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The Public Interest and Governing Boards of Nonprofit Health Care Institutions

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I. INTRODUCTION

A significant amount of recent activity in health care policy has focused on supplanting regulatory intervention in the allocation and pricing of health care services with legislative strategies that will promote competitive markets.[1] Among those activities facing particular scrutiny are state programs to review and approve hospital budgets and rates,[2] federally mandated certificate-of-need programs that review and approve substantial capital expenditures and new services undertaken by health care providers,[3] and utilization review conducted by professional standards review organizations.[4] Proponents of competition strategies are concerned principally with performance issues including whether regulation can fairly correct misdistributions in health care services, curb the potential for excessive demand, and control increases in the costs of providing services.[5]

While it is worthwhile to examine the performance of regulatory programs in terms of their manifest functions, these endeav-

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1. *See, e.g.*, Health Planning and Resources Development Amendments of 1979, Pub. L. No. 96-79, § 103, 93 Stat. 594-95; National Healthcare Reform Act of 1980, H.R. 7527, 96th Cong., 2d Sess. (1980).

2. *See generally* CONN. GEN. STAT. ANN. §§ 19-73a to -73t (West 1977 & Supp. 1980); MD. PUB. HEALTH CODE ANN. §§ 568H-568Z (Supp. 1978); MASS. GEN. LAWS ANN. ch. 6A, §§ 37-44 (West Supp. 1981); N.J. STAT. ANN. §§ 26:2H-1 to -4.1, -9, -10, -12, -14, -18, 17:48-7 (West Supp. 1980-81); N.Y. PUB. HEALTH LAW §§ 2801, 2801-c, 2803, 2803-b, 2804, 2805, 2805-a, 2805-g, 2806, 2807, 2807-a (McKinney 1977 & Supp. 1980-81); WASH. REV. CODE ANN. §§ 70.39.010-.910 (1975 & Supp. 1981).

3. *See generally* 42 U.S.C. § 300m-6 (1976 & Supp. III 1979).

4. *See generally* 42 U.S.C. § 1320C-1 to -22 (1976 & Supp. III 1979).

5. R. MERTON, SOCIAL THEORY AND SOCIAL STRUCTURE 73-138 (2d ed. 1968).

ors sometimes neglect the latent functions[6] fulfilled by regulatory agencies. For one thing, health care institutions are regulated primarily by public or quasi-public agencies, and the public nature of this regulation in itself promotes key values. Regulatory programs in the health care industry are ultimately accountable to legislative policies and purposes. Regardless of whether this accountability derives directly from the legislature or through intermediation of judicial review, the result is that health care providers and insurers operate within a defined set of objectives that, at least in theory, represents an intricate balancing of sometimes quite diverse interests. The outcome of this balancing in a public forum generally is perceived as legitimate because it is achieved through the political process in a manner consistent with the democratic structure of our society.[7]

Furthermore, the reliance on regulation to develop and implement policy affecting health care institutions offers consumers and providers alike an opportunity to participate directly in policymaking processes through devices such as public hearings and notice and comment procedures for promulgating regulations.[8] Regulation also facilitates consumer access to information about the operation of health care institutions that is publicly disclosed in regulatory filings. If this information is not routinely disclosed, the public may obtain it through "Freedom of Information" statutes.[9]

Public regulation can also be an effective means of attaining cost-containment objectives, in large part because government functions as a major payor in the system.[10] For the twelve-month period ending in March 1980, federal, state, and local governments funded forty percent of all personal health care expenditures[11] and

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6. *Id.*

7. For a more detailed discussion of this point, see Weiner, *Public Values on Private Regulation: Some Reflections on Cost Containment Strategies* (forthcoming in MILBANK MEMORIAL FUND Q.).

8. *See, e.g.*, 5 U.S.C. § 553 (1976); MASS. GEN. LAWS ANN. ch. 30A, §§ 2-3 (West 1979).

9. 5 U.S.C. § 552 (1976); MASS. GEN. LAWS ANN. ch. 4, § 7 ¶ 26 (West 1976); *id.* ch. 66, § 10 (West Supp. 1981). Privileged or confidential trade secrets and commercial or financial information obtained from a person are exempt from disclosure under the Federal Freedom of Information Act (FOIA). The FOIA, however, does not create a private cause of action to enjoin disclosure of information that may fall within any of its exemptions, and federal agencies may disclose cost reports submitted by Medicare providers. *See* Parkridge Hosp., Inc. v. Califano, 625 F.2d 719 (6th Cir. 1980); Humana of Va., Inc. v. Blue Cross, Inc., 622 F.2d 76 (4th Cir. 1980).

10. The term "payors" is used to include both the individual users who pay for services out of pocket and the "third-party" payors, such as commercial insurance companies, Blue Cross/Blue Shield, and the Medicare and Medicaid programs.

11. *See National Health Expenditures and Related Measures for the Year Ending in*

fifty-six percent of all hospital care expenditures.[12] Moreover, the percentage of hospital care expenditures, as well as all personal health care expenditures, funded directly through public sources has steadily increased over the last five years. The share of public funding of hospital care expenditures rose from fifty-four percent in 1976 to fifty-six percent in 1980.[13] The public has also directly or indirectly funded hospitals and other health care institutions through federal loans for construction,[14] federal loans and grants to medical schools and students in professional health training programs,[15] lost governmental revenue because of tax exemptions for charitable institutions,[16] and tax deductions for medical expenditures.[17] Because of its role as payor, government's interest in cost containment necessarily will remain strong. Furthermore, since regulation heretofore has been the principal mode for achieving cost containment, public accountability, public participation, and public access to information appear to be reasonably well entrenched as effectual elements in cost control efforts.

Within competitive models, private regulatory relationships replace public ones. Instead of a public agency imposing resource constraints on private providers, these constraints either are self-imposed or are enforced by other private parties and mechanisms such as health care plans. In neither case is a public agency available to ensure that private responses to resource constraints are consistent with the public interest. The competitive models assume that a market in which consumers are free to choose among health care plans will ipso facto serve the public interest. It is not likely, however, that every consumer will find a plan or provider that reflects both his or her economic and noneconomic values. Moreover, it is not necessarily the case, at least for the foreseeable future, that competitive plans or providers will produce an array of choices that most appropriately maximize the public benefit in a

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March 1980, HEALTH CARE FINANCING TRENDS, Summer 1980, at 5. The federal government funds 28% of all personal health care expenditures, and state and local governments fund 12% of these expenditures.

12. *Id.* Forty-one percent (41%) of hospital care expenditures are funded by the federal government and fifteen percent (15%) are funded by state and local governments.

13. *Id.*

14. 42 U.S.C. §§ 291 to 291o-1 (1976).

15. 42 U.S.C. §§ 292 to 295g-10 (1976 & Supp. III 1979).

16. 26 U.S.C. §§ 501(a), (c)(3) (1976 & Supp. III 1980).

17. Greenspan & Vogel, *Taxation and Its Effects Upon Public and Private Health Insurance and Medical Demand*, HEALTH CARE FINANCING REV., Spring 1980, at 39. The authors estimated that tax revenue foregone by the federal government due to tax deductions for health insurance alone would amount to $10.6 billion in 1980. *Id.* at 40.

perceptibly legitimate fashion.

The question, then, is how one can ensure in a system characterized primarily by private competitive relationships, that private responses to constraint are consistent with the public interest and that the public has an opportunity to participate in the decisions that produce these responses. A critical issue in such a system is the extent to which health care institutions have developed effective corporate governance mechanisms that allow the public to help shape institutional policies. This Article specifically considers whether the existing legal system permits corporate governance mechanisms to function in a manner that promotes the public interest, particularly the public's interest in disclosure and participation in institutional policy development. The Article focuses on the viability of corporate governance structures in the health care industry, with special emphasis on the nonprofit hospital corporation.[18]

The Article begins with an overview of the issue of role reversal between management and directors of nonprofit corporations. The manifestations of role reversal are seen in the trend in nonprofit corporations toward excessive delegation of board powers to executive committees, the elimination of the potential for independent control over the board of directors by the absence of membership requirements for nonprofit corporations, and abuse of the power to alter the charters and bylaws of these corporations, particularly with respect to the size and composition of the board of directors.

The Article argues that a principal reason for the reversal of the direction of managerial control is the insufficient development

18. Hospitals are the most visible institution in the health care system, and voluntary nonprofit entities are the predominant form of hospital organization, accounting for approximately 70% of all nonfederal short-term general and other special hospital beds. *See* AMERICAN HOSPITAL ASSOCIATION, HOSPITAL STATISTICS 4-7 (1980). The 1979 survey data in this volume indicate that approximately 9% of all hospital beds in the United States are in federal hospitals; 19% are in nonfederal psychiatric, tuberculosis, and other special and long-term general hospitals; and 72% are in nonfederal short-term general and other special hospitals. The form of ownership is not delineated for the second group of hospitals, but among the nonfederal short-term general and other special hospitals 70% of the beds are accounted for by nongovernmental, nonprofit hospitals, 8% are accounted for by investor-owned (for-profit) hospitals, and 22% of the beds are found in state and local governmental hospitals. In addition to their predominance in the health care system, voluntary nonprofit hospitals are the focus of this Article because they are typically organized as nonprofit or charitable corporations pursuant to state nonprofit corporation enabling acts, although occasionally nonprofit hospitals may be organized as unincorporated trusts. 2A HOSPITAL LAW MANUAL, *Governing Board* § 1.

in the nonprofit sector of statutory and judicial remedies to enforce the supervisory role of the board of directors. The Article contends that statutory mechanisms to ensure the board's accountability to the membership are inadequate, if not nonexistent. Since nonprofit corporation statutes allow for a situation in which control need not be extended beyond the corporation's original promoters, it is submitted that the definition of "members" in these statutes do not adequately protect the public interests that health care institutions serve.

Given this analysis, the Article concludes that the statutory framework for nonprofit corporations must be refined for the purposes of health care institutions, principally hospitals, so that the direction of managerial control rests squarely with the board of directors; so that the membership of nonprofit corporations is broadly defined; and so that the functions of the members are analogous to those of shareholders in the for-profit sector. This Article regards these reforms as critical in an environment in which private regulation is widely believed to be an effective and desirable alternative to public health care regulation. Without them the public interest cannot be protected in a competitive system.

