class Action Over COVID-19 Impact on Planned Merger*, D&O DIARY (May 19, 2020), https://www.dandodiary.com/2020/05/articles/coronavirus/shareholder-files-state-court-class-action-over-covid-19-impact-on-planned-merger/ [https://perma.cc/4KYK-CFPN].

side the court of public opinion,[23] even if the legal duties for both for-profit and nonprofit directors to consider these basic issues are nominally the same.[24]

We seek to make strides toward correcting this differential treatment. In both for-profit and nonprofit settings, incentives for value creation can be better aligned by creating more effective governance institutions.[25] For-profits have been studied extensively, but nonprofits remain the subject of relatively thin amounts of research into these issues.[26] We find this difference surprising, particularly given the size and scope of the nonprofit sector.

We are not the first to identify potential problems with nonprofit governance. We do, however, use this observation to make two unique contributions to the literature. First, we conduct an exhaustive analysis into why existing nonprofit governance frameworks break down. Next, we use this conclusion to make novel, concrete, and attainable reforms for improving nonprofit governance that encompass both private and public law solutions.

We focus on relatively larger nonprofits throughout our discussion, both because the ramifications of misconduct are comparatively larger and because larger organizations are more likely to have the governance infrastructure to adopt our proposals.[27] Also, although a variety of criticisms have been levied against nonprofits, we restrict our attention mainly to the difficult problem of

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[23] *See infra* Part II.

[24] *See, e.g.*, Brent Ashley, *Guest Post: 7 Steps for Ensuring Director Oversight During COVID-19*, D&O DIARY (June 4, 2020), https://www.dandodiary.com/2020/06/articles/director-and-officer-liability/guest-post-7-steps-for-ensuring-director-oversight-during-covid-19/ [https://perma.cc/P2F6-Y6XQ].

[25] *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985) (analyzing organizations through transaction cost economics).

[26] Nonprofits have still been the subject of excellent research projects that have advanced the state of knowledge significantly. *See, e.g.*, Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505 (2010); Brian Galle & David I. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities*, 94 B.U. L. REV. 1881 (2014); Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777 (2012); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 576 (2009); James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010); Robert A. Katz, *Can Principal-Agent Models Help Explain Charitable Gifts and Organizations?*, 2000 WIS. L. REV. 1; Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-off*, 108 COLUM. L. REV. 749 (2008); Anup Malani & Guy David, *Does Nonprofit Status Signal Quality?*, 37 J. LEGAL STUD. 551 (2008); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007); Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L.J. 731 (1994) (book review).

[27] Small nonprofits in aggregate also can pose sizable problems that are worthy of attention. *See, e.g.*, Eric Franklin Amarante, *Unregulated Charity*, 94 WASH. L. REV. 1503, 1506 (2019) (analyzing the IRS's decision to essentially ignore charities with under fifty thousand dollars in annual gross receipts).

addressing nonprofit managerial agency costs, which also pose one of the quintessential problems in corporate law.[28] This problem encompasses situations in which management puts its own interests ahead of those of the organization, such as fraud, self-dealing, failures to carry out the nonprofit's mission, and extreme failures of oversight and monitoring the nonprofit's operations (for convenience, our discussion often lumps these together into "agency costs"). It does not, however, encompass all complaints made about nonprofit governance, such as a lack of board diversity.[29] Finally, our analysis concentrates on commercial nonprofit corporations, rather than on donative trusts, although many of the problems we analyze also arise in trusts, and we think our proposed solutions could be fruitfully applied in that context as well.[30]

Our analysis proceeds in three Parts. Part I provides a legal primer on nonprofits, specifying as a matter of state and federal law their similarities to, and differences from, other organizational forms. Nonprofits' core distinctive legal feature is their prohibition on distributing earnings to private parties, but many implications flow from this deceptively simple statement, ranging from the behavior expected of management, to who has legal standing to sue for violations of that behavior, to the public and private disclosures that the nonprofit is required to make.[31]

Part II then turns to the key problem of agency costs, which plague any firm—nonprofit or for-profit—in which there is separation of ownership and control. Much of corporate law revolves around mechanisms to mitigate these problems. We contrast those mechanisms that have achieved success among for-profit firms with the systems that are designed to curb management costs in nonprofit firms, and show the significant gaps that emerge when doing so.[32]

Part III develops attainable ways to minimize nonprofit agency costs. We focus on three possibilities. The first involves reforming existing nonprofit disclosure rules to facilitate a private-ordering certification-based system. The second leverages the current nonprofit enforcement framework that relies on state attor-

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[28] *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[29] *See, e.g.*, Elizabeth A. Castillo, *Why Are We Still Struggling with Diversity, Equity, and Inclusion in Nonprofit Governance?*, NONPROFIT Q. (Nov. 20, 2018), https://nonprofitquarterly.org/why-are-we-still-struggling-with-diversity-equity-and-inclusion-in-nonprofit-governance/ [https://perma.cc/PU95-Q3NW].

[30] *See, e.g.*, John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 656 (1995) (detailing the presence of fiduciary duties in trust relationships); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623 (2004) (applying an agency costs theory to donative trusts); Lee-ford Tritt, *The Limitations of an Economic Agency Cost Theory of Trust Law*, 32 CARDOZO L. REV. 2579, 2585 (2011) (noting some inaccuracies produced by applying the agency cost theory to trust property).

[31] *See infra* notes 34–96 and accompanying text.

[32] *See infra* notes 97–223 and accompanying text.

neys general; we suggest how the existing incentive framework could be reconceived to promote meaningful attorney general oversight. The third considers expanding existing federal oversight from the Internal Revenue Service (IRS) into a broader system of monitoring nonprofit governance.[33] We then conclude.

I. NONPROFIT PRIMER

State business law statutes authorize organizations of various types, with the menu of options catering to differing needs that the company, its promoters, and its owners might have.[34] This Part develops the fundamental role of nonprofits that follows directly from essential attributes of nonprofit state and federal law. Section A details the historical role of nonprofits.[35] Section B then explains various aspects of state law to which nonprofits must adhere.[36] Finally, Section C discusses the impact of federal tax law on nonprofits.[37] We use this essential nature of nonprofits that we identify in this Part to motivate our later inquiry into how well law and policy currently do, and might in the future, further that purpose.

A. The Role of Nonprofits

It is a common misconception that nonprofits are simply organizations set up to leverage preferential tax treatment under federal and state law. Historically, nonprofits formed before any preferential tax treatment was offered,[38] and a significant slice—estimated at one quarter—of nonprofits have no tax exemption today.[39] What explains the role for nonprofits, if not their tax advantages?

Professor Henry Hansmann offered a compelling theory in what has become one of the most cited law review articles of all time.[40] Just like corporations or limited liability companies (LLCs), nonprofit organizations are simply creatures of state organizational law statutes. Like any organizational form, then, the attributes of nonprofits are determined by state statutes. And the

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[33] *See infra* notes 227–338 and accompanying text.

[34] *See generally* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010) (describing the increase in unincorporated business types, including partnerships and limited liability companies).

[35] *See infra* notes 38–60 and accompanying text.

[36] *See infra* notes 61–84 and accompanying text.

[37] *See infra* notes 85–96 and accompanying text.

[38] *See generally* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) (detailing the long history of employee-owned companies in America).

[39] *See, e.g.*, Am. Auto. Ass'n v. Comm'r, 19 T.C. 1146, 1162 (1953) (denying tax-exempt status to the American Automobile Association, or "AAA"); LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 15 (2d ed. 1999) (estimating that 25% of nonprofits have no federal tax exemption).

[40] Hansmann, *supra* note 26, at 837; Fred R. Shapiro & Michelle Pearse, *The Most-Cited Law Review Articles of All Time*, 110 MICH. L. REV. 1483, 1489, 1492 tbl.1 (2012).

unique feature of state nonprofit organization statutes is a prohibition on distributing net earnings to private individuals.[41] A nonprofit's excess profits therefore remain within the firm and are not distributed to management or owners. This "nondistribution constraint," as Hansmann characterized it, provides the essential feature of the nonprofit corporate form.[42]

Because private individuals are barred from withdrawing the nonprofit's net earnings, nonprofits offer a commitment to trust and quality, pledging to refrain from taking advantage of those who interact with the firm.[43] This commitment derives from the theoretical assumption that firms are run in the interests of their owners: those who hold the right to appoint management and the right to the firm's residual earnings.[44] If management does not do what owners desire, owners will appoint different managers who will. We can therefore expect that whoever owns the firm will make a fundamental difference in how that firm is run, which drives the essential difference between nonprofits and traditional corporations.

In a traditional for-profit firm, owners may have some heterogeneous interests, but they are generally united in their desire to maximize the financial value of the firm.[45] Traditional for-profit firms, therefore, have the incentive to wring every dollar possible out of those who interact with the firm, as doing so increases the value of the firm, the satisfaction of its owners, and the chance that management will retain its employment.

There are, of course, some constraints on this behavior by for-profit firms, but these constraints are incomplete. Nonowners can bargain for particularized protections by contract, but contracts will necessarily be incompletely written and enforced, incapable of perfectly addressing every possible contingency that might arise in the future.[46] Regulation or the desire to protect a firm-specific reputation for quality will fill some of the remaining gaps, but it will lessen, not

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[41] *See, e.g.*, REVISED MODEL NONPROFIT CORP. ACT §§ 13.01–.02 (AM. BAR ASS'N 1987) (prohibiting most distributions).

[42] Hansmann, *supra* note 26, at 838; *see also* Brian Galle, *Social Enterprise: Who Needs It?*, 54 B.C. L. REV. 2025, 2027–31 (2013) (detailing a number of features of the nonprofit firm).

[43] Hansmann, *supra* note 26, at 843–45.

[44] HANSMANN, *supra* note 38, at 21.

[45] *Id.* This is, of course, a simplification; shareholders can differ along many important dimensions, such as time horizons, or the desire to even *reduce* (rather than increase) the financial value of firms. *See* Barbara A. Bliss, Peter Molk & Frank Partnoy, *Negative Activism*, 97 WASH. U. L. REV. 1333, 1344–68 (2020) (studying the phenomenon of activists that seek to reduce company values); Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 805–12 (2012) (arguing that corporations should nevertheless invest for the long term).

[46] Hansmann, *supra* note 26, at 845, 849–63 (addressing several areas of contract failure that are served by nonprofits).

eliminate, the problem, again due to the inability to provide complete deterrence.[47]

Nonprofits step in to engender trust by nonowners because of their defining feature: their lack of a group entitled to the firm's residual earnings, and therefore the lack of an incentive for management to maximize the dollars extracted from those with whom the firm interacts.[48] In circumstances where contract, regulation, and reputation do not dictate the firm's behavior, then, we will expect nonprofits, on average, to provide a higher quality product or service than a traditional firm, because the nonprofit management's goal is not dictated by maximizing the firm's profits. Instead, management is freed to pursue other goals, such as the organization's mission, social good, or public purpose.[49] Nonprofits will therefore achieve particular success in "trust" industries, where those who interact with the firm must trust the firm to treat them fairly.[50] Consequently, entrepreneurs will organize firms more often as nonprofits in these industries,[51] and nonprofits will persist in these industries over the long term because of their competitive advantage derived from their nondistribution constraint.[52]

An example reinforces the point. Consider hospitals, an industry that features a variety of ownership types.[53] When the hospital is investor-owned, it has the incentive to maximize profits, focusing on profitable services,[54] cutting costs,[55] and inflating patient diagnostic codes for maximum reimbursement.[56] Physician-owned cooperative hospitals, while retaining investor-owned firms' incentive to maximize profits, have the motivation to do so in a way that takes

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[47] *See, e.g.*, Scott Baker & Albert H. Choi, *Reputation and Litigation: Why Costly Legal Sanctions Can Work Better Than Reputational Sanctions*, 47 J. LEGAL STUD. 45, 50 (2018); Peter Molk, *The Ownership of Health Insurers*, 2016 U. ILL. L. REV. 873, 881.

[48] Hansmann, *supra* note 26, at 859.

[49] *See, e.g.*, John Armour et al., *Agency Problems and Legal Strategies*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 35, 43 n.30 (2d ed. 2009).

[50] Hansmann, *supra* note 26, at 845–68.

[51] Edward L. Glaeser & Andrei Shleifer, *Not-for-Profit Entrepreneurs*, 81 J. PUB. ECON. 99, 102 (2001) (modeling the nonprofit formation decision by profit-maximizing entrepreneurs).

[52] HANSMANN, *supra* note 38, at 22–23.

[53] The hospital industry is by no means the only market with multiple coexisting ownership forms. For in-depth treatment of ownership issues in the health insurance market, for example, see Molk, *supra* note 47, at 889.

[54] Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 YALE J. ON REG. 139, 157 (2007).

[55] David M. Cutler & Jill R. Horwitz, *Converting Hospitals from Not-for-Profit to For-Profit Status: Why and What Effects?*, *in* THE CHANGING HOSPITAL INDUSTRY: COMPARING NOT-FOR-PROFIT AND FOR-PROFIT INSTITUTIONS 45, 46–47 (David M. Cutler ed., 2000); Yu-Chu Shen, *Changes in Hospital Performance After Ownership Conversions*, 40 INQUIRY 217, 219 (2003).

[56] Elaine Silverman & Jonathan Skinner, *Are For-Profit Hospitals Really Different? Medicare Upcoding and Market Structure* 4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 8133, 2001), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=260546 [https://perma.cc/32PH-A9N5].

doctor-owners' interests into account, focusing on doctor-friendly design and quality services.[57] Government-owned facilities lose the profit incentive of investor- or physician-owned hospitals, and in exchange adopt a government-imposed purpose, which more often is to provide specialized care for veterans or to serve as a medical provider of last resort to the poor.[58]

Notice, however, that none of these organizations have much incentive to protect the interests of patients or the broader public beyond the minimum baseline needed to carry out a successful enterprise. Enter the nonprofit hospital. The nonprofit, with nobody entitled to accumulated earnings, and sometimes with no group entitled to appoint management, has no owners in the traditional sense. The nonprofit, therefore, does not have the incentive to prioritize one group over another. We would therefore expect the nonprofit to be the organization that strikes the delicate balance that considers all stakeholder interests, not simply those of investor-owners or policyholder-owners.[59] The nonprofit, for example, might be the firm we most expect to maximize the quality of medical services for its customers, doing so in a way that also incorporates the interests of physicians, employees, the general public, and the full variety of stakeholders.[60]

As the example shows, nonprofits' nondistribution constraint and concomitant lack of owners provide a measure of protection for nonowners and define the role of nonprofit enterprise. We next turn to a consideration of relevant provisions from state and federal law that help define this essential role and the associated implications for nonprofit governance.

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[57] Maya A. Babu et al., *Physician-Owned Hospitals, Neurosurgeons, and Disclosure: Lessons from Law and the Literature*, 68 NEUROSURGERY 1724, 1725 (2011); Lawrence P. Casalino et al., *Focused Factories? Physician-Owned Specialty Facilities*, 22 HEALTH AFFS. 56, 56 (2003); Jeffrey Stensland & Ariel Winter, *Do Physician-Owned Cardiac Hospitals Increase Utilization?*, 25 HEALTH AFFS. 119, 127 (2006). Physician-owned facilities are a particular example of worker ownership, whose ownership structure is generally responsive to worker interests. For more on worker ownership, see Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 918 (2014).

[58] Horwitz, *supra* note 54, at 158. The more that nonprofits compete with for-profits in healthcare, however, the more that nonprofits pursue a product differentiation strategy. *See* Jihwan Moon & Steven M. Shugan, *Nonprofit Versus For-Profit Health Care Competition: How Service Mix Makes Nonprofit Hospitals More Profitable*, 57 J. MKTG. RSCH. 193, 206 (2020).

[59] Molk, *supra* note 57, at 951.

[60] *See generally* Horwitz, *supra* note 54, at 171–75 (analyzing the profitability of services provided by various types of hospitals); Joseph P. Newhouse, *Toward a Theory of Nonprofit Institutions: An Economic Model of a Hospital*, 60 AM. ECON. REV. 64 (1970) (describing the economic efficiency of nonprofit hospitals). *But see* Tomas J. Philipson & Richard A. Posner, *Antitrust in the Not-for-Profit Sector*, 52 J.L. & ECON. 1, 1 (2009) (suggesting that nonprofits still may have motives to reduce consumer welfare); Caitlin M. Durand, Note, *Who Blesses This Merger? Antitrust's Role in Maintaining Access to Reproductive Health Care in the Wake of Catholic Hospital Mergers*, 61 B.C. L. REV. 2595, 2637 (2020) (arguing that Catholic hospitals, many of which are nonprofits, reduce consumer welfare by eliminating access to reproductive health care services).

B. State Law

Although it is true that many nonprofits file for preferential tax treatment under § 501(c) of the Internal Revenue Code, and that the potential for preferential tax treatment undoubtedly can be a strong inducement to organize as a nonprofit, nonprofits can and do exist with no corresponding § 501(c) status.[61] We therefore look first to the state organizational law of nonprofits, as all nonprofits need to incorporate, before turning to the additional federal tax rules that apply to the (sizable) subset of tax-preferenced nonprofits.

