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The Public-Spirited Defendant and Others: Liability of Directors and Officers of Not-for-Profit Corporations, 17 J. Marshall L. Rev. 665 (1984)

Bennet B. Harvey Jr.

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THE PUBLIC-SPIRITED DEFENDANT AND OTHERS: LIABILITY OF DIRECTORS AND OFFICERS OF NOT-FOR-PROFIT CORPORATIONS

BENNET B. HARVEY, JR.*

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No people do so much harm as those who go about doing good.

Bishop Mandell Creighton, *Life*

The good received, the giver is forgot.

Congreve, "Epistle to Lord Halifax"

No good deed goes unpunished.

Clare Booth Luce, "Love is a
Verb"

*As I know more of mankind I expect less of them, and am ready
now to call a man a good man, upon easier terms than I was
formerly.*

*Boswell's Life of Samuel John-
son, vol. iv.*

INTRODUCTION

In recent years there have been a growing number of actions brought against directors¹ and officers of not-for-profit²

1. It has been common for statutes, articles of incorporation, and by-laws to refer to the members of the boards of not-for-profit corporation as "trustees." See, e.g., RC OHIO, § 1702.01(K); *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1007 (D.D.C. 1974). Happily this practice seems to be on the wane; it has contributed to confusion regarding the obligations of board members. Therefore, in this article the word "director" is used; in discussions of material which uses the other term, the first reference to board members will be "directors ('trustees')."

2. The term "nonprofit" is often used. There is no real distinction between that term and "not-for-profit." H. OLECK, *NON-PROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS*, (4th ed. 1980). In this article "not-for-profit" is used in the belief that it better reflects the fact that, while these corporations sometimes earn profits, the earning of profits is not among their purposes. See *infra* text accompanying notes 23-28.

corporations.³ Although the volume of reported cases involving not-for-profit corporations remains a small fraction of that regarding business corporations⁴ there is ample reason for concern on the part of persons who donate their time to or are employed by not-for-profits that their positions may lead to unforeseen and, from their perspective, unjust results. The author's experience with not-for-profit corporations is that many persons who work with them enjoy an unjustified feeling of vulnerability. They assume that because they are providing valuable services to their communities without pecuniary compensation or, in the case of employees, for significantly less money than is available in the business sector they must be entitled to immunity from the liabilities which plague their less public-spirited counterparts in business corporations.

3. While no statistics on the absolute number of such cases filed each year are available, the growth is reflected in the concern of business executives who also serve on the boards of not-for-profit corporations. RESEARCH AND FORECASTS, INC., SURVEY OF BUSINESS EXECUTIVES OF NOT-PROFIT BOARDS (1979) (prepared for the accounting firm of Touche Ross & Co.). Among the questions asked was whether the directors had perceived an increase in the pressure of suits and potential personal liability in the past ten years; seventy-two percent of all respondents and seventy-one percent of respondents on the boards of cultural institutions answered affirmatively. *Id.* at 30. Eighty percent of the respondents expected increasing legal liabilities in the next ten years. *Id.* at 32.

A similar attitude is apparent among persons asked to serve on the boards of business corporations. A survey of more than six hundred major corporations in 1982 indicated that fifteen percent of those declining to serve said they did so because of concern about increased liability. KORN/FERRY, BOARDS OF DIRECTORS, NINTH ANNUAL STUDY 20 (1982).

4. The paucity of cases concerning not-for-profit corporations is out of proportion to the ratio between the numbers of not-for-profit and business corporations, to the extent that ratio can be computed. Professor Oleck reports on an attempt in September of 1978 to obtain basic statistics on business and nonprofit corporations on file with the nation's fifty-one corporation regulatory departments. The thirty states which revealed how many corporations of each type were in their files reported approximately 1,920,268 business and 522,657 nonprofit corporations; thus there were about twenty-seven percent as many nonprofits as business corporations. OLECK, *supra* note 2, at § 2, pp. 11-14. In 1979, 2,557,000 for-profit corporations filed returns with the Internal Revenue Service. STATISTICAL ABSTRACT OF THE UNITED STATES 261 (104d ed. 1984). Assuming, as Oleck does not, that the figures obtained from the states are accurate, and assuming further that the ratio of the thirty states is the national ratio, there would be approximately 690,390 not-for-profit corporations in this country.

Probably one reason that there are few cases in which wrongdoing by officers and directors of not-for-profit corporations is alleged is that, despite the massive assets of many such corporations (*see infra* note 7), most are small. Also, despite the factors mentioned in the text accompanying notes 5 through 7, as tending to increase the number of such cases, people who devote time and attention to not-for-profit corporations which pursue charitable purposes may not be as litigious as the population at large, or may not be inclined to expend money for litigation which does not promise to advance their own pecuniary interests.