II. Control and Accountability in Nonprofit Corporations

A. *A Critique of the Present System*

That problems exist with the governance of many nonprofit health care institutions is a declaration made by an increasing number of individuals concerned about the future of the health care industry. In a recent essay,[19] one such commentator, Professor Robert Clark, raised a number of issues concerning the governance of nonprofit hospitals that relate to the focus of this Article. While both Clark and the authors of this Article have similar concerns about the state and direction of hospital governance,[20] Clark approached the problems raised by nonprofit dominance from a perspective that is different from the one used in this Article. Despite this difference, it is useful to examine Clark's analysis to understand the magnitude of the issues arising from the management of nonprofit health care corporations today.

Clark suggested that nonprofit hospitals may be operationally inefficient, that they are imprecise in the manner in which they

19. Clark, *Does the Non-profit Form Fit the Hospital Industry?*, 93 Harv. L. Rev. 1417 (1980).
20. *Id.*

respond to demands for service, and that they promote costly "high technology medical care."[21] Clark proposed two alternative hypotheses—"voluntary" and "elitist"—to explain the economic behavior of nonprofit hospitals. Both hypotheses presume that hospitals function as minigovernments to the extent that they engage in the production of public goods and exact "taxes" from patients and donors. The "taxpayer" is defined as either a patient, a third-party payor acting in a patient's behalf, or a donor who pays for hospital services that benefit some other individuals or the public at large.[22]

The voluntary hypothesis posits that hospitals acting as minigovernments in fact explain their cross-subsidization program to consumers, disclose their redistribution programs (*i.e.*, free care, research programs, and teaching activities), allow consumers a role in selecting managers, and consider adjusting charges to customers who prefer to pay a greater or lesser amount of the "tax."[23] The elitist hypothesis, on the other hand, posits that those who control hospitals act as an elitist government. They charge for services at rates that will allow funds to be directed toward research, teaching, and favored departments and patients. They do not fully disclose or advertise this practice, and they do not provide consumers with any real choices, either by differential pricing or by permitting consumers to participate in the redistribution decisions. The elitist hypothesis concludes that those who control nonprofit hospitals operate as an "undemocratic ruling class with respect to the hospital's minigovernmental functions."[24]

Clark found some support for the elitist hypothesis as the better explanation for the economic behavior of nonprofit hospitals, in part because nonprofits engage more frequently than for-profit hospitals in cross-subsidization practices and because nonprofits often inadequately disclose their "taxation" policies. Clark also concluded that nonprofit hospitals' minigovernmental activities are determined by an elitist group of individuals who tend to perpetuate their control by selecting their successors.[25]

The issue of control in the nonprofit hospital was explored more fully by Clark in a parallel hypothesis (the "exploitation" hypothesis) which suggested that control is more often exercised out

21. *Id.* at 1417-19.
22. *Id.* at 1433, 1437-41.
23. *Id.*
24. *Id.* at 1439.
25. *Id.* at 1465-66.

of self-interest than out of any sense of fiduciary responsibilities.[26] While the supporting data are unclear, Clark found some support for the exploitation hypothesis in the existence of significant incentives for physicians to exploit the nonprofit hospital for their own personal financial and professional gain. In this connection, physicians might successfully manipulate the nonprofit institutions' favorable public image for their own benefit.[27] This practice diminishes the likelihood that nonprofit hospitals will either disclose redistribution programs and cross-subsidization practices or allow consumers a role in selecting the hospitals' officers and directors.[28]

Clark's conclusions are consistent with the findings of other commentators insofar as they assert that physicians and managers of nonprofit health care institutions exercise an inordinate degree of control over matters that the corporation's directors and members traditionally have commanded.[29] As a partial explanation for directors' dereliction of their duties, Clark noted that few incentives exist for directors of nonprofit hospitals to exercise control over hospital managers.[30] Nevertheless, directors of nonprofit hospital corporations theoretically remain responsible for directing managers of the corporation, and the directors may not neglect their fiduciary duty to participate actively in the management of corporate affairs.[31] In view of this criticism of the roles now played by many directors of nonprofit corporations, Clark's inquiry into the operational activities of nonprofit hospitals should be extended. It is important to consider *why* physicians and managers

26. The notion of the fiduciary character of nonprofit organizations was suggested in the work of Henry Hansmann, who argued that nonprofit corporations have developed as a response to "contract failure." "Contract failure" arises when a consumer is unable to impose adequate constraints on an institution by the ordinary mechanism of direct and private contract. In industries providing complex, personal services of a nonstandardized nature, such as the health care industry, it is difficult for the consumer to determine whether services are performed competently. In such industries nonprofits arise as a response to consumer distrust of ordinary contractual remedies to control quality, and the consumer takes advantage of the "nondistribution constraint" characteristic of nonprofit organizations to impose additional constraints upon organizational behavior. *See* Hansmann, *The Role of Non-profit Enterprises*, 89 YALE L.J. 835 (1980). Hansmann qualified the analysis by explaining that hospitals seem to represent an unusual case and that other factors—chiefly the historical development of the hospital industry—explain the emergence of nonprofit hospitals as the prevalent form of organization. *Id.* at 866-68.

27. Clark, *supra* note 19, at 1433-37.

28. *Id.* at 1465-71.

29. *See* notes 36-40 *infra* and accompanying text.

30. Clark, *supra* note 19, at 1445.

31. W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 9.09 (3d ed. 1978).

are able to exercise such expansive control. It is the hope of this Article that by examining the management issues in nonprofit health care corporations and the statutory framework for their regulation, the answers can be found to two more central questions—namely, whether the nonprofit corporate governance mechanisms can sustain a level of public accountability and participation in a competitive environment and whether the mechanisms can function in a manner consistent with the public interest.

B. *The Nature of the Problem*

The board of directors of a nonprofit corporation is responsible for setting institutional policies and monitoring the implementation of those policies on a regular basis.[32] Because the activities of nonprofit corporations can significantly affect the public interest, directors of such institutions have recently become the focus of much debate. Some observers have charged that many directors of nonprofit corporations inadequately fulfill their responsibilities.[33] Other commentators, however, while agreeing with the assessment that many directors have been laggard, have observed changes in the boards of nonprofit corporations in recent years.[34] These commentators argue that some boards are in fact assuming their responsibilities, in part because they are motivated by the fear that legal sanctions for the breach of their fiduciary duties may be imposed upon them. While this latter perspective is no doubt true for some boards, it is nevertheless the case that many directors frequently fail even to recoguize that they are obliged to oversee the management of the corporation. Often the board of directors of a nonprofit corporation restricts its functions to perfunctory approval of management proposals and, when necessary, the selection

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32. Anthony, *Can Nonprofit Organizations Be Well Managed?*, 37 VITAL SPEECHES OF THE DAY 442, 443 (1971); *see* Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 381 F. Supp. 1003, 1014 (D.D.C. 1974).

33. R. ANTHONY & R. HERZLINGER, MANAGEMENT CONTROL IN NON-PROFIT ORGANIZATIONS 66-68 (1975). The authors cite a study of 7,000 board actions recorded in the minutes of the board meetings of 19 public colleges and universities. The study found that a mere 6% of the board decisions were planning decisions. Most of the board actions were routine in nature, and a substantial percentage of the routine decisions were ratifications of decisions already made by the administration. *Id.* at 67. The directors of nonprofit hospital corporations have also failed to respond adequately to their supervisory roles. *See* Donnelly, *The Trustee as Steward for the Community and the Sponsor*, HOSPITAL PROGRESS, July 1979, at 62; Ford, *Business Not as Usual in Hospitals*, HOSPITALS, Apr. 1, 1980, at 159.

34. R. ANTHONY & R. HERZLINGER, *supra* note 33, at 68.

of a new corporation president.[35]

Reports of an inappropriate reversal of the supervisory role of the board of directors and the management functions of corporate officers and employees evidence the fact that nonprofit boards often do not exercise the full scope of their authority.[36] The direction of overall managerial control sometimes ceases to flow from the board and emanates instead from the corporate officers and other managerial employees. The "capture" of the board by management may arise in the common arrangement in which the members of the corporation, who are the functional equivalent of shareholders, are also the officers and employees of the corporation.[37] This situation creates dual power groups in the board and the management. The balance of power resides in management, however, since it in fact elects the board of directors. Such an arrangement is often accompanied by the presence of either a management-dominated board executive committee or an independent administrative committee comprised of managers who assume the board's responsibilities.[38]

An even more unfortunate situation arises when either the corporation has no members or the articles of incorporation provide that the board of directors is coterminous with the corporation's membership. The absence of an effective membership means that the "watchdog" function of shareholders, minimal though it may be, is nonexistent and that no independent group is empowered to elect the board of directors. Self-perpetuation of the existing board and the appointment of friendly successors inevitably results from this type of an arrangement.[39] A self-perpetuating board of directors in turn naturally exacerbates the possibility of role reversal beween management and the board, since control of the board is more easily "captured" when the directors need not account for their actions to a membership that elects them.[40]

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35. Anthony, *supra* note 32, at 443.

36. Oleck, *Proprietary Mentality and the New Non-Profit Corporations Laws,* 20 CLEV. ST. L. REV. 145, 162-63 (1971).

37. *Id.* at 162-63, 167-68.

38. *Id.*

39. Taft, *Control of Foundations and Other Non-Profit Corporations,* 18 CLEV. ST. L. REV. 478, 482 (1969).

40. While it is difficult to document the extent of self-perpetuation accompanied by role reversal, the leading legal commentator in the field of nonprofit corporations estimates that approximately one-half of all nonprofit organizations are dominated by individuals or small groups who seek their own advantage from this affiliation. Oleck, *supra* noto 36, at 165. *See also* Oleck, *Nature of Nonprofit Organizations in 1979,* 10 U. TOL. L. REV. 962 (1979), which suggests that in the past decade lawyers, state legislatures, and state adminis-

Two other trends in the governance of nonprofit corporations tend to support the observation that boards of directors of nonprofit corporations often fail to fulfill properly their supervisory functions. First, executive and other board committees are too frequently relied upon to do work that is the responsibility of the entire board. One commentator has noted that nonprofit organizations inappropriately rely upon committees more often than business organizations.[41] Second, in nonprofit corporations the power to amend the corporate bylaws may reside solely in the board.[42] If a small group or an individual gains control of the board, the size and composition of the board can be easily manipulated to preserve that control through a board-approved amendment to the articles or the bylaws.[43]

The overall effect of these trends is to create weak links in the structure of accountability in nonprofit corporations. An ineffective accountability structure is in turn responsible at least in part for the mediocre management practices with which nonprofit organizations have become associated.[44] There are, however, other problems inherent in an attempt to manage nonprofit organizations efficiently and effectively. These problems include the absence of the profit motive as a measure of performance, the diminished impact of market forces, the dominance of professionals within management, and the effect of donor behavior on corporate planning.