The differentiating feature of nonprofit organizations, as a doctrinal matter, is their prohibition on distributing net profits to individuals. This prohibition is supplied by state law. States are remarkably harmonious in their requirement that organizations formed under nonprofit corporation statutes are prohibited from "mak[ing] any distributions," as enunciated in the Revised Model Nonprofit Corporation Act.[62]

The nondistribution constraint is where nonprofit state statutes break most dramatically from the state law of other organizational forms. The rest of state nonprofit corporation law largely mirrors the law of general corporations.[63] For example, just like traditional corporations, nonprofits can usually be formed for "any lawful activity,"[64] have perpetual duration,[65] and their management is subject to familiar corporate law fiduciary duties of loyalty, care, and good faith.[66] And, just as with traditional corporations, much of the rest of state nonprofit corporate law supplies default provisions, which the nonprofit is free to alter as it sees fit.

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[61] *See* SALAMON, *supra* note 39, at 15 (estimating that 25% of nonprofits do not seek a federal tax exemption).

[62] *See* REVISED MODEL NONPROFIT CORP. ACT §§ 13.01–.02 (AM. BAR ASS'N 1987) (providing limited exceptions for restricted repurchase of memberships and for restricted distributions upon dissolution); *see also* ARIZ. REV. STAT. ANN. § 10-11301 (2020) (adopting the Model Act's approach); OHIO REV. CODE ANN. § 1702.01(C) (West 2020) (stating that nonprofit earnings are "not distributable to[] its members, directors, officers, or other private persons, except [for] the payment of reasonable compensation for services rendered"); WASH. REV. CODE § 24.03.005(16) (2020) (defining nonprofits as "a corporation no part of the income of which is distributable to its members, directors or officers").

[63] *See, e.g.*, Hansmann, *supra* note 26, at 840.

[64] REVISED MODEL NONPROFIT CORP. ACT § 3.01; *see also* CONN. GEN. STAT. § 33-1035 (2020). Some state laws are more restrictive on this point. *See, e.g.*, 805 ILL. COMP. STAT. 105/103.05 (2020) (authorizing nonprofit corporations in thirty-five categories); MASS. GEN. LAWS ch. 180, § 4 (2020) (providing a list of fourteen purposes for which nonprofit corporations may be formed). This approach was common historically. Note, *Permissible Purposes for Nonprofit Corporations*, 51 COLUM. L. REV. 889, 890 (1951).

[65] REVISED MODEL NONPROFIT CORP. ACT § 3.02; *see also* OR. REV. STAT. § 65.077 (2020).

[66] REVISED MODEL NONPROFIT CORP. ACT § 8.30; *see also* FLA. STAT. § 617.0830 (2020).

There are three additional notable areas, however, in which nonprofit law breaks from traditional corporate law that are relevant for our analysis. The first is an absence of a requirement for election of managers by shareholders. For traditional corporations, shareholders' election of directors is one of the few mandatory protections to which shareholders are entitled.[67] Nonprofits, however, have no traditional owners, and by extension no shareholders. Instead, a nonprofit may specify that its management either is elected by the nonprofit's membership base, or appointed by the nonprofit's directors, or designated in whatever other manner the nonprofit's charter or bylaws provide.[68]

Another difference concerns external oversight of the nonprofit's operations. Nonprofits, particularly those that are organized to provide a public benefit, are answerable to state attorneys general. Attorneys general have concurrent oversight over matters ranging from voluntary[69] or judicial[70] dissolution, to assessing whether a nonprofit's action is ultra vires,[71] to removing directors,[72] to approving conflicted transactions,[73] to approving mergers,[74] to approving a sale of all or substantially all assets.[75] For corporations, shareholders police compliance with governance restrictions; for nonprofits, the attorney general is set up to be a key filler of this role.

The final relevant difference pertains to the internal affairs doctrine. Under traditional corporate law, matters related to disputes that are internal to the corporation are decided under the law of the state in which the corporation forms.[76] Thus, issues involving disputes between the corporation and its directors, officers, and shareholders are decided under the laws of the incorporation state.[77] Scholars have theorized the internal affairs doctrine as driving a robust competition among states to attract organizational formations, because it provides states with the control needed to develop an attractive suite of business laws.[78]

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[67] DEL. CODE ANN. tit. 8, § 211(b) (2020); MODEL BUS. CORP. ACT § 8.03 (AM. BAR ASS'N 2016). *See generally* Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 510 (2017) (discussing the mandatory rules of corporations).

[68] REVISED MODEL NONPROFIT CORP. ACT § 8.04.

[69] *Id.* § 14.03.

[70] *Id.* § 14.30.

[71] *Id.* § 3.04.

[72] *Id.* § 8.10.

[73] *Id.* § 8.31.

[74] *Id.* § 11.02.

[75] *Id.* § 12.02.

[76] *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. b, g (AM. L. INST. 1971).

[77] *Id.* cmt. b, g; *see, e.g.*, Edgar v. Mite Corp., 457 U.S. 624, 645 (1982). For a fuller history of the internal affairs doctrine and its relationship to choice of jurisdiction, in addition to choice of law, see Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485, 500–04 (2016).

[78] Roberta Romano, in particular, has argued for how states' control over the development of their respective business law enables states to attract companies by committing credibly to producing re-

Despite being well-respected in the context of traditional corporations, the internal affairs doctrine receives a more mixed reception when applied to nonprofits. Some jurisdictions expressly recognize the doctrine in the nonprofit context.[79] Other jurisdictions have not ruled one way or the other. Some states, however, refuse to recognize the internal affairs doctrine, and indeed have offered interpretive guidance that expressly rejects the doctrine.[80] For instance, California's Attorney General, backed by the state's courts,[81] has claimed "oversight over foreign entities involved in the nonprofit sector in California"[82] and has noted that "[e]ven though foreign nonprofit corporations have been formed and incorporated elsewhere, they may be subject to California corporate law enforced by the Attorney General."[83] And New York imposes on foreign nonprofit corporations a set of rules regarding member derivative actions, indemnification of directors and officers, and mergers or consolidations.[84]

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sponsive organizational law in the future. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9 (1993); Roberta Romano, *The Market for Corporate Law Redux*, *in* 2 OXFORD HANDBOOK OF LAW AND ECONOMICS 358, 365 (Francesco Parisi ed., 2017) [hereinafter Romano, *Redux*]; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 276–78 (1985). For a recent empirical assessment of this theory, see Peter Molk, *Delaware's Dominance and the Future of Organizational Law*, 55 GA. L. REV 1111 (2021).

[79] *See, e.g.*, Boomer Dev., LLC v. Nat'l Ass'n of Home Builders of the U.S., 258 F. Supp. 3d 1, 23 (D.D.C. 2017); State *ex rel.* Petro v. Gold, 166 Ohio App. 3d 371, 2006-Ohio-943, 850 N.E.2d 1218, at ¶¶ 45–47.

[80] Unfortunately, we are unsure of the precise number of states that depart from the internal affairs doctrine for nonprofits. *See, e.g.*, Marion R. Fremont-Smith, *Attorney General Oversight of Charities* 11 (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 41, 2007), https://cpl.hks.harvard.edu/files/cpl/files/workingpaper_41.pdf?m=1440179611 [https://perma.cc/48V2-G4AR]; Antonia M. Grumbach, Whither Internal Affairs: State Regulation of the Internal Affairs of Foreign Not-for-Profit Corporations: An Exploratory Discussion 12–14 (Oct. 2005), https://www.law.nyu.edu/sites/default/files/npf/Grumbach%20October%202005.pdf [https://perma.cc/V2ED-YH73].

[81] *See, e.g.*, Am. Ctr. for Educ., Inc. v. Cavnar, 145 Cal. Rptr. 736, 743 (Ct. App. 1978) ("Where a charity has been organized by California residents, is located in this state and has all of its assets and most of its activity here, we believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law merely because the founders chose to incorporate elsewhere."), *superseded by statute*, CAL. PROB. CODE § 24 (West 1991).

[82] CAL. DEP'T OF JUST., ATTORNEY GENERAL'S GUIDE FOR CHARITIES 100 (2020), https://oag.ca.gov/sites/all/files/agweb/pdfs/charities/publications/guide_for_charities.pdf [https://perma.cc/9ULC-QZG9].

[83] *Id.* at 102; *see also Laws & Regulations*, CAL. OFF. OF THE ATT'Y GEN., https://www.oag.ca.gov/charities/laws [https://perma.cc/SC7L-ERTS] (click on the first FAQ) (explaining that California's nonprofit law "applies to all foreign charitable corporations . . . doing business or holding property in California for charitable purposes").

[84] N.Y. NOT-FOR-PROFIT CORP. LAW § 1320 (McKinney 2020).

C. Federal Tax Law

Although nonprofits are creatures of state law and are not required to seek preferential federal tax treatment, the majority do so.[85] An organization that avails itself of these tax advantages also subjects itself to additional federal legal rules and oversight that are relevant for our following analysis. These federal requirements are principally aimed at preserving the tax base, ensuring that tax-exempt nonprofit assets do not migrate to private individuals.[86]

Some federal requirements serve to strengthen rules that already exist under state law.[87] For instance, charitable organizations formed under § 501(c)(3) of the Internal Revenue Code are prohibited from allowing net earnings to inure to the benefit of any private individual.[88] This private inurement doctrine prevents private individuals from benefitting more than an incidental amount from an exempt nonprofit's activities,[89] reinforcing states' nondistribution constraint.[90] In addition, the IRS requires nonprofits to operate in accordance with their exempt purpose, placing limits on the extent to which the nonprofit can pursue operations beyond its organizational purposes, at the risk of losing its federal tax-exempt status.[91]

The other notable feature of federal tax law is perhaps its most visible: a requirement that nonprofits make specific information required by Form 990 or one of its derivatives available to the public.[92] All nonprofits must make public filings that scale with the organization's gross receipts; the most comprehensive disclosures, made via a Form 990, apply to organizations with annual gross receipts of at least $200,000 or total assets of at least $500,000.[93] The IRS and some state regulators use the Form 990 for monitoring purposes,

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[85] SALAMON, *supra* note 39, at 24.

[86] *See, e.g.*, Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571, 575 (1998).

[87] Although state oversight has been characterized as a broader mission to protect the public interest, nonprofits that are exempt under federal law often receive favorable state tax treatment, giving states a similar interest in preserving the tax base. Peter Molk, *Reforming Nonprofit Exemption Requirements*, 17 FORDHAM J. CORP. & FIN. L. 475, 487 (2012); Swords, *supra* note 86, at 575.

[88] I.R.C. § 501(c)(3) (West 2020).

[89] I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

[90] *See generally* Hansmann, *supra* note 26, at 874 n.107 (noting how this prohibition mimics states' nondistribution requirement).

[91] *See, e.g.*, Molk, *supra* note 87, at 489–93.

[92] *See* I.R.S. Form 990, Return of Organization Exempt from Income Tax (OMB No. 1545-0047) (2020), https://www.irs.gov/pub/irs-pdf/f990.pdf [https://perma.cc/BR39-LZ7M] [hereinafter I.R.S. Form 990].

[93] Form 990-EZ must be completed by organizations with annual gross receipts between $50,000 and $200,000 and total assets of under $500,000, and Form 990-N is to be completed by organizations with annual gross receipts under $50,000. *Form 990 Series Which Forms Do Exempt Organizations File Filing Phase In*, IRS (July 14, 2020), https://www.irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in [https://perma.cc/38RT-3H4S].

and it also serves as a way for the nonprofit to convey information about its purpose and operations to the general public in a standardized manner.[94] Various third-party organizations process this information into formats that may be more easily digestible by the public when deciding which organizations to patronize.[95]

The Form 990 currently stands at twelve pages and includes a series of questions soliciting descriptive, numerical, and yes/no answers to questions along three main dimensions: (1) information the IRS uses to apply the tax code; (2) information about the nonprofit's programs and activities; and (3) disclosures about the nonprofit's internal governance and management, including financial disclosures and information about governance practices and attributes.[96] We develop in more detail the content of these disclosures, and the areas where additional detail would be useful, in the next two Parts.

II. ASSESSING GOVERNANCE MONITORS

Now that we understand what a nonprofit organization is as a legal matter, and the role these organizations are intended to fill, in Section A of this Part we develop the central corporate law agency problem, in which a company's management pursues its own self-interest instead of the company's interest, and discuss the legal duties designed to mitigate this problem.[97] In Section B, we then arrive at the central problem of nonprofit governance that serves as the basis for the rest of this Article: the lack of parties with vested interests to police these duties. We survey traditional and non-traditional potential enforcement agents, showing their current failures under existing nonprofit incentive frameworks,[98] before turning to proposals for solutions in the next Part.[99]

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[94] *See, e.g.*, I.R.S., INSTRUCTIONS FOR FORM 990 RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX 2 (2020), https://www.irs.gov/pub/irs-pdf/i990.pdf [https://perma.cc/ZWT3-BKLQ] [hereinafter INSTRUCTIONS FOR I.R.S. FORM 990]; Swords, *supra* note 86, at 577–80.

[95] *See, e.g.*, *Our Story*, CANDID, https://candid.org/about/our-story [https://perma.cc/S6YB-TETQ] ("Every year, millions of nonprofits spend trillions of dollars around the world. We find out where that money comes from, where it goes, and why it matters."); *Overview*, CHARITY NAVIGATOR, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=628 [https://perma.cc/KA69-8VP5] ("[T]he nation's largest and most-utilized evaluator of charities.").

[96] I.R.S. Form 990, *supra* note 92; Swords, *supra* note 86, at 605.

[97] *See infra* notes 100–114 and accompanying text.

[98] Of course, this is not to suggest a blanket refusal by nonprofits to comply with the law. Theory and empirical evidence suggest that many nonprofits will comply with the law for a variety of reasons. *See, e.g.*, Brian Galle, *Why Do Foundations Follow the Law? Evidence from Adoption of the Uniform Prudent Management of Institutional Funds Act*, 36 J. POL'Y ANALYSIS & MGMT. 532, 551 (2017).

[99] *See infra* notes 115–223 and accompanying text.

A. The Agency Cost Problem

A fundamental problem for traditional corporations is the problem of agency costs.[100] The basis for agency cost theory is a misalignment of incentives between a principal and his or her agent. Within for-profits, the shareholders are typically viewed as principals with management serving as their agents. The separation of management from control gives rise to agency costs, as the interests of the shareholder principals diverge from the implementation of those desires by the agent (the firm's management).[101]

Although nonprofits have no shareholders, they do still have agency costs, due to breakdowns between what is best for the principal (here, the nonprofit firm) and its agent management. Theoretical and empirical work validate this point.[102] Indeed, the case for agency cost problems can be stronger for nonprofits because nonprofit management can have soft targets for performance that make detecting agency costs more difficult.[103]

Because of agency costs, managers may enrich themselves at the expense of the firm or shirk in their managerial efforts. Managers may invest firm resources in ways that maximize the returns of the manager, instead of those of the firm, such as by having a nicer office[104] or by undertaking an acquisition for purposes of empire building value.[105] Shirking may lead the manager to make certain errors in judgment that a manager whose incentives are better aligned with those of the firm might avoid.

Legal fiduciary duties are designed to address this problem. As we noted in the prior Part, management of for-profits and nonprofits have the same basic duties: a duty of care and a duty of loyalty. The duty of care requires management to exercise reasonable care in carrying out their management responsibilities. The duty is relatively easy to satisfy, with the board typically being re-

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[100] Claire A. Hill & Brett H. McDonnell, *The Agency Cost Paradigm: The Good, the Bad, and the Ugly*, 38 SEATTLE U. L. REV. 561, 562 (2015); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986). This is true in nonprofits. *See* Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1267 (2011).

[101] Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 232 (2008); Jensen & Meckling, *supra* note 28, at 308.

[102] John E. Core et al., *Agency Problems of Excess Endowment Holdings in Not-for-Profit Firms*, 41 J. ACCT. & ECON. 307, 309–10 (2006); Galle & Walker, *supra* note 26, at 1882; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 507 (1981).

[103] Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345, 1410–11 (2003).

[104] James S. Ang et al., *Agency Costs and Ownership Structure*, 55 J. FIN. 81, 86 (2000).

[105] Jarrad Harford et al., *The Sources of Value Destruction in Acquisitions by Entrenched Managers*, 106 J. FIN. ECON. 247, 248 (2012); Wei Shi et al., *Independent Director Death and CEO Acquisitiveness: Build an Empire or Pursue a Quiet Life?*, 38 STRATEGIC MGMT. J. 780, 780 (2017).

quired to show only basic non-reckless conduct in its decision-making.[106] Delaware law also provides for exculpation for such claims and a shield from directors' personal financial liability, if the board exercised its business judgment[107] and was informed in its decision-making.[108] Given the low bar, cases that find liability are rare under Delaware law. Nonprofit duty-of-care cases are equally rare.[109]

The duty of loyalty is designed to reduce management's incentive to pursue its self-interest at the company's expense, requiring corporate management to act in the company's interest.[110] The duty of loyalty focuses on oversight duties as well as self-dealing, such as usurping corporate opportunities and engaging in conflicted, interested transactions.[111] These duties exist in both for-profit and nonprofit organizations and operate similarly.[112] Unlike the duty of care, the duty of loyalty cannot be completely waived or exculpated, and the hurdle on management to satisfy this duty is significantly higher.[113]

In the for-profit context, these duties combine to empower corporate boards and shareholders to check meaningful amounts of poor governance, and though the check is imperfect, it is effective across a variety of circumstances.[114] Although the legal duties carry over to the nonprofit context, the effectiveness of boards, shareholders, and outside monitors in enforcing those duties does not. We examine this failure in the next Section, which assesses the suite of potential nonprofit monitors.

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[106] *See, e.g.*, MODEL BUS. CORP. ACT § 8.30(a) (AM. BAR ASS'N 2016).

[107] DEL. CODE ANN. tit. 8, § 102(b)(7) (2020).

