

BLURRING. NOT FADING.
LOOKING AT THE DUTIES OF CARE AND LOYALTY AS
NONPROFITS MOVE INTO COMMERCIALISM

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I. INTRODUCTION

The Nonprofit Organization is an entity distinct unto itself.¹ It can sue and be sued. It can enter into legal contracts. It can produce goods. It can offer services. It can make investments. The Nonprofit Organization, as an entity distinct from its for-profit counterparts, is organized and operates to further a philanthropic purpose.² This purpose is independent of and supplants the pursuit of economic gain of the founders of the organization and those who contribute financially to the organization.³

The traditional distinction, however, between for-profits and Nonprofit Organizations have increasingly become blurred as Nonprofit Organizations, in an effort to achieve the mission, continue to pursue increased commercial activity in response to economic challenges.⁴ To accomplish legal, ethical, and effective implementation and continuation of a commercial venture, the members of the governing board of the Nonprofit Organization (the “Board”) and other individuals with similar responsibilities and influence to the Nonprofit Organization (together, the “Board and Others”) should be aware of the roles of the duties of loyalty and care when deciding whether to enter into a commercial venture and when managing the subsequent ongoing operations of the organization. Too frequently, management marginalizes legal issues in favor of business issues.⁵ Yet, the legalities can affect the business’ viability and productivity depending on the

¹ For the purposes of this article the defined term “Nonprofit Organization” refers to both tax-exempt and non-tax-exempt nonprofit organizations.

² Michael W. Peregrine, *Legal Concerns in Specific Health Care Delivery Settings: Nonprofit Corporate Governance*, in 3 HEALTH L. PRAC. GUIDE 43:2 (2010) (“The concept of nonprofit status refers to a corporation formed for the purpose of serving a public (charitable) or mutual benefit purpose, rather than the pursuit of profits.”).

³ Gail A. Lasprogata & Marya N. Cotton, *Contemplating “Enterprise”: The Business and Legal Challenges of Entrepreneurship*, 41 AM. BUS. L.J. 67, 75 (2003).

⁴ Howard P. Tuckman, *Commercialization and For-Profits in Disguise*, INT’L ENCYCLOPEDIA OF CIVIL SOC’Y 1, 1-2 (Helmut K. Anheier et al. eds., 2010) (demonstrating that nonprofits’ serious challenge of raising funds results in their pursuit of commercial activities); Lasprogata & Cotton, *supra* note 3, at 73 (indicating that the “morphing of the nonprofit and for-profit sectors has both sides accusing the other of unfair competition. While nonprofits are charging fees, producing and marketing typically commercial products, and otherwise looking like for-profits, for-profits are entering the social services arena previously occupied by nonprofits alone.”); J. Gregory Dees, Duke Univ., *Philanthropy and Enterprise: Harnessing the Power of Business and Entrepreneurship For Social Change*, Session IV: Social Enterprise and Private Enterprise (Aug. 2, 2007, 11:00-12:45 PM), <http://www.brookings.edu/global/aspden/2007dees.pdf>; *see also* Evelyn Alicia Lewis, *When Entrepreneurs of Commercial Nonprofits Divorce: Is It Anybody’s Business? A Perspective on Individual Property Rights in Nonprofits*, 73 N.C. L. REV. 1761, 1761 (1995).

⁵ Lasprogata & Cotton, *supra* note 3, at 70.

information known and decisions made and, therefore, should be an integral part of management's decisions to enter into and continuing to engage in a commercial venture as a Nonprofit Organization.⁶

In section II, this article describes what is meant by the status of an entity as a nonprofit business and as a tax-exempt business. In section III, this article provides a description of the blurring of the distinction between Nonprofit Organizations and for-profits as a result of commercialism undertaken by the Nonprofit Organizations. Section IV sets forth the concepts of corporate governance, the duty of loyalty, and the duty of care. Further, this section provides specific examples of how the duty of loyalty and duty of care should be effectuated with regards to a Nonprofit Organization's decision to enter and continued operation in a commercial venture. Finally, section V provides the conclusions to be drawn from this analysis and offers suggestions for future developments.

II. THE NONPROFIT ORGANIZATION

The world of Nonprofit Organizations is extraordinarily diverse and competitive. While for-profit businesses are organized and operated to pursue corporate profit and gains for the shareholders, the Nonprofit Organization's purpose is its philanthropic mission; accordingly, its organization and operation must substantially fall in line.⁷ To obtain the status of "nonprofit," an organization is prohibited from distributing its profits to the individuals who exercise control and influence over it such as officers, directors, members, or significant stakeholders.⁸ Similar to for-profits, state law governs the creation and governance of nonprofits.⁹ The status of an organization as a nonprofit does not necessarily mean it is a tax-exempt organization. Rather, the types of organizations that fall under the term "nonprofit" comprise a broader population than the types of organizations that fall under the term "tax-exempt."¹⁰

While a nonprofit is a business entity created under and governed by state law, a tax-exempt organization is a federal law creation, principally governed in the United States by the Internal Revenue Code (the "Code").¹¹ In particular, Section 501 of the Code provides the primary source for the exemption from taxation.¹² Section 501(a) of the Code allows for exemption from federal income tax for any organization that meets the criteria of Section

⁶ *Id.*

⁷ Peregrine, *supra* note 2, at 2.

⁸ Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981).

⁹ Lasprogata & Cotton, *supra* note 3, at 75. Similarly, if the Nonprofit Organization is organized as a corporation, like the for-profit, it will have a board of directors responsible for the management of the organization. *Id.*

¹⁰ *Id.*

¹¹ *Id.* ("There are a number of categories of tax exempt organizations in Section 501."); *see also* Peregrine, *supra* note 2 ("Furthermore, the determination of tax-exempt status and charitable trust status are not necessarily one and the same. A nonprofit corporation is not automatically recognized by virtue of its state incorporation as exempt from income tax under the Internal Revenue Code (IRC). Conversely, the lack of tax-exempt status under the IRC will not prevent the state regulators from concluding that all of the corporation's assets are held for charitable purposes (consistent with its charitable dedication clause), notwithstanding a failure to obtain tax exemption.").

¹² I.R.C. § 501(c)(3) (2010) and accompanying Treasury Regulations; *see* PANEL ON THE NONPROFIT SECTOR, *infra* note 111, at 10; Lasprogata & Cotton, *supra* note 3, at 77.

501(c) of the Code, the “charitable exemption.”¹³ Often, tax-exempt Nonprofit Organizations are referred to as “charitable” organizations. “Charitable” is the actual term used to describe one of the types of organizations that qualifies for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. However, the word “charitable” has become accepted as a more generic term to apply to “religious,” “scientific,” “educational,” and other similar purposes for which 501(c) applies.¹⁴ The tax-exempt status of a nonprofit allows the organization to be exempt from the obligation to pay certain federal taxes, such as excise tax and employment taxes, and relieves the organization of some state taxation.¹⁵

Consequent to these characteristics, this analysis would be incomplete without integrating two key characteristics of the Nonprofit Organization. First, that a Nonprofit Organization’s business activities are limited to those in furtherance of its mission.¹⁶ In the United States, most Nonprofit Organizations of import are corporations.¹⁷ This mission limitation means that the Nonprofit Organization’s business purpose is limited to activities specifically set forth in its organizing documentation, namely its charter or Articles of Incorporation.¹⁸

Second, a Nonprofit Organization must retain its profit and, bound by its mission limitation, apply it to the purpose(s) under which the Nonprofit Organization was organized and created.¹⁹ A Nonprofit Organization by its definition is not precluded from generating a profit. Many actually do. Instead, a Nonprofit Organization may not distribute profit to the directors, officers, members, or other interested parties of the Nonprofit Organization in their private capacity.²⁰ This “private inurement doctrine,” in which the Nonprofit Organization’s net earnings may not inure to the benefit of private parties, is central to the law governing Nonprofit Organizations.²¹ The doctrine marks a very clear line between Nonprofit Organizations and for-profits.²² Despite this doctrine, a Nonprofit Organization

¹³ I.R.C. § 501(a), (c).

¹⁴ Lasprogata & Cotton, *supra* note 3, at 75 (“There are member-serving organizations such as social clubs, business leagues, and labor unions. These organizations primarily exist to provide some benefit to their members rather than the public at large. A second category is referred to as public-serving or charitable organizations. These are organizations defined in Section 501(c)(3) of the Code. They quite broadly include a spectrum of activities designed to improve the quality of life by improving arts, education, social welfare and health. Social service nonprofit organizations are included in this definition.”); *see also* Peregrine, *supra* note 2 (indicating that “[i]t is important to note that a corporation need not maintain a ‘charitable’ corporate mission in order to maintain nonprofit status. Indeed, the laws of many states allow the incorporation of a nonprofit entity created to benefit only a small group of persons not in need of charity (the ‘mutual benefit corporation’).”).

¹⁵ Lasprogata & Cotton, *supra* note 3.

¹⁶ Peregrine, *supra* note 2.

¹⁷ Hansmann, *supra* note 8.

¹⁸ Peregrine, *supra* note 2.

¹⁹ *Id.*

²⁰ Lasprogata & Cotton, *supra* note 3; *see also* Peregrine, *supra* note 2 (indicating that while it is acceptable for the nonprofit corporation to maintain an operating surplus, that surplus must be applied towards stated charitable purposes).

²¹ *Id.* *See also* Treas. Reg. § 1.501(c)(3)-1(c)(2).

²² DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 2–3 (1988); Lasprogata & Cotton, *supra* note 3; Peregrine, *supra* note 2 (“It is prohibited from making distributions of profits and net earnings (other

may still identify a legitimate concern related to the financial performance of the organization and seek to engage in commercial activities in response to that concern. It must not, however, lose sight of its primary purpose, its mission, and direct substantially all of its business activity in pursuit of that purpose.