The profit margin in proprietary organizations provides a readily available criterion for determining the organization's efficiency and effectiveness.[45] The nonprofit organization, however, cannot use a single criterion for measuring both aspects of performance, since economic efficiency is not invariably consistent with the most effective means of achieving the organization's purposes. Moreover, performance evaluation of service-related industries is difficult even in the for-profit sector because the quality of services cannot easily be measured.

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trative agencies have not changed the manner in which they treat nonprofit organizations.

41. Oleck, *supra* note 36, at 156-62, 166.

42. *See* notes 94-114 *infra* and accompanying text.

43. Taft, *supra* note 39, at 483-84.

44. Anthony, *supra* note 32, at 442-43.

45. R. ANTHONY & R. HERZLINGER, *supra* note 33, at 35-38. The authors also note that profits are not a panacea for measuring performance in the for-profit secter, because they tend to measure current rather than long-run performance, they fail to compare actual performance with the potential level of profit, and they are dependent upon discretionary choices made among various accounting techniques.

The diminished impact of market forces upon management choices also complicates the management of nonprofit organizations. For-profit organizations invariably increase profits when the number of customers increases. Nonprofit organizations, however, do not necessarily benefit from increased demand, particularly if the organizations' incomes are fixed by endowment or annual giving, or if third-party payors reimburse the organizations on a cost-per-unit-of-service basis regardless of volume.[46] In addition, because demand is not an accurate measure of success and performance is difficult to measure, nonprofit managers may be influenced by their personal assessments of organizational goals and appropriate resource utilization.[47]

The role of professionals in nonprofit organizations such as health care institutions contributes to the complexity of the management task. In many nonprofit organizations two parallel lines of management coexist—one consisting of the professional provider staff and the other consisting of managers.[48] The number of lateral components in the organization thus creates a staggering supervisory responsibility for any board of directors. Furthermore, professional providers are trained to exalt certain values and skills that may be antithetical to the management process. These values and skills include a tendency to measure achievement in accordance with professional standards promoted by an outside organization; a desire to remain in the practice of the profession rather than to devote full-time attention to management activities; a preference for working independently; inadequate training in or appreciation of management skills; and a tendency to give inadequate consideration to the financial implications of their activities.[49]

Managers of nonprofit organizations must also consider the influence of donors on the fiscal policies of the organization. Few incentives exist for the nonprofit organization to refuse to accept donations for capital expenditures that do not fulfill the specific needs of the institution. Donors tend to prefer edifices that will become visible symbols of their generosity. Yet such a gift requires

46. Vladeck, *Why Non-Profits Go Broke*, 42 PUB. INTEREST 86, 91-92 (1976).

47. R. ANTHONY & R. HERZLINGER, *supra* note 33, at 44-45.

48. Selby, *Better Performance from 'Nonprofits'*, 56 HARV. BUS. REV. Sept.-Oct. 1978, at 92, 98. *See also* Rushing, *Differences in Profit and Nonprofit Organizations: Study of Effectiveness and Efficiency in General Short Stay Hospitals*, 19 AD. SCI. Q. 474, 476-77 (1974). Rushing suggests that decisionmaking in for-profit hospitals is simpler than in nonprofit hospitals because the investor-owners in for profit hospitals are often physicians and the number of competing interests that the board must satisfy is reduced.

49. R. ANTHONY & R. HERZLINGER, *supra* note 33, at 46-48.

the institution to carry operating expenses in support of the capital expenditure. The operating expenses in turn place unnecessary financial pressures on the institution.[50] Moreover, nonprofit organizations tend to reward donors by making them directors—often without regard to the donor's qualifications for the position.

Managing a nonprofit organization, then, is a demanding task. A well-managed nonprofit organization requires sophisticated techniques of accounting, including the development of program and responsibility structures and systematic performance evaluation. It demands well-designed pricing policies, cost accounting, use of accrual accounting, and review of the constant emphasis on output measures. It also requires better compensation for senior management and a reward system for good management at all levels.[51]

First and foremost, however, it must be understood that a nonprofit organization cannot be managed well unless the board of directors (or the equivalent governing body in entities not organized as corporations) gains ascendancy in the organizational structure. The board must take an active role in establishing an accountability structure, overseeing management activities, and conducting long-range institutional planning.[52] Arguably, the complexity of the management process in nonprofit organizations necessitates a more vigorous corporate governance structure than one might find in the for-profit sector.[53] If a functional governance system exists, many of the needed managerial reforms will be the natural result of the supervisory activities of a highly skilled and effective board of directors.

III. Nonprofit Corporation Statutes

In light of the conclusions set forth in the preceding section, the question arises whether the existing statutory requirements for forming and operating nonprofit corporations are sufficient to ensure the kind of corporate accountability necessary to achieve effective and efficient nonprofit management, or whether they have in fact contributed to the present widespread lack of responsibility among boards of directors. An examination of the legal constraints on managerial activities must therefore be undertaken to determine whether the legal system actually encourages or discourages

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50. Vladeck, *supra* note 46, at 93-94, 99-101.
51. *See* R. Anthony & R. Herzlinger, *supra* note 33, at 315-48.
52. Ellman, *On Developing a Law of Nonprofit Corporations*, 1979 Ariz. St. L.J. 153.
53. R. Anthony & R. Herzlinger, *supra* note 33, at 67.

accountability in the governance structure. Additionally, an examination of the provisions of typical nonprofit corporation statutes and relevant case law is necessary to determine whether the perception that legal sanctions may ensue from irresponsible board actions is valid.

A. *Overview*

The term "nonprofit organization" is used in the most general sense to mean an organization in which "no part of the income or profit is distributed to its members, directors, or officers."[54] Some commentators distinguish between "nonprofit" and "not for profit" organizations on the ground that nonprofit organizations may earn a "profit" (surplus) so long as the proceeds are returned to the organization and used for the purposes for which the organization operates.[55] The more widely held view, however, is that the distinction between "nonprofit" and "not for profit" is largely academic,[56] because in any case profits may not be distributed among the members of the corporation except upon dissolution of certain noncharitable organizations[57] and in other very limited circumstances.[58]

The nonprofit corporation falls within the rubric of nonprofit organizations. It exists in some form in every jurisdiction,[59] and many states have enacted specific nonprofit corporation statutes.

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54. Oleck, *Nature of Nonprofit Organizations in 1979, supra* note 40, at 962.

55. Pasley, *Organization and Operation of Non-Profit Corporations—Some General Considerations,* 19 CLEV. ST. L. REV. 239, 241 (1970). It should be noted that in any event "profits" may he distributed indirectly through salaries and other intangible benefits that may accrue to members. These indirect distributions may be made without violating the principles underlying the nondistribution constraint.

56. Oleck, *Nature of Nonprofit Organizations in 1979, supra* note 40, at 963-64.

57. If an organization is charitable in nature the assets must be distributed upon dissolution to a charity with a similar purpose. *In re* Troy, 364 Mass. 15, 306 N.E.2d 203 (1973). If an organization is not charitable in nature the assets may be distributed among the members upon dissolution. *In re* Los Angeles County Pioneer, 40 Cal. 2d 852, 862, 257 P.2d 1, 7 (1953).

58. In New York a nonprofit corporation may issue subvention certificates in exchange for voluntary capital contributions and may make periodic payments to the certificate holders in an amount that does not exceed two-thirds of the maximum interest rate authorized by the New York General Obligations Law. N.Y. NOT-FOR-PROFIT CORP. LAW §§ 504-505 (McKinney 1970).

59. Historically, the nonprofit corporation preceded the business corporation. Nonprofit corporation statutes appeared in the colonial period of American history. In recent times, however, the nonprofit corporation statutes have become stepchildren of the business corporation laws, and the provisions of nonprofit statutes are frequently characterized as sketchy and confusing. Haller, *The Model Non-Profit Corporation Act,* 9 BAYLOR L. REV. 309 (1951); Rooney, *Maitland and the Corporate Revolution,* 26 N.Y.U. L. REV. 24 (1951).

These statutes ordinarily define a nonprofit corporation as a corporation in which no part of the corporation's income is distributed to its members, directors, or officers.[60] The Model Nonprofit Corporation Act (the Model Act), as well as some state statutes, further provide that nonprofit corporations may be formed for any lawful purpose,[61] or for a business purpose,[62] so long as the nondistribution constraint is preserved.

Many nonprofit corporation statutes limit the purposes for which nonprofit corporations may be formed.[63] The most common of these limitations confines corporate activities to those that further charitable purposes. Charitable purposes are typically ones that serve to relieve poverty, advance religion and education, promote health, and further governmental or municipal objectives, and that benefit either the general public or some indefinite class

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60. Oleck, *Nature of Nonprofit Organizations in 1979, supra* note 40, at 962-63.

61. ABA MODEL NONPROFIT CORPORATION ACT § 4 (rev. ed. 1964); MICH. COMP. LAWS ANN. § 450.117 (1973). The MODEL NONPROFIT CORPORATION ACT § 4, provides:

> Corporations may be organized under this Act for any lawful purpose or purposes, including, without being limited to, any one or more of the following purposes: Charitable; benevolent; eleemosynary; educational; civic; patriotic; political; religious; social; fraternal; literary; cultural; athletic; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association; but labor unions, cooperative organizations, and organizations subject to any of the provisions of the insurance laws of this Stato may not be organized under this Act.

62. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) (McKinney 1970). This provision states that "Type C" not-for-profit corporations "may be formed for any lawful business purpose to achieve a lawful public or quasi-public objective."

63. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 180, § 4 (West Supp. 1981). A nonprofit corporation may be formed in Massachusetts for one or more of the following purposes:

> (a) for any civic, educational, charitable, benevolent or religious purpose;
> (b) for the prosecution of any antiquarian, historical, literary, scientific, medical, chiropractic, artistic, monumental or musical purpose;
> (c) for establishing and maintaining libraries;
> (d) for supporting any missionary enterprise having for its object the dissemination of religious or educational instruction in foreign countries;
> (e) for promoting temperance or morality in the commonwealth;
> (f) for fostering, encouraging or engaging in athletic exercises or yachting;
> (g) for encouraging the raising of choice breeds of domestic animals and poultry;
> (h) for the association and accommodation of societies of Free Masons, Odd Fellows, Knights of Pythias or other charitable or social bodies of a like character and purpose;
> (i) for the establishment and maintenance of places for reading rooms, libraries or social meetings;
> (j) for establishing boards of trade, chambers of commerce and bodies of like nature;
> (k) for providing nonprofit credit counseling services, as defined in section four A;
> (l) for encouraging agriculture or horticulture; for improving and ornamenting the streets and public squares of any city or town by planting and cultivating ornamental trees therein and also otherwise improving tbe physical aspects of such city or town and furthering the recreation and enjoyment of the inhabitants thereof.