[108] Smith v. Van Gorkom, 488 A.2d 858, 864 (Del. 1985) (en banc).

[109] *See, e.g.*, Vacco v. Diamandopoulos, 715 N.Y.S.2d 269, 271–73 (Sup. Ct. 1998).

[110] *See, e.g.*, MODEL BUS. CORP. ACT § 8.30(a).

[111] *Id.*

[112] *See, e.g.*, Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701, 713 (2008) ("State law nonprofit corporate board governance responsibilities are essentially the same as those that apply to the for-profit corporate director.").

[113] This is true for traditional corporations, but states like Delaware allow LLCs and some other relatively new organizational forms to waive fiduciary duties completely, including the duty of loyalty. Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1710–17 (2020).

[114] *See, e.g.*, Matthew D. Cain et al., *The Shifting Tides of Merger Litigation*, 71 VAND. L. REV. 603, 639 (2018); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 373, 376 (2018). Fiduciary duties are effective not only by operating on management directly, but also by empowering corporate counsel to advise management on abiding by fiduciary duties. *See, e.g.*, Richard W. Painter, *Fiduciary Principles in Legal Representation*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 263, 272 (Evan J. Criddle et al. eds., 2019).

B. Evaluating Existing Nonprofit Monitors

1. The Nonprofit Itself

The most obvious place to start is with the organization itself. Corporate directors are charged with overseeing the company, with legal duties that reinforce this obligation. Fiduciary duties of care and loyalty require directors to act with the skill of a reasonably prudent person in the circumstances, and in a manner the directors reasonably believe to be in the corporation's best interest, respectively.[115] Courts extend familiar corporate law fiduciary duties of care and loyalty to nonprofits,[116] whose board responsibilities effectively mimic those of traditional corporations.[117] We might therefore expect diligent nonprofit board members to provide one meaningful check on agency costs.

There are problems with this story, however. One potential issue comes from, in most states, the absence of a requirement that nonprofit directors be disinterested. Interested transactions—in which a director stands to profit from a nonprofit's action—are an area that is potentially ripe for abuse in the nonprofit space.[118] Several high-profile examples have made the point.[119] Adelphi University, for instance, replaced eighteen of its trustees after it was discovered that firms owned by some of those trustees earned undisclosed, significant income from business with Adelphi.[120] Two trustees of the $10 billion Bishop Estate charity were indicted for steering business to a real-estate developer in

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[115] *See, e.g.*, MODEL BUS. CORP. ACT § 8.30(a), (b).

[116] *See, e.g.*, Bittinger v. Tecumseh Prods. Co., 123 F.3d 877, 888 (6th Cir. 1997) (Ryan, J., dissenting); Rockwell v. Trs. of the Berkshire Museum, No. 1776CV00253, 2017 WL 6940932, at *10 (Mass. Super. Ct. Nov. 7, 2017), *aff'd sub. nom.* Hatt v. McGraw, 111 N.E.3d 1111 (Mass. App. Ct. 2018); Commonwealth v. New Founds., Inc., 182 A.3d 1059, 1066 (Pa. Commw. Ct. 2018); Protestant Episcopal Church v. Episcopal Church, 806 S.E.2d 82, 101 (S.C. 2017) (Hearn, J., concurring); Reedeker v. Salisbury, 952 P.2d 577, 587 (Utah Ct. App. 1998).

[117] Bishop, *supra* note 112, at 713.

[118] Hansmann, *supra* note 26, at 874–75.

[119] Additional prominent examples are collected in Deborah A. DeMott, *Self-dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 133–34 (1993). Recent examples are collected in NAT'L ASS'N OF STATE CHARITY OFFS., NATIONAL ASSOCIATION OF STATE CHARITIES OFFICIALS (NASCO) ANNUAL REPORT ON STATE ENFORCEMENT AND REGULATION: JANUARY 2019–MARCH 2020, at 7–10 (2020), https://www.nasconet.org/wp-content/uploads/2020/04/NASCO-Annual-Report-Jan-2019-March-2020-final.pdf [https://perma.cc/H8KS-224K]; Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002*, at 4 (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 20, 2003), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=451240 [https://perma.cc/SP6K-RBGM].

[120] Bruce Lambert, *New York Regents Oust 18 Trustees from Adelphi U.*, N.Y. TIMES (Feb. 11, 1997), https://www.nytimes.com/1997/02/11/nyregion/new-york-regents-oust-18-trustees-from-adelphi-u.html [https://perma.cc/BP8Z-Q3G5]. *See generally* LIONEL S. LEWIS, WHEN POWER CORRUPTS: ACADEMIC GOVERNING BOARDS IN THE SHADOW OF THE ADELPHI CASE (2000) (documenting the circumstances that led to the replacement of eighteen of Adelphi's nineteen trustees).

exchange for payments totaling $100,000.[121] Directors of the University of Medicine and Dentistry of New Jersey, formerly the largest public hospital system in the United States and now part of Rutgers University, obtained jobs for family and friends and engaged in other self-interested transactions, ultimately resulting in a deferred criminal prosecution agreement and the appointment of a federal monitor.[122] Conflicted transactions on a smaller scale are the norm; a recent survey found that twenty-one percent of nonprofits reported buying or renting goods, services, or property from a board member or affiliated company during the prior two years, with the number being even higher among larger nonprofits.[123]

In the traditional corporate space, stock exchange requirements for independent directors ensure that a majority of the board has financial independence to evaluate the company's operations critically.[124] This dispassionate assessment serves as a valuable monitoring function. Nonprofits have no stock, however, and do not list on exchanges.[125] Independence requirements must therefore come from state statutes and, according to a recent survey, only five states had such a requirement.[126]

Of course, nonprofits can employ independent directors without a statutory mandate to that effect. Nonprofit advisors recommend independent directors as a matter of best practices, and anecdotal surveys suggest many nonprofits appear to follow the recommendation.[127]

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[121] Paul M. Barrett, *At Bishop Estate, Scandal Widens as Powerhouse's Chair Is Indicted*, WALL ST. J. (Apr. 19, 1999), https://www.wsj.com/articles/SB924469946310962758 [https://perma.cc/9Z67-R9EL]; *Bishop Estate Trustee Is Indicted by Grand Jury for Alleged Kickback*, WALL ST. J. (Dec. 1, 1998), https://www.wsj.com/articles/SB912474495859562000 [https://perma.cc/JNM2-5GS5].

[122] Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83, 90–98 (2007).

[123] FRANCIE OSTROWER, URB. INST. CTR. ON NONPROFITS & PHILANTHROPY, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY 8 (2007), https://www.urban.org/research/publication/nonprofit-governance-united-states/view/full_report [https://perma.cc/8CDT-5WP6] (finding that 41% of nonprofits with ten million or more in annual expenses reported conflicted transactions within the previous two years).

[124] Boozang, *supra* note 122, at 131.

[125] *See supra* notes 67–68 and accompanying text (describing the lack of traditional shareholders within nonprofit corporations).

[126] *See* Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 FORDHAM L. REV. 609, 614 (2007) (listing five states with some measure of an independent director requirement).

[127] ABA COORDINATING COMM. ON NONPROFIT GOVERNANCE, GUIDE TO NONPROFIT CORPORATE GOVERNANCE IN THE WAKE OF SARBANES-OXLEY 2 (2005) [hereinafter ABA GUIDE]; Herrington J. Bryce, *Nonprofit Board Responsibilities: The Basics*, NONPROFIT Q. (Aug. 21, 2017), https://nonprofitquarterly.org/nonprofit-board-governance-responsibilities-basic-guide/ [https://perma.cc/W47R-C28J].

We use comprehensive nonprofit filing data to verify the point. Using nonprofit data filed in IRS Forms 990, we can examine the prevalence of independent director usage. The Form asks nonprofits to, among other things, provide the number of total voting directors as well as the number of independent directors. The Form defines a director as independent if the director: (1) is not compensated as an employee by the nonprofit or a related organization; (2) is compensated under ten thousand dollars as an independent contractor by the nonprofit or related organizations, other than reasonable compensation for directorial services; and (3), along with the director's family members, is not involved in interested transactions with the nonprofit or related organizations.[128]

We examined all 1.7 million Forms 990 (required to be filed by larger tax-exempt nonprofits) filed from 2010 through 2018 by nonprofits reporting at least one voting director to determine systematically the extent of nonprofit director independence in practice.[129] The results are summarized in Table 1. As we can see, despite lacking a statutory mandate, nonprofits show a remarkable, stable appetite for independent directors. A full 71% of nonprofits have, under the Form 990 definition of independence, a completely independent board, and 90% of nonprofits have at least one independent director. In theory, then, nonprofit boards should be in an admirable position to reduce agency costs due to self-interested behavior by a subset of directors.

Table 1
Degree of Board Independence

	at least one member	at least 25%	at least 51%	at least 75%	fully independent
2018	90%	89%	87%	84%	72%
2017	90%	89%	87%	84%	72%
2016	90%	89%	87%	84%	72%
2015	90%	89%	87%	84%	71%
2014	90%	89%	87%	83%	71%
2013	90%	89%	87%	83%	71%
2012	89%	89%	87%	83%	70%
2011	88%	87%	85%	82%	70%
2010	89%	88%	86%	82%	68%
Overall	90%	89%	87%	83%	71%

We also can examine the prevalence of conflict-of-interest policies, which help formally address duty of loyalty issues, among nonprofits. Form 990 re-

[128] INSTRUCTIONS FOR I.R.S. FORM 990, *supra* note 94, at 20.

[129] The IRS makes Forms 990 available electronically at https://registry.opendata.aws/irs990/ [https://perma.cc/TGG2-DRMM]. Much of the data has been helpfully extracted and aggregated by Professor Jesse Lecy, who has made the data available to interested researchers. *Projects*, JESSE D. LECY, http://www.lecy.info/projects [https://perma.cc/2JKN-JSWG].

quires nonprofits to disclose whether they have a written conflict of interest policy, and if so, whether management was required to disclose interests that could give rise to conflicts and whether the nonprofit monitored and enforced compliance with its conflict-of-interest policy.[130] We summarize the prevalence of these policies in Table 2.

Table 2
Board Conflict of Interest Policies

	All nonprofits			Nonprofits with only minority of board independent		
	has a conflict policy	conflicts must be disclosed	conflict policy policed	has a conflict policy	conflicts must be disclosed	conflict policy policed
2018	62%	57%	54%	39%	34%	31%
2017	63%	58%	55%	40%	35%	32%
2016	63%	58%	55%	40%	35%	32%
2015	63%	58%	54%	40%	35%	32%
2014	63%	57%	54%	40%	35%	32%
2013	63%	57%	54%	40%	35%	32%
2012	64%	57%	54%	40%	35%	32%
2011	59%	53%	49%	36%	30%	27%
2010	64%	58%	55%	42%	36%	33%
Overall	63%	57%	54%	40%	35%	32%

Unfortunately, it appears that nonprofits' appetite for formal conflict of interest policies is considerably lower than their appetite for independent directors. Although 90% of nonprofits have a majority disinterested board, 63% of nonprofits have a conflict-of-interest policy, 57% require disclosure of conflicts, and only 54% actually monitor and enforce their policies.

The picture is grimmer among nonprofits with a minority independent board, which are the nonprofits about which we might be most worried. Among these organizations, only 40% have a written conflict of interest policy, 35% require conflicts to be disclosed, and 32% actually monitor and enforce their conflict policies.

Therefore, although nonprofit boards report admirable levels of independence, for many nonprofits those board members are under no obligation to disclose conflicts, the nonprofit itself has no disclosure policy, or the nonprofit publicly reports failing to police its own policy.[131] Even for nonprofits with a

[130] I.R.S. Form 990, *supra* note 92, at 6, pt. VI, items 12a–c.

[131] Principles of corporate law nevertheless will provide some support in these instances, because safe harbors for conflicted transactions will apply only if a majority of independent directors, measured with respect to a particular transaction, approve the transaction. Andrew F. Tuch, *Reassessing Self-dealing: Between No Conflict and Fairness*, 88 FORDHAM L. REV. 939, 951 (2019). Assuming the transaction is challenged—an assumption we confront shortly—a court's scrutiny into whether a conflicted transaction was nevertheless approved by disinterested directors, or was entirely fair, supplies a valuable safeguard against breaches of the duty of loyalty by the board.

majority of independent board members, then, there is reason to question the board's capability to manage agency costs.

Yet a significant portion of nonprofits not only have independent boards, but also report having conflict of interest policies that are enforced by the organization. Can these nonprofit boards be trusted? Not necessarily. Independence is but one desirable attribute for a responsible steward; directors must also have good business sense and an understanding of their monitoring role to be trusted with overseeing an organization. Unfortunately, this is an area of clear difference between directors of traditional and nonprofit corporations.[132] Doubtless, many nonprofits have directors with the necessary business knowledge to detect managerial self-interest issues, and traditional corporations do not have an unblemished track record.[133] For many other nonprofits, however, a key attribute of a successful director is not their business acumen, but rather their willingness to donate to the organization or their ability to line up other successful donors.[134] Other nonprofits hire directors because of the directors' close ties to the nonprofit's mission, as with a private family foundation whose directors must be comprised of family members.[135]

Undoubtedly, many directors serve in their capacity because of a strong identity with the nonprofit's mission. This enthusiasm can provide a powerful and desirable non-pecuniary motivator for the director to expend effort beyond what we might expect from their analogous for-profit counterparts.[136] Yet enthusiasm for the nonprofit's mission provides little help if the director lacks the basic knowledge to identify and correct governance failures.

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[132] *See, e.g.*, James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 675 (1985) ("In contrast to directors of business corporations, nonprofit board members may have few other institutional, board, corporate, or legal experiences. Often they have little sense of what is expected from them as a director." (footnote omitted)).

[133] The directors of Theranos provide a recent compelling example of oversight failure. For analysis, see Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 356 (2020); Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 689–91 (2020).

[134] *See* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 481–82 (1996) (noting "the pervasively poor attorney general enforcement" that "has generally not improved"); Fishman, *supra* note 132, at 674 ("Board members of nonprofits are sought for many reasons, including deep pockets, prestige within the community, contacts with prominent individuals or sources of funding, and general interest in the organization."); Elizabeth K. Keating & Peter Frumkin, *Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation*, 63 PUB. ADMIN. REV. 3, 9 (2003) ("[T]he board has opportunities to monitor performance. This oversight is effective in some cases, while in others, the board meets infrequently, is poorly informed, or lacks the necessary skills."); *see also* ABA GUIDE, *supra* note 127, at 22 (listing "financial expert, key donor, [and] fundraiser" as potential board member "chief attributes"); OSTROWER, *supra* note 123, at 17 ("[N]onprofits use large boards as a fundraising tool . . . .").

[135] ABA GUIDE, *supra* note 127, at 22.

[136] Indeed, many nonprofit directors receive no financial compensation for their duties.

Moreover, other characteristics that make for-profit boards effective monitors also fail to carry over to the nonprofit context. A key component of the duty of loyalty applicable to corporate boards is the duty of oversight. Enshrined in *In re Caremark International Inc. Derivative Litigation*, the oversight duty requires members of the board of directors to assure:

> [T]hat information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[137]

The Delaware Supreme Court clarified this duty in *Stone v. Ritter*, in which, quoting *Caremark*, it emphasized that:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[138]

Though three recent cases challenging the oversight duty raised eyebrows by making it past a motion to dismiss,[139] no case has fundamentally altered this oversight duty.

In addition, in traditional firms, better monitoring includes an understanding by the board of the key risks that may impact a company. Oftentimes, such risk analysis is undertaken through a risk assessment committee of the board.[140] Increasingly, boards are concerned with compliance across a range of issues. For-profit boards have made compliance more central in recent years due to anti-bribery, audit, and data-protection-related risks.[141] In doing so, boards provide oversight to ensure that their firms have implemented a credible compliance program to both identify and manage risks. The compliance

[137] 698 A.2d 959, 970 (Del. Ch. 1996).

[138] 911 A.2d 362, 369 (Del. 2006) (en banc) (quoting *Caremark*, 698 A.2d at 971).

[139] Marchand v. Barnhill, 212 A.3d 805, 808 (Del. 2019) (en banc); Hughes v. Hu, C.A. No. 2019-0112, 2020 WL 1987029, at *4 (Del. Ch. Apr. 27, 2020); *In re* Clovis Oncology, Inc. Derivative Litig., C.A. No. 2017-0222, 2019 WL 4850188, at *23 (Del. Ch. Oct. 1, 2019).

[140] Some organizational form issues, such as the keeping of minutes or board records, are not required of nonprofits in certain states.

[141] *See* Ravi Venkatesan & Leslie Benton, *How Companies Can Take a Stand Against Bribery*, HARV. BUS. REV. (Sept. 17, 2018), https://hbr.org/2018/09/how-companies-can-take-a-stand-against-bribery [https://perma.cc/BBH7-YENL].

function also includes creating appropriate compliance reporting systems and controls, and testing these controls to ensure that they function properly.[142] Recent guidance from the Department of Justice on the "Evaluation of Corporate Compliance Programs,"[143] the International Organization for Standardization (ISO) standards for compliance management systems through ISO 37301,[144] and the U.S. Sentencing Guidelines,[145] incentivize boards of traditional corporations to take their monitoring duties seriously. Although the same legal duties extend to nonprofits as well,[146] as evidenced by the United Way example that opened this Article, the duty often goes unpoliced by the firm.[147]

Publicly traded for-profit companies have even greater systems in place, such as periodic and yearly disclosure requirements that produce a snapshot of the firm and the risk that it faces. As part of good governance, boards of directors assess the veracity and adequacy of the company's disclosures. Further, section 302 of the Sarbanes-Oxley Act contains a CEO and CFO certification requirement to certify that disclosures are accurate and complete.[148] A yearly audit provides an accounting mechanism to review the financial health of a firm to ensure that the stated performance of the firm matches up to its actual performance based on the internal numbers generated by management.[149] Although auditors have not always been infallible gatekeepers for corporate governance,[150] they can be effective.[151]

Audit committees among publicly traded companies play a particularly important role in this regard by ensuring that any deficiencies in financial and

142 *See* Michael Ramos, *Evaluate the Control Environment*, J. ACCT. (May 1, 2004), https://www.journalofaccountancy.com/issues/2004/may/evaluatethecontrolenvironment.html [https://perma.cc/AL7K-EGT6].