III. COMMERCIALISM & BLURRING

It is important to not underestimate the competitive world of the Nonprofit Organization. A Nonprofit Organization must distinguish itself. Traditionally, Nonprofit Organizations have continued their operations in furtherance of their mission by relying on grants from the government and private foundations, donations from private individuals, and fees for services.²³ Among other things, the challenging economic situation has increased the need for the Nonprofit Organization to reach beyond the traditional grant and private donation approach.²⁴ In an effort to make themselves viable, Nonprofits Organizations' activities may "blur the boundaries" between Nonprofit Organizations and for-profit enterprises by pursuing commercial methods.²⁵ "[C]ommercialism refers to the process of applying business or commercial methods to an organization, usually implying adoption of the profit motive as a prime *raison d'être*."²⁶ Along this line, Nonprofit Organizations pursuing profit-oriented business (i.e., commercialism) have characteristically found such opportunities in printing, garments, private universities, consultancy services, marketing cellular phones, and investing.²⁷ Consequently, the values, mission and practices of the Nonprofit Organizations mix with the relevant forces in the market economy.²⁸

This move towards commercialism by Nonprofit Organizations has been attributed to several factors beginning with the severely elevated inflation and cutbacks in funding by

than reasonable compensation for services rendered) to individuals in a controlling position such as directors, officers, members, or founders (known as the 'nondistribution constraint'), or otherwise for private benefit. This 'constraint' is similar to the prohibition against private inurement of the earnings of tax-exempt organizations as provided for in the federal Treasury Regulations. The 'nondistribution restraint' is most often manifested through statutory provisions that separately set forth the types of distributions of corporate assets prior to dissolution, types of distributions of corporate assets upon dissolution, and a general prohibition on loans to directors and officers except (under certain circumstances) to a director who is employed by the corporation." (footnotes omitted).

²³ Lasprogata & Cotton, *supra* note 3, at 68.

²⁴ Tuckman, *supra* note 4, at 1-2.

²⁵ Jude L. Fernando & Alan W. Heston, *Introduction: NGOs Between States, Markets and Civil Society*, AM. ACAD. POL. & SOC. SCI. 8, 11 (1997) (including "pursuing professionalization and standardization of organizational practices."). Dean Tuckman explains the need for commercialism: "The problem is that many nonprofits have exhausted their existing sources of revenue and this leads for a search for new revenue sources to foster stability and growth. One such source is engaging in the same type of commercial activity that for-profit firms are involved in which creates the risk that nonprofits start to copy nonprofits both in terms of the goals they pursue and the way that they provide products and services. The hiring of managers from commercial enterprises may hasten this process and ultimately undermine the fundamental justification for an organization's special status as a nonprofit organization." Tuckman, *supra* note 4, at 2.

²⁶ Tuckman, *supra* note 4, at 2.

²⁷ Fernando & Heston, *supra* note 25, at 14.

²⁸ *Id.*

the presidential administration of Ronald Reagan.²⁹ Over time, Nonprofit Organizations have been required to be more self-sufficient.³⁰ In more recent history, increased pressure on Nonprofit Organizations to be self-sufficient has spawned from the diversion of government funds and public attention from the nonpublic sector to the banking crisis and wars in Iraq and Afghanistan.³¹ “Autonomy appears crucial for the legitimacy of the organizations as well as their operational flexibility.”³² Further, new Nonprofit Organizations have outpaced the growth of private philanthropists, foundations and companies that will financially support the activities of the Nonprofit Organizations.³³ With the increasing number of Nonprofit Organizations, the competition for the limited resources is increasing.³⁴ In essence, even with all the money that governments and philanthropies of the world contribute “there’s just not enough money.”³⁵ As a result, various Nonprofit Organizations have followed the advice of consultants and experts, and have pursued new revenue streams, applying business techniques that resemble those of for-profits.³⁶ Thus, the traditional distinctions between for-profits and nonprofits have blurred as the Nonprofit Organizations continue to pursue increased commercial activity.³⁷

Some claim that Nonprofit Organizations act like for-profit businesses, in some situations, by making large profits, paying elevated salaries, moving into fine offices, investing prolifically, and employing lobbyists and other means to influence legislation.³⁸ These critics claim that the Nonprofit Organizations are engaging in unfair competition because Nonprofit Organizations gain an unfair advantage over their for-profit counterparts, particularly tax-exempt organizations that may offer very similar goods or services but benefit from the tax-exemption.³⁹ In this way, they argue, the Nonprofit Organizations exploit the tax-exempt status.⁴⁰ One of the advantages for a tax-exempt organization under

²⁹ Tuckman, *supra* note 4, at 1-2 (indicating that a reason there is a growth in commercial activities by nonprofits is the serious challenge to raise funds). The traditionally clear line between for-profits and Nonprofit Organizations continues to become increasingly blurred, and is primarily due to the economy causing serious challenges for the nonprofit to raise funds the traditional way, necessitating a more commercialized approach. *Id.*: see also Fernando & Heston, *supra* note 25.

³⁰ Tuckman, *supra* note 4.

³¹ *Id.*

³² Fernando & Heston, *supra* note 25, at 14.

³³ Tuckman, *supra* note 4.

³⁴ Lasprogata & Cotton, *supra* note 3, at 68.

³⁵ *Grants & Grantees*, THE ROCKEFELLER FOUNDATION, <http://www.rockefellerfoundation.org/grants> (last visited Mar. 3, 2011) (“It will take much more—and *more* will have to come from private investment capital.”).

³⁶ Fernando & Heston, *supra* note 25; Tuckman, *supra* note 4, at 2. This process may also involve hiring people from the for-profit sector. *Id.*

³⁷ Lewis, *supra* note 4.

³⁸ Gilbert M. Gaul & Neill A. Borowski, *Atlanta Business: Non-Profit Organizations Tax-exempt Status Shortchanges U.S. of Billions*, ATLANTA J. & CONST., May 9, 1993, at F1; see also Heather Gottry, *Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship*, 6 GEO. J. ON POVERTY L. & POL’Y 249, 250 (1999); Tuckman, *supra* note 4, at 2.

³⁹ Gottry, *supra* note 38.

⁴⁰ *Id.*

section 501(c)(3) of the Internal Revenue Code is that the contributions or gifts made to the tax-exempt organization or for its benefit are deductible from the donor's taxes.⁴¹ This becomes an added benefit to the tax-exempt organization because it incentivizes giving to the organization.⁴² The public policy purpose behind this tax deduction is to support the notion that these organizations generally serve a public purpose that the government wants to encourage.⁴³ Other than the mere fact that the benefit inures to the public, the government's view is that it also benefits from the public purpose when it does not have to otherwise disperse funds to meet the need addressed by the 501(c)(3) organization.⁴⁴

The critical perspective is that if the Nonprofit Organizations can so readily develop commercial ventures, they should not benefit from the privileges associated with the use of the terminology "nonprofit" that engenders trust and the federal tax-exempt status.⁴⁵ In fact, the Nonprofit Organizations may be in violation of the requirements for use of the "nonprofit" term and the ability to claim tax-exempt status.⁴⁶ When benefitting from the status of being a Nonprofit (such as tax breaks), how does an organization ethically and legally also avidly pursue commercialism, whereby the company achieves a degree of unfair competition over for-profit companies?⁴⁷

From a Nonprofit Organization's perspective, commercialism is required for the nonprofit to keep up, replacing federal funds that were lost due to budget cuts and economic issues.⁴⁸ In addition, in order to achieve a healthy organization, Nonprofit Organizations are pursuing diversified sources of income.⁴⁹ The tax-exempt nonprofits further argue that they are taxed on the income they earn for activities that are unrelated to the tax-exempt purpose for which they have the tax-exemption. In response, the critics hold that the tax does not adequately compensate for the advantage derived.⁵⁰

IV. CORPORATE GOVERNANCE

As seen above, there are fundamental differences between the for-profit organization and the Nonprofit Organization deriving primarily from the concepts of

⁴¹ Lasprogata & Cotton, *supra* note 3, at 76.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 73 (indicating that the "morphing" of the nonprofit and for-profit sectors has both sides accusing the other of unfair competition. While nonprofits are charging fees, producing and marketing typically commercial products, and otherwise looking like for-profits, for-profits are entering the social services arena previously occupied by nonprofits alone.)

⁴⁶ *Id.*

⁴⁷ Allan Maram, *Commercialization of the Nonprofit Sector: A Discussion and Critical Analysis*, 2 SOC. & PUB. POL'Y REV., no. 2, at 1, 3 (2008).

⁴⁸ Lasprogata & Cotton, *supra* note 3, at 73-74 ("In their defense, nonprofit leaders argue that they have been forced into the positions they are in by the harsh and unforgiving fiscal environment and the need for more capital to stay alive, let alone compete.")

⁴⁹ Gottry, *supra* note 38.

⁵⁰ *Id.* at 250-51 (indicating that the argument points to the advantage to be derived relating to the gains from the activities that do fulfill the tax-exempt purpose).

mission limitation and the private inurement doctrine requiring allocation of profit back to the mission.⁵¹ Despite these differences, however, there are parallels. One parallel area in particular is the duties and responsibilities of the Board and Others⁵² of the organization with regard to corporate governance.⁵³ Through efforts to ensure transparency, accountability, and fairness of the business entity's dealings, the requirements of corporate governance ultimately seek to ensure that the business entity performs successfully for its shareholders, in the case of for-profit companies, and for the mission in the interests of the public, in the case of Nonprofit Organizations. In recent years, due to corporate malfeasance, businesses have come under a great deal of scrutiny. Corporate governance took on a new life after virtual obscurity, when in light of various massive cases of corporate malfeasance, governments implemented significantly more onerous requirements to thwart the perceived improper, if not illegal, behavior of business management.⁵⁴

Some argue that the Internal Revenue Service (the "IRS"), regulating primarily through public disclosure, has become the leader in Nonprofit Organization governance reform.⁵⁵ In 2008, the IRS issued a position paper concerning governance and, in particular, the 501(c)(3) Nonprofit Organization.⁵⁶ In that position paper, the IRS stated that it does "not require charities to have governance and management policies," but "will review an organization's application for exemption and annual information returns to determine whether the organization has implemented policies relating to executive compensation, conflicts of interest, investments, fundraising, documenting governance decisions, document

⁵¹ Peregrine, *supra* note 2.

⁵² While aspects of the analysis in this section may emphasize the Board's duties, this discussion is meant to be relevant to the duties of the Board and Others, essentially any individual that owes a fiduciary duty to the Nonprofit Organization, including if there is another form of management authority other than a board of directors.

⁵³ Some state statutes provide limited liability for officers, directors, and other persons serving nonprofit entities without compensation; *see e.g.*, Illinois General Not For Profit Act of 1986: Limited Liability of Directors, Officers, Board Members, & Persons Without Compensation Ill. Comp. Stat. § 108.70 (1986).