Id.

of persons.[64] Charitable corporations, therefore, are a type of nonprofit corporation. In some states the nonprofit corporation statute sets forth a distinct set of provisions governing charitable corporations. The California nonprofit corporation statute, for example, contains three separate regulatory schemes, each of which corresponds to different corporate purposes. Public benefit corporations must be formed for public or charitable purposes—not for the private gain of any person—and are not permitted to distribute gains. Religious corporations must be organized primarily or exclusively for religious purposes and not for the private gain of any person. Mutual benefit corporations are defined as any other nonprofit corporation that does not make distributions to members except upon dissolution, and that operates to provide social, economic, political, psychological, or other benefits to its members.[65]

B. Provisions for Institutional Control and Accountability in Charitable Corporations

A careful examination of nonprofit corporation statutes as they apply to health care institutions reveals that their provisions place minimal constraints upon management in comparison to for-profit or business corporation statutes. The nonprofit statutes offer few incentives for the board of directors to direct corporate management and virtually no penalties for boards that fail to exercise their responsibilities to control the activities of the institution. Furthermore, the statutes provide substantial encouragement for boards to create self-perpetuating structures, which often are controlled by management.

An examination of the provisions of four prototype statutes—the nonprofit corporation statutes in California, New York, Massachusetts, and Ohio—supports these conclusions. This section compares these nonprofit corporation statutes with parallel provisions of the business corporation statutes in the same jurisdictions. Specifically, the Article focuses its comparison on the provisions of each statute addressing the existence and rights of shareholders and members, the procedures for electing and removing directors, the procedures for determining the composition and size of the

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64. RESTATEMENT (SECOND) OF TRUSTS § 368 (1959). *See* Congregational Church v. Attorney Gen., 1978 Mass. Adv. Sh. 2760, 2764-65, 381 N.E.2d 1305, 1307-08 (1978); *In re* Troy, 364 Mass. 15, 57-58, 306 N.E.2d 203, 227-28 (1973); Barrett v. Brooks Hosp., Inc., 338 Mass. 754, 758-62, 157 N.E.2d 638, 640-42 (1959).

65. CAL. CORP. CODE §§ 5110-6910, 7110-8910, 9110-9690 (West Supp. 1981). *See also* 1978 Cal. Stats. ch. 567, *as amended by* 1979 Cal. Stats. ch. 724.

board, and the authority of the board to delegate its responsibilities to outsiders.

The four jurisdictions examined in this comparison represent the four major typologies among nonprofit corporation statutes. The California statute delineates a comprehensive approach to defining a nonprofit corporation's rights and obligations. This approach departs from the Model Act in several respects, principally in that it establishes separate statutory schemes for religious, public benefit, and mutual benefit nonprofit corporations.[66] The New York statute, while structurally similar to the California law in that it is a comprehensive statute departing from the Model Act, does not systematically categorize nonprofit corporations and resembles an enabling act more than a regulatory scheme.[67] The Ohio statute represents those statutes that substantially follow the Model Act. Massachusetts, on the other hand, is analyzed as a prototype statute because it neither substantially follows the Model Act nor provides a comprehensive framework for regulating nonprofit corporations.[68]

1. The Role of Shareholders and Members

The most salient distinction between business and nonprofit corporation statutes derives from a comparison of the roles of shareholders and members in their respective entities. In business corporations the shareholders own the corporation's assets, and modern corporation statutes accordingly provide shareholders with

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66. The division of typologies used in this Article is similar to the one proposed in Note, *Membership Rights in Nonprofit Corporations: A Need for Increased Legal Recognition and Protection*, 29 VAND. L. REV. 747, 752 (1976). The Note proposes to divide statutes among those consolidated acts that follow the Model Act, those consolidated acts not comparable to the Model Act, and business codes that incorporate provisions for nonprofits. This Article, however, makes a further distinction among those consolidated statutes in which the acts are not comparable to the Model Act. Consolidated statutes that do not follow the Act include those such as California's, which more systematically delineate subcategories of nonprofit corporations, and those such as New York's, which make fewer distinctions.

67. Enabling acts primarily authorize the organization and administration of a corporation and define its relationship to the state. Regulatory schemes tend to include provisions that prohibit or restrict certain corporate activities and impose upon the corporation affirmative obligations to the public. *See* ABA MODEL NONPROFIT CORPORATION ACT, *supra* note 61, at ix.

68. The discussion in this Article omits an analysis of the "afterthought" jurisdictions; namely, those jurisdictions that incorporate the nonprofit corporation provisions in a business corporation statute. *Id.* at 753-54. The omission is due to the fact that such provisions furnish a limited amount of data for analysis and that the Massachusetts statute reflects many of the same issues as "afterthought" statutes.

certain rights attaching to ownership status. These rights include approval of dissolutions, mergers, consolidations, and sale of all or a large part of the corporate assets; selection and removal of directors; inspection of the corporate books and records for legitimate purposes; and right of derivative actions under specific circumstances for certain types of corporate injuries.[69]

In a nonprofit corporation members may perform functions similar to those of shareholders in a business corporation. The statutes typically define members as those persons who acquire membership status in accordance with the provisions of the corporate charter (articles of incorporation) or the bylaws.[70] Members have rights similar to those of shareholders except that members do not own the assets of a charitable corporation. Accordingly, members do not receive payment upon dissolution, nor do they have the right to dissent and receive payment when the corporation votes either to undertake a major reorganization or to sell its assets.

The typical nonprofit corporation statute, however, does not require all corporations to have members. In particular, the charitable corporation, a category encompassing most hospitals and other nonprofit health care institutions,[71] need not provide for members.[72] A corporation that chooses not to have members typically empowers the board of directors to approve any action for which the statute requires approval of the membership.[73] In this

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69. N. LATTIN, THE LAW OF CORPORATIONS §§ 87-101 (2d ed. 1971).

70. MASS. GEN. LAWS ANN. ch. 180, § 2(e) (West Supp. 1981); N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(9) (McKinney 1970); OHIO REV. CODE ANN. § 1702.01(H) (Page 1978). In California members are defined by statute as persons who have certain minimal voting rights or persons who are designated as members by either the articles of incorporation or the bylaws—so long as these persons have voting rights with respect to amendments to the articles or bylaws. CAL. CORP. CODE § 5056 (West Supp. 1981).

71. In Massachusetts, as in many states, hospitals and other nonprofit health care corporations are charitable corporations. Barrett v. Brooks Hosp., Inc., 338 Mass. 754, 758-62, 157 N.E.2d 638, 640-42 (1959). New York corporations that are imbued with charitable purposes such as promoting health are designated "Type B" corporations. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) (McKinney 1970). In California, nonprofit hospitals and other health care institutions qualify as "public benefit corporations." A "public benefit corporation" is a charitable corporation. CAL. CORP. CODE §§ 5060, 5111 (West Supp. 1981).

72. CAL. CORP. CODE § 5310 (West Supp. 1981); N.Y. NOT-FOR-PROFIT CORP. LAW § 601(a) (McKinney Supp. 1980); OHIO REV. CODE ANN. §§ 1702.04(B), .14 (Page 1978). In Massachusetts a nonprofit corporation need not have members, although certain individuals must perform the functions of members. MASS. GEN. LAWS ANN. ch. 180, §§ 2(e), 3 (West Supp. 1981). But since the individuals performing the functions of members may be the same persons as the directors of the corporation, however, separate bodies within the corporate governance structure in effect are eliminated. *Id.*

73. CAL. CORP. CODE § 5310(b)(1) (West Supp. 1981).

regard, California provides that rights and privileges of members vest in the board.[74] Moreover, the California scheme treats a corporation in which the board is coterminous with the membership as a nonmembership corporation.[75]

The rationale for omitting a membership in nonprofit corporations often is based on the absence of an ownership interest in the assets of the corporation. The analogy between shareholders and members is said to be imperfect, at least in the case of charitable corporations, because members have no need to protect their individual investments in the corporation;[76] the rights of shareholders are so intimately tied to their ownership interests that it is often difficult in drafting legislation to segregate the oversight function from the obligations regarding preservation of assets. Moreover, a membership requirement would undermine the potential for a single substantial donor to exercise control over the conduct of a charitable corporation's activities. The legislative drafters may wish to defer to the interests of these substantial donors on the ground that protecting the donors' dominion is a legitimate legislative goal.[77]

When a jurisdiction permits a nonprofit corporation to have no members, the role of corporate owners may be fulfilled by the state attorney general. Jurisdictions often authorize the attorney general to bring an action to enforce any right that would reside in a member of a charitable corporation that actually had members.[78] The attorney general's task as an enforcer of membership rights requires a substantial commitment of personnel in order to supervise adequately the assets of charitable corporations, since by all accounts these assets add up to tens of billions of dollars.[79] In the past, the personnel commitments in the various attorneys general's

74. *Id.* § 5310(b).

75. *Id.* § 5310(c).

76. Ellman, *supra* note 52, at 157-58.

77. Andrews, *Procedures for Electing Directors of Nonprofit Corporations Pursuant to the New Nonprofit Corporation Law*, 13 U. S.F. L. Rev. 857, 864-65 (1979).