143 FRAUD SECTION, CRIMINAL DIV., U.S. DEP'T OF JUST., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS (2020), https://www.justice.gov/criminal-fraud/page/file/937501/download [https://perma.cc/T8BP-MQVH]. The policy was most recently updated in June 2020.

144 TECH. COMM. 309, INT'L ORG. FOR STANDARDIZATION, ISO 37301: COMPLIANCE MANAGEMENT SYSTEMS—REQUIREMENTS WITH GUIDANCE FOR USE (2021), https://www.iso.org/standard/75080.html [https://perma.cc/JV6A-TD7X].

145 U.S. SENT'G GUIDELINES MANUAL § 8B2.1(a) (U.S. SENT'G COMM'N 2018).

146 *See supra* note 112 and accompanying text.

147 Amanda Rowe Tillotson & John Tropman, *Early Responders, Late Responders, and Nonresponders: The Principal-Agent Problem in Board Oversight of Nonprofit CEOs*, 38 HUM. SERV. ORGS. 374, 382 (2014).

148 Sarbanes-Oxley Act of 2002 § 302(a), 15 U.S.C. § 7241(a).

149 *See All About Auditors: What Investors Need to Know*, U.S. SEC. & EXCH. COMM'N (June 24, 2002), https://www.sec.gov/reportspubs/investor-publications/investorpubsaboutauditorshtm.html [https://perma.cc/963N-EV2L].

150 Bryan K. Church & Lori B. Shefchik, *PCAOB Inspections and Large Accounting Firms*, 26 ACCT. HORIZONS 43, 45 (2012).

151 Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1592 (2010).

audit matters are promptly addressed to the entire board and to regulators.[152] The audit committee also analyzes the information given to it by its outside auditors. The SEC requires that all members of the audit committee be independent and not receive consulting or advisory fees (beyond director compensation) from the company or its subsidiaries.[153] But, as noted before, nonprofits are not publicly traded and are not subject to these requirements.

2. The State Attorneys General

If the nonprofit itself does not provide an adequate mitigator of agency costs, perhaps an external entity, like state attorneys general, might. State attorneys general are tasked under state organizational law with oversight of the nonprofits that do business in their state, with the goal of making sure those nonprofits are serving the missions for which they were established.[154] Robust monitoring by these state attorneys general could spell the answer to nonprofit governance issues.

In practice, however, state attorneys general have proven poor at this component of their jobs. Some of the explanation lies in the meager resources that state attorneys general devote to nonprofit oversight. Most attorney general offices have no meaningful staff devoted to overseeing nonprofits. Recent studies report that over half the states have attorney general offices with only three or fewer full-time equivalent staff overseeing all the nonprofits in their state; a third of states have fewer than one.[155] Three-quarters of states have one or fewer full-time equivalent attorneys dedicated to nonprofit oversight.[156] Even if staffed, attorneys general offices often lack the kind of information about nonprofit operations that would facilitate monitoring of nonprofit management; only eight states require nonprofits to register and file financial reports with attorneys general offices,[157] and many states have no registration

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[152] *Audit Committee Role & Responsibilities*, CFA INST., https://www.cfainstitute.org/en/advocacy/issues/audit-committee-role-practices#:~:text=The%20primary%20purpose%20of%20a,compliance%20with%20laws%20and%20regulations [https://perma.cc/G2LL-4K3K].

[153] *See* Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1(m) (identifying the rules for audit committees).

[154] *See supra* notes 69–75 and accompanying text.

[155] CINDY M. LOTT ET AL., URB. INST., STATE REGULATION AND ENFORCEMENT IN THE CHARITABLE SECTOR 1, 8 (2016), https://www.urban.org/sites/default/files/publication/84161/2000925-State-Regulation-and-Enforcement-in-the-Charitable-Sector.pdf [https://perma.cc/Y4HG-J7J3].

[156] Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128 (2007).

[157] Fremont-Smith, *supra* note 126, at 628.

requirements at all.[158] The consensus, therefore, has long been that state attorneys general in practice serve as poor monitors.[159]

This protracted failure has seemingly surprised commentators. Yet, we think that it may not be surprising to see few resources devoted to oversight by state attorneys general. Oversight reflects a classic commons problem. Each attorney general in every state in which a nonprofit does meaningful business generally has the authority to police that nonprofit's behavior.[160] Attorneys general, however, are typically tasked with protecting the public interest of only those citizens within their state.[161] The rational attorney general, there-

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[158] NAT'L ASS'N OF STATE CHARITIES OFFS. (NASCO), STATE CHARITY REGISTRATION PROVISIONS—AS OF MAY 15, 2020 (2020), https://www.nasconet.org/wp-content/uploads/2020/05/NASCO-State-Charities-Registration-Survey-5.15.20-.pdf [https://perma.cc/V7D4-9C2J] (listing eight states without any registration requirements).

[159] *See* Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 39 (1993) ("[T]he effectiveness of attorney general enforcement is likely to be sporadic, at best."); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 262 (2003) ("Staffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent."); Brian Galle, *Design and Implementation of a Charitable Regulation Regime*, *in* RESEARCH HANDBOOK ON NOT-FOR-PROFIT LAW 530, 545 (Matthew Harding ed., 2018) ("Due to resource constraints and political disinterest, enforcement by state or federal officials is typically modest given the size of the sector."); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 622 (1999) ("While the powers of the attorney general are substantial, the extent of the supervision the attorney general provides is limited." (footnote omitted)); Hansmann, *supra* note 102, at 601 ("Commonly, little or no staff in the attorney general's office is assigned to look after the affairs of nonprofits . . . ."); Klick & Sitkoff, *supra* note 26, at 817 ("[I]t is widely believed that the supervision of charitable trusts by the state attorneys general is inadequate."); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 251 ("[T]o the extent the public must rely on attorneys general to regulate nonprofits, regulation 'is likely to be sporadic, at best.'" (quoting Blasko et al., *supra* note 159, at 39)); Dana Brakman Reiser, *Regulating Social Enterprise*, 14 U.C. DAVIS BUS. L.J. 231, 244 (2013) (noting an absence of state attorney general monitoring because of resource constraints, despite the potential value of monitoring); Swords, *supra* note 86, at 578 ("[I]t is clear that neither the [IRS] nor any state charities office have sufficient staff to adequately review these [Form 990] filings.").

[160] *See, e.g.*, *supra* notes 82–84 and accompanying text; *see also* N.Y. NOT-FOR-PROFIT CORP. LAW § 1303 (McKinney 2020) (providing the attorney general with the power to bring an action against out-of-state corporations that do business within the state); BECERRA, *supra* note 82, at 100 ("The Attorney General has oversight over foreign entities involved in the nonprofit sector in California."); *State Filing Requirements for Nonprofits*, NAT'L COUNCIL OF NONPROFITS, https://www.councilofnonprofits.org/tools-resources/state-filing-requirements-nonprofits [https://perma.cc/9KVH-CE34].

[161] *See, e.g.*, RESTATEMENT OF THE LAW, CHARITABLE NONPROFIT ORGANIZATIONS § 5.01 (AM. L. INST. Tentative Draft No. 2, 2017) ("The state attorney general: (a) has the authority to protect charitable assets and interests within the jurisdiction of the state and to seek judicial relief to protect the public interest in those assets and interests . . . ."); *Charities*, N.M. OFF. OF THE ATT'Y GEN., https://www.nmag.gov/charities.aspx [https://perma.cc/AW5M-5WAU] ("The Office of the Attorney General has the duty to protect the interests of all beneficiaries of charities within its jurisdiction."). This requirement is reinforced by the practical issues of attorneys general overwhelmingly being subject to election by voters within their state. *See Attorneys General*, NAT'L ASS'N OF ATT'YS GEN., https://www.naag.org/attorneys-general [https://perma.cc/87FR-AT5B] (noting that the attorney gen-

fore, cares about a nonprofit's indiscretions only to the extent those indiscretions affect citizens within her state. This gives the attorney general an incomplete incentive to police any of the larger nonprofits whose activities extend outside her state's borders. The benefits from costly monitoring will accrue partially to citizens to whom she is not answerable, while the costs are borne entirely by her office. For nonprofits of any meaningful size whose fundraising or operations cross state borders, then, the attorney general will rationally devote comparatively less effort to oversight than the problem deserves.[162]

Consequently, commentators have found that the comparatively rare situations in which attorneys general act either drastically under-reflect the overall problem of nonprofit mismanagement,[163] or else are motivated by political payoffs among local constituents.[164] The Pennsylvania Attorney General's intervention in the Milton Hershey School Trust's (Trust) attempted divestment of its Hershey Company stake is illustrative of this latter phenomenon. The Trust, with its $17 billion endowment, funds the Milton Hershey School, a cost-free school for children from lower-income families.[165] In 2002, the Trust announced a plan to divest its controlling stake in the Hershey company to diversify its holdings, prompting an abnormal increase in the value of Hershey

eral is elected in forty-three states). To the extent the attorney general has political ambitions involving other elected offices, the focus on domestic citizens is reinforced. Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 946 (2004) ("Political cynics believe that 'A.G.' stands not for 'attorney general' but for 'aspiring governor.'").

[162] This is, of course, a problem for various enforcement efforts brought by attorneys general outside the nonprofit space as well, which can be alleviated by coordination among attorneys general across states—a solution we raise later. *See, e.g.*, Jim Estes, Opinion, *How the Big Tobacco Deal Went Bad*, N.Y. TIMES (Oct. 6, 2014), https://www.nytimes.com/2014/10/07/opinion/how-the-big-tobacco-deal-went-bad.html [https://perma.cc/JBY9-SSEM]. Yet these coordination efforts are often unsuccessful. *See, e.g.*, Swords, *supra* note 86, at 577–78 & n.19 (describing efforts to coordinate nonprofit registration requirements, which have endured since at least 1993); Jennifer Chandler, *Multi-state Registration = Multiple States of Confusion*, NAT'L COUNCIL OF NONPROFITS (Apr. 11, 2018), https://www.councilofnonprofits.org/thought-leadership/multi-state-registration-multiple-states-of-confusion [https://perma.cc/F2MG-XR5S] (describing continuing efforts to achieve coordination, apparently still without success).

[163] *See, e.g.*, Gary, *supra* note 159, at 623 ("The worst abuses receive attention, but many problems probably go undetected or unaddressed."); Jenkins, *supra* note 156, at 1131.

[164] *See* Brody, *supra* note 161, at 947–48 ("The incentives of this nearly universally elective office impel the incumbent to ignore cases that are politically dangerous and to jump into matters that are politically irresistible but implicate only 'business' decisions of charity managers." (footnote omitted)); Klick & Sitkoff, *supra* note 26, at 817 ("[T]he underlying structural problem [is] that the attorney general is typically a political officer whose ambition toward higher office provides either little incentive to supervise charitable trusts or . . . perverse incentives to impose local political preferences.").

[165] *About Milton Hershey School*, MILTON HERSHEY SCH., https://www.mhskids.org/about/ [https://perma.cc/6HYZ-NZM4]; *see* Milton Hershey Sch. & Sch. Tr. Form 990, Return of Organization Exempt from Income Tax 1 (2018) (showing $17.4 billion in net assets at end of fiscal period).

stock of twenty-five percent.[166] The Pennsylvania Attorney General, who was running for governor at the time, intervened and obtained a preliminary injunction of the sale, on the grounds that the sale would harm the local Pennsylvania economy and community.[167] The Trust abandoned the sale soon after, and the stock price of Hershey tumbled twelve percent.[168] A study by Jonathan Klick and Robert Sitkoff estimated the Attorney General's actions sacrificed $2.7 billion in Hershey shareholder wealth, $850 million in foregone assets to the Trust, and forced the Trust to maintain an undesirably undiversified investment position[169]—country-wide costs that exceeded any plausible measure of benefits to the local Pennsylvania economy.[170] But because the attorney general's job is to protect the local state constituency's interest, the rational action is to focus on the local costs while ignoring any effects that spill over into other states, making the Pennsylvania Attorney General's actions not surprising given this more myopic cost-benefit analysis. In their current manifestation, then, state attorneys general provide a poor deterrent to nonprofit agency costs.

3. The IRS

If not the state attorneys general, then perhaps the other public agency charged with nonprofit oversight—the IRS—can provide the desired monitoring. Two comparative advantages are immediately apparent. First, the IRS directly receives useful disclosures about larger exempt nonprofit operations through the yearly Forms 990 that nonprofits must file.[171] Many state attorneys general, on the other hand, receive no disclosures at all,[172] and Forms 990 are not made available to the public until twelve to eighteen months after they are filed.[173] Second, the IRS, as a federal agency with nationwide interests, should internalize the effects of a nonprofit's activities that spread beyond state lines. Unlike state attorneys general whose interests are confined within state bor-

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[166] Klick & Sitkoff, *supra* note 26, at 755.

[167] *Id.* at 755–56.

[168] *Id.* at 756.

[169] *Id.* at 756–59.

[170] The Attorney General also lost his election campaign. Emily Sanders, *Fisher Concedes to Rendell After Receiving 45 Percent of the Vote*, DAILY PENNSYLVANIAN (Nov. 6, 2002), https://www.thedp.com/article/2002/11/fisher_concedes_to_rendell_after_receiving_45_percent_of_the_vote [https://perma.cc/52A3-D5TT].

[171] *See supra* note 92 and accompanying text.

[172] MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 315–17, app. at 476 tbl.1 (2004) (listing disclosure requirements by state).

[173] *How Long Does It Take for Forms 990 to Appear on Candid's Website?*, CANDID, https://learning.candid.org/resources/knowledge-base/lag-time/ [https://perma.cc/PKR7-AUBF].

ders, the IRS will have a stronger incentive to monitor nonprofits with widespread activities.[174]

Nevertheless, there are both theoretical and practical concerns with relying on the IRS as a monitor. Theoretically, although the state attorneys general are charged with protecting the general public interest, the IRS's interest is narrower, focusing only on ensuring that assets with preferential tax treatment are not funneled into private, non-preferenced uses.[175] The sizable number of nonprofits without a tax exemption or preferential tax treatment therefore escape IRS oversight.[176] So too do general governance issues that do not raise issues about misappropriation of funds, such as allegations of general managerial incompetence or a failure to pursue one's charitable mission with sufficient diligence.[177]

Practically, observers have noted chronic understaffing at the IRS relative to the scope of its responsibilities.[178] This understaffing carries over to its exempt organization oversight division,[179] where it has been estimated that it would take seventy-nine years to audit all currently existing nonprofits.[180] It would require a significant increase in resources for the IRS to be an effective

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[174] *Cf. supra* notes 160–162 and accompanying text.

[175] *See* Swords, *supra* note 86, at 575–76 (describing the IRS's interest as "largely focused on whether any of an organization's assets are being improperly diverted from charitable uses into private, personal hands," while noting that "[s]tate charities offices generally are charged with protecting the public's interest in charities").

[176] *See supra* note 39 and accompanying text (noting that approximately one quarter of nonprofits do not possess a tax exemption).

[177] A broad conception of the IRS's interest in tax-exempt spending could be read to include general governance issues at exempt nonprofits, because those issues result in a failure to maximize the efficiency of tax-advantaged dollars. *Cf.* Swords, *supra* note 86, at 575 n.14 (citing the argument from former Assistant Commissioner of the IRS Office of Exempt Plans/Exempt Organizations, justifying a broader mission in 1997). The IRS's interest, however, is generally not construed this broadly, and with existing strains on IRS resources, we suspect little to change in the future. *Id.* at 575.

[178] *See, e.g.*, Jory Heckman, *Watchdog Finds IRS 'Underfunded, Understaffed and at the Mercy of Shutdowns*,*'* FED. NEWS NETWORK (Feb. 13, 2019), https://federalnewsnetwork.com/government-shutdown/2019/02/watchdog-finds-irs-underfunded-understaffed-and-at-the-mercy-of-shutdowns/ [https://perma.cc/9DG6-T25X]; Paul Kiel & Jesse Eisinger, *How the IRS Was Gutted*, PROPUBLICA (Dec. 11, 2018), https://www.propublica.org/article/how-the-irs-was-gutted [https://perma.cc/T8DP-RBQY].

[179] *See, e.g.*, Lloyd Hitoshi Mayer, *"The Better Part of Valour Is Discretion": Should the IRS Change or Surrender Its Oversight of Tax-Exempt Organizations?*, 7 COLUM. J. TAX L. 80, 97–101 (2016).