⁵⁴ THE GOVERNANCE OF PUBLIC AND NON-PROFIT ORGANIZATIONS: WHAT DO BOARDS DO? 4 (Chris Cornforth ed., 2003) [hereinafter Cornforth]; *see also* Lasprogata & Cotton, *supra* note 3, at 72-73 ("In the meantime, with scandals like the United Way of America and the recent Red Cross embarrassment in New York City, attention has been focused on nonprofit efficiency and accountability.").

⁵⁵ *See* Lisa A. Runquist & Michael E. Malamut, *The IRS's New Regulation of Nonprofit Governance*, 18 BUS. L. TODAY 29, 30, 33 (2009); *see also* I.R.S. POSITION PAPER, GOVERNANCE AND RELATED TOPICS – 501(C)(3) ORGANIZATIONS (Feb. 4 2008), available at http://www.irs.gov/pub/irs-tege/governance_practices.pdf. The Position Paper is structured as a discussion of six specific governance topics: (i) Mission; (ii) Organizational Documents; (iii) Governing Body; (iv) Governance and Management Policies; (v) Financial Statements and Form 990 Reporting; and (vi) Transparency. *Id.* The discussion reflects governance themes from both the several public speeches of recent months by IRS Commissioner Steven Miller, as well as those from Parts VI and XI from the new Form 990 for fiscal year 2008. In this way, the Position Paper significantly updates and expands upon the February 2007 discussion draft of "Good Governance Practices" for charitable organizations, which has now been withdrawn from the IRS web site. Peregrine, *supra* note 2, at § 44; *see also* I.R.S. FORM 990: RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX (2010). If required to file the Form 990, a Nonprofit Organization will need to file it annually with the IRS. Runquist, *supra* note 55, at 29. Many states also require an annual filing of the Form 990 as well. *Id.* "The resulting IRS foray into corporate governance is simplistic; neither the form nor the instructions recognize the many problems that may result from the revised form." *Id.*

⁵⁶ I.R.S. POSITION PAPER, *supra* note 55.

retention and destruction, and whistleblower claims.”⁵⁷ The implied result is that a properly organized and operated nonprofit will have governance and management policies.

Even with the IRS’s efforts, corporate governance of Nonprofit Organizations has been mostly managed by state law.⁵⁸ The law applicable to Nonprofit Organization is quite underdeveloped compared to the law of for-profits.⁵⁹ State laws concerning Nonprofit Organizations, in the area of directors’ and officers’ duties and responsibilities and other areas, have been modeled after state laws concerning for-profit organizations, most notably the Model Business Corporation Act and other laws governing corporations.⁶⁰ As a result, directors of Nonprofit Organizations must operate under a standard of fiduciary duty similar to that of the directors of for-profit corporations.⁶¹ At the state level, the attorney general is most frequently the authority responsible for regulatory oversight of Nonprofit Organizations and the Board and Others, including those who raise funds or other assets for the organization within that particular state.⁶² In addition, in the wake of the Sarbanes-Oxley Act of 2002, some states have proposed laws that apply Sarbanes-Oxley-type corporate governance provisions to Nonprofit Organizations.⁶³ In terms of state’s general

⁵⁷ *Id.* at § 4; *see also* I.R.S. FORM 990, *supra* note 55.

⁵⁸ Runquist & Malamut, *supra* note 55, at 29.

⁵⁹ Hansmann, *supra* note 8, at 500.

⁶⁰ Peregrine, *supra* note 2, at § 3 (“It should be noted, however, that nonprofit corporation law has traditionally been significantly affected by developments in business corporate law. Nonprofit corporate law began to converge with business corporation law in the early twentieth century. Many state nonprofit corporation statutes were based in large part on the state business corporation law, particularly with respect to administrative management, corporate bylaws, internal procedures, and qualification and renewal of board members. Indeed, the drafters of the American Bar Association’s (ABA’s) Model Nonprofit Corporation Act, 3d Edition (MNPCA) closely followed the provisions of the Model Business Corporation Act (MBCA), as appropriate, including provisions dealing with secretary of state filings, corporate formation, corporate powers, foreign corporation qualification, requirements for a corporate office and agent, and merger/dissolution procedures. Furthermore, the MNPCA adopts (with few exceptions) the provisions of the MBCA with respect to the standards that govern the conduct of nonprofit directors. Under this view, directors of nonprofit corporations should be held to the standards of directors of business corporations (as opposed, for example, to standards applicable to trustees of charitable trusts). This is held without regard of the fact that directors of nonprofit corporations are not in comparable positions to, or operating under similar circumstances as, their for-profit counterparts, due to the differences in corporate goals.”) (citations omitted).

⁶¹ *Id.* (stating “litigation is conducted, contracts are executed, and money is borrowed all in the name of the nonprofit corporation itself, rather than in the name of individual trustees, just as in the case of business corporations. In addition, adoption by most states of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) confirms the application of traditional corporate law principles to financial investment practices of charitable corporations (particularly with regard to UPMIFA’s shift away from a ‘legal list’ of approved types of investments.”).

⁶² *Id.* at § 40.

⁶³ ABA COORDINATING COMMITTEE ON NONPROFIT GOVERNANCE, GUIDE TO NONPROFIT CORPORATE GOVERNANCE IN THE WAKE OF SARBANES-OXLEY, *Forward* (2005) (indicating that California was the first to pass such legislation). *But see* James J. Fishman, *Stealth Preemption: The IRS’s Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 576 (2010) (indicating that despite the fact that the Sarbanes-Oxley Act of 2002 does not apply directly to Nonprofit Organizations, many organizations have been willing to adopt the associated reforms).

corporations statutes, Delaware law is noteworthy for a variety of reasons, including the fact that it has a corporations code that applies to both for-profit and nonprofit corporations.⁶⁴

Nonprofit Organizations have come under a great deal of scrutiny for a number of reasons, including their move into commercialism.⁶⁵ In recent years, many Nonprofit Organizations have not adequately incorporated corporate governance requirements.⁶⁶ In light of that, the decision of a Nonprofit Organization to engage in commercial activities and methods is a complicated one and, therefore, implicates the duties associated with corporate governance. The deeper a Nonprofit Organization's efforts towards commercialism become, the more involved management should be and the more sensitive the situation is for corporate governance purposes. Moving into commercialism requires an evaluation of several factors such as tax considerations, ideology, measuring of success, federal law, state law, and structural ramifications, the details of which would not necessarily be relevant in a for-profit venture.⁶⁷

Corporate governance derives from the basic fiduciary relationship at the core of the business entity. In the case of a Nonprofit Organization, this involves its Board, committees of the Board with delegated powers, and individuals with similar roles or functions, such as officers and other senior management (cumulatively referred to as "the Board and Others").⁶⁸ Those responsible for corporate governance are charged with the fiduciary

⁶⁴ Peregrine, *supra* note 2, at § 37 (stating "Delaware cases are worthy of note by nonprofit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including a specialized court, the Chancery Court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code applicable to for-profit and nonprofit corporations alike. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations—and those who regulate them—even where those organizations are not governed by Delaware law.").

⁶⁵ ABA COORDINATING COMMITTEE, *supra* note 63; *see also* Gottry, *supra* note 38, at 249-50 (indicating that scandals such as with Jim Bakker, Pat Robertson and United Way of America have also contributed to the scrutiny); Runquist & Malamut, *supra* note 55, at 29 ("In light of the Enron debacle and parallel scandals in the nonprofit world, Congress and the IRS have put nonprofits, and specifically nonprofit governance, under the microscope. Sarbanes-Oxley (SOX) instituted federal corporate governance oversight of public companies.").

⁶⁶ Richard Wallace, *Nonprofit Corporate Governance: Playing the Game by the Rules* (Oct. 1, 2002) (unpublished paper, available at <http://www.docstoc.com/docs/45687493/Nonprofit-Corporate-Governance>). For example, the non-profits maintained many directors in management positions. *Id.* Towards this end, a goal of corporate governance for both non-profit and for-profit companies is to achieve a board of directors that is primarily independent of the company and can guide the non-profit ethically and legally. *Id.* A director that is also company management is not independent and represents a source of conflict. *Id.*

⁶⁷ Gottry, *supra* note 38, at 251; *see also*, Peregrine, *supra* note 2, at § 2 ("Most state nonprofit corporation statutes also provide for an entity's perpetual duration and a broad recitation of general powers, including a nonexclusive list of specific powers (*e.g.*, to do all things necessary or convenient to carry out its affairs, including without limitation, power to [recite in statute specific powers]). These statutes also typically authorize the corporation to do all things necessary or convenient, not inconsistent with law, to further the activities and affairs of the corporation. These provisions are designed in large part to (a) protect against the situation where a court incorrectly determines that a nonprofit corporation lacks a specific power because it was not enumerated in its Articles of Incorporation; and (b) relieve the drafter from being required to recite general corporate powers in the Articles of Incorporation.").

⁶⁸ Peregrine, *supra* note 2, at § 4 (indicating that "federal courts, as well as the courts of virtually every state, have ruled on the matter, generally considering the existence of a fiduciary relationship of fact").

duty.⁶⁹ As the individual ultimately responsible for the management of the business of the organization, a director must perform fiduciary duties with the awareness that he acts on behalf of others. In the case of a Nonprofit Organization, this includes the public.⁷⁰ Those with a fiduciary duty must take steps that amount to more than the mere absence of bad faith or fraud.⁷¹ Rather, they must establish rules, systems, and business practices that ensure the transparency, accountability, and fairness of the entity's business dealings.⁷²

In the recent case of *Health Alliance of Greater Cincinnati v. Christ Hospital*, the court determined that a fiduciary is a person that has a duty to act primarily for the benefit of another.⁷³ The duty is created by one person's undertaking of some matter and is related to that undertaking.⁷⁴ In the case of a Nonprofit Organization, the Board and Others act on behalf of the Nonprofit Organization. Further, the ultimate body to whom the Nonprofit Organization is accountable is the public.⁷⁵ This underscores the necessity that a Nonprofit Organization clearly set forth the relevant, individual responsibilities and requirements of the Board and Others.⁷⁶ As determined by the *Health Alliance* case:

A fiduciary relationship is formed when special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position and superiority or influence, acquired by virtue of this special trust. A fiduciary relationship may be created outside of a contractual relationship where both parties understand that a special trust or confidence has been reposed. The law has been zealous in guarding against abuse of a fiduciary relationship.⁷⁷

⁶⁹ *Id.* at § 5.