78. N.Y. Not-For-Profit Corp. Law § 112(a)(7) (McKinney Supp. 1980).

79. Estimates of the precise dollar amount of the assets held by nonprofit corporations are difficult to obtain. Most estimates do not segregate corporate assets from assets held by other nonprofit organizations. Annual giving to charitable organizations generally was estimated at $30 to $40 billion in the late 1970s. One study found that in 1974 receipts of charitable nonprofits totalled over $80 billion. *See generally* Abrams, *Regulating Charity—The State's Role*, 35 Record of the Bar of the City of New York 481-87 (Nov. 1980); Ellman, *supra* note 52, at 163; Oleck, *Nature of the Nonprofit Organizations in 1979*, *supra* note 40, at 965-69.

offices have not kept pace with the enormity of the task.[80]

The advantage of the attorneys general's enforcer role lies in the wide range of additional jurisdiction granted to attorneys general over charitable corporations. They have broad powers to investigate and bring actions to determine matters such as whether the public has been defrauded by the corporation, whether the corporation is fulfilling its charitable purpose, and whether the directors and officers are fulfilling their fiduciary duties to the corporation.[81] This expansion of the statutory powers of the attorneys general seems to be accompanied by an awareness that the charitable supervisory staffs of various attorney general offices need to increase in size.[82]

For two reasons, however, the enforcement activities of the attorneys general cannot replace the exercise of membership rights in a corporate governance structure. First, even a vigorous and well-staffed regulatory body will be further removed from the events that give rise to enforcement activities than would be a group of corporate members. Members maintain an ongoing relationship with the monitored institutions, and the availability of even minimal rights of membership creates an opportunity to detect malfeasance. Second, an attorney general directs most of his efforts toward the preservation of corporate assets. His responsibilities do not include overseeing substantive corporate policies. Membership rights thus connote a broader range of interests than those with which an attorney general can adequately deal, including the collective power to select and remove directors and ultimately to control the direction of institutional policies and programs.[83]

Moreover, the overriding significance of providing for members in a corporate governance structure lies in the maintenance of a balance of power. The existence of a third group in a corporate structure—even a group with minimal duties—permits the organization to maintain a buffer between the dual power groups of man-

80. Abrams, *supra* note 79, at 485; Oleck, *Nature of Nonprofit Organizations in 1979*, *supra* note 40, at 969-72.

81. *See, e.g.*, CAL. CORP. CODE §§ 5223, 5225-5226, 5236-5237, 5241-5242, 5250, 5913, 6010, 6510-6511, 6611, 6716 (West Supp. 1981).

82. Oleck, *Nature of Nonprofit Organizations in 1979*, *supra* note 40, at 485.

83. The argument here assumes that membership rights roughly parallel the rights of shareholders in a business corporation. Unfortunately, the rights of members in membership corporations are often diminished in comparison to those of shareholders in business corporations. The need to strengthen the rights of members is addressed in text accompanying notes 84-112 *infra*.

agement and the board of directors. Whether the members have a direct pecuniary interest in the preservation of corporate assets is immaterial. The incidents of ownership in a business normally include the right to perform certain institutional functions such as the collective right to elect and remove directors, the right to inspect corporate books and records under certain circumstances, and standing to sue corporate officers and directors derivatively for wrongs inflicted upon the corporation. These activities do not just determine the profitability of an entity; they also set the direction of corporate policy. These functions need to be performed by an independent body, even when that body must be made up of persons who are not the actual owners of the corporate assets.

2. Termination of Membership Rights

Even if a nonprofit charitable corporation chooses to have members, the composition of the membership may be relatively unstable because the statutory right to remain a member is tenuous at best. In New York, for example, membership status in nonprofit corporations may be defined by the provisions of the certificate of incorporation or the corporate bylaws.[84] If the corporation defines the qualifications for membership in the bylaws, a change in the composition of the membership may be effected by the relatively simple process of amending the bylaws.[85] Bylaws may be amended by a vote of the members entitled to vote in an election of directors or by the board of directors.[86] An amendment adopted by the board may be further amended or repealed by the members, but the statute does not require the subsequent approval of the membership.[87]

In New York individual memberships may be terminated by expulsion.[88] The nonprofit corporation statute omits a definition of

84. N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(9) (McKinney 1970). *But see In re* Adelson, N.Y.L.J. at 12 (Sup. Ct. Spec. Term, Pt. 1, Nov. 26, 1976). A member whose status derives solely from the certificate of incorporation or the bylaws without any specific membership rights may be treated merely as an "honorific" member.

85. Note that members of the public at large are not entitled to membership in a corporation, even when the corporate purpose is to benefit the public. People v. Holstein Friesian Assoc., 41 Hun 439, 441 (1866).

86. N.Y. NOT-FOR-PROFIT CORP. LAW § 602(b) (McKinney 1970). The statute also permits a governmental body regulating an entity to amend or repeal a bylaw to the extent provided in its statutory authorization. *Id.* § 602(d).

87. *Id.* § 602(c). If a bylaw change regulates an impending election, however, it must be set forth in the notice of the next membership meeting held for the purpose of electing directors. *Id.* § 602(e).

88. *Id.* § 601(e).

expulsion, but courts have implied a requirement that in the absence of express procedures in the certificate or bylaws members may be expelled only by a vote of the membership.[89] The absence of clear statutory criteria and processes for expelling members has attracted the public's attention and led to recent legislative reforms. For example, California has enacted new statutory provisions requiring expulsions, suspensions, or terminations to be undertaken in good faith and in a fair and reasonable manner.[90] The statute, which details a procedure that complies with these fairness requirements, requires notice and an opportunity to respond, and includes specific provisions for judicial review.[91]

3. Voting Rights

The voting rights of members in charitable corporations do not receive the same protection afforded shareholder voting rights in business corporations. Typically, both members and shareholders vote to approve major corporate reorganizations, approve dissolutions and sales of part or all of the corporate assets, amend the charter (articles of incorporation) or bylaws, and select and remove directors.[92] An individual member, though, stands less chance than a shareholder to be granted the full range of voting rights and to retain the voting rights initially extended to him.[93]

In a New York business corporation at least one class of shareholders or bondholders must retain full voting rights if another class of shareholders is to be either denied voting rights or extended only limited voting rights.[94] A shareholder whose voting rights are limited or denied by an amendment to the certificate (articles) of incorporation occurring after he purchased his shares

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89. Weinberg v. Carton, 196 Misc. 74, 90 N.Y.S.2d 398 (Sup. Ct. 1949).

90. CAL. CORP. CODE § 5341 (West Supp. 1981).

91. *Id.*

92. *See* note 69 *supra*. *See also* MASS. GEN. LAWS ANN. ch. 180, §§ 6, 10, 10A, 11 (West Supp. 1981); MASS. R. CIV. P. 23.1.

93. Nonprofit corporation statutes offer limited protection to the voting rights of members. *See* Note, *supra* note 66, at 755-64. The author notes that members who challenge statutory provisions and bylaws permitting a limitation or denial of member voting rights have met with practically no success. *Id.* at 756.

94. N.Y. BUS. CORP. LAW §§ 501(a), 613(a) (McKinney 1970). At common law each shareholder was entitled to one vote. Although modern corporation statutes have modified the rule by permitting cumulative voting, nonvoting shares, and voting in proportion to the number of shares held, business corporation statutes often recite the modified common-law rule; namely, that each share is entitled to one vote subject to modifications set forth in the corporate charter. *See* N. LATTIN, *supra* note 69, § 89.

may dissent and receive payment for his shares.[95] Furthermore, a modification in voting rights must be undertaken through an amendment to the certificate of incorporation, a procedure that requires a majority vote of all outstanding shares entitled to vote on a certificate amendment.[96]

In New York charitable corporations at least one class of members must retain full voting rights in order for the corporation to limit or deny the voting rights of other classes.[97] Nevertheless, charitable corporations may limit or deny existing voting rights more easily than business corporations, since the modification in voting rights may be achieved either by an amendment to the bylaws or by a resolution of the board of directors if such a resolution is permitted in the bylaws.[98] Bylaws may be amended either by the members entitled to vote in an election of directors or by the board, unless the certificate of incorporation or the bylaws adopted by the members prohibit board-adopted amendments.[99] If voting rights are stated in the certificate and an amendment proposes to limit or deny the voting rights of a class, however, the amendment gives rise to automatic voting rights on the part of the adversely affected class.[100]

While New York thus offers only somewhat diminished protection of members' voting rights in a charitable corporation compared to that afforded the rights of shareholders, Massachusetts permits relatively easy member disenfranchisement. Member voting rights may be designated either in the articles or in the corporate bylaws,[101] but no single class of members needs to have full voting rights. The bylaws may be amended by the members, or by the directors if the bylaws so permit,[102] and the proportion of members required to amend the bylaws may be set forth in the articles or bylaws.[103] If a bylaw amendment is proposed that would disenfranchise or further limit the voting rights of a particular

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95. N.Y. BUS. CORP. LAW §§ 804(a)(1), 806(b)(6) (McKinney Supp. 1980).

96. *Id.* §§ 612(a), 803.

97. N.Y. NOT-FOR-PROFIT CORP. LAW § 612 (McKinney Supp. 1980).

98. *Id.* § 601(b) (McKinney 1970).

99. *Id.* § 602(b). Amendments adopted by the board may be subsequently adopted or repealed by the members, although the board is not required to present the amendment for member approval, but is required to notice certain provisions. *Id.* § 602(c).

100. *Id.* § 802(b) (McKinney Supp. 1980).

101. MASS. GEN. LAWS ANN. ch. 180, § 3 (West Supp. 1981).

102. *Id.* § 6A; *id.* ch. 156B, § 17. The board-amended bylaws must be included in the general notice for the next shareholders' meeting following the board's action, and the shareholders are entitled to further amend or repeal the board-adopted amendment.

103. *Id.* ch. 180, § 6A; *id.* ch. 156B, § 8(a) (West 1970).

class, the affected class does not acquire an automatic right to vote on the amendment.[104] In contrast, the Massachusetts business corporation statute provides that a limitation of voting rights must be set forth in the articles of incorporation.[105] Moreover, an amendment to the articles requires at least a two-thirds vote of each class of outstanding stock entitled to vote on the matter.[106]

Similarly, the California business corporation statute generally requires that limitations on voting rights of a class be set forth in the articles of incorporation,[107] but limitations on voting rights in a nonprofit corporation may be contained in the articles *or* the bylaws.[108] The California nonprofit corporation statute does improve upon many statutory schemes, however, because under the California scheme a class of members whose rights may be adversely affected by a proposed bylaw amendment acquires automatic voting rights on the proposal without regard to any limitations contained in the bylaws.[109]

Ohio offers near parity between the status of shareholders' and members' voting rights. Ohio appears to permit voting rights to be altered through an amendment to the articles of incorporation or the corporate regulations (bylaws), regardless of whether the corporation is for-profit or nonprofit.[110] Moreover, Ohio will not per-

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104. Jessie v. Boynton, 372 Mass. 293, 361 N.E.2d 1267 (1977). The court in *Jessie* held that the nonprofit corporation statute does not require a separate class vote for any amendment to the articles in which the rights of a class are adversely affected.

105. MASS. GEN. LAWS ANN. ch. 156B, §§ 13(a)(5), 26, 41 (West 1970).

106. *Id.* § 71. The Massachusetts business corporation statute adds a provision that gives rise to automatic voting rights for a class adversely affected by an amendment to the articles of incorporation, regardless of the extent of voting rights granted to the class by the articles. *Id.* § 77. The nonprofit corporation statute does not allow for automatic voting rights to be extended to an adversely affected class.

107. CAL. CORP. CODE §§ 400(a), 700(a) (West 1977).

108. *Id.* § 5610 (West Supp. 1981).