[180] JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS 9 (2d ed. 2006). *See generally id.* (noting that most applications for tax exemption are greeted by a rubber-stamp approval); Heath C. DeJean, Comment, *High-Stakes Word Search: Ensuring Fair and Effective IRS Centralization in Tax Exemption*, 75 LA. L. REV. 259, 266–68 (2014) (describing the "triage" process for processing exemption applications).

monitor,[181] and with the current IRS prioritization of its other responsibilities,[182] this seems unlikely.[183]

4. Other Nonprofits

Having considered public agencies, we now turn to potential private monitors. The first candidate we consider is nonprofits themselves. Self-enforcement has proven successful in a remarkable variety of markets where trust is an issue, ranging from the broker-dealer industry,[184] to dairy milk,[185] to law[186] and medical practice,[187] to food and nutrition dietitians,[188] to the real estate market.[189] Commentators, on occasion, have hoped that perhaps nonprofits could be counted upon to police their own activity as these other markets have done.[190]

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[181] *See generally* Chye-Ching Huang, *Depletion of IRS Enforcement Is Undermining the Tax Code*, CTR. ON BUDGET & POL'Y PRIORITIES (Feb. 11, 2020), https://www.cbpp.org/federal-tax/depletion-of-irs-enforcement-is-undermining-the-tax-code [https://perma.cc/MG75-LK5X] (noting that, from 2010 through 2018, there was a 24% decrease in enforcement budget and 31% decrease in enforcement personnel).

[182] *See, e.g.*, IRS: CRIMINAL INVESTIGATION, INTERNAL REV. SERV., ANNUAL REPORT 2019 (2019), https://www.irs.gov/pub/irs-utl/2019_irs_criminal_investigation_annual_report.pdf [https://perma.cc/5HXR-WE6E] (reporting no criminal investigations against exempt organizations); TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2018, at 6 (2019), https://www.treasury.gov/tigta/auditreports/2019reports/201930063fr.pdf [https://perma.cc/WQ3S-SLE3] (reporting that 5.4% of examination and collection staffing are devoted to tax-exempt and government entities combined); Joel N. Crouch, *Update on IRS Civil Enforcement Priorities*, MEADOWS COLLIER: MC TALKS TAX BLOG (Jan. 20, 2020), https://www.meadowscollier.com/update-on-irs-civil-enforcement-priorities [https://perma.cc/7BQA-T8JU] (reporting five areas of IRS enforcement focus, none of which include exempt organizations); *Program and Emphasis Areas for IRS Criminal Investigation*, INTERNAL REV. SERV., https://www.irs.gov/compliance/criminal-investigation/program-and-emphasis-areas-for-irs-criminal-investigation [https://perma.cc/TF7C-6QSZ] (Mar. 5, 2021) (stating that there are sixteen program and emphasis areas for criminal investigation, none of which include exempt organizations).

[183] Mayer, *supra* note 179, at 99 ("Nor is a significant increase in resources for the exempt organizations function [within the IRS] likely in the foreseeable future . . . .").

[184] *About FINRA*, FINRA, https://www.finra.org/about [https://perma.cc/K7U5-N6A4].

[185] *The REAL Seal Story*, REAL, https://www.realseal.com/the-real-story/ [https://perma.cc/YH6U-X7TN].

[186] MODEL RULES OF PRO. CONDUCT pmbl., para. 10–12 (AM. BAR ASS'N 2020). *Contra* Fred C. Zacharias, *The Myth of Self-Regulation*, 93 MINN. L. REV. 1147, 1148 (2009) (contending that legal practice is also subject to external regulation).

[187] William D. White, *Professional Self-Regulation in Medicine*, 16 AMA J. ETHICS 275, 275 (2014), https://journalofethics.ama-assn.org/sites/journalofethics.ama-assn.org/files/2018-05/hlaw1-1404.pdf [https://perma.cc/3KYN-D5KL].

[188] *Registered Dietitian (RD) or Registered Dietitian Nutritionist (RDN) Certification*, COMM'N ON DIETETIC REGISTRATION, https://www.cdrnet.org/certifications/registered-dietitian-rd-certification [https://perma.cc/PQS4-8UEP].

[189] *About NAR*, NAT'L ASS'N OF REALTORS, https://www.nar.realtor/about-nar [https://perma.cc/M78B-CUT4].

[190] *See, e.g.*, Swords, *supra* note 86, at 579.

There is potentially much to be gained by robust nonprofit self-enforcement. Nonprofits, through their legal nondistribution constraint, make a credible commitment to providing high-quality goods and services, which has market value when traditional entities cannot be trusted to do so.[191] Because their competitive market advantage comes from encouraging trust from consumers in their services, nonprofits as a group have an interest in maximizing that trust through robust protection of the nonprofit brand.[192] Others have noted the "warm glow" that people may feel when interacting with charitable nonprofits.[193] Publicized instances of nonprofit malfeasance can undermine the trust value from choosing the nonprofit form, leaving the organization saddled with the disadvantages of a nonprofit while unable to capitalize on the benefits.[194]

Yet attempts by nonprofits to police themselves have failed, seemingly surprising those who recognize the potential for its success.[195] We think much of this failure likely stems from the same commons problem plaguing state attorney general enforcement—the benefits from robust enforcement accrue to nonprofits as a whole, while the costs are borne by the enforcer.[196] Coordination will be difficult to achieve given the number of nonprofit entities that would require coordination. The United States has well over one million non-

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[191] *See supra* Part I.A.

[192] *See, e.g.*, Swords, *supra* note 86, at 579 ("[T]he exposure of cases of abuse and corruption by nonprofit organizations is very likely to have caused an erosion in the public's confidence in the sector. It may then be in the sector's interest to help ferret out these problems.").

[193] Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1222 (2010) (identifying the "warm glow" experienced by employees at nonprofits); Rodrigues, *supra* note 100, at 1259 (arguing for the importance of the nonprofit "warm glow" among a variety of groups that interact with nonprofits).

[194] *See* Hansmann, *supra* note 26, at 875 ("[T]he potential for [abuses] weaken[s] the nonprofit form by undermining its effectiveness as a response to contract failure."); *id.* at 877–79 (summarizing costs of adopting the nonprofit form); Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT L. REV. 803, 804 (2005) ("The failure to condemn [wayward nonprofits] has weakened social support for the nonprofit sector . . . ."); Swords, *supra* note 86, at 579 (noting the problems for nonprofits as a whole suffering from instances of bad actors).

[195] Sidel, *supra* note 194, at 834; *see* Swords, *supra* note 86, at 579–80 & n.28 (describing limited attempts by nonprofits in the 1990s to provide self-regulation). This is not to say nonprofit self-enforcement is destined to fail. *See, e.g.*, Mary Kay Gugerty, *The Emergence of Nonprofit Self-Regulation in Africa*, 39 NONPROFIT & VOLUNTARY SECTOR Q. 1087 (2010) (analyzing nonprofit self-regulation in several African countries); Aseem Prakash & Mary Kay Gugerty, *Trust but Verify?: Voluntary Regulation Programs in the Nonprofit Sector*, 4 REGUL. & GOVERNANCE 22, 42 (2010) (analyzing a variety of nonprofit self-regulation programs); Mark Sidel, *State Regulation and the Emergence of Self-Regulation in the Chinese and Vietnamese Nonprofit and Philanthropic Sectors*, *in* REGULATORY WAVES: COMPARATIVE PERSPECTIVES ON STATE REGULATION AND SELF-REGULATION POLICIES IN THE NONPROFIT SECTOR (Oonagh B. Breen et al. eds., 2017) (analyzing nonprofit self-regulation in China and Vietnam); Sidel, *supra* note 194, at 813–25 (analyzing nonprofit self-regulation in a variety of countries).

[196] *See supra* notes 160–162 and accompanying text.

profits,[197] and coordination becomes more difficult as the number and geographic area of entities to be coordinated expands, because monitoring and sanctioning free-riders becomes prohibitively difficult.[198]

Another explanation for self-regulation's failure may lie in its minimal benefit for most established nonprofits, which are the firms with the greatest means to implement such a solution. The trust provided by the nondistribution constraint can be provided through alternative methods, particularly a firm's reputation and record of treating patrons fairly.[199] If reputation and the nondistribution constraints are substitutable means for nonprofits to generate trust, then we would generally expect the nondistribution constraint to be important for new nonprofits, but less important once the firm has developed a reputation over years of operation.[200] If true, then the firms that have the most interest in robust self-enforcement are the new, unestablished firms with little meaningful

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[197] *See, e.g.*, IRS, CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS, TAX YEAR 2015, at 1 (2018), https://www.irs.gov/pub/irs-pdf/p5331.pdf [https://perma.cc/N2AE-MTB7] (reporting 1.1 million exempt nonprofits).

[198] *See, e.g.*, MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 46 (1971) ("[C]osts of organization are an increasing function of the number of individuals in the group.").

[199] *See, e.g.*, Herrington J. Bryce, *The Public's Trust in Nonprofit Organizations: The Role of Relationship Marketing and Management*, 49 CAL. MGMT. REV., July 2007, at 112, 112 ("The public's positive or negative experiences in core transactions with an organization may be the principal bases for the impairment or improvement of the public trust."); Claire A. Hill, *Marshalling Reputation to Minimize Problematic Business Conduct*, 99 B.U. L. REV. 1193, 1207–13 (2019) [hereinafter Hill, *Marshalling Reputation*] (summarizing evidence on reputation's value to companies); Claire A. Hill, *Repetition, Ritual, and Reputation: How Do Market Participants Deal with (Some Types of) Incomplete Information?*, 2020 WIS. L. REV. 515, 523–24 (analyzing the complementary roles served by repeated interactions, norms, and reputation in contracting problems); Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 61, 76 (Richard Schmalensee & Robert Willig eds., 1989); Kishanthi Parella, *Public Relations Litigation*, 72 VAND. L. REV. 1285, 1296 (2019) ("A corporate reputation influences [patrons'] decisions to provide or withhold their resources; therefore, reputation has important competitive consequences.").

[200] More generally, we would expect the nondistribution constraint to diminish in importance as the firm develops a valuable reputation that is costly to acquire. One necessary, but not sufficient component of satisfying this assumption, is operating for a period of time. *See, e.g.*, Andreas Ortmann & Mark Schlesinger, *Trust, Repute, and the Role of Nonprofit Enterprise*, *in* THE STUDY OF NONPROFIT ENTERPRISE: THEORIES AND APPROACHES 77, 103 (Helmut K. Anheier & Avner Ben-Ner eds., 2003) (noting the need for repeated interaction and for strong information flows). This hypothesis is consistent with some existing evidence about nonprofits that has otherwise been difficult to explain. For example, many established nonprofits fail to advertise their nonprofit status, but this is to be expected if the nondistribution constraint adds little value to their existing firm-specific reputation for trust. Malani & David, *supra* note 26, at 555. Additionally, patrons' recognition of what it means to be a nonprofit, and their ability to identify correctly a firm as being nonprofit, is far from perfect, which again might be expected if patrons generally rely on reputation over nonprofit status as a signal for quality and trustworthiness. Steven E. Permut, Comment, *Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann*, 90 YALE L.J. 1623, 1626–28 (1981). *Contra* Hansmann, *supra* note 26, at 896–97 (noting that not all individuals need conscious awareness of the nondistribution constraint's implications for the nonprofit form to succeed).

power to do so, while the established nonprofits with the resources to implement such a solution will find little gains from doing so. Indeed, the powerful, established nonprofits, to the extent they are driven to maximize their market presence, may even have an interest in keeping out entry of new competitor firms by reducing the value of the nonprofit signal, leading them to actively resist such a coordinated solution.[201]

Thus, even if coordination problems were not formidable, the nonprofits with the most means to pursue self-regulation arguably are the firms with the least interest in doing so. We must therefore continue our search for effective nonprofit monitors.

5. Patrons

Our search next brings us to other private parties who have an interest in reducing nonprofit agency costs. The first group we consider is the patrons of the firm who consume the firm's products or services, providing the firm with its source of income.

As a legal matter, private parties usually lack standing to sue the nonprofits or its officers directly for mismanagement of the company; the state attorneys general are the parties empowered to bring suit.[202] Some states allow members of member-based nonprofits to sue the nonprofit derivatively,[203] but in addition to having to satisfy standing requirements,[204] three sizable barriers stand in the way of robust policing by derivative suits.

The first is financial. Derivative suits work for traditional corporations because shareholders of the corporation have a financial interest in maximizing the value of their shares; derivative suits are one means of correcting wayward

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[201] *Contra* Hansmann, *supra* note 26, at 875–76 (positing ethical constraints on otherwise economically rational nonprofit behavior). Moreover, in many industries, nonprofits compete not just with other nonprofit firms, but also with for-profit ones. *Id.* at 863 ("[C]ommercial nonprofits almost always operate in competition with proprietary firms that provide similar services . . . ."). For these nonprofits, the gains from keeping out entry of new nonprofits are more attenuated because of entry by competing for-profits.

[202] *See, e.g.*, Brody, *supra* note 161, at 957; Hansmann, *supra* note 102, at 606–07. On occasion, standing can be expanded to private parties. *See, e.g.*, Consumers Union of U.S., Inc. v. State, 840 N.E.2d 68, 82 (N.Y. 2005) (noting that limited standing had been granted in a proposed merger of a nonprofit health insurer to private policyholders who faced premium increases).

[203] *See, e.g.*, Fox v. Prof'l Wrecker Operators of Fla., 801 So. 2d 175, 180 (Fla. Dist. Ct. App. 2001). *See generally* Thomas E. Rutledge, *Who Will Watch the Watchers?: Derivative Actions in Nonprofit Corporations*, 103 KY. L.J. ONLINE 31 (2015), https://www.kentuckylawjournal.org/online-originals/index.php/2015/04/22/who-will-watch-the-watchers [https://perma.cc/5HC4-CB2J] (advocating for the application of derivative suits to nonprofits even when statutes are silent on the issue).

[204] *See* REVISED MODEL NONPROFIT CORP. ACT § 6.30 (AM. BAR ASS'N 1987) (authorizing derivative suits by the lesser of fifty members or by members collectively holding 5% of the voting power); *see also, e.g.*, ARIZ. REV. STAT. ANN. § 10-3631 (2020) (authorizing derivative suits by the lesser of fifty members or by members collectively holding 25% of the voting power).

management and ensuring the corporation has maximal financial value.[205] Nonprofits, by law, have no owners and therefore no financial ownership interest for members to maximize through derivative suits.[206] Instead, members have a more attenuated incentive to bear the costs of suing if doing so would enable the nonprofit to pursue its company mission more effectively, which we suspect is difficult to satisfy.[207]

The second is practical. In states that expand derivative standing beyond the state attorney general, standing is expanded only to a group of the nonprofit's members. A nonprofit's members, however, are only a subset of the patrons that have an interest in deterring nonprofit misbehavior.[208] Some nonprofits have no members; these organizations therefore will go unpoliced by derivative suits unless those suits are brought by the attorney general or another director. Other nonprofits have members but also have donors, customers, or beneficiaries without membership rights; these parties' potential to deter mismanagement goes untapped, even if they have the initiative to sue.

Given these difficulties, we suspect it far more likely that patrons will simply choose to patronize other firms more aligned with their desires rather than suing wayward management.[209] This response will provide a modest market check on general management inefficiency, but it will hardly deter the more egregious and troublesome cases of fraud and mismanagement that provide large potential gains to its perpetrators.[210]

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[205] *See, e.g.*, Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 401–05 (2008).

[206] *See supra* notes 41–42 and accompanying text (describing the nonprofit nondistribution constraint).

[207] Still, non-financial incentives can be powerful motivators. *See, e.g.*, Brian Galle, *Valuing the Right to Sue: An Empirical Examination of Nonprofit Agency Costs*, 60 J.L. & ECON. 413, 413 (2017) (noting that private foundations in which donors have standing to sue receive more donations and have lower administrative costs); Hansmann, *supra* note 102, at 609 ("[I]t is clear that patrons will commonly feel a strong interest in seeing that the managers of nonprofits adhere to their fiduciary duties.").

[208] *See, e.g.*, Hansmann, *supra* note 102, at 613 ("[T]here is no reason to confine standing to those patrons who are also members, for among nonprofits in general there is no sharp demarcation between the interests of members and those of other patrons.").

[209] *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) (theorizing that patrons can effect change through exiting the organization or agitating for change); Henry Hansmann & Reinier Kraakman, Exit, Voice, and Liability: The Evolution of Organizational Law (June 2008) (unpublished manuscript) (on file with authors) (explaining that exit rights and control rights can serve as powerful complements to each other).

[210] *See, e.g.*, Putnam Barber et al., Does Mandatory Disclosure Matter? The Case of Nonprofit Fundraising 19 (June 9, 2020) (unpublished manuscript), https://ssrn.com/abstract=3625800 [https://perma.cc/B2LK-B7G4] (finding that donors shift dollars away from organizations that are seen as operationally inefficient).

The third is practical as well. Nonprofits have a comparative advantage in situations where the quality of performance is difficult to verify (without third-party certification) so that the value of trust is important; the nondistribution constraint makes it more likely that a nonprofit will provide higher quality goods and services in these situations.[211] But these are precisely the circumstances where monitoring will be more difficult, making it unlikely that at least some patrons will have the means to identify indiscretions to bring suit against this category of nonprofits.

6. The Media

We next assess another potential private monitor: the media. The media have been responsible for identifying and publicizing high-profile cases of nonprofit misbehavior in the past, and given the response these stories can generate, it seems reasonable to assume that the media have the incentive to continue doing so.[212] With the need to attract attention, however, it seems likely that the media will police only the most egregious instances of agency costs, such as large scale frauds; lesser indiscretions that may be significant in the aggregate will not be publicized if they do not attract attention.[213]

In the absence of traditional media monitoring nonprofits, social media takes a more important role. Many nonprofits use social media as a way to drive engagement with the nonprofit. Similarly, social media helps to build the brand. The ability of social media to change brand perception is an important part of brand value and brand strategy.[214] Whereas traditional media requires reports as monitors, social media through crowdsourcing creates a new channel with which to monitor the behavior of nonprofits.