⁷⁰ MODEL NONPROFIT CORP. ACT (hereinafter "MNPCA") § 8.01(b) (2008) ("Except as provided in Section 8.12, all corporate powers must be exercised by or under the authority of the board of directors of the nonprofit corporation, and the activities and affairs of the corporation must be managed by or under the direction, and subject to the oversight, of its board of directors."); *see also* DEL. CODE ANN. tit. 8, § 141 (2010) (stating "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation."); *Lutz v. Boas*, 171 A.2d 381, 390 (Del. Ch. 1961); *Loft v. Guth*, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd*, 5 A.2d 503 (Del. 1939).

⁷¹ *Guth*, 2 A.2d at 239.

⁷² EDWARDS, ANGELL, PALMER & DODGE, LLP & ROGER D. GLENN, CORPORATE RESPONSIBILITIES OF PUBLIC COMPANIES, at Exhibit F (2009).

⁷³ *See Health Alliance of Greater Cincinnati v. Christ Hosp.*, No. C-070426, 2008 WL 4394738, at *6 (Ohio Ct. App. Sept. 30, 2008).

⁷⁴ *Id.*

⁷⁵ *See Peregrine*, *supra* note 2, at § 3 ("Furthermore, net profits in business corporations are distributable to shareholders who own the for-profit on a collective basis. In contrast, no individual possesses an ownership or proprietary interest in a nonprofit corporation, the ultimate beneficiary of which is the general public.").

⁷⁶ *See Cornforth*, *supra* note 54, at 5.

⁷⁷ *Peregrine*, *supra* note 2, at § 4 (citing *Health Alliance*, 2008 WL 4394738, at *6); *see generally* EDWARDS, ANGELL, PALMER & DODGE, LLP, *supra* note 72; HEALTHCARE ASS'N OF N.Y. STATE & HEALTHCARE TRS. OF NEW YORK STATE, NON-PROFIT CORPORATE ACCOUNTABILITY: A GUIDEBOOK (2004); Wallace, *supra* note 66. Both the collaborating nonprofit and for-profit company face similar ethical and legal corporate governance requirements,

The fiduciary relationship of the Board and Others obligates them to fulfill their duties of loyalty and care in good faith to ensure the Nonprofit Organization follows the mission limitation and properly allocates profits.⁷⁸ For a tax-exempt nonprofit in particular, it is the Board and Others' responsibility to ensure that the organization meets, and continues to qualify for, the tax-exemption by adhering to the Code requirements of section 501(c)(3), along with the related Treasury Regulations.⁷⁹

Consistent with their duties, the Board and Others need to perform a two-layer analysis: 1) organizational and 2) operational.⁸⁰ At the first layer, a Nonprofit Organization must be organized with a mission limitation and a profit allocation appropriate to the mission.⁸¹ Tax-exempt nonprofits must have been organized exclusively for one or more of the charitable purposes of section 501(c)(3).⁸² This has been referred to as the Organizational Test.⁸³ Under the Organizational Test, the focus is mostly on the nonprofit's organizational documents, which must articulate a charitable purpose for the organization.⁸⁴

In order for the Board and Others to perform their duty, a Nonprofit Organization must clearly have defined its mission and values (1) so that the Board and Others know to which standards they should hold the management of the company accountable and (2) to ensure that the Nonprofit Organization properly uses the resources available to it, which will influence its stated purpose.⁸⁵ A Nonprofit Organization, despite a legitimate concern with financial performance, should primarily be focused on the pursuit of its articulated mission in light of its purpose, as the forming document (which will be the Articles of Incorporation if the organization is a corporation) narrowly or broadly defines it.⁸⁶ In this regard, a Nonprofit Organization may conduct a commercial activity that supports a philanthropic

including separation of powers between management and the board of directors, creating a code of ethics, implementing an audit committee with its own charters, creating a conflicts of interest policy, establishing internal controls, reporting financial and other key information to the board, regulating compensation and monitoring interested party transactions.

⁷⁸ Peregrine, *supra* note 2, at § 10. A discussion of good faith is also relevant to the analysis of duty of care. The good faith element of the fiduciary duty is the requirement that the individual acts with honest intention, openness and fair dealing. Relevant to the performance of this obligation, the individual should consider, among other things, whether 1) his actions reflect honesty and fairness consistent with the individual's duty and obligations to the nonprofit; 2) his actions reflect an intention to take advantage of the nonprofit in violation of his duty of loyalty; and 3) he believed his actions and decisions were in the best interest of the nonprofit. *Id.* Under these standards, the assets of the nonprofit must not inure to the benefit of insiders ("private inurement doctrine"), nor shall a private benefit be conferred on an outsider ("private benefit doctrine"). Lasprogata & Cotton, *supra* note 3, at 77 ("It must not participate in any campaign for political office, or engage in any attempts to influence legislation as a substantial part of its activities (together referred to as political activity).").

⁷⁹ Lasprogata & Cotton, *supra* note 3, at 76.

⁸⁰ *See id.* at 77-80.

⁸¹ Peregrine, *supra* note 2, at § 2.

⁸² Lasprogata & Cotton, *supra* note 3, at 78-80.

⁸³ *Id.* *See also* Treas. Reg. § 1.501(c)(3) - 1(a)(1).

⁸⁴ *Id.*

⁸⁵ *See* Peregrine, *supra* note 2, at § 2.

⁸⁶ *See* Lasprogata & Cotton, *supra* note 3, at 77.

purpose.⁸⁷ Compliance with the articulated purpose in the organizational documents and avoidance of mission drift during operation can be influenced by how the organizational documents articulate the purpose(s) of the Nonprofit Organization.⁸⁸ Consequently, some states allow Nonprofit Organizations to disclose a purpose that is more general in nature, which in turn, encompasses more activities within Nonprofit Organization's mission limitation.⁸⁹

Similarly, a Nonprofit Organization must continue to follow the mission limitation in its operation and properly allocate profits, pursuant to the private inurement doctrine.⁹⁰ A Nonprofit Organization's activities must remain substantially dedicated to the philanthropic purpose.⁹¹ A tax-exempt nonprofit, again, must operate exclusively for the purpose of one or more of the charitable purposes of 501(c)(3).⁹² In addition, a tax-exempt nonprofit must report and pay taxes on any unrelated business income.⁹³ This has been referred to as the Operational Test.⁹⁴ These factors are very important for corporate governance considerations in a Nonprofit Organization. The Board and Others (particularly the Board) are obligated in good faith to manage these factors, pursuant to their fiduciary duties of loyalty and care when 1) deciding to enter into a commercial venture and 2) on an on-going basis.

A. *Duty of Loyalty*

The Model Nonprofit Corporation Act mandates that a director shall discharge his or her duties as a director, including his or her duties as a member of a committee, in a manner the director reasonably believes to be in the best interest of the corporation.⁹⁵ This duty of loyalty arises from the position of trust and confidence held by the Board and Others.⁹⁶ The duty of loyalty requires the Board and Others to subordinate their personal interests in good faith to those of the Nonprofit Organization and its mission.⁹⁷ The duty of loyalty prohibits the Board and Others from using their positions at the Nonprofit Organization or the Nonprofit Organization's confidential information for financial gain for themselves or a third party, including another Nonprofit Organization.⁹⁸ The courts have

⁸⁷ *See id.*

⁸⁸ *Id.*

⁸⁹ Peregrine, *supra* note 2, at § 21.

⁹⁰ Lasprogata & Cotton, *supra* note 3, at 74.

⁹¹ *Id.* at 78.

⁹² I.R.C. § 501(c)(3); Lasprogata & Cotton, *supra* note 3, at 76-77.

⁹³ Lasprogata & Cotton, *supra* note 3, at 82-83.

⁹⁴ *Id.* at 78. *See also* Treas. Reg. § 1.50(c)(3)-1(a)(1).

⁹⁵ MNPCA § 8.30(a).

⁹⁶ *See* Health Alliance of Greater Cincinnati v. Christ Hosp., No. C-070426, 2008 WL 4394738 (Ohio Ct. App. 2008); *see* I.R.S. POSITION PAPER, *supra* note 55, at § 4(B) (stating that directors owe a duty of loyalty); ABA COORDINATING COMMITTEE, *supra* note 63, at 29; Peregrine, *supra* note 2, at § 23.

⁹⁷ *See* MNPCA § 8.30(a); ABA COORDINATING COMMITTEE, *supra* note 63, at 29.

⁹⁸ KURTZ, *supra* note 22, at 59; Peregrine, *supra* note 2, at § 23.

more closely scrutinized the application of the duty of loyalty versus the duty of care.⁹⁹ Governed by the duty of loyalty, a director must act in *good faith* and with a *reasonable belief* to “maintain: (a) unequivocal allegiance to the corporate mission; and (b) personal disinterest when considering the business affairs of the corporation.”¹⁰⁰ To determine good faith, the courts typically use a “facts and circumstances” analysis; the essence of the analysis being the director’s state of mind.¹⁰¹ While the analysis applies specifically to directors, it should be considered relevant to the entire Board and Others.

Courts will also analyze whether a director, and the Board and Others more broadly, acted with the reasonable belief that a decision was in the best interests of the Nonprofit Organization.¹⁰²

In evaluating compliance with this ‘reasonable belief’ standard, courts will apply both an objective and substantive test. The objective component of the analysis is that the director must *reasonably believe* the action is in the best interest of the corporation. The subjective component is that the director *must actually believe* the action to be in the corporation’s best interests. As with the ‘good faith’ requirement, courts will likely apply a facts and circumstances analysis to evaluate compliance with the ‘reasonable belief’ requirement.¹⁰³

For the Board and Others, the duty of loyalty also involves such concepts as the conflict of interest, protecting confidential information from disclosure, appropriation of a business opportunity, the unlawful distribution of corporate assets, and in certain jurisdictions, the making of loans and guarantees.¹⁰⁴

⁹⁹ Peregrine, *supra* note 2, at § 22 (indicating that the business judgment rule weighs in favor of finding fulfillment of the duty of care). “The definition of the duty of loyalty reflects application of a general corporate law standard in evaluating compliance, rather than the stricter ‘trust’ standard. This is consistent with its approach to the duty of care. The principal difference between a corporate-based approach and a trustee-based approach to duty of loyalty violations is in the area of remedy. Under the corporate law approach, courts typically require the breaching director to restore the appropriated corporate opportunity or reimburse the corporation for the benefit received as the case may be. Under a trust approach, a court may require not only that the breaching director return lost profits to the corporation, but may also impose a constructive trust on the diverted property for the benefit of the corporation.” *Id.* at § 25.