109. *Id.* § 5813. The recent amendments to the California nonprofit corporation statute appear to prohibit a denial of voting rights altogether in public benefit corporations. A member is defined in the statute as a person who has the right to vote in the election of a director or to vote to dissolve or reorganize the corporation, even if the articles of incorporation do not designate this person as a member. A member is further defined as one who is designated as a member in the articles and who also has voting rights on amendments to the articles. *Id.* § 5056(a); *see* Andrews, *supra* note 77, at 862-64. As a result, every statutory member must possess some voting rights. California also provides for a type of membership that is not designated by statute. A person could have some or all of the rights of members and even be referred to as a "member" without acquiring statutory "member" designation. CAL. CORP. CODE § 5056(b) (West Supp. 1981). These provisions may give rise to a two-class membership system, which enables a small number of participants in the organizational structure to maintain substantial control.

110. 12 OHIO JUR. 3D *Business Relationships* § 558 (1979).

mit the trustees (directors) of a nonprofit corporation to amend the regulations without the approval of memhers.[111]

Notwithstanding Ohio's apparent consistency, the crux of the matter is that as a general rule shareholder voting rights in a business corporation are created in the charter (articles of incorporation), and amendments to the charter usually require the approval of a significant majority of the shareholders. Nonprofit corporation statutes, as applied to charitable corporations, however, typically permit voting rights to be defined in the hylaws. The bylaws generally may be amended by the board of directors or by member votes of a lesser proportion than the majorities required for shareholders in a business corporation.

The relative ease with which voting rights may be abrogated in nonprofit corporations reflects the fact that voting rights are intimately connected with ownership rights. In business corporations a shareholder whose voting rights are limited or denied after he acquires the shares and without his assent may often dissent and receive payment for his shares.[112] In a nonprofit charitable corporation the members do not have a proprietary interest in the assets of the corporation, and the provisions of nonprofit corporation statutes fail to differentiate between policy issues pertaining to ownership interests and those that are directed toward necessary corporate governance functions. The selection and removal of directors, considered below, is one such governance function that is critical to the establishment of institutional policy direction. The absence of members' direct ownership interest in a nonprofit charitable corporation does not obviate the need for maintaining the membership franchise.

4. Election of Directors

In a nonprofit charitable corporation the board of directors may be self-perpetuating because the corporation has no members. In a nonmembership corporation the authority to replace directors resides in the board itself.[113] Moreover, even when the corporation has members, the voting rights of the membership may be rather tenuous.[114] Even assuming a corporation has a membership with relatively stable voting rights, however, a question arises regarding

111. Ohio Rev. Code Ann. §§ 1702.38(C), (E). *See* Veterans of World War I v. Levy, 118 N.E.2d 670 (Ohio App. 1954).

112. *See* note 95 *supra* and accompanying text.

113. *See* notes 39-40 *supra* and accompanying text.

114. *See* notes 92-112 *supra* and accompanying text.

the scope of the members' authority to elect the corporate directors.

In a business corporation the shareholders who possess voting rights typically elect the directors.[115] In a nonprofit corporation the authority of the voting members to elect directors may be undermined by statutory provisions permitting designation of directors. In California, for example, directors of business corporations are elected by a plurality of the shares of shareholders who are entitled to vote and serve one year terms.[116] At least one class of shareholders or bondholders must retain full voting rights—including the right to elect directors.[117]

In California nonprofit charitable corporations, directors are elected at an annual meeting by the members entitled to vote[118] and serve for one year unless the bylaws or articles of incorporation provide for other terms of up to three years in length.[119] Not all directors, however, must be elected. Up to one-third of the directors in a membership corporation, as well as all or any portion of the directors of a nonmembership corporation, may be designated in accordance with the provisions of the articles or the bylaws.[120] Moreover, any person designated as a director by an elected officer of the corporation becomes a member of the board apparently without regard to the one-third rule.[121]

5. Size and Composition of the Board of Directors

The size and composition of a nonprofit charitable corporation's board of directors often can be changed with relative ease. Massachusetts permits the size and composition of the board to be set forth in the corporation's articles or bylaws.[122] If the bylaws

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115. In closely held business corporations shareholders may, however, delegate the authority to elect directors to designated persons or shareholders. A discussion of the statutory basis and rationale for such practice is set forth in Part III, section B(6) *infra*.

116. CAL. CORP. CODE §§ 301, 600(b), 708(c) (West 1977).

117. *Id.* § 400(a).

118. *Id.* § 5510(b) (West Supp. 1980-1981).

119. *Id.* § 5220(a).

120. *Id.* § 5520(d).

121. *Id.* § 5220(e); *see* Andrews, *supra* note 77, at 864. It should be noted that notwithstanding any other provision of the California nonprofit corporation code, no more than 49% of the directors of a California nonprofit public benefit corporation may be "interested persons." Interested persons are individuals who receive compensation, other than directorate fees, from the corporation, or who are related to a person receiving this compensation. CAL. CORP. CODE § 5227 (West Supp. 1981).

122. MASS. GEN. LAWS ANN. ch. 180, §§ 3, 6A (West Supp. 1981); *cf. id.* ch. 156B, §§ 13, 16 (West 1970) (similar provisions regarding for-profit corporations).

govern the board size and composition, modifications may be achieved rather simply.[123] In many states, bylaws may be amended by the board of directors without subsequent ratification by the members.[124]

The Ohio nonprofit corporation statute permits less flexibility than many other statutes. That statute requires that an Ohio nonprofit corporation have at least three trustees (directors). Unless the articles of incorporation state a fixed number of trustees or provide for a method for voting members to determine such a number, the number may be fixed or changed only by the voting members at a meeting called for the purpose of electing trustees. A change in the number of trustees cannot have the effect of shortening the term of any incumbent trustees.[125] Ohio, however, does permit a board to designate ex-officio trustees, and, if the articles or bylaws permit, these ex-officio trustees may have voting rights.[126]

6. Delegation of Directors' Authority

At common law corporate decisionmaking was a responsibility of the board of directors. The directors could delegate authority to officers of the corporation, but the ultimate responsibility for supervising the managerial activity resided in the board.[127] Most corporation statutes adopt this common-law concept, and courts have been reluctant to recognize any form of management agreement that would undermine the authority of the board of directors.[128] Management agreements may be executed with other companies, which then take over managerial responsibilities, or they may be executed with individuals such as shareholders, who perform the management functions without the usual board approval.[129]

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123. *See* text accompanying notes 101-06 *supra*.

124. The extent of the board's power to amend the bylaws of a nonprofit corporation is illustrated in Harris v. Board of Directors, 55 Ill. App. 3d 392, 370 N.E.2d 1121 (1977). The members of the corporation adopted a proposal to remove all the directors. In response to the proposed resolution the board of directors amended the corporate bylaws to permit the board to elect its own membership and to limit the voting rights of members. The court upheld the bylaw amendment because the Illinois nonprofit corporation statute empowered the board to amend the bylaws.

125. OHIO REV. CODE ANN. § 1702.27(A)(1)-(2) (Page 1978).

126. *Id.* § 1702.27(A)(4).

127. N. LATTIN, *supra* note 69, §§ 69, 73.

128. *Id.* §§ 73-74.

129. For example, shareholders may provide that certain individuals will hold positions as corporate officers to whom salaries are guaranteed; that certain shareholders have disproportionate decisionmaking authority over specified matters; or that shareholder approval is required for matters that are typically within the purview of the board of directors.

Nonprofit and business corporation statutes address the extent to which the board of directors' authority to manage the corporation may be delegated to board committees, management companies, and designated shareholders. Nonprofit corporation statutes are very similar to business corporation statutes in terms of the board's power to delegate its authority to executive and other board committees. Both types of statutes generally authorize broad delegation to these committees and reserve for the entire board only such powers as the authority to fill vacancies, alter the bylaws, appoint committees, and approve self-dealing transactions and major corporate reorganizations.[130] Typically, however, these statutes do provide that the committee structure must function under the ultimate direction of the board.

The provisions of business corporation statutes governing delegation of board authority to individuals or groups who are not board members have been expanded recently to allow for even more extensive delegation. Closely held business corporations may under certain circumstances delegate the entire management function of the board to outsiders.[131] The liberalization of delegation authority in closely held business corporations seems to have had a pervasive effect upon some drafters of nonprofit corporation statutes. Unfortunately, the rationale for permitting broad delegation of authority in closely held corporations cannot be applied consistently to similar delegation in nonprofit corporations.

The New York statutory scheme typifies this trend towards a generalized liberalization of delegable authority that fails to respond to the variances in policy considerations between nonprofit corporations and closely held for-profit corporations. The New York for-profit corporation statute states that the business of the corporation shall be managed under the direction of its board, subject to certain exceptions including the delegation of authority as permitted under special provisions applicable to closely held corporations.[132] The certificate of incorporation may restrict the board's duty to manage a business corporation, or it may under certain conditions permit a shareholder to manage some or all of the corporation's activities. The delegation must, however, be authorized by all the shareholders and be accompanied by notice to transferees. None of the shares of stock may be listed on a national

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130. *See, e.g.*, CAL. CORP. CODE §§ 311, 5212(a) (West 1977 & Supp. 1981).

131. *See, e.g.*, N.Y. BUS. CORP. LAW §§ 620(b), 701 (McKinney 1963 & Supp. 1980-1981).

132. *Id.* § 701.

exchange or regularly quoted in an over-the-counter market, and the existence of the arrangement must be conspicuously noted on every share. The directors of the corporation are relieved of liability for their own actions, but the shareholders who authorize the arrangement must assume the liability of directors.[133]

Nonprofit corporations in New York may also delegate the authority of the board to any person or management company if permitted by the articles of incorporation.[134] At first glance, management companies appear to be placed in a position similar to corporate officers who act under the direction of the board. In fact, it appears that management companies operating a New York nonprofit corporation may take on the same independence allowed a management company in a closely held corporation. The realities of not having a membership to determine whether the board is supervising the management company create possible areas of abuse. More importantly, however, New York's nonprofit corporation statute undermines the board's power of "ultimate direction" over the management company by providing that the persons to whom the corporation management responsibilities are delegated are subject to the same obligations and liabilities as the directors.[135] This provision permits the management company to take on the responsibilities of directors in lieu of the board. It appears also to permit the certificate of incorporation to immunize the board from liability when a management company has assumed these responsibilities.

California also permits shareholders in closely held business corporations to execute management agreements, even if the agreements interfere with the discretion of the board or turn the corporation into an unincorporated partnership.[136] The statute carefully defines close corporations as corporations having no more than ten shareholders of record among all classes of their issued shares.[137] Many of the other restrictions placed upon the delegation of board authority to outsiders by the New York statute are similar to those imposed upon a California close corporation implementing a share-

133. *Id.* §§ 620(b)-(g).