7. Auditors

Next, we consider the role that financial auditors might play. Auditors provide a gatekeeping function in the realm of publicly traded corporations, verifying a company's financial condition that can both expose financial fraud

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[211] *See supra* note 43 and accompanying text (discussing nonprofits' commitment to trust and quality).

[212] *See, e.g.*, Linda Sugin, *Strengthening Charity Law: Replacing Media Oversight with Advance Rulings for Nonprofit Fiduciaries*, 89 TUL. L. REV. 869, 889 (2015) (noting several instances of media-led policing); Troy Fleming, Consumer News, *"Pay for Play" Scandal at the Better Business Bureau Leads to Consumer Mistrust of the Business Rating Organization*, 23 LOY. CONSUMER L. REV. 445, 451 (2011) (noting ABC's role in unearthing a pay-for-play scheme at the nonprofit Better Business Bureau's Los Angeles chapter).

[213] *See generally* Sugin, *supra* note 212, at 890 ("A small scandal involving a well-known individual is likely to get more press attention than a larger one that is less sensational.").

[214] Travis Tae Oh et al., *The Past, Present, and Future of Brand Research*, 31 MKTG. LETTERS 151, 156 (2020).

at an early stage as well as deter companies from engaging in fraud in the first place due to the threat of discovery.[215]

Nonprofits are under no federal obligation to obtain audited financial reports even if they are exempt;[216] any obligation must instead come from state law. Twenty-six states impose some sort of audit requirement.[217] These requirements are typically triggered by surpassing a minimum level of contributions, often on the order of $500,000 or $1 million.[218]

Yet significant holes remain. Twenty-four states have no audit requirements.[219] Even those states that do have requirements typically exempt nonprofits that do not rely on donations from the requirement.[220] Nonprofits that do not traditionally rely on donations, such as nursing homes and hospitals, will therefore not be subject to the state-level requirement.[221] Finally, the public does not always have access to audit reports that are filed pursuant to state requirements,[222] leaving the information actionable only by state agencies who, for reasons already discussed, currently lack the incentive and means to do so.[223]

III. Toward Robust Nonprofit Monitoring

Existing nonprofit monitors present a host of problems. Weak policing of both firm governance and nonprofits' nondistribution constraint results not only in the provocative examples provided at this Article's outset, but also undermines the legal essence of what it means to be a nonprofit organization. Given the size of nonprofit operations, the problems from largely autonomous and unmonitored management can be severe. At the same time, we recognize that managerial discretion is often necessary to carry out the balancing of diverse constituency interests in which nonprofits often engage. We therefore propose three solutions that we hope will address governance problems, while respecting the

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215 *See, e.g.*, Tuch, *supra* note 151, at 1592.

216 The Form 990 requires no audit nor other external verification, although it does require firms to identify whether their financial statements have been audited. I.R.S. Form 990, *supra* note 92, at 3, 12, pt. XII. A federal audit requirement is triggered if the nonprofit receives money from the federal government and spends more than 750,000 federal dollars in a single year. *Federal Law Audit Requirements*, NAT'L COUNCIL OF NONPROFITS, https://www.councilofnonprofits.org/nonprofit-audit-guide/federal-law-audit-requirements [https://perma.cc/GVX3-DF9G].

217 *State Law Nonprofit Audit Requirements*, NAT'L COUNCIL OF NONPROFITS, https://www.councilofnonprofits.org/nonprofit-audit-guide/state-law-audit-requirements [https://perma.cc/QE8Q-MG9B].

218 *Id.*

219 *Id.*

220 *Id.*

221 *See, e.g.*, Hansmann, *supra* note 26, at 884 (noting these nonprofits' historical inability to attract donations).

222 *Contra* CAL. GOV'T CODE § 12586(e)(1) (West 2020) (requiring audited financial reports to be available to the public); CONN. GEN. STAT. § 21a-190c(b) (2020).

223 *See supra* Part II.B.2.

unique spaces in which nonprofit management often operates. Section A of this Part discusses potential options for disclosure and private certification.[224] Section B proposes more streamlined oversight by state attorneys general.[225] Finally, Section C discusses the potential impact of federal nonprofit monitoring.[226]

A. Disclosure and Private Certification

We first consider disclosure and private certification, which we envision working together to enhance monitoring of nonprofit governance. Although Henry Hansmann first suggested disclosure of annual financial statements and conflicted transactions as a solution in 1981, and others have suggested it since that time,[227] the mechanisms and empirical understanding of disclosure have progressed significantly, particularly in the for-profit sector and the effects of Sarbanes-Oxley. Similarly, certification in other nonprofit contexts has been recommended before,[228] but we extend this work in new directions by laying the groundwork for a more robust certification mechanism.

We integrate the empirical learning on disclosures and certification to craft an administrable proposal for nonprofit disclosure that provides needed improvements for nonprofits without imposing overly burdensome costs. Similarly, third-party certification regimes have become more nuanced and practical, particularly given advancements in the corporate social responsibility and environmental, social, governance (CSR/ESG) space that have been studied in detail in operations,[229] management,[230] economics,[231] and law.[232] These third-

[224] *See infra* notes 227–273 and accompanying text.

[225] *See infra* notes 274–326 and accompanying text.

[226] *See infra* notes 327–338 and accompanying text.

[227] Hansmann, *supra* note 102, at 522; *see also* Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559, 561 (2005) (recommending combining disclosure with enforcement); Swords, *supra* note 86, at 593 (focusing on tax disclosure).

[228] Brian Galle, *Self-Regulation of Social Enterprise*, *in* THE CAMBRIDGE HANDBOOK OF SOCIAL ENTERPRISE LAW 26, 27 (Benjamin Means & Joseph W. Yockey eds., 2018); Peter Molk, *Do We Need Specialized Business Forms for Social Enterprise?*, *in* THE CAMBRIDGE HANDBOOK, *supra*, at 241, 242.

[229] Li Chen & Hau L. Lee, *Sourcing Under Supplier Responsibility Risk: The Effects of Certification, Audit, and Contingency Payment*, 63 MGMT. SCI. 2795, 2796 (2017).

[230] Andrew A. King et al., *The Strategic Use of Decentralized Institutions: Exploring Certification with the ISO 14001 Management Standard*, 48 ACAD. MGMT. J. 1091, 1091 (2005); Lauren Lanahan & Daniel Armanios, *Does More Certification Always Benefit a Venture?*, 29 ORG. SCI. 931, 941 (2018).

[231] Jens Hainmueller et al., *Consumer Demand for Fair Trade: Evidence from a Multistore Field Experiment*, 97 REV. ECON. & STAT. 242, 243 (2015); Ginger Zhe Jin & Phillip Leslie, *The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards*, 118 Q.J. ECON. 409, 410 (2003).

party certification regimes have proven resilient in their ability to craft incentives and reward users in ways that we think also could be fruitfully applied to the problem of nonprofit governance.[233]

1. Disclosure

Disclosure plays an important role in governance. Unlike prior papers that address disclosure, we focus our disclosure recommendations specifically on disclosures that will improve monitoring. Broadly, disclosure of information makes it easier for the public at large to police agency costs.[234] Currently, as we discussed above, there is no disclosure system that applies to nonprofits across the board; disclosure requirements (if any) vary by state and by the nonprofit's tax-exempt status. Policing nonprofit governance could be accomplished better through a broader disclosure requirement of nonprofit finances as well as the establishment of risk, executive pay, and audit committees. As we emphasized in the Introduction, we think these requirements should be linked to a size or revenue threshold to refrain from introducing overly burdensome requirements on small nonprofits. Thus, there would be more, and different, information disclosed than through various types of financial and other disclosures that some nonprofits already make through Forms 990.

Disclosure makes reputational penalties strong. Disclosure allows reputational penalties to play a quasi-regulatory function by penalizing bad actors for their poor judgment and oversight. Reputational penalties have long been studied as a form of deterrence in other contexts. In one of the first studies that surveyed the empirical literature of reputational penalties (albeit only in finance and economics and based on a certain definition of an "event" for study), Jon Karpoff found that reputational penalties are significant when a regulator can reveal wrongdoing by a firm against its customers or investors.[235] More recent work by John Armour, Colin Mayer, and Andrea Polo finds that the deterrence effect of reputational penalties is roughly nine times the size of corresponding fines. Such reputational penalties also focus on conduct that affects customers or investors.[236]

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[232] Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937, 951 (2020); Galle, *supra* note 228, at 31 (noting limits of certification regimes as well).

[233] Mayer, *supra* note 179, at 120 (suggesting concern as to third-party nonprofit certification).

[234] Angel Hsu et al., Comment, *Mobilize Citizens to Track Sustainability*, 508 NATURE 33, 34–35 (2014).

[235] Jonathan M. Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 361, 368 (Michael L. Barnett & Timothy G. Pollock eds., 2012).

[236] John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets*, 52 J. FIN. & QUANTITATIVE ANALYSIS 1429, 1429 (2017).

Legal scholarship has pushed for reputational sanctions of corporations in other contexts. For example, Claire Hill advocates for increased reputational sanctions given the limitations of traditional legal recourse against bad behavior by firms.[237] Her arguments concentrate on institutional investors and for-profit governance.

In many cases, reputational penalties are increasing for organizations due to social media and crowdsourcing on the internet. For example, in the same week, Starbucks moved from banning Black Lives Matter t-shirts for their employees to actually printing them up for all employees to wear because of significant and immediate pressure from its stakeholders.[238]

We think that the potential for reputational penalties is potentially even greater in the nonprofit context. Reputation and trust matter arguably more for at least some nonprofits than for-profits, because the nonprofit form, through its nondistribution constraint, can have a comparative advantage in industries where trust and reputation are particularly important.[239]

To leverage reputation's ability to promote more effective nonprofit governance, we envision expanding disclosure to concentrate on key governance risks. As with publicly traded companies' SEC-mandated risk disclosures, nonprofit risk disclosures would assist interested stakeholders and the public in evaluating which nonprofits to patronize. A prospective law student choosing between two similar schools, for example, might lean toward the one that has meaningful plans for weathering unexpected revenue declines without devaluing the diploma credential that will assist the student in attaining employment.[240] These disclosures also will help with outside monitoring, highlighting companies whose directors are not focused on these issues and which might have the most severe governance failures.

We envision these disclosures as detailing self-interested approved transactions as well as providing narrative information about risk management issues, such as the Item 1A in a 10-K SEC filing and Item 3's Legal Proceedings narratives from for-profit companies. As an alternative, we envision nonprofits being able to opt out of the filing by explaining, in narrative form, why a detailed disclosure of business risk is not warranted.

Disclosures that target risk send important signals about how society expects nonprofits to operate. The current Form 990 system, which inquires into

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[237] Hill, *Marshalling Reputation*, *supra* note 199, at 1193.

[238] Rex Crum, *Starbucks Reverses Course, Will Let Staff Wear Black Lives Matter T-shirts: Coffee Giant to Provide 250,000 Newly Designed T-shirts to Its Workforce*, MERCURY NEWS, https://www.mercurynews.com/2020/06/12/starbucks-reverses-course-will-let-staff-wear-black-lives-matter-t-shirts/ [https://perma.cc/2KHQ-5JKN] (June 12, 2020).

[239] *See supra* Part I.A.

[240] Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355, 362 (1973).

a number of issues in nonprofit governance but omits key questions about risk assessment, sends a message to nonprofits that risk management is of only secondary importance. Required disclosures of narratives about those risks or, alternatively, narratives about why those risks need not be considered, ensure that at least some amount of managerial attention is paid to deterring these instances of governance failures.

Although disclosure of risk is effective for publicly traded for-profit companies,[241] some might note that privately held for-profit companies do not have to disclose risks. Why then are nonprofit governance problems different from those of privately held for-profits to justify disclosure? Our answer derives from the fact that for-profits lack the same monitoring problems as nonprofits. Owners, investors, and takeover threats serve as effective, if imperfect, constraints on for-profit governance misconduct that nonprofits lack.[242] Hence, by requiring a statement on risk, this requirement forces nonprofit management to confront these issues.

2. Certification

It is difficult for outside stakeholders to identify the quality of organizations.[243] This is particularly true when those organizations are nonprofits, whose nondistribution constraint leads them to thrive in trust industries.[244] Certification by third parties offers a market-based solution to address the information asymmetry issue that emerges about whether a given nonprofit can be trusted to have reasonable governance and constraints.

Certification, in turn, allows for credible, digestible signaling of quality governance by those organizations that receive a certifier's approval.[245] When firms receive certification, this reduces information asymmetries, as certifica-

[241] Hillary A. Sale & Donald C. Langevoort, *"We Believe":* Omnicare*, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763, 788 (2016).

[242] *See supra* note 114 and accompanying text (demonstrating the effectiveness of legal duties in the for-profit context).

[243] Vinit M. Desai, *Third-Party Certifications as an Organizational Performance Liability*, 44 J. MGMT. 3096, 3096–97 (2018); Violina P. Rindova et al., *Being Good or Being Known: An Empirical Examination of the Dimensions, Antecedents, and Consequences of Organizational Reputation*, 48 ACAD. MGMT. J. 1033, 1033 (2005).

[244] *See supra* Part I.A.

[245] Brian L. Connelly et al., *Signaling Theory: A Review and Assessment*, 37 J. MGMT. 39, 45 (2011) ("For signaling to take place, the signaler should benefit by some action from the receiver that the receiver would not otherwise have done (i.e., signaling should have a strategic effect); this usually involves selection of the signaler in favor of some alternatives."); Oliver Heil & Thomas S. Robertson, *Toward a Theory of Competitive Market Signaling: A Research Agenda*, 12 STRATEGIC MGMT. J. 403, 404 (1991).

tion provides a signal that the firm in question is compliant with legal and regulatory requirements.[246]

This signal reduces uncertainty regarding doing business with such firms. Without such certification, there are increased transaction costs because of the lack of trust between a firm and the stakeholders in its business relationships.[247] For nonprofits, such as hospitals and universities, this signaling provides credible reassurance of the organization's trustworthiness that otherwise may be hidden to external parties or may be non-credible.[248]

Information asymmetries can be larger in nonprofits relative to for-profits because of nonprofits' dissimilar disclosure requirements for publicly traded firms (and the agency costs are greater than privately held firms with less disclosure), a lack of functioning markets for takeovers and managers, and less effective monitoring by auditors. Among for-profits, incentive-based pay and the market for managers deter managerial opportunism, as managers who seek to maximize their executive pay or climb the pay and prestige ladders to larger for-profit firms must refrain from abusing their managerial positions.[249] Among nonprofits, however, incentive-based pay is rare,[250] and empirical evidence suggests that the market for managers is less tethered to diligent pursuit of the nonprofit's mission.[251] Further, among public for-profits, hostile corporate takeovers and activist investors correct particularly wayward management by replacing it with directors who will better maximize the value of the firm.[252] Nonprofits, however, have no stock and thus no hostile takeovers or activist investors. Certification can therefore prove particularly valuable in this space by reducing the costs of conveying credible quality signals to the public, allowing those firms with good governance to signal it through certification to their stakeholders.

Certification can be done via government in a regulatory setting, by third parties through self-governance, or with third-party monitoring encouraged by government. All three already occur in different contexts. Government certification occurs, for example, with certification of training, such as the Depart-

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[246] Ivan Montiel et al., *Using Private Management Standard Certification to Reduce Information Asymmetries in Corrupt Environments*, 33 STRATEGIC MGMT. J. 1103, 1106 (2012).

[247] *See generally* WILLIAMSON, *supra* note 25 (describing the theory of transaction cost economics).

[248] *See* Spence, *supra* note 240, at 362.

[249] Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965).

[250] *See* Galle & Walker, *supra* note 26, at 1894.

[251] *See, e.g.*, Richard Arnould et al., *Does Managed Care Change the Mission of Nonprofit Hospitals? Evidence from the Managerial Labor Market* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 7924, 2000), https://www.nber.org/papers/w7924 [https://perma.cc/NC6X-A8X6].

[252] *See supra* note 246 and accompanying text.

ment of Transportation Transit Safety and Security Program. This program certifies the training of individuals for safety in transport.[253] Third-party certification may be encouraged by regulatory bodies, such as the Environmental Protection Agency energy star program.[254] Finally, certification may be entirely a private function, such as in environmental or labor standards[255] or auditing.[256]

We advocate third-party private certification for a certification-based solution to nonprofit governance. Private certification allows for robust competition specifically tailored to corporate governance, as already occurs in the for-profit context through proxy advisory organizations such as International Shareholder Services or Glass-Lewis.[257] Moreover, the rise of interest in ESG has shown private certification's ability to respond to social and governance issues through a variety of avenues spanning multiple private actors ranging from investment advisors to formal certifiers.[258]

Nevertheless, a private certification system faces several hurdles that would need to be overcome. One is to ensure the presence of sufficient market demand to support a private solution; one might think that the absence of private certifiers in this area suggests a lack of interest by nonprofit customers in this information. Yet the success of nonprofit-focused ratings agencies, such as Charity Navigator, suggest a private appetite for this type of information.[259] Charity Navigator's ratings have been criticized, however, for failing to capture true governance issues,[260] and the ratings lack the nuance that might adjust for an individual's particularized tastes about various aspects of nonprofit op-

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[253] *Transit Safety and Security Program (TSSP) Certificate*, U.S. DEP'T OF TRANSP. (May 7, 2020), https://www.transportation.gov/tsi/transit-safety-and-security-program-tssp-certificate-0 [https://perma.cc/X6YG-KJSC].