¹⁰⁰ *Id.* at § 22 (“Because a breach of the duty of loyalty involves a potential subversion of the charitable nature of a charitable nonprofit organization (i.e., absence of self-interest), historically, courts have closely scrutinized related director conduct. The standard of review in such cases focuses more on fundamental fairness to the corporation than on the decision-making process of governance and management. This is in contrast to the duty of care, in the application of which courts will often apply the business judgment rule to protect decisions made in good faith by a disinterested director, reasonably informed under the circumstances, who rationally believed the decision to be in the best interests of the corporation.”). *Id.*

¹⁰¹ REVISED MODEL NONPROFIT CORP. ACT § 8.30, comment 5 (1987). This analysis includes “whether his or her conduct evidenced honesty and faithfulness to the director’s fiduciary duties, or an intent to make personal gain for the director, or for a third party.” Peregrine, *supra* note 2, at § 24.

¹⁰² MNPCA § 8.30(a)(2).

¹⁰³ Peregrine, *supra* note 2, at § 25 (emphasis in original).

¹⁰⁴ *Id.* “Accordingly, the duty of loyalty owed by a nonprofit corporate director also includes an obligation to maintain the confidentiality of all information regarding the activities of the corporation until the activities are disclosed to the public by the corporation or are otherwise in the public milieu. This facet of the duty of loyalty presumes that the director is not the corporate spokesman, and that disclosure of corporate activities is properly

Many state laws require that a conflict of interest must be approved by the disinterested directors and shareholders.¹⁰⁵ Section 5.02 of the American Law Institute's Principles of Corporate Governance differs slightly, emphasizing the fairness of the overall transaction. The text requires full disclosure of the transaction and the conflict of interest thereto.¹⁰⁶ Then, the conflict of interest must be authorized or ratified by disinterested directors.¹⁰⁷ If the disinterested directors refuse to authorize the transaction, the individual with the conflict of interest must show that the transaction was fair.¹⁰⁸ Under the ALI Principles of Corporate Governance, even if a majority of directors approve a decision to engage in a commercial venture after full disclosure of conflicts had been made, the decision may not be valid if it is deemed to not have been reasonably fair to the organization at the time that it was made.¹⁰⁹ If the disinterested directors approve the transaction, then a party challenging the decision must show that the transaction is a waste of corporate assets.¹¹⁰

In circumstances of a Nonprofit Organization's commercial venture, the duty of loyalty may come under particular scrutiny at the point when the Board and Others make the decision to enter into the commercial venture.¹¹¹ "A conflict of interest arises when a board member or staff person's duty of loyalty to the [Nonprofit] organization comes into conflict with a competing financial or personal interest that he or she (or a relative) may have in a proposed transaction."¹¹² The duty of loyalty would command, among other things, that an individual with the duty disclose any conflict of interest that he may have.¹¹³ For instance, a

the province of a designated individual, to whom the director should defer with respect to dissemination of confidential information. The director is further obligated to use 'reasonable diligence to protect and safeguard' corporate information and may not use it for personal gain. Injunctive relief is a method often used by corporations to protect against director breach of confidentiality." *Id.* at § 32.

¹⁰⁵ See, e.g., DEL. CODE ANN. tit.8, § 144 (2010); see also WILLIAM MEADE FLETCHER, 3 FLETCHER CYCLOPEDIA OF THE LAW OF CORPS. § 915.20 (2011) (citing 1 PRINCIPLES OF CORPORATE GOVERNANCE § 5.02, comment a (2010)).

¹⁰⁶ FLETCHER, *supra* note 105, at § 915.20 (citing 1 PRINCIPLES OF CORPORATE GOVERNANCE § 5.02(b)).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* (citing 1 PRINCIPLES OF CORPORATE GOVERNANCE § 5.02(a)(2)(B)).

¹¹⁰ *Id.* (citing 1 PRINCIPLES OF CORPORATE GOVERNANCE § 5.02(a)(2)(D)).

¹¹¹ PANEL ON THE NONPROFIT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS 9 (2007).

¹¹² *Id.*

¹¹³ See Peregrine, *supra* note 2, at § 35 (citing *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1020 (D.D.C. 1974)) (explaining that "(a) knowingly permitting the corporation to enter into a business transaction with any corporation in which the trustee has a material interest without previously informing the board or appropriate committee reviewing the transaction of the trustee's interest therein and of any significant facts known to the trustee which might suggest that the transaction might not be in the corporation's best interests; (b) actively participating in (or voting in favor of) the decision of a board, committee or subcommittee to transacting business with a corporation in which the trustee has a material interest; or (c) otherwise failing to perform his duties honestly, in good faith, and with reasonable diligence and care" violates a trustee's fiduciary duty of loyalty). "The impact of Judge Gesell's conclusion was diminished in part by his decision not to impose relief such as monetary damages or the removal of the implicated directors due to the absence of evidence of financial harm. Instead, he ordered a series of internal compliance actions designed to enhance the board's awareness of, and adherence to, duty of care and loyalty obligations as they may be implicated in future transactions. There is, accordingly, a danger of applying a "no harm, no foul" caveat to the

director may have a financial interest in the outcome of the commercial venture. Or, the commercial venture may involve another entity on whose Board the director serves as a director or an officer. Also, a family member might hold a similar position. A key point to keep in mind is that the Nonprofit Organization should have clear and appropriate procedures to address conflicts of interest and, at the appropriate time when deciding to engage in a commercial venture, the organization should follow them.¹¹⁴ The procedures should be applicable to anyone who has the ability to influence decisions made on behalf of the Nonprofit Organization.¹¹⁵

B. *Duty of Care*

In its 2008 Position Paper on Corporate Governance, the IRS emphasized the duty of care through its encouragement of “an active and engaged board” explaining that “it is important to the success of a charity and to its compliance with applicable law.”¹¹⁶ The application of the duty of care can be broken down into two categories: 1) decision making and 2) oversight.¹¹⁷ “Decision making” applies to the instances when the Board, along with management, makes a specific decision or pursues a specific action.¹¹⁸ “Oversight” refers to the general role of the board of directors in overseeing the management of the day-to-day operations of the nonprofit’s business.¹¹⁹ The oversight function, while ultimately the Board’s responsibility, is shared with the corporate management. Board oversight is an ongoing obligation of the Board and Others. Generally, a director should consider the following steps, among others: 1) understand his fiduciary duties to the organization; 2) continue to be informed about these duties and the organization in general; 3) do not take things at face value, but instead be skeptical and ask questions; and 4) when making

duty of loyalty based upon the Stern decision. Such a caveat is inappropriate in the context of today’s highly regulated health care financial environment given the enormous economic pressure placed upon nonprofit health care corporations and the potential serious harm to a corporation from its unknowing participation in a conflict of interest transaction.” *Id.*

¹¹⁴ PANEL ON THE NONPROFIT SECTOR, *supra* note 111 (indicating that “[c]establishing and enforcing a conflict-of-interest policy is an important part of protecting charitable organizations from unethical or illegal practices. The policy need not be complex, but it must be consistent with the laws of the state in which the nonprofit is organized and should be tailored to specific organizational needs and characteristics.”); *see also* I.R.S. POSITION PAPER, *supra* note 55, at § 4(B) (indicating that the IRS encourages nonprofits to adopt and regularly evaluate a written conflict of interest policy “that requires directors and staff to act solely in the interests of the charity without regard for personal interests; includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and prescribes a course of action in the event a conflict of interest is identified.”); I.R.S., INSTRUCTIONS FOR FORM 1023: APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(c)(3) OF THE INTERNAL REVENUE CODE (2006) (providing an example of a conflicts of interest policy).

¹¹⁵ PANEL ON THE NONPROFIT SECTOR, *supra* note 111.

¹¹⁶ I.R.S. POSITION PAPER, *supra* note 55, at § 3.

¹¹⁷ Peregrine, *supra* note 2, at § 16.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

decisions and applying judgment, use complete, undivided loyalty and care towards the organization and disclose conflicts for approval.¹²⁰

The oversight and decision-making aspects of the duty of care are relevant first to the Nonprofit Organization's decision to enter into a commercial venture and, second, to the ongoing operations relevant to the commercial venture. First, the decision to enter into a commercial venture triggers the Board's decision-making obligations pursuant to the duty of care. The decision-making obligation necessitates that those holding the duty of care be reasonably informed when making decisions.¹²¹ There is no defined prescription to effectuate this responsibility and, certainly, no rubric has been provided for analyzing a Nonprofit Organization's move into commercialism. The decision-making obligation of the Board and Others of a Nonprofit Organization does not differ greatly from that of a for-profit organization.¹²² However, there are key issues singularly relevant to a Nonprofit Organization given the very nature of the organization. The more potential profit the commercial venture offers to the Nonprofit Organization, the more potential there is for risk. The Board and Others need to consider the risks of the commercial venture and determine whether those risks are worth the ultimate financial, and otherwise, benefit to the Nonprofit Organization.¹²³ When contemplating the move by a Nonprofit Organization into commercialism, the following considerations are relevant for decision making: 1) what the risks of the commercial venture are and whether the Nonprofit Organization can afford to take those risks; 2) what is needed from the Nonprofit Organization for the commercial venture and whether the nonprofit can afford to meet the needs; 3) how the culture of the Nonprofit Organization aligns with the culture and goals of the commercial venture; and 4) what the timeline of the venture is and whether the Nonprofit Organization can meet it.¹²⁴

Under the first consideration, the Nonprofit Organization should analyze the risks of the commercial venture and their effect on its bottom line, the organization, and its reputation.¹²⁵ The second consideration requires Nonprofit Organization management to look at the skills, knowledge and resources required for the venture and whether the Nonprofit Organization has the ability to supply them.¹²⁶ Management should compare the needs requested to the value of the potential benefit of the collaboration. In this way, the approach that may make sense to Nonprofit Organization management would be to wade in gradually to collaborations and evaluate the costs and risks as it moves further along in collaborations.¹²⁷ The Nonprofit Organization's third consideration requires an evaluation

¹²⁰ See PANEL ON THE NONPROFIT SECTOR, *supra* note 111, at 8 (indicating "they should be familiar with the basic rules and requirements with which their organization must comply and should secure the necessary legal advice and assistance to structure appropriate monitoring and oversight mechanisms"); Peregrine, *supra* note 2, at § 6.

¹²¹ Peregrine, *supra* note 2, at § 15.

¹²² See *id.*

¹²³ Lasprogata & Cotton, *supra* note 3, at 70.