134. N.Y. NOT-FOR-PROFIT CORP. LAW § 701(a) (McKinney Supp. 1980-1981).

135. *Id.* § 701(b).

136. CAL. CORP. CODE § 300(b) (West Supp. 1981). By contrast, Ohio prohibits delegation of board functions in nonprofit charitable corporations to a management company. 6 OHIO JUR. 3d *Associations* § 397 (1978); *cf.* State v. Conn, 115 Ohio St. 607, 614-15, 155 N.E. 138, 140 (1927) (for-profit insurance corporation).

137. CAL. CORP. CODE § 158(a) (West 1977 & Supp. 1981).

holder agreement. In particular, the shareholders participating in the arrangement become liable as if they were directors.[138]

California likewise allows nonprofit public benefit corporations to delegate the management of the corporation to management companies.[139] The activities and affairs of the nonprofit corporation, as well as all corporate powers, must be exercised under the ultimate direction of the board.[140] Unlike the New York statute, however, the California statute clearly imposes liability upon the directors themselves.[141] Thus, the board of directors must continue to supervise actively the management company.

An argument can be made that permitting management agreements in closely held corporations serves legislative policy goals. It decreases the regulatory impact of business corporation statutes on small, owner-operated corporations.[142] If the number of investors is limited, if the investors agree that certain board functions should be delegated, and if the public is not adversely affected by that decision, the potential for misuse of corporate authority is of little consequence to the public.

The public investment in health care institutions, on the other hand, is enormous,[143] and the interest of taxpayers and consumers in the proper management of health care institutions is therefore substantial. This statutory scheme, when applied to health care institutions, allows directors effectively to escape liability for their actions through the delegation of authority, and can only serve to diminish director supervision thereby impeding effective corporate management and accountability. As noted above, however, the residual effect of liberalizing management control provisions of business corporation statutes apparently has been the concomitant liberalization of nonprofit corporation statutes without the accompanying constraints that limit the application of these provisions to small, closely held corporations.

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138. *Id.* § 300(d).

139. *Id.* § 5210 (West Supp. 1981).

140. *Id.*

141. *Id.* §§ 5210, 5230-5238.

142. *See* Berger, *California's New General Corporation Law: Close and Closely-Held Corporations*, 7 PAC. L.J. 585 (1976).

143. *See* notes 10-17 *supra* and accompanying text.

C. *Liability of Directors: The Adequacy of Existing Procedural Devices*

1. Statutory Provisions

The final issue to be explored in this part of the Article is whether nonprofit corporation statutes provide adequate procedural devices for imposing liability upon directors who have breached their fiduciary duties to the corporation. The derivative suit may be used by shareholders in business corporations in certain circumstances to recover damages for an injury to the corporation, such as an injury caused by the breach of the directors' fiduciary duties.[144] A derivative suit must be brought in the name of the corporation, and recovery generally lies in favor of the corporation rather than the shareholder.[145]

Generally, nonprofit corporation statutes and rules of civil procedure have not addressed adequately the procedural issues that arise during an action to impose liability on the directors of nonprofit corporations. In those jurisdictions that have considered the issue at all, procedural devices are often delineated in a patchwork quilt of statutory provisions. For example, rule 23.1 of the Massachusetts Rules of Civil Procedure engrafts the phrase "or member" onto the term "shareholder" when describing the procedure for bringing derivative actions.[146] The Massachusetts nonprofit corporation statute neither provides specific linkages between the civil procedure rules and the body of corporate law nor defines the scope of duties of nonprofit directors.[147] In the Massachusetts business corporation statute, however, specific provisions address the fiduciary duties of a director and the remedies available to assure performance of these duties.[148]

In Ohio a provision of the nonprofit corporation statute states that trustees (directors) are liable for damages to the corporation when they engage in certain activities, such as making loans to of-

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144. Shareholders sometimes may bring direct actions against the corporation as well, when a duty owed directly to a shareholder is breached. Also, the shareholder may bring a direct action to enjoin the corporation from performing some action that would cause it to exceed its purposes and powers.

145. *See* N. LATTIN, *supra* note 69, §§ 104-106.

146. MASS. R. CIV. P. 23.1. One could question whether any person has standing to bring derivative actions in Massachusetts in the situation in which the corporation chooses to have no members and decides instead to have directors perform certain membership functions when required by statute.

147. MASS. GEN. LAWS ANN. ch. 180, § 10A (West Supp. 1981).

148. *Id.* ch. 156B, §§ 46, 60-65 (West 1970 & Supp. 1981).

ficers, trustees, or members that are not in the usual course of the corporation's affairs or in compliance with the provisions of the articles.[149] Even so, neither the nonprofit corporation statute nor the civil procedure rules provide for the enforcement of that provision by members in the event that the corporation fails to enforce its rights against trustees. The Ohio Rules of Civil Procedure authorize derivative actions by shareholders, but it appears this rule does not apply to members of nonprofit corporations.[150]

2. Judicially Created Devices

(a) Derivative suits

Legislatures often fail to provide appropriate procedural devices for bringing derivative actions on behalf of nonprofit corporations, a failure that in turn creates an awkward vacuum for the courts. In *Governing Board v. Pannill*,[151] for example, a member of The Texas Society of the Daughters of the American Revolution, a nonprofit corporation, brought a derivative action against the corporation alleging an ultra vires act. The nonprofit corporation statute in Texas expressly authorizes derivative suits in cases alleging ultra vires actions on the part of the corporation.[152] The procedural prerequisites for bringing such an action, however, are set forth neither in the state's nonprofit corporation statute nor in its rules of civil procedure. The business corporation statute, on the other hand, does state the requirements for a derivative suit. The court ultimately borrowed case law and procedural requirements from the business corporation statute, including proof of a demand upon the corporation or the futility of such a demand.[153]

While many courts permit the members of nonprofit corporations to bring an equitable action in the form of a derivative suit, legislative resolution would avoid the uncertainty created by a judicial adoption of the business corporation statutes and civil proce-

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149. OHIO REV. CODE ANN. § 1702.55(B) (Page 1978).

150. OHIO R. CIV. P. 23.1; 6 OHIO JUR. 3d *Associations* § 49 n.71 (1979). *But see In re* Cleveland Sav. Soc'y, 90 Ohio Op. 2d 399, 183 N.E.2d 234 (1962).

151. 561 S.W.2d 517 (Tex. Civ. App. 1977).

152. TEX. CORP. CODE ANN. tit. 32, § 1396-2.03(b)(2) (Vernon 1980).

153. 561 S.W.2d at 524-25. *See also* Atwell v. Bide-A-Wee Home Assoc., 59 Misc. 2d 321, 299 N.Y.S.2d 40 (Sup. Ct. 1969); Texas Soc'y v. Fort Bend Chapter, 590 S.W.2d 156 (Tex. Civ. App. 1979). The New York Court in *Atwell* held that members of a nonprofit corporation had standing to bring a derivative action by analogizing members to shareholders, for whom the business corporation statute authorized a derivative action. Subsequently, New York amended the nonprofit corporation statute to provide expressly that derivative actions could be brought by members of nonprofit corporations.

dure rules intended for proprietary corporations.[154] For example, to prevent frivolous actions, the New York statute requires that at least five percent of any class of members or capital certificate holders join in a derivative action.[155] Such a provision is tailored to the needs of nonprofit organizations. A measured legislative response would clarify the right of a nonprofit corporation member to bring such an action and would also adapt the procedural requirements to the specific needs of nonprofit corporations.

(b) *The Breach of a Charitable Trust Theory:* Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries

Notwithstanding the difficulties that may be encountered by members who attempt to bring a derivative action for the breach of a director's fiduciary duties, some courts have recognized a cause of action arising from a breach of a charitable trust. Under this theory nonprofit corporate members may argue that they are the beneficiaries of an implied charitable trust that has been impressed upon the assets of the charitable corporation.

The decision in *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*[156] is frequently cited as a landmark case for the imposition of liability upon nonprofit corporation directors under the breach of a charitable trust theory. Plaintiffs, who were patients at defendant hospital, sued the directors for breaching various fiduciary duties. Several hospital directors were affiliated with various financial institutions in which the hospital had deposited large sums of money in interest-free accounts. For approximately eighteen years the management of the hospital was handled almost exclusively by two trustee-officers, and neither the Finance Committee nor the Investment Committee of the hospital had met for over ten years. The Board and the Ex-

154. It is especially important to legislate the right of nonprofit corporation members to bring derivative actions in view of the historical reluctance of courts to interfere in the internal affairs of nonprofit corporations and to grant standing to nonprofit corporation members desiring to bring a derivative action on behalf of the corporation. For a thoughtful discussion of judicial noninterference in the affairs of voluntary or nonprofit associations, see Maraghy, *Internal Control Trends in Nonprofit Organizations,* in TRENDS IN NONPROFIT ORGANIZATIONS LAW 59-63 (H. Oleck ed. 1977). The problems encountered by members who attempt to gain standing to sue derivatively are outlined in Note, *supra* note 66, at 768-74. *See* note 66 *supra.* A primary obstacle to members obtaining standing in the absence of legislation is that members have no direct pecuniary interest in the corporate assets.

155. N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a) (McKinney Supp. 1980-1981).

156. 381 F. Supp. 1003 (D.D.C. 1974).

ecutive Committee of the hospital routinely accepted the recommendations of the two officers.[157]

The *Stern* court found that the individual directors had breached their fiduciary duties to the corporation through mismanagement, nonmanagement, and self-dealing. The court set forth a standard of care that was adapted largely from principles of corporate liability.[158] Under this standard liability for mismanagement may occur when a director has committed gross negligence or is otherwise guilty of more than mere mistakes of judgment.[159] Liability for nonmanagement may arise when a director fails either to acquire the information necessary to supervise investment policy or to attend regularly meetings at which such policies are considered, although a corporate director may delegate the investment activity per se.[160] A director may also be liable for self-dealing if he fails to disclose interlocking responsibilities or influences the corporation to transact business with a company in which he has a significant interest or control.[161]

While the *Stern* decision has been widely regarded as a potential threat to boards of nonprofit corporations that do not attend to their responsibilities, the case actually presents few, if any, obstacles to neglectful directors. For one thing, the relief granted by the court did not include removal of the directors, a power which the court may exercise in a breach of trust case. The court instead ordered that the corporate investment policy be written and approved by a disinterested board; that each newly elected member of the board read the court's opinion; that prior to each meeting the board members receive a corporate financial report; and that reports of the corporation's auditors be available to the public for five years.[162]

Perhaps more important is that the case has not had the im-

157. *Id.* at 1007-08.