[254] David L. Markell & Robert L. Glicksman, *A Holistic Look at Agency Enforcement*, 93 N.C. L. REV. 1, 63 (2014).

[255] Tim Bartley, *Institutional Emergence in an Era of Globalization: The Rise of Transnational Private Regulation of Labor and Environmental Conditions*, 113 AM. J. SOCIO. 297, 297–341 (2007); Burkard Eberlein et al., *Transnational Business Governance Interactions: Conceptualization and Framework for Analysis*, 8 REGUL. & GOVERNANCE 1, 1–14 (2014); Galit A. Sarfaty, *Global Supply Chain Auditing*, *in* THE CAMBRIDGE HANDBOOK OF COMPLIANCE 977, 979 (Benjamin van Rooij & D. Daniel Sokol eds., forthcoming 2021).

[256] *See supra* note 254 and accompanying text.

[257] Jill Fisch et al., *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101, 113–14 (2018); Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUD. 3394, 3399 (2016).

[258] Paul Rissman & Diana Kearney, *Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability Accounting, and Their Effects on Corporate Social Responsibility*, 49 ENV'T L. REP. 10,155, 10,163 (2019).

[259] Experimental studies have confirmed this appetite. Alexander L. Brown et al., *Social Distance and Quality Ratings in Charity Choice*, 66 J. BEHAV. & EXPERIMENTAL ECON. 9, 9 (2017).

[260] *See, e.g.*, William MacAskill, *What Charity Navigator Gets Wrong About Effective Altruism*, STAN. SOC. INNOVATION REV. (Dec. 3, 2013), https://ssir.org/articles/entry/what_charity_navigator_gets_wrong_about_effective_altruism [https://perma.cc/RW6X-H5BE].

erations, instead applying one single ratings methodology to all organizations.[261] We sense a market opportunity for other certifiers who offer flexible approaches to cater to nonprofit patrons' particular tastes.[262]

A private certification system must also avoid the problem of conveying a false signal about an organization's activities in an effort to attract certification business. This worry is a concern in all certification regimes, with "greenwashing" of firms' environmental or social characteristics, and credit ratings, being two familiar examples.[263] Jodi Short and Michael Toeffel have shown that situations involving self-dealing, where third-party monitors are paid directly by the firms being certified, are particularly problematic.[264] For example, they find that monitoring of global supply chain compliance is less stringent when payment comes from the firm being audited,[265] or other potential conflicts of interest.[266] The key component of a nonprofit certification system, then, is to align incentives among the certifier, the party it certifies, and the parties for whom the certification has value.

Others have already considered how to solve this problem in the related context of social enterprise, using a mixture of public and private methods, and we think those lessons would carry over to the general nonprofit governance context well.[267] For instance, we might have a rotating panel of certifiers for any particular firm, or a legal system of liability for false certifications.[268] To be sure, this raises the cost of entry to the certification market, resulting in a

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[261] *Charity Navigator's Methodology*, CHARITY NAVIGATOR, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=5593 [https://perma.cc/K2EK-7DMH].

[262] We think this is particularly true for private foundations, which must meet minimum qualified distribution amounts per year to avoid excise taxes. *Taxes on Failure to Distribute Income—Private Foundations*, IRS (June 3, 2020), https://www.irs.gov/charities-non-profits/private-foundations/taxes-on-failure-to-distribute-income-private-foundations [https://perma.cc/8VF7-4C7N]. Certifiers could provide a valuable service by screening for particular governance risks with which these foundations would not want to associate their dollars.

[263] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 653 (1999).

[264] Jodi L. Short & Michael W. Toffel, *The Integrity of Private Third-Party Compliance Monitoring*, 42 ADMIN. & REGUL. L. NEWS, Fall 2016, at 22, 22.

[265] Jodi L. Short et al., *Monitoring Global Supply Chains*, 37 STRATEGIC MGMT. J. 1878, 1878 (2016).

[266] John M. Griffin & Dragon Yongjun Tang, *Did Credit Rating Agencies Make Unbiased Assumptions on CDOs?*, 101 AM. ECON. REV. 125, 130 (2011); Nathan J. Newton et al., *Internal Control Opinion Shopping and Audit Market Competition*, 91 ACCT. REV. 603, 604 (2016).

[267] *See, e.g.*, Galle, *supra* note 228, at 31; Molk, *supra* note 228, at 242.

[268] Moreover, online platforms have brought enhanced transparency of third-party certification, making it easier to monitor certifiers. Jane K. Winn, *The Secession of the Successful: The Rise of Amazon as Private Global Consumer Protection Regulator*, 58 ARIZ. L. REV. 193, 201 (2016) (quoting the Amazon Marketplace website as noting that "[s]ellers with excessive guarantee claims and/or service chargebacks may be subject to warnings, suspensions, and account termination").

potentially more highly concentrated certification market.[269] The lack of competition may reduce quality of certification.[270] Without checks on the quality of certification, however, the incentive to certify falsely nonprofits' compliance with various types of regulation, or to overplay the effectiveness of the certification,[271] may be too significant.

A final hurdle for a certification-based solution is to generate buy-in from existing nonprofits. We expect it could take considerable time—years—for a particular certification system to gain traction, requiring proponents to be willing to invest significant time in this solution. At first, before the certification has gained meaningful recognition among nonprofit patrons, there would be little reason for nonprofits to invest meaningful effort or expense in opting into a certification system. Moreover, because established nonprofits likely rely more on their firm-specific reputation to generate trust from patrons than the value of a certification,[272] it may be difficult to attract the type of well-known, highly visible nonprofits that could help the certification gain initial success.[273]

B. State Attorneys General

We also consider a solution built upon the existing oversight framework supplied by the state attorneys general. States already give their attorneys general the legal power to oversee the operations of charities within their borders, so beginning with this existing authority could be useful. At the same time, state attorneys general currently provide only weak oversight, so significant changes are warranted.

1. The Benefits of a Unitary Oversight System

The challenge, as we identified above, concerns particularly larger nonprofits whose operations cross state lines.[274] For these organizations, the costs of oversight are borne entirely by the single monitoring state attorney general, whereas the benefits accrue to all. The rational state attorney general, in decid-

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[269] Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1176–77 (2003).

[270] Jonathan M. Barnett, *Intermediaries Revisited: Is Efficient Certification Consistent with Profit Maximization?*, 37 J. CORP. L. 475, 499 (2012).

[271] This concern in particular has been levied against the popular social enterprise certifier B Lab. *See, e.g.*, J. William Callison, *Benefit Corporations, Innovation, and Statutory Design*, 26 REGENT U. L. REV. 143, 154 (2013).

[272] *See supra* notes 199–201 and accompanying text.

[273] A savvy, well-funded certifier could help accelerate this early period by subsidizing initial adoption of the certification system by established nonprofits, or alternatively could create an initial group of important adopters that could generate momentum to scale up.

[274] *See supra* Part II.B.2.

ing how much effort to exert in policing these nonprofits, considers the benefits only of the attorney general's state's citizens.[275] A state attorney general therefore devotes comparatively less attention to overseeing organizations with interstate operations than would be optimal given the full scope of these organizations' operations.

Achieving efficient levels of oversight requires attorneys general to incorporate the full national effect of nonprofit operations. Although this problem could be solved by building robust coordination among state attorneys general offices, as a practical matter coordination across this number of entities happens in only the most extraordinary circumstances,[276] and we doubt whether most would view nonprofit monitoring as sufficiently extraordinary.

We therefore suggest a new approach: making only a single state attorney general responsible for the oversight of each nonprofit. Following this approach eliminates the difficulties that arise from coordinating among multiple oversight entities. Which state attorney general should monitor? We consider three natural candidates.

2. Which State Should Monitor?

Two natural contenders arise for choosing the monitoring state: (1) the nonprofit's state of incorporation, and (2) the state in which the nonprofit has its most significant operations. We think the state of incorporation is the better choice for the state whose attorney general will monitor. The potential advantages of this approach have been studied extensively in the context of Delaware's success at attracting business incorporations, and many of those lessons carry over to the current proposal.[277] Rather than comprehensively repeating that literature here, we simply provide its high notes.

Allowing companies to choose their state of incorporation, and consequently the legal system that will govern internal disputes, encourages states to compete with one another[278] to attract incorporations because more incorporations means more fees and power for the state.[279] To encourage formations, states have to offer a package of benefits that is attractive to companies. For

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[275] *See supra* note 161 and accompanying text.

[276] *See, e.g.*, *supra* note 162 and accompanying text (discussing successes and failures of state attorney general coordination).

[277] *See infra* notes 289–292 and accompanying text.

[278] Although the most direct competition is among states, competition also may include broader jurisdictions, such as the federal government or other countries. *See, e.g.*, William J. Moon, *Delaware's New Competition*, 114 NW. U. L. REV. 1403, 1403 (2020) (identifying other countries as competing for state incorporations); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) (identifying the federal government as the main competitor of Delaware for state incorporations).

[279] For a recent summary on the main theories in this area, see Molk, *supra* note 78.

traditional, for-profit entities, this package generally consists of a high-quality legal system—the statutory law, the courts that apply that law, and the legislature that drafts that law—that offers robust investor protection and, consequently, the lowest cost of capital to organizations.[280]

Much of this argument carries over to nonprofits. Although they lack traditional shareholders, nonprofits nevertheless need to attract capital. Nonprofits might have an easier time raising capital from donors if their governing state provides a meaningful set of donor protections, which Brian Galle has shown can help attract donations.[281] Nonprofits also might gain more favorable debt terms if state oversight improves nonprofit governance and reduces the probability of bankruptcy. States could offer protection through their statutes, such as giving donors the right to sue;[282] or through a legislature that can be trusted to respond to evolving donor and governance needs of the future;[283] or through a state attorney general who can be relied upon to monitor and enforce optimal nonprofit governance that minimizes agency costs.[284] Because it is fairly easy to change one's state of incorporation,[285] basing monitoring on the incorporation state could provide for healthy competition among states to attract nonprofit business, and therefore the greatest potential for an optimal regulatory system.[286]

There are also merits, however, to choosing the state in which the nonprofit has its largest presence as the monitoring state, rather than the state of formation. Depending on how it is ultimately defined, this could be the state in which the nonprofit locates its headquarters, or the state from which the nonprofit derives most of its revenue, or the state whose citizens contribute the largest share of donations to the nonprofit (if it relies on donations). Whichever combination of these factors is chosen, we could imagine the attorney general in that state may have an easier time monitoring the nonprofit, given the close geographic proximity to some of the problematic behavior that may result. We note, however, that many of the problems we identify stem from problematic corporate governance issues, and it is not immediately clear how geographic

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[280] *Id.* For initial seminal work in this area, see Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977).

[281] *See* Galle, *supra* note 207, at 414 (focusing on valuing the right to sue).

[282] *Id.* at 416.

[283] *See, e.g.*, Romano, *Redux*, *supra* note 78, at 365–66.

[284] *See supra* Part II.B.2 (assessing the role of the state attorney general in enforcement).

[285] Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 586–87 (1990); *cf.* ROMANO, *supra* note 78, at 34–35 (arguing that these costs are nontrivial).

[286] We address the potential for competition to produce a "race to the bottom" in nonprofit regulation below in Part III.B.5.b.

proximity can help police these.[287] Moreover, it is considerably more difficult for firms to change monitors under this alternative specification,[288] making competition among states to attract organizations—and the resulting hope for optimal oversight—less vigorous. At the same time, difficulty in switching monitors reduces the chance for suboptimal gaming of monitors, reducing the chance that states might compete to attract nonprofits by minimizing oversight.

3. Why States Would Monitor

Whichever method is adopted to select the monitoring state attorney general, the next challenge is to incentivize that official to care about a nonprofit's operations outside the attorney general's state's borders to encourage appropriate levels of costly oversight. Under the current system, state attorneys general internalize the effects only on their state citizens. We must therefore expand the lens.

We do so by appealing to state finances. Outside the nonprofit context, one explanation for states' interest in attracting corporate formations is the significant revenue that states derive from the fees those businesses pay. Delaware, for example, obtains over twenty-five percent of all its taxes from its franchise fees paid by companies incorporated or otherwise formed in Delaware.[289] If robust state attorney general oversight is a desirable characteristic for nonprofits—it could reduce capital costs[290] and promote stakeholder trust by strengthening the nondistribution constraint's commitment[291]—then a similar story could unfold here as well, with states encouraged to engage in meaningful monitoring so they can attract nonprofits and their formation fees. As states grow more successful in becoming the location of choice for nonprofits, they could increase their nonprofit franchise fees to cover these monitoring costs, with excess fees used to fund other desirable state programs.[292]

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[287] Indeed, traditional for-profit firms rely on shareholders from all over the country to monitor these issues.

[288] Instead of merely reincorporating, the nonprofit would potentially be required to shift its headquarters, commercial operations, or donor base.

[289] BUDGET DEV. & PLAN. DIV., DEL. OFF. OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR'S RECOMMENDED BUDGET: FISCAL YEAR 2020, at 6–7 (2020), https://budget.delaware.gov/budget/fy2020/documents/operating/financial-summary.pdf [https://perma.cc/G94T-J9WZ].

[290] *See supra* notes 281–286 and accompanying text.

[291] *See supra* notes 191–201 and accompanying text.

[292] Many states charge nonprofits only a token amount for formation within their state. Delaware, for example, charges exempt nonprofits only $25 per year, while it charges publicly traded corporations up to $250,000 per year. *Annual Report and Tax Instructions*, DEL. DIV. OF CORPS., https://corp.delaware.gov/paytaxes/ [https://perma.cc/3GK9-SXTG].

In essence, then, the state attorney general could mirror some of the value provided by private certification.[293] And as discussed in the context of this earlier solution, there are a number of challenges in convincing nonprofits to buy into the system, as well as getting those who interact with the nonprofit to know both the state that regulates the nonprofit's activity and the implications that this regulation has for the nonprofit's behavior.[294]

Yet the space of regulatory certification is full of examples where these challenges have been overcome. We next give particular color to one of these success stories from insurance solvency regulation, which has overcome similar problems that would be faced by state attorney general monitoring of nonprofits.

4. A Success Story from Insurance Solvency Regulation

Insurance solvency regulation serves as an instructive example for overcoming collective action challenges in having state attorneys general monitor nonprofits. Within the United States, the federal government leaves states to regulate the fiscal healthiness of insurance companies.[295] Each state maintains the power to regulate the solvency of all insurers that do business within its borders,[296] but the same collective action problems that plague state attorneys general in the nonprofit context imply that solvency regulation efforts by insurance regulators will be suboptimally low. The cost of monitoring interstate insurers is borne by the individual regulator, but those efforts benefit citizens of other states. Moreover, requiring insurers to comply with differing yet overlapping solvency requirements in each individual state in which they conduct business can be administratively costly and unnecessary, just as forcing nonprofits to comply with fundraising disclosures and other restrictions in every state where they conduct business can be duplicative.[297] State insurance regulators have therefore coordinated their system of solvency regulation, and only

[293] *See supra* Part III.A.

[294] *See supra* Part III.A.

[295] This is part of a broader system of state-based insurance regulation. McCarran-Ferguson Act, Pub. L. No. 79-15, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–1015); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 20–26 (1993). Recently, the federal government assumed a role with systemically important financial institutions, some of which are insurance companies. For discussion of this assumption, see Jeremy C. Kress et al., *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. 1455, 1500 (2019); Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1571 (2014).

[296] Schwarcz & Schwarcz, *supra* note 295, at 1579.

[297] *Id.* at 1580.

one state monitors an insurer's solvency in a system. These coordinated efforts are generally viewed as successful.[298]

As with nonprofits, state insurance regulators face the same two problems of choosing a single state regulator to monitor solvency and ensuring that the regulator's monitoring reflects nationwide policyholder risk, rather than merely the risk within one state. Insurance regulators solve the first problem by placing the regulator of the insurer's domiciliary state, analogous to the state of formation for nonprofits, in charge of solvency monitoring.[299] Although alternative ways could have been used to designate the overseeing state, there are benefits to having the domiciliary state be in charge. Insurers can change their domiciliary state,[300] and this threat of exit encourages regulators to offer an attractive package to maintain the economic benefits of retaining domiciled insurers.[301]

Regulators have solved the second problem of ensuring sufficient regulatory effort by jointly agreeing on a minimum set of solvency standards for each state regulator to apply. States are subjected to extensive audits to ensure compliance with the standard.[302] The consequences of failing the audit are severe; if a state loses its accreditation, then its domestic insurers will move to other, accredited states, taking their economic influence with them.[303]

State regulators may depart above (but not below) this required minimum baseline and implement heightened standards, and there is some market incentive for them to do so.[304] Some policyholders and other market participants may value

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[298] Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation?: Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1763–70 (2010) (noting that "the present system of solvency regulation appears to have been effective in the recent financial crisis," while analyzing the multiple areas for potential improvement).

[299] Daniel Schwarcz, *Is U.S. Insurance Regulation Unconstitutional?*, 25 CONN. INS. L.J. 191, 195–96, 206 (2018).