¹²⁴ *Id.* at 87-88 ("However, social service nonprofit organizations vary dramatically both in their objectives and in how they achieve those objectives in their day-to-day operations. This makes it very difficult to identify one or more entrepreneurial strategies that are uniformly appropriate."). *Id.* at 88.

¹²⁵ Lasprogata & Cotton, *supra* note 3, at 87.

¹²⁶ *Id.*

¹²⁷ *Id.*

of the organization's values and mission compared to those of the venture. The Board and Others needs to decide if they align. If not, the Board and Others need to decide if the organization can adapt.¹²⁸ This begs a careful consideration of the potential for mission drift.¹²⁹ Fourthly, the Nonprofit Organization needs to consider the timeline for the venture and whether it can function within that timeline. Effective planning is essential for this determination.¹³⁰ Planning requires a full and detailed understanding of the marketplace for the commercial venture and evaluation of the risks and corresponding preventative approaches.¹³¹

Essential to the analysis of the duty of care is the role of the business judgment rule.¹³² To determine if a director has met his or her duty of care, the court may apply the business judgment rule. The business judgment rule is designed to ensure that directors have plenty of opportunity to sufficiently exercise their power to manage the business affairs of the organization pursuant to the powers granted to them under the relevant statutes.¹³³ Pursuant to the business judgment rule, a director will not be liable for a good faith decision he or she has made if the director: a) was disinterested (i.e. no conflicts or self-dealing); b) was reasonably informed about the circumstances relevant to the situation; and c) rationally believed the decision to be made in the best interests of the organization.¹³⁴ If these standards are met, a court will generally not question a director's decision unless clearly irrational.¹³⁵ In order for this to occur, actual business judgment must have been exercised.¹³⁶ A director must perform reasonable diligence in order to be able to exercise business judgment.¹³⁷ This includes a director informing himself of "all the material

¹²⁸ *Id.* at 87-88 ("This is a principal concern for many social service nonprofit organizations that value service and public participation over the bottom line. To many nonprofit staff, 'earning money' is offensive. In recent years, resistance to the idea of entrepreneurship in nonprofits has diminished due to increased familiarity with the opportunities and immediate financial pressures.")

¹²⁹ See discussion of mission drift, *infra* note 165.

¹³⁰ Lasprogata & Cotton, *supra* note 3, at 88.

¹³¹ Lasprogata & Cotton, *supra* note 3, at 88. This requires an understanding of the marketplace and the organizational resources at hand. In other words, it requires good planning. Obviously, hasty decision-making and inadequate planning lay the groundwork for failure in any venture. *Id.*

¹³² *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

¹³³ *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981).

¹³⁴ See, e.g., *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 54 (Del. 1989); Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for Conduct of Not-for-Profit Directors*, 33 J. HEALTH L. 422, 465 (2000).

¹³⁵ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (finding that the rule "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"); see generally Peregrine & Schwartz, *supra* note 134, at 466 (indicating that while the Rule is not easily transposed to the nonprofit context, the drafters of the Revised Model Act, several courts, and a number of observers have all supported such applications).

¹³⁶ See *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (stating that "[a]pplication of the [business judgment] rule of necessity depends upon a showing that informed directors did in fact make a business judgment authorizing the transaction under review").

¹³⁷ See, e.g., *Burt v. Irvine Co.*, 47 Cal. App. 828, 851 (1st Dist. 1965); *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (N.Y. Sup. Ct. 1944).

information reasonably available to [him]” before making the business decision.¹³⁸ As a result, the director cannot ignore what is going on with a Nonprofit Organization, including commercial activities or mission drift.¹³⁹ Accordingly, in order to find that the business judgment rule does not apply, in some jurisdictions, a claimant must rebut the presumption that the decision was an informed decision and establish that the director acted in bad faith.¹⁴⁰ The court in *Smith v. Van Gorkom*, under the business judgment rule, articulated that the standard to determine a director’s liability requires a showing of gross negligence.¹⁴¹

In the case of those with a duty of care to the Nonprofit Organization evaluating the decision to enter into commercial activities, the business judgment rule would not protect the decision if, as in the case of *Van Gorkom*, the decision makers breached their duty of care “(1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision . . . and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important.”¹⁴² The “informed decision” analysis will be performed based on whether the directors were informed as of the time the decision was made.¹⁴³ Further, if the decision was not informed at the time it was made, under the *Van Gorkom* approach, a court may look to the actions that the individual with the duty took subsequent to the decision being made.¹⁴⁴

In light of this standard, the decision to commercialize should include the evaluation of several factors to determine whether or not it is likely that the organization will encounter risks but also, importantly, the general conclusion as to whether the venture will be successful. For instance, the Board and Others need to determine if the commercial venture aligns with and will not interfere with the mission and goals of the organization.¹⁴⁵ The Board and Others should consider whether there is a market to consume the product or service offered by the commercial venture, and whether the Nonprofit Organization will have products or services to meet the needs of the market for the commercial venture.¹⁴⁶ Moreover, at a basic level, the Board and Others should consider whether the Nonprofit Organization needs additional revenue and whether the commercial venture will achieve the necessary revenue and not taint the Nonprofit Organization with overly prohibitive risk,

¹³⁸ *Van Gorkom*, 488 A.2d at 872.

¹³⁹ *Id.*

¹⁴⁰ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006); see also *Aronson*, 473 A.2d at 812; *Van Gorkom*, 488 A.2d at 872.

¹⁴¹ *Van Gorkom*, 488 A.2d at 873 (citing *Aronson*, 473 A.2d at 812).

¹⁴² *Van Gorkom*, 488 A.2d at 893.

¹⁴³ See *id.* at 875.

¹⁴⁴ *Id.*

¹⁴⁵ Tuckman, *supra* note 4, at 505.

¹⁴⁶ *Id.* Since not all organizations will make the ultimate decision to engage in a commercial venture: “The existence of these conditions suggests that the [for profit in disguise] problem will not exist throughout the nonprofit sector but rather in those areas where commercialism is feasible and the administration begins to seek out and provide commercial products and services. It is unlikely to be found in providers of services to abused wives, hospices, homeless and/or animal shelters and more likely to exist for art galleries, educational institutions, health care providers or research facilities, and museums.” *Id.*

including the risk of a tax-exempt nonprofit losing its tax-exempt status.¹⁴⁷ With a commercial venture, it is not easy to find the ideal balance between using commercialism to achieve the mission versus crossing the line into substantial efforts towards commercialism and losing sight of the mission. This is especially true given that focusing to some degree on commercialism may ultimately help the Nonprofit Organization achieve greater impact towards its mission in the long run.¹⁴⁸

Second, the oversight function of the directors will apply to the activity of the Nonprofit Organization whilst engaging in commercial activity. Oversight requires the directors to make a reasonable inquiry on an ongoing basis. The Nonprofit Organization is organized and operated primarily for a philanthropic purpose and not intended to line the pockets of the founders or those that support it financially.¹⁴⁹

Ensuring the proper ongoing operation of the Nonprofit Organization is challenging, especially in the context of pursuing a commercial venture as part of the business of the organization while trying to balance the pursuit of the organization's mission with the need for more funds.¹⁵⁰ Nonprofits can earn profits but, by their nature, cannot distribute the earnings to the directors, officers, management, members, employees or other interested parties to the organization.¹⁵¹ For both the tax-exempt and non-tax-exempt nonprofit, the company's continuing operations must be devoted to the purpose or purposes articulated in the organizational documents (mission limitation), and it must properly allocate profits towards that mission.¹⁵² This is particularly relevant in two ways. First, the commercialism by the Nonprofit Organization, as articulated by critics, takes the organization into a new realm possibly adverse to the purely philanthropic activities in support of the mission.¹⁵³ This new realm may, if not done properly, violate the Nonprofit Organization's status as a nonprofit and/or tax-exempt entity. Second, commercialism may be evidence of or the cause of mission drift.¹⁵⁴

It is the Board and Others' duty to ensure that in its day-to-day operations, the organization follows its organizational documents.¹⁵⁵ If the Articles articulate an exclusive, narrowly-defined purpose or purposes, then that may preclude the organization from functioning in a commercial venture even if financially insubstantial.¹⁵⁶ By its nature, a tax-

¹⁴⁷ Lasprogata & Cotton, *supra* note 3, at 70.

¹⁴⁸ Dees, *supra* note 4, at 10-11.

¹⁴⁹ Lasprogata & Cotton, *supra* note 3, at 74.

¹⁵⁰ Tuckman, *supra* note 4, at 506.

¹⁵¹ Lasprogata & Cotton, *supra* note 3, at 74.

¹⁵² *Id.* at 77-78.

¹⁵³ *Id.* at 74.

¹⁵⁴ *See* Tuckman, *supra* note 4, at 506.

¹⁵⁵ *See* I.R.S. POSITION PAPER, *supra* note 55, at § 2 (stating "[r]egardless of whether a charity is a trust, corporation, unincorporated association, or other type of organization, it must have organizational documents that provide the framework for its governance and management").

¹⁵⁶ Lasprogata & Cotton, *supra* note 3, at 77. "To that end, the Articles of a social service nonprofit organization seeking exemption from federal income tax should contain a statement of purpose that reflects the charitable purposes identified in Section 501(c)(3) of the Code. Additionally, the Articles must obligate the organization to

exempt nonprofit's purpose is limited. Generally, the requirements to meet the Organizational Test are more easily fulfilled by the Board and Others because it generally requires properly prepared Articles.¹⁵⁷ Achieving compliance with the Operational Test requires monitoring compliance of the Nonprofit Organization's business on an ongoing basis in order to determine if the organization continues to engage in business that qualifies as nonprofit and, if tax-exempt, "exclusively charitable."¹⁵⁸ To accomplish this task, the Board and Others should ensure that the Nonprofit Organization has clear policies and procedures in place that provide a means for management, staff, volunteers, clients, and others affiliated with the Nonprofit Organization to report suspected wrongdoing without fear of retaliatory measures.¹⁵⁹

The organization will be regarded as operated exclusively for one or more exempt purposes only if it engages substantially in activities that accomplish those purposes. If more than an insubstantial amount of the corporation's activities are not in furtherance of its exempt purposes, it will not qualify as a charitable organization defined in Section 501(c)(3).¹⁶⁰

Pursuant to the Board and Other's oversight function, they should understand that there is a critical difference between the organization's "activity" and "purpose." Depending on the jurisdiction and applicable law, if a Nonprofit Organization's primary activity is a commercial trade or business, that does not automatically mean that the organization becomes disqualified as a nonprofit business nor as a tax-exempt organization.¹⁶¹ The critical distinction is that the commercial activity needs to be in furtherance of the Nonprofit Organization's purpose to pursue its philanthropic mission.¹⁶² For a tax-exempt nonprofit,

further such exempt purposes as its primary activity and prohibit the organization from engaging in any meaningful way in activities that are not in furtherance of some exempt purpose." *Id.* at 77-78.