158. Considerable controversy surrounds the choice of a standard of care to which directors of charitable corporations may be held. Some argue that as stewards of assets that are impressed with a charitable trust, trustees should be held to the higher fiduciary standard of care specifically applicable to trusts. Others argue that they should be liable only for breaches of the fiduciary duties of corporate directors. The prevailing trend seems to favor the corporate standard. California recently resolved the controversy legislatively by adding provisions to its public benefit corporation statute that define the standard of care for directors of charitable corporations. The standard is largely derived from principles of corporate liability. CAL. CORP. CODE §§ 5230-5238 (West Supp. 1981).

159. 381 F. Supp. at 1013.

160. *Id.* at 1013-14.

161. *Id.* at 1014-15.

162. *Id.* at 1020-21.

pact that many commentators expected. Some courts have not been willing to imply a charitable trust upon assets of corporations unless the parties specifically intended to create a trust.[163] Furthermore, the theory is applicable only to a trustee's misuse of trust assets and not to the full range of a corporate director's fiduciary responsibilities. Finally, since it was decided in 1974, the *Stern* case has been relied upon specifically only once for the proposition that nonprofit corporation directors may be liable for breach of fiduciary duties; that decision was issued by a trial court.[164]

The utility of the *Stern* case is also limited by authority in jurisdictions that hold that nltra vires actions must be brought by way of a quo warranto action and that the attorney general is an indispensable party in such an action.[165] In a jurisdiction following this rule, a potential plaintiff would have to convince the attorney general that his case is worthy of prosecution. Moreover, limited staff resources still might prevent the attorney general's intervention regardless of the merit of the case.

(c) *The Corporate Negligence Theory:* Darling v. Charleston Community Memorial Hospital

The leading case on hospital corporate negligence liability is *Darling v. Charleston Community Memorial Hospital.*[166] *Darling* announced a theory of corporate liability for the failure of a hospital to establish a system in which nurses would inform the administration and medical staff of inadequate treatment rendered by a physician granted hospital privileges. Liability under *Darling* arises from the failure of the hospital to review the treatment rendered. The application of a corporate negligence theory does not depend upon establishing the elements of respondeat superior, but

163. *See* Note, *supra* note 66, at 767.

164. Midlantic Nat'l Bank v. Frank G. Thompson Foundation, 170 N.J. Super. 128, 135, 405 A.2d 866, 870 (1979). The court held that directors of a foundation that is organized as a charitable corporation are held to a corporate standard of care which permits directers to delegate authority to supervise investments. The *Stern* case was distinguished in Newman v. Forward Lands, Inc., 430 F. Supp. 1320, 1322 (E.D. Pa. 1977), a case in which the court held that contractors do not have standing to sue directors of nonprofit corporations with which they contract.

165. *See* Oleksy v. Sisters of Mercy, 92 Mich. App. 770, 285 N.W.2d 455 (1979); Oleksy v. Sisters of Mercy, 74 Mich. App. 374, 253 N.W.2d 772 (1977). *Contra,* Jones v. Grant, 344 So. 2d 1210 (Ala. 1977); Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

166. 33 Ill. 2d 326, 211 N.E.2d 253 (1965), *cert. denied,* 383 U.S. 946 (1966).

rather exposes the hospital to liability for failing to oversee the acts of physicians who are not employees.[167]

The *Darling* decision represented a departure from previous doctrine. The expectation was that it would cause hospital directors to examine their responsibilities to oversee the quality of care provided within their institution. In the sixteen years since it was decided, however, the case has never been relied upon specifically outside of Illinois.[168] As a result of the *Darling* decision, however, some courts have given credence to the duty of a hospital to use reasonable care in granting medical staff privileges, as well as the duty to terminate or limit staff privileges when the hospital becomes aware of the incompetence of a staff physician.[169]

The anticipated impact of *Darling* upon individual directors of hospital corporations has not materialized. While a corporation may be found negligent under a *Darling* theory, among reported cases neither a single individual director nor a single board has been held liable for failing to oversee the granting of staff privileges. Even if the directors were to be held individually responsible, an extension of the *Darling* decision would address only one of the potential fiduciary duties of a director—to avoid financial losses due to corporate negligence for personally failing to oversee the quality of care. The board of directors, however, answers to a broader range of fiduciary obligations, including the duty of loyalty, the duty of care in preserving assets, a duty to supervise investments, and a duty to avoid self-dealing.

IV. Conclusion

Although this Article has concentrated upon comparing nonprofit and business corporation statutes, it recognizes that corporate governance mechanisms in the for-profit sector have been subject to critical scrutiny as well.[170] In small, closely held business

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167. *Id.* at 333.

168. Dunn, *Hospital Corporate Liability: The Trend Continues,* Medicolegal News 16 (Oct. 1980), (citing Bost v. Riley, 44 N.C. App. 638, 262 S.E.2d 391 (1980) and Johnson v. Misrecordia Community Hosp., 97 Wisc. 2d 521, 294 N.W.2d 501 (1980)). Dunn states that only in the last several years have significant additional strides been taken in the development of the *Darling* theory.

169. Comment, *The Hospital-Physician Relationship: Hospital Responsibility for Malpractice of Physicians,* 50 Wash. L. Rev. 385, 414-16 (1975). *See also* Mitchell County Hosp. Auth. v. Joiner, 229 Ga. 140, 189 S.E.2d 412 (1972).

170. *See, e.g.,* Mace, *Directors: Myth and Reality—Ten Years Later,* 32 Rutgers L. Rev. 293 (1979); Moss, *The Crises of Corporate Accountability: A Legislator's View,* 5 J. Corp. L. 251 (1978). Mace surveyed corporate directors and chief executive officers in a wide

corporations, however, an ineffective governance mechanism may have little, if any, impact upon the public interest, while publicly held corporations are subjected to federal and state regulations, ensuring at least a minimal level of accountability to the public.[171] Recently, federal regulations and statutes have expanded federal jurisdiction into areas that relate to strengthening for-profit corporate governance mechanisms.[172]

Nonprofit hospitals and other health care institutions possess some of the significant characteristics of large, publicly held business corporations. Roughly forty-five billion dollars are expended annually by the consumers of services rendered by voluntary, nonprofit hospitals.[173] The share of public funding of hospital care expenditures is rising steadily, and direct public funding now stands at fifty-six percent of all hospital care expenditures. In addition, there are other areas of substantial indirect public funding of hospital expenditures, such as lost governmental revenues from tax exemptions for institutions, tax deductions for personal medical expenditures, and federal loans and grants.[174]

The extent of the public's investment as taxpayers—not to mention as consumers of institutional health care services—makes it imperative that such health care institutions cultivate systematic public participation in policymaking activities and make adequate public disclosure of information concerning their operation and

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range of business corporations and found that boards of directors function as an overseer of management primarily in crisis situations such as when a successor chief executive officer needs to be replaced. In other policymaking roles business boards take an advisory position but rarely exercise systematic decisionmaking authority.

171. One such regulatory scheme is found in the authority of the Securities and Exchange Commission to require full public disclosure of information necessary for potential investors to make investment decisions. *See* Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976 & Supp. III 1979); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979).

172. Regulations issued by the Securities and Exchange Commission (SEC) in 1978 require proxy statements to disclose extensive information about the directors, their relationship to the corporation, and their participation at board and committee meetings. Upon the request of a resigning board member, the corporation is also required to file information with the SEC describing the reasons for the resignee's dissatisfaction with company management. 17 C.F.R. § 240.14a-101, Item 6(f). In 1977 Congress enacted the Foreign Corrupt Practices Act of 1977. The Act requires publicly held corporations to meet certain internal accounting standards in order to disclose any activity that might violate the statute. 15 U.S.C. § 78m(b) (Supp. III 1979).

173. AMERICAN HOSPITAL ASSOCIATION, *supra* note 18, at 4-7 (1980). The estimate is conservatively generated by multiplying the percentage of nonprofit, nongovernmental beds found in nonfederal short-term general and other special hospitals by annual hospital expenditures.

174. *See* text accompanying notes 10-17 *supra*.

finance. In an environment in which deregulation is gaining popular support, it is necessary to reexamine corporate governance mechanisms to determine whether they can ensure representation of the public's interest.

The analytical exercise undertaken in this Article suggests that corporate governance mechanisms will require refinements to achieve these objectives. Insufficient attention has been directed toward the development of judicial and statutory remedies to enforce the supervisory role of the boards of directors. The statutory framework for nonprofit charitable corporations may have contributed in a substantial way to the trend, noted by other commentators, of role reversal between management and the board of directors. In particular, nonprofit corporation statutes do not generally require memberships, which in turn may create self-perpetuating boards. In corporations that do establish memberships, voting rights are abrogated easily through amendments to bylaws and often through board resolutions. Similarly, categories of memberships may be eliminated through bylaw amendments. The rights of members to bring derivative actions for wrongdoing on the part of the board have not been developed fully through legislative avenues. Finally, management companies may under some circumstances operate without supervision by the board of directors.

The identified deficiencies in nonprofit corporate governance mechanisms, as they apply to health care institutions, may be corrected in several ways. First, nonprofit health care corporations[175] should be required to have members, and the qualifications for membership should be identified in the articles of incorporation rather than the bylaws. Second, membership rights should include minimal voting rights, especially the election of the directors. Third, the right of members to bring derivative actions should be established in nonprofit corporation statutes, and the statutes should be amended to define the appropriate procedures required to maintain derivative suits on behalf of nonprofit corporations. Fourth, management companies and other delegations of managerial authority should be clearly subject to the supervisory authority of the board of directors. Last, to ensure a diversified membership in the corporation that reflects the public interest of taxpayers and

175. Nonprofit health care corporations may be defined as nonprofit corporations engaged in the direct delivery of health care services and receiving patient care revenue in excess of a dollar amount considered appropriate in the particular jurisdiction. The dollar limit would function to exclude relatively small nonprofit clinics and group practices, whose regulation is of lesser concern to the public because government funding is limited.

consumers, public benefit programs, like Medicare and Medicaid, should require, as a condition of participation for nonprofit health care institutions, a membership that at least in part reflects the population in the area served by the health care institution.[176] The members could be appointed in a variety of ways, but the method chosen should ensure a broad-based representation of the public served by each institution.

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176. 42 U.S.C. §§ 1395aa, 1396a(1)-(43) (1976 & Supp. III 1979).