[300] REDOMESTICATION MODEL BILL § 1 (NAT'L ASS'N OF INS. COMM'RS 1980) (allowing redomestication if the insurer designates its principal place of business in a new state). For some states, redomestication is a costlier process than changing one's incorporation state. *See, e.g.*, FLA. STAT. § 628.281 (2020) (requiring only that domiciled insurers have an office, records, and assets within Florida). *See generally* NAT'L ASS'N OF INS. COMM'RS, UCAA UNIFORM CERTIFICATION OF AUTHORITY APPLICATION: REDOMESTICATION OF A FOREIGN (NON-DOMESTIC) INSURER: STATE REQUIREMENT REFERENCE CHART WHEN SELECTING A NEW DOMICILIARY STATE (2021), https://www.naic.org/documents/industry_ucaa_chart_redomestication.pdf?85 [https://perma.cc/S6G9-W9EG] (summarizing state redomestication requirements).

[301] *See* Schwarcz, *supra* note 299, at 206 (noting the pressure faced by New Mexico to adopt new legislation to maintain domesticated insurers).

[302] NAT'L ASS'N OF INS. COMM'RS, FINANCIAL REGULATION STANDARDS AND ACCREDITATION PROGRAM 10 (2019), https://www.naic.org/documents/cmte_f_frsa_pamphlet.pdf [https://perma.cc/NKQ5-KERQ].

[303] *See* Schwarcz, *supra* note 299, at 195–96 (arguing that this compulsory power is so effective that it makes insurance regulation unconstitutional under a separation of powers analysis).

[304] *See, e.g.*, *id.* at 205 (noting that the coordinated program is designed so that "individual state departments' solvency regulation meets minimum standards"); *Accreditation*, NAT'L ASS'N OF INS.

doing business with more heavily regulated insurers, leading state regulators to implement higher standards to attract business to their state.[305] Additionally, insurance regulators are required to seize and wind down domiciled insurers that fail solvency tests, with losses funded through a prospective assessment on other insurers in the state.[306] Seizures and accompanying financial assessments do not make insurers especially well-liked by their regulated constituents,[307] giving them reason to monitor and prevent insolvencies to avoid having to intervene.[308]

To be sure, there are meaningful differences between insurer solvency regulation and oversight of nonprofit entities. Yet the success in the insurance context suggests similar coordination could be achieved in the nonprofit space.

5. Two Challenges

Before concluding, we consider what we think are two of the most significant unique challenges in designing a state attorney general-led solution.[309]

COMM'RS, https://content.naic.org/cipr_topics/topic_accreditation.htm [https://perma.cc/8BBW-HUSU] (June 23, 2020) ("The purpose of the accreditation program is for state insurance departments to meet baseline standards of solvency regulation . . . .").

[305] *See, e.g.*, Brief for the Appellee at 9, Curcio v. Comm'r, 689 F.3d 217 (2d Cir. 2012) (No. 10-3578), 2011 WL 1977515 (noting that the plan administrator chose insurance plans only from companies licensed by New York because they were "perceive[d] as more reliable"). In addition, insurers' financial health is regularly rated by consumer-facing organizations, with strong financial condition often seen as a favorable attribute. AM BEST, GUIDE TO BEST'S FINANCIAL STRENGTH RATINGS–(FSR) 1 (2019), http://www.ambest.com/ratings/guide.pdf [https://perma.cc/E997-ETQJ].

[306] *See, e.g.*, Daniel Schwarcz, *Ending Public Utility Style Rate Regulation in Insurance*, 35 YALE J. ON REGUL. 941, 976 n.178 (2018); Adam Hodkin, Note, *Insurer Insolvency: Problems & Solutions*, 20 HOFSTRA L. REV. 727, 743–44 (1992); *Troubled Companies*, NAT'L ASS'N OF INS. COMM'RS, https://ontent.naic.org/cipr_topics/topic_troubled_companies.htm [https://perma.cc/AND8-B65Q] (Mar. 9, 2020).

[307] *See, e.g.*, Nicole Friedman, *California Puts Former Berkshire Insurance Unit Under State Control*, WALL ST. J. (Nov. 5, 2019), https://www.wsj.com/articles/california-puts-former-berkshire-insurance-unit-under-state-control-11572996598 [https://perma.cc/UGG2-Z7ZK] (characterizing a seizure publicly as "bad news for insurers in the state and for the citizens who will pay, ultimately, for the legal defense of this illogical, vindictive action" (quoting Jeffrey Silver)).

[308] This is especially true to the extent that the regulator wishes to enter private practice in the future, from which they often come before becoming a regulator. For more on this potential problem, see Michael J. Mishak, *Drinks, Dinners, Junkets and Jobs: How the Insurance Industry Courts State Commissioners*, CTR. FOR PUB. INTEGRITY, https://publicintegrity.org/politics/state-politics/drinks-dinners-junkets-and-jobs-how-the-insurance-industry-courts-state-commissioners/ [https://perma.cc/58NC-VVWH] (Oct. 3, 2016). *See generally* Schwarcz, *supra* note 298, at 1759, 1763 (expressing concerns about regulatory capture).

[309] Gaining traction among the nonprofit community and its patrons is certainly a challenge, but it is not unique to state attorney general oversight. For more of a discussion on this challenge, see *supra* notes 272–273 and accompanying text.

a. The Scope of Oversight

Foremost among the remaining challenges involves defining the scope of regulatory involvement. To deploy limited regulatory capital in its most productive manner, we recommend extending oversight along two dimensions. The first involves policing the nonprofit nondistribution constraint. As identified throughout this Article, the nondistribution constraint provides the legal difference between nonprofit and for-profit firms.[310] Weak enforcement of this constraint means that, for practical purposes, the line between nonprofit and for-profit firms can become considerably blurred. Robust oversight of this essential attribute of nonprofit firms can help the collective nonprofit sector by promoting the trust that the form can have a comparative advantage in generating.

The second dimension of oversight should involve flagging the most egregious cases of agency cost abuse, such as fraud or illegal conduct. Curbing these clear cases should provide significant value, while minimizing concerns of regulatory overreach that could otherwise result if regulators began questioning firms' ordinary business decisions.

We recognize that governance failures below these high bars are still troubling, and to police them we suggest relying on the existing, imperfect monitors identified in Part II. Aiding those existing monitors brings up a potential third suggested dimension of attorney general oversight: monitoring nonprofit disclosures, such as those made through Form 990 or that we recommend above.[311] Disclosure serves little value if it cannot be relied upon as accurate. Oversight by state attorneys general would effectively act as an additional certification mechanism for these disclosures.[312] State attorneys general have an interest in trustworthy nonprofits forming within their state and therefore in accurate disclosures.[313] They are thus a party who would be motivated to make sure these disclosures, which are designed to promote trustworthy nonprofits, are accurate.[314]

b. Preventing a Race to the Bottom

Earlier in this Part, we identified the financial incentives that might lead state attorneys general to "race to the top" in offering comprehensive nonprofit

[310] *See supra* Part I.

[311] *See supra* Part III.A.1.

[312] The IRS, of course, would also be a natural fit for monitoring these disclosures.

[313] *See supra* Part III.B.3.

[314] A common yet difficult problem faced by certification systems is how to trust the certifier. Successful systems are often built on the threat of a certifier suffering meaningful losses should its certification later prove to be inaccurate. *See, e.g.*, Srinivasan Krishnamurthy et al., *Auditor Reputation, Auditor Independence, and the Stock-Market Impact of Andersen's Indictment on Its Client Firms*, 23 CONTEMP. ACCT. RSCH. 465, 468 (2006); Molk, *supra* note 228, at 250.

oversight.[315] What of the worry that states might respond by "racing to the bottom," encouraging bad governance by attracting nonprofit formations through offering minimal oversight that allows those nonprofits to engage in opportunism?

Preventing this undesirable outcome could be done with some coordination among the states. Happily, the state attorneys general have already developed a centralized organization that can help facilitate this coordination: the National Association of Attorneys General.[316] Following the example of insurance solvency regulation, we could imagine the attorneys general agreeing on a minimum baseline approach to nonprofit monitoring for all states to employ.[317] To encourage states to offer that minimum baseline, nonprofits formed within a state meeting the baseline could be required to comply with oversight-related provisions of only its formation state. As with insurance solvency regulation, if states dip below this threshold, nonprofits would then have to comply with monitoring in all states in which they do business, leading nonprofits whose activities span state lines to shift their state of formation (and accompanying revenue) to another compliant state.[318] This solution that coerces states to comply thereby achieves a coordination goal long-sought by nonprofit firms and commentators.[319]

An additional inducement could be added to ensure state compliance with a minimum standard, built on a principle of rewarding "carrots" or punishing "sticks."[320] The carrots-based approach would reward states that fulfill their oversight functions with particular success. If we measure success by the ability to attract nonprofit formations, then carrots could be supplied if a nonprofit's formation state could collect money payments from other states where the nonprofit has activities. This payment might, for example, reflect the saved oversight that the non-formation state enjoys.

Alternatively, sticks could be levied if states had guaranty funds that paid out when a domestic nonprofit was found to have engaged in misconduct, analogous to state solvency regulation guaranty funds. Even if the funds were

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[315] *See supra* Part III.B.3.

[316] *About NAAG*, NAT'L ASS'N OF ATT'YS GEN., https://www.naag.org/about-naag [https://perma.cc/PAN5-EEKN].

[317] We think that even a flexible principles-based approach, which leaves discretion to individual regulators, could be successfully coordinated among the states, for the same reasons it could prove successful in insurance solvency regulation. Schwarcz, *supra* note 298, at 1766–69.

[318] *See supra* note 301 and accompanying text (describing the threat of exit with respect to the insurance solvency market).

[319] *See supra* note 162 and accompanying text.

[320] For more on the difference between these approaches, as well as an analysis of when one might be more favorable than the other, see Brian Galle, *The Tragedy of the Carrots: Economics & Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 802 (2012).

supplied by other domestic nonprofits, the pressure to refrain from assessing them could push for more diligent oversight by regulators, as it does with insurance solvency regulation.[321]

Market forces also should provide some corrective force, even if states are unable to coordinate on a minimum baseline. Should state attorneys general prove opportunistic with their enforcement targets, nonprofits could simply reincorporate (and bring associated revenue) to a state with a more principled enforcement regime. Similarly, a nonprofit might form in a state with lax oversight, but doing so sends a negative signal to donors and patrons who rely on good governance that the nonprofit should not be trusted, analogous to a for-profit firm's decision to form in Nevada (with its weak governance requirements) instead of Delaware.[322]

Finally, the threat of federalizing nonprofit oversight consistently lurks in the background to deter state-based over- or under-ambitious oversight.[323] Indeed, several inroads have already been made by the IRS, evidencing federal oversight as a legitimate concern.[324] Weak state enforcement therefore risks having state enforcement power coopted by a federal agency.

Notably, any of these approaches that relies on state coordination would require states to give up some of their oversight power, which some states have been loath to do.[325] We hope that the potential for significant welfare gains might be sufficient to overcome this resistance. Helpfully, nonprofit governance regulation does not seem particularly salient to the public most of the time, increasing the potential that individual states and their elected regulators might be willing to relinquish some power to achieve desirable national coordination.[326]

C. Federalizing Nonprofit Enforcement

Finally, we briefly consider the potential for federalizing nonprofit monitoring. Rather than state-level action, federal-level action may be warranted

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[321] *See supra* notes 307–308 and accompanying text.

[322] *See, e.g.*, Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 938 (2012). For some firms, however, Nevada's weak enforcement can be optimal in that it reduces the inefficiently high monitoring required in other jurisdictions. Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165, 1169 (2012).

[323] Roe, *supra* note 278, at 590.

[324] For discussion of existing IRS enforcement, see *supra* Part II.B.3.

[325] *See, e.g.*, *supra* note 82 and accompanying text (detailing California's purported control over nonprofits located outside the state's borders).

[326] Public salience may explain the success of coordinated insurance solvency regulation but not of other types of insurance regulation, such as regulation of price, which matters more to local constituents. *See* Schwarcz, *supra* note 298, at 1759 (expressing concerns that low-salience regulatory topics will lead to coordinated under-regulation in insurance).

beyond existing federal tax regulation. Other countries with similar legal and market structures employ this approach. Australia relies on a public enforcement body, the Australian National Charities Commission, in the nonprofit setting, with enumerated oversight functions and disclosure requirements.[327] Similarly, England and Wales each have public charity commissions charged with nonprofit oversight.[328]

The potential advantages of federal oversight are several. The IRS, a federal body, already conducts nonprofit oversight, and the existing apparatus could be adapted to meet these broader goals. Moreover, to the extent it is more immune from political pressure than state attorneys general might be, a federal overseer might address some of the concerns that have been raised with opportunistic attorney general enforcement.[329] Finally, eliminating state competition by federalizing nonprofit enforcement also eliminates the worry of a race to the bottom among states that might maximize their nonprofit formation business by minimizing nonprofit oversight.

However, we expect that these advantages would be outweighed by the potential downsides. Most significantly, compared to an attorney general-led solution, a federal solution loses the element of competing for nonprofit incorporations, perhaps reducing the incentive to supply high-quality nonprofit law and services.[330] It also relies on federal oversight being independent rather than targeting nonprofits for political or other reasons. Recent allegations of politically motivated IRS oversight of new nonprofit tax exemptions call this assumption into question,[331] and the rich literature on regulatory capture shows the problems from relying on only a single oversight body.[332] Finally, federal oversight would impinge on corporate governance features that have long derived solely from state law, and implementing such a fundamental shift would involve some serious heavy lifting.[333]

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[327] Ian Ramsay & Miranda Webster, *Registered Charities and Governance Standard 5: An Evaluation*, 45 AUSTL. BUS. L. REV. 127, 127 (2017).

[328] Ian Murray, *Regulating Charity in a Federated State: The Australian Perspective*, 9 NONPROFIT POL'Y F., no. 4, 2019, at 1, 1.

[329] Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 MICH. L. REV. 570, 573 (1996). *Contra generally* Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553 (2001) (challenging this view).

[330] Alternatively, if we were concerned more about a race to the bottom among attorneys general, then eliminating this competition could be beneficial.

[331] *See, e.g.*, Lloyd Hitoshi Mayer, *The Promises and Perils of Using Big Data to Regulate Nonprofits*, 94 WASH. L. REV. 1281, 1322 (2019).

[332] *See, e.g.*, Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089, 1089 (1991).

[333] Creative solutions might attempt to combine the advantages of both revamped state and federal oversight. Environmental law provides an example of a dynamic regulatory federalism that combines both federal and state levels of enforcement. *See, e.g.*, Revesz, *supra* note 329, at 558. *See generally* Lloyd Hitoshi Mayer, *Fragmented Oversight of Nonprofits in the United States: Does It Work?*

D. Measuring Nonprofit Effectiveness

Because they may have goals beyond wealth maximization, nonprofits face a challenge of identifying the appropriate performance metrics to measure success; for-profit measures cannot just be applied to nonprofits with an expectation of success. For-profits can measure success by growth, expected cash-flows in the future, higher profit margins, or numerous accepted valuation benchmarks.[334] Nonprofits may not want to grow, may value concepts, such as stakeholder engagement, and may have broad public policy goals independent of any profitability concerns.

How then to assess what is "good" nonprofit governance? Some organizational structures already attempt to solve the effectiveness issue by laying out predetermined measurements. B Lab, which certifies B Corporations, has attempted to measure the nebulous concept of social enterprise.[335] Guidestar and Charity Navigator also attempt to measure specific financial-related aspects of nonprofit operations.[336] These principles can be tailored to the nonprofit space for nonprofits for "high quality" governance as part of the standard setting that we discussed with regard to certification in Part III.A.2.

Additionally, nonprofits can be measured, more modestly, in part for what they do not do, rather than what they do. That is, many fiduciary duties—in both the for-profit and nonprofit context—are based on negative duties (boards should not do certain things) rather than on positive duties to undertake certain actions. For example, the duty of care under Delaware law requires informed decision-making, refraining from gross negligence.[337] The duty of loyalty is the absence of self-dealing or lack of oversight.[338] These negative duties provide a frame-

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Can It Work?, 91 CHI.-KENT L. REV. 937 (2016) (discussing some advantages of dual state-federal oversight).

[334] A number of academics have suggested quantifying rankings to reflect effective corporate governance. *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 783 (2009) (offering an alternative measure of quality of corporate governance, with a simplified set of six factors, which the authors link to performance); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 119 (2003) (creating a firm-level index in which the authors identified a correlation between anti-takeover measures and Tobin's Q). These metrics do not work for nonprofit governance because they measure issues that typically apply in the for-profit setting.

[335] Suntae Kim & Todd Schifeling, Varied Incumbent Behaviors and Mobilization for New Organizational Forms: The Rise of Triple-Bottom Line Business Amid Both Corporate Social Responsibility and Irresponsibility 7 (July 11, 2016) (unpublished manuscript), https://ssrn.com/abstract=2794335 [https://perma.cc/9GDB-QV6D].

[336] *See supra* note 95 and accompanying text.

[337] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Gagliardi v. Trifoods Int'l, Inc. 683 A.2d 1049, 1050 (Del. Ch. 1996).

[338] Gantler v. Stephens, 965 A.2d 695, 706–08 (Del. 2009) (en banc); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

work for how to measure the minimum for what good governance in the nonprofit setting requires: the absence of particularly problematic behavior.

CONCLUSION

Nonprofits by their nature lack many of the monitors of managerial misconduct that are enjoyed by for-profit organizations. This problem, although not novel, has persisted for decades without being addressed. We propose three attainable ways of tackling it with the goals of reinvigorating stakeholder trust in the nonprofit organizational form and of promoting better social outcomes across the variety of sectors in which nonprofits flourish.