¹⁵⁷ Lasprogata & Cotton, *supra* note 3, at 78.

¹⁵⁸ *Id.*

¹⁵⁹ PANEL ON THE NONPROFIT SECTOR, *supra* note 111, at 10.

¹⁶⁰ Lasprogata & Cotton, *supra* note 3, at 78. "Even if the corporation operates to further an exempt purpose, but substantially engages in another activity with a non-exempt (e.g., commercial) purpose, it will fail the Operational Test and be ineligible for (or lose) tax-exempt status. Thus, the Operational Test assesses not only whether an organization's activities conform to its tax-exempt status, but also whether the organization is engaged in impermissible activities that are in pursuit of a non-exempt purpose. The line is drawn when the activities, permissible or impermissible, become 'substantial.'" *Id.*

¹⁶¹ *See id.* at 79-80 (discussing *Monterey Pub. Parking Corp. v. United States*, 321 F. Supp. 972 (N.D. Cal. 1970)).

¹⁶² *See, e.g., Fed'n Pharmacy Servs., Inc. v. Comm'r*, 72 T.C. 687 (1979) *aff'd* *Fed'n Pharmacy Servs., Inc. v. Comm'r*, 625 F.2d 804 (8th Cir. 1980); *see also* Lasprogata & Cotton, *supra* note 3, at 79 (describing the *Federation* case, "[T]he U.S. Tax Court denied tax-exempt status to a nonprofit corporation organized to provide prescription drugs at discount prices to the elderly and handicapped. The organization's social service mission was to promote health and relieve financial distress for that charitable class. It discounted drugs and even provided a delivery service when necessary. Additionally, the corporation had many characteristics frequently associated with a nonprofit organization Unfortunately for Federation Pharmacy, the U.S. Tax Court could not differentiate it from any other for-profit drugstore In short, Federation Pharmacy failed the Operational Test because it substantially engaged in activity with a non-exempt (i.e., commercial) purpose, rendering it ineligible for tax-exempt status In Federation Pharmacy, the court found that Federation Pharmacy's commercial operations did not further its stated social purpose.").

those purposes must be exclusively exempt purposes, i.e. charitable.¹⁶³ The Nonprofit Organization will be deemed as operating exclusively for the charitable (tax-exempt) purpose if substantially all of its operations are devoted to the charitable purpose or purposes.¹⁶⁴

The Board, ultimately responsible for the management of the organization, is also responsible in its oversight function to prevent mission drift evidenced by or caused by the commercialism.¹⁶⁵ Since top management and other designated authorities usually perform aspects of the oversight function for the Board, oversight implicates the responsibilities of the Board and Others. Mission drift occurs when the activities of the Nonprofit Organization no longer relate to or support, in large part, the mission of the organization.¹⁶⁶ The traditional role of the Board of Nonprofit Organizations is that it serves as the “guardians of the charity’s mission.”¹⁶⁷ Though mission drift is often a gradual occurrence, the Board should consider that possibility when making the initial decision to enter into commercial activities.¹⁶⁸ Moreover, mission drift may be an intentional or unintentional occurrence.¹⁶⁹ As part of corporate governance, the Board needs to be vigilant to ensure that the time and activities allocated to a commercialized venture do not erode and erase the mission and values of the Nonprofit Organizations.¹⁷⁰ Still, an activity that seemingly runs counter to the purpose of the Nonprofit Organization may actually support the mission.

¹⁶³ I.R.C. § 501(c)(3); *see also* *Aid to Artisans, Inc. v. Comm’r*, 71 T.C. 202, 209-10 (1978); Lasprogata & Cotton, *supra* note 3, at 78; I.R.S., *Exemption Requirements - § 501(c)(3) Organizations*, Nov. 15, 2010, <http://www.irs.gov/charities/charitable/article/0,,id=96099,00.html>.

¹⁶⁴ Treas. Reg. § 1.501(c)(3)-1(c) (2008); *see also* Lasprogata & Cotton, *supra* note 3, at 78 (stating that “if more than an insubstantial amount of the [nonprofit’s] activities are not in furtherance of its exempt purposes, it will not qualify as a charitable organization defined in Section 501(c)(3)”).

¹⁶⁵ PANEL ON THE NONPROFIT SECTOR, *supra* note 111, at 13 (“The board must protect the assets of the organization and provide oversight to ensure that its financial, human and material resources are used appropriately to further the organization’s mission.”); Peregrine, *supra* note 2, at § 1, 8 (indicating that directors are responsible for “directing and overseeing the management of corporate affairs”); *see also* I.R.S. POSITION PAPER, *supra* note 55, at § 5 (articulating the duty “to ensure that financial resources are used to further charitable purposes and that the organization’s funds are appropriately accounted for”); Tuckman, *supra* note 4, at 506 (stating that many mission statements are written in broad, unfocused, and all-encompassing terms, making it difficult to tell when the activities of a nonprofit are causing it to drift away from its intended mission. As a result, individual nonprofits and their boards are largely free to judge whether an activity is mission appropriate.”). *Id.*

¹⁶⁶ *See* Cornforth, *supra* note 54, at 7-8.

¹⁶⁷ *Id.*

¹⁶⁸ *See infra* Section IV. B.

¹⁶⁹ Tuckman, *supra* note 4, at 506. “It can be intentional, as when a nonprofit consciously decides to redirect its activities in a new direction, when it is influenced to seek a new direction through government or donor pressure or it may be unintentional, as when thought is not given to the effects of commercial activity and the organization gradually addresses its output of goods and services to a different mission over time.”

¹⁷⁰ *See* Tuckman, *supra* note 4, at 504; Dennis R. Young & Lester M. Salamon, *Commercialization, Social Ventures, and For-Profit Competition, in THE STATE OF NONPROFIT AMERICA* 423, 442 (2002); Estelle James, *Commercialism and the Mission of Nonprofits*, SOC’Y. J. 29, 29 (2003) (“So long as the charitable goal of the nonprofit remains the driving force, such commercialization has a positive impact on the finances and long-term stability of the organization and the sector.”). *But see*, Dees, *supra* note 4, at 10-11 (stating that “[w]hen philanthropists invest in enterprises, they need to be confident that the incentives inherent in the enterprise are aligned with their intended social impact, or that safeguards are in place should financial rewards ever threaten to pull the organization away from the desired social impact”); Lasprogata & Cotton, *supra* note 3, at 86.

The Board should carefully monitor mission drift for corporate governance purposes because it is often challenging to detect.¹⁷¹ With mission drift, the Nonprofit Organization would fail the Operational Test.¹⁷² One of the biggest challenges for the Nonprofit Organization is to prevent mission drift and stay focused on the goals of the organization.¹⁷³ This challenge is particularly relevant with regards to Nonprofit Organizations that engage in commercialism.

The Board should recognize the distinction between commercialism that benefits the Nonprofit Organization's mission and commercialism that distorts it.¹⁷⁴ Commercial activity can cause philanthropic behavior to change. In this way, those with a duty of care, performing the oversight function, should not assume that an organization and individuals that were once philanthropic will stay philanthropic, especially when involved in commercial ventures.¹⁷⁵ Further, commercialism may encourage the Nonprofit Organization's Board and Others to give in to the force of popular will, instead of firmly pursuing the mission.¹⁷⁶ Succumbing to this pressure could result in the questionable situation of a Nonprofit Organization claiming a mission but not pursuing it, and potentially, the organization running afoul of laws and rules that govern its status as a Nonprofit Organization.

To be vigilant for mission drift, the Board and Others should consider as part of their oversight function, among other things, setting up a compliance program that monitors such issues.¹⁷⁷ For example, a compliance program should monitor the hiring or increased involvement of people in the day-to-day functioning of the organization's business who may be driven by personal gain and, therefore, spend the majority of their time on for-profit activities, neglecting or completely losing the mission of philanthropy. Similarly, a compliance program should monitor people's reallocation of work pursuits towards the commercial activities and away from the philanthropic activities that support the mission. A commercial venture may pressure Nonprofit Organizations to neglect certain aspects of their philanthropic activities that support the mission. Moreover, there may be conflicts of interest between the mission of the Nonprofit Organization and the intent of the commercial activities. For instance, money that is raised in the philanthropic, non-commercial activities may end up being channeled towards the betterment of for-profit activities or actually bailing out failed commercial projects, including cross-sector collaborations.¹⁷⁸ These concepts are symptomatic but not necessarily conclusive. It is,

¹⁷¹ Tuckman, *supra* note 4.

¹⁷² See *infra* Section IV and note 160.

¹⁷³ Sean Silverthorne, *Achieving Excellence in Nonprofits, Q & A with: Herman B. Leonard*, HARVARD BUSINESS SCHOOL (Oct. 27, 2008), <http://hbswk.hbs.edu/item/5942.html>.

¹⁷⁴ See James, *supra* note 170, at 29-30.

¹⁷⁵ Tuckman, *supra* note 4, at 505, 506-07.

¹⁷⁶ See Young & Salamon, *supra* note 170, at 442.

¹⁷⁷ See Runquist & Malamut, *supra* note 55, at 31-32 (stating that while the IRS Code does not require these types of policies and procedures, the implication from Form 990 is that a well-run nonprofit would have policies and procedures such as conflicts of interest policy, whistle-blower policy, record retention and destruction policy, compensation policy, joint venture policy (which is relevant to joint ventures with for-profit partners), Form 990 disclosure policy, and governance disclosure policy). *Id.*

¹⁷⁸ Tuckman, *supra* note 4, at 506.

however, incumbent upon the directors (and by implication the Board and Others) to provide the oversight function required by the duty of care and to implement mechanisms to monitor and address these types of activities.¹⁷⁹ This means creating and implementing a strategy and system to accomplish the mission and goals in light of the commercial venture.¹⁸⁰ The strategy should include actions and decision-making that aligns with the values and mission of the organization.

A director of a Nonprofit Organization has a duty to oversee the corporate compliance programs of the organization, including ensuring that activity is directed towards the purpose of furthering the mission. In dicta, the court in *In re Caremark International, Inc., Derivative Litigation* identified the duty of the director to oversee the organization's compliance programs.¹⁸¹ The *Caremark* court stated that the director's duty includes a good faith attempt to assure that: (i) a corporate information and reporting system exists and is adequate based on Board determination; and (ii) the organization's information and reporting system is adequate to capture and provide reliable and appropriate information to the Board concerning organizational compliance with applicable laws in a timely way and in the ordinary course of business.¹⁸² The Board will need to determine the relevant types of information and the necessary details to monitor in order for the Board to serve its function.¹⁸³ The *Caremark* court determined that in certain circumstances, a director's failure to reasonably oversee the implementation and continued application of this system could be a breach of the director's duty of care.¹⁸⁴ The *Caremark* court described the conditions for liability for failure to oversee compliance programs where the appropriate individuals: (a) "utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."¹⁸⁵ The liability attaches if, under this standard, the individual knew he was not performing a fiduciary duty, thereby evidencing a conscious disregard of that duty.

¹⁷⁹ *Id.* For specific industries, some governmental and non-governmental organizations have provided guidance for these compliance systems. See OIG Supplemental Compliance Program Guidance for Hospitals, 70 Fed. Reg. 4958 (Jan. 31, 2005); OIG Compliance Program for Hospitals, 63 Fed. Reg. 8987 (Feb 23, 1998). Arguably, failure to ensure these compliance programs may be considered "obstruction of justice" pursuant to the terms of Sections 802 and 1102 of Sarbanes-Oxley Act. Peregrine, *supra* note 2, at § 36.

¹⁸⁰ Silverthorne, *supra* note 173.

¹⁸¹ *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

¹⁸² *Id.*; Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 365 (Del. 2006) (assessing oversight liability using *Caremark*); see also *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64-67 (Del. 2006) (addressing corporate fiduciary duty).

¹⁸³ *In re Caremark*, 698 A.2d at 970. "The court did, however, acknowledge that no rationally designed information and reporting system could be expected to remove the possibility that the organization will violate applicable laws or otherwise fail to identify corporate acts potentially inconsistent with law." Peregrine, *supra* note 2, at § 36.

¹⁸⁴ *In re Caremark*, 698 A.2d at 970.

¹⁸⁵ Stone, 911 A.2d, at 370.

V. CONCLUSIONS AND THE FUTURE

A nonprofit entrepreneur is someone who responds to the changing environment of that sector by designing new ways to create value for his or her organization. Nonprofit entrepreneurs are social entrepreneurs. They recognize and relentlessly pursue new opportunities that serve their mission. They engage in a process of continuous innovation, adaptation and learning. They act boldly without being limited to resources currently in hand. They also exhibit a heightened sense of accountability to the constituencies served and for the outcome created.¹⁸⁶

In an effort to keep from fading away, Nonprofit Organizations engage more and more in commercialism, which may blur the boundaries between the Nonprofit Organization and for-profit organizations. Some argue that commercialism is, in fact, the strongest force shaping non-profit business these days.¹⁸⁷ While a for-profit business is organized and operated to pursue corporate profit and gains to the shareholders, a Nonprofit Organization's organization and operation must substantially tract in line with its philanthropic mission.¹⁸⁸ "[Nonprofits] need to be understood within the context of increasingly open and competitive national and international markets."¹⁸⁹ On the one hand, Nonprofit Organizations are under heightened scrutiny which underscores the importance of corporate governance, and, on the other hand, they have a legitimate concern for the bottom line and finding new and improved programs to prop up the bottom line while achieving the mission.¹⁹⁰ While Nonprofit Organizations seek to increase independence and viability, commercialism has deeper implications.¹⁹¹

From the perspective of the Board and Others, status as a Nonprofit Organization does not mean that the organization should never make a profit. Instead, pursuant to mission limitation and the private inurement doctrine, the profit must be used in support of the mission and cannot be paid out to a shareholder or to another residual claimant. When considering a decision to enter into a commercial venture, the Nonprofit Organization's Board and Others, as required by duties of loyalty and care, should ensure that the intended goals and operations of the commercial venture align with the Nonprofit Organization's mission¹⁹² and that there is a system to ensure continued alignment. The Board and Others must realize that the Nonprofit Organization may conduct commercial activity to reasonably support its mission so long as the activity does not cause the Nonprofit Organization to violate the applicable laws or experience mission drift.¹⁹³ If involvement in the commercial

¹⁸⁶ Lasprogata & Cotton, *supra* note 3, at 68-69.

¹⁸⁷ See Young & Salamon, *supra* note 170, at 424.

¹⁸⁸ Peregrine, *supra* note 2, at § 3.

¹⁸⁹ Fernando & Heston, *supra* note 25, at 14.

¹⁹⁰ Lasprogata & Cotton, *supra* note 3, at 68; see also Alnoor Ebrahim, *Accountability*, in INT'L ENCYCLOPEDIA OF CIVIL SOC'Y, *supra* note 4, at 4 ("Over the past decade, regulators, funders, and civil society actors themselves have moved to increase accountability in [civil society organizations], particularly in terms of financial disclosure, transparency in governance, and measurement of performance.").

¹⁹¹ See Young & Salamon, *supra* note 170.

¹⁹² Dees, *supra* note 4, at 10.

¹⁹³ See Peregrine, *supra* note 2 at § 3.

venture drifts from the original path and endangers the Nonprofit Organization's mission (and tax-exempt status), there should be safety measures in place to ensure a proper and legal response.¹⁹⁴

In the developing law of Nonprofit Organizations, it can be argued that because the mission of the Nonprofit Organization is the primary focus, plenty of discretion should be provided to the Board and Others to interpret the Nonprofit Organization's mission and operations related thereto. This approach would modify the traditional fiduciary doctrine applied to Nonprofit Organizations, which was derived from that of for-profit organizations and either underappreciated or did not include the mission consideration in its analysis.¹⁹⁵ Drawing a parallel to the business judgment rule, this new approach is something like a mission judgment rule, providing freedom to those holding the fiduciary duty to make decisions but requiring them to, in good faith, consider and factor in the Nonprofit Organization's mission. In addition, a mission-focused approach would provide a more relevant and "sustainable doctrinal basis for assessing [the Board and Others'] conduct under the duty of loyalty."¹⁹⁶

Critics who assert that the Nonprofit Organizations are obtaining an unfair advantage may not fully understand or account for the impact that commercialism has on the Nonprofit Organizations' business, potentially causing considerable complications and blurring of the distinctions between for-profits and Nonprofit Organizations.¹⁹⁷ Managed correctly by the Board and Others, these changes may be viewed as entrepreneurial, admirable, and promising as they foreshadow greater independence and stability for nonprofits.¹⁹⁸ Independent of the arguments from the critics, the levels of philanthropic needs today require more services in the face of fewer resources.¹⁹⁹ Redefining the Nonprofit Organization's relationship with the market economy may be necessary for the success of Nonprofit Organizations in the future.²⁰⁰ The law of Nonprofit Organizations was largely derived from or modeled from the law applicable to for-profits; it follows, then, that an organization that wants to establish a lasting impact for a philanthropic missions is wise to include for-profit business methods and market-oriented approaches as reasonable parts of the overall business operations.²⁰¹

¹⁹⁴ *Id.*

¹⁹⁵ Peter D. Jacobson & Soniya Keskar Mathur, *Health Law 2010: It's Not All About the Money*, 36 AM. J.L. & MED. 389, 396-97 (2010) (discussing the "mission primacy" approach).

¹⁹⁶ *Id.* at 397.

¹⁹⁷ Gottry, *supra* note 38, at 251.

¹⁹⁸ Maram, *supra* note 47, at 1, 3; *see also* Tuckman, *supra* note 4, at 506 (citing to James E. Austin, Robert Gutierrez, Enrique Ogliastrì, & Ezequiel Reficco, *Capitalizing on Convergence*, STANFORD SOCIAL INNOVATION REV. WINTER 2007, at 24 (stating that the "threat of for-profits in disguise entering the nonprofit sector is of less concern than the fact that the line between nonprofits and for-profits blurs to the point where the rationale for retaining the nonprofit sector can become an issue for public policy. This is especially the case for [sic] as nonprofit collaboration with corporations takes new and creative forms.")).

¹⁹⁹ Gottry, *supra* note 38, at 251.

²⁰⁰ Fernando & Heston, *supra* note 25, at 14.

²⁰¹ Dees, *supra* note 4, at 3 (stating additionally that "[a]nyone who wants to create lasting solutions to social problems would be wise to include business methods and market-oriented approaches as part of their overall tool kit. This is particularly true when the social problem being addressed is poverty in the developing world.

Similarly, in the case of the Nonprofit Organization, the Board and Others have what seems to be a simultaneous obligation to ensure both the furtherance of the mission and the financial stability of the organization. As a result, corporate governance, by means of fiduciary duties, needs to be shifted for the Nonprofit Organization as it relates to that of the for-profit, to instead make the mission the recognized purpose of the Nonprofit Organization. In further recognition of the challenge of measuring success and providing accountability, adequate discretion (different from the for-profit context) should be allotted Nonprofit Organization's directors to interpret the organization's mission. With such discretion, analysis of fiduciary duties in the Nonprofit Organization context should reference mission-focused values instead of the traditional reference points of fiduciary duty analysis related to for-profits, which tend to ignore the mission concept.²⁰² This approach would underscore the relevance of the mission to the corporate governance evaluations and better ensure that the directors integrate the mission into their decision-making process and oversight function within the duty of care. Further, the emphasis on the mission would make a clearer basis for determining when the duty of loyalty is upheld or not.²⁰³ It is also important to consider that while internal controls are essential, a balance needs to be struck with just the right amount of emphasis. A certain degree of emphasis may stifle innovation in subtle or not so subtle ways. This could affect morale and with the shifting of emphasis to compliance programs, resources that would have otherwise possibly gone to development of new ideas might be dispensed other ways.²⁰⁴ This is undoubtedly a challenging and delicate balance to achieve. "Just as free-market ideologues should not assume that fraud carries no social costs, neither should regulators assume that compliance is free."²⁰⁵

They are not claiming that all social problems are amenable to market-based solutions or that any major social problem will be solved by business methods alone.”).

²⁰² Jacobson & Mathur, *supra* note 195, at 396-97.

²⁰³ *Id.* at 397.

²⁰⁴ *Id.*

²⁰⁵ Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031, 1063 (2007).