In the past this blithe sense of security seems to have had a basis in fact. In the nineteenth and early twentieth centuries, pillars of the community enjoyed respect approaching awe, and their economic power relative to the common man often assured them of the good will of the courts and an aversion of lawyers, both public and private, and injured parties toward bringing them to the bar. Several factors have contributed to a change in this situation. In the absence of special circumstances such as an employer-employee relationship, or a very small community dominated by one individual or a clique, it is no longer an act of courage on the part of a plaintiff or his lawyer to sue a powerful and affluent person; extrajudicial reprisal is generally no longer available to the defendant. In fact, the wealthy are now favorite targets of litigation because of their wealth.⁵ Furthermore, the direction of charitable organizations is no longer concentrated in the hands of those who own the major institutions of the community; the ownership of those institutions has become dispersed and charitable boards comprise corporate executives, professional people, housewives, artists, retired persons and people with quite ordinary jobs, many of whom have rather substantial assets but no great influence.⁶ Moreover, there is more at stake because the assets of many not-for-profit organizations subject to waste or misapplication have become immense.⁷ Other factors leading to the increased exposure of directors, officers, and employees of not-for-profit corporations to liability are those applicable to society at large, an increased awareness that litigation can be profitable even when the alleged wrong is dubious and a growing segment of the population which is concerned with the public interest.

In addition to the factors leading to increased litigation against directors and others connected with not-for-profit organizations are those factors which make findings of liability more

5. It has been said that this is "an age when law is dominated by the search for the deep pocket." *Hixon v. Sherwin-Williams Co.*, 691 F.2d 1005, 1009 (7th Cir. 1982).

6. See *OLECK*, *supra* note 2, at 462-64 for a discussion of qualifications for directors.

7. *BAKAL, CHARITY USA* (Times Book 1979), states that American Association of Fund-Raising Counsel data indicate that bequests of \$39.6 billion were given to charities in this country in 1978, more than double the amount given in 1968 and about eight times that given in 1954, based on Internal Revenue Service figures covering estates of \$60,000 or more. *Id.* at 10. The assets of the American Cancer Society were \$229 million at the end of the 1978 fiscal year. *Id.* at 11. The 1835 YMCA's in the country had assets valued, at cost, at \$1 billion, while the endowment fund of Harvard University at that time was more than \$1.4 billion. *Id.* A survey of 1006 of the 2400 institutions of higher learning in the United States in 1976 indicated that they had a total endowment of \$14.4 billion, while the same year the approximately 7000 hospitals in this country reported assets of \$64 billion. *Id.*

likely. Although strict standards of liability were applied to trustees of charitable trusts, the concept of the fiduciary duties of directors of all corporations, whether or not operated for profit, was rudimentary at best.⁸ In the past three decades, courts have explored and defined the complex relationships between the parties to business corporations, and have recognized fiduciary duties where none were seen before.⁹ As the relationships between director and shareholder, officer and employee, and the various other parties to business corporations became defined, lawyers and courts began to see analogies in the not-for-profit sector.¹⁰ The exposures of directors and officers of not-for-profit corporations are in large part those encountered by persons holding similar positions in business corporations. Among them are taking corporate opportunities,¹¹ self-dealing,¹² mismanagement and nonmanagement,¹³ liability under tax laws,¹⁴ breach of contract,¹⁵ tort,¹⁶ abuse of civil rights,¹⁷ viola-

8. Stern, *Potential Liability of the Board of Directors of a Health Maintenance Organization*, 3 WHITTIER L. REV. 1, 2 (1981).

9. See, e.g., Perlman v. Feldman, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); Donahue v. Rodd Electrotrope Co. of New England, Inc., 367 Mass. 578, 328 N.E.2d 505 (1975); Francis v. United Jersey Bank, 162 N.J. Super. 355, 392 A.2d 1233 (1978), *aff'd*, 87 N.J. 15, 432 A.2d 815 (1981); Katzowitz v. Sidler, 24 N.Y.2d 512, 249 N.E.2d 359, 301 N.Y.S.2d 470 (1969).

10. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974); American Center for Educ. Inc. v. Cavnar, 80 Cal. App. 3d 476, 484, 145 Cal. Rptr. 736, 745-6 (1978); Ray v. Homewood Hosp., Inc., 223 Minn. 440, 442, 27 N.W.2d 409, 411 (1947); Midlantic Nat'l Bank v. Frank G. Thompson Found., 170 N.J. Super. 128, 131, 405 A.2d 866, 871 (1979); Leeds v. Harrison, 7 N.J. Super. 558, 563, 72 A.2d 371, 377 (1950).

11. Mile-O-Mo Fishing Club, Inc. v. Noble, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965); Valle v. North Jersey Automobile Club, 125 N.J. Super. 302, 310 A.2d 518 (1973), *modified and aff'd*, 141 N.J. Super. 568, 359 A.2d 504 (1976), *modified and aff'd*, 74 N.J. 109, 376 A.2d 1192 (1977); New York Medical College & Hosp. for Women v. Dieffenbach, 125 Misc. 698, 211 N.Y.S. 799 (1925).

12. Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974); United States v. Mount Vernon Mortgage Corp., 128 F. Supp. 629 (D.D.C. 1954); Eurich v. Korean Found., Inc., 31 Ill. App. 3d 474, 176 N.E.2d 692 (1961); Gilbert v. McLeod Infirmary, 219 S.C. 174, 64 S.E.2d 524 (1951); Old Settlers Club of Milwaukee County, Inc. v. Haun, 245 Wis. 213, 13 N.W.2d 913 (1944).

13. Stern, 381 F. Supp. at 1003; Lynch v. John M. Redfield Found., 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970); Societa Operaria Di Mutuo Soccorso Villalba v. Di Maria, 40 N.J. Super. 344, 122 A.2d 897 (1956).

14. Adams v. Commissioner, 70 T.C. 373 (1978).

15. Newman v. Forward Lands, Inc., 430 F. Supp. 1320 (E.D. Pa. 1977); Macaluso v. Jenkins, 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981).

16. Northwest Suburban Congregation Beth Judea, Inc. v. Rosen, 103 Ill. App. 3d 1137, 432 N.E.2d 335 (1982); Mullins v. Pine Manor College, 389 Mass. 47, 449 N.E.2d 331 (1983).

tion of the purposes of the corporation¹⁸ and violation of the purpose for which such corporations may be formed under state law.¹⁹ Consequently, the cases in those areas involving persons connected with business corporations offer guidance and, to a great degree, precedent. These decisions, however, do not resolve several issues that must be confronted in not-for-profit cases. The first is whether the standards of care and loyalty which apply to directors and officers of business corporations are the appropriate ones to apply in the not-for-profit context. The second is to determine who has standing to sue for violations of those standards. Certain other matters are unique to not-for-profit corporations because of special legislation; the most significant of these are liability imposed upon "insiders" for conflict of interest transactions under the federal tax laws²⁰ and liability for violation of investment standards imposed by statutes in some states.²¹ The purpose of this article is to examine the standards which have been and will be applied by courts in determining whether directors and officers should be held liable for alleged breaches of their duties, and the standing of various parties to bring suit against them. After general discussion of those topics, cases brought against directors and officers alleging conflict of interest, mismanagement and nonmanagement, violation of corporate purposes, that directors and officers have exceeded their authority or powers, that the corporate veil should be pierced, and miscellaneous violations of statutes are examined. The application of what is left of the doctrine of charitable immunity to directors and officers, and indemnification, insurance and contribution are also touched upon.

TYPES OF NOT-FOR-PROFIT CORPORATIONS

The corporations with which this article is concerned are those formed under special not-for-profit corporation statutes of the several states or, in the few states which do not have such statutes, formed for not-for-profit purposes under the general

17. *Tillman v. Wheaton-Haven Recreation Ass'n, Inc.*, 517 F.2d 1141 (4th Cir. 1975).

18. *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964); *Queen of Angels Hospital v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977); *McDaniel v. Frisco Employees' Hosp. Ass'n*, 510 S.W.2d 752 (Mo. App. 1974); *Commonwealth v. Barnes Found.*, 398 Pa. 458, 159 A.2d 500 (1960).

19. *Miami Retreat Found., v. Ervin*, 62 So. 2d 748 (Fla. 1952).

20. I.R.C. §§ 170, 4941 (West Supp. 1983).

21. *See, e.g.*, CAL. CORP. CODE §§ 10250, 10251 (West 1977 & Supp. 1984); 33 N.J. STAT. ANN. § 15:18-18 (West Supp. 1983); N.Y. NOT-FOR-PROFIT CORP. LAW § 512 (McKinney 1970 & Supp. 1984).

business corporation statutes.²² The words "not-for-profit," however, are somewhat misleading, because the statutes under which such corporations are formed do not forbid them to earn a profit²³ and many in fact do earn substantial profits from their operations. What is forbidden is that any portion of those profits be distributed to the members or directors of the corporation by reason of their status as such.²⁴ Of course, directors and members who are also employees of the corporation may receive salaries.²⁵ In addition, the modern trend is to permit directors who provide goods or services to the corporation to receive reasonable compensation therefor.²⁶

Not-for-profit corporation statutes normally describe the purposes for which corporations may be formed under them. The Model Non-Profit Corporation Act²⁷ states that:

Corporations may be organized under this Act for any lawful purpose or purposes, including, without being limited to, any one of the following purposes: charitable; benevolent; eleemosynary; educational; civic; patriotic; political; religious; social; fraternal; literary; cultural; athletic; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association; but labor unions, cooperative organizations, and organizations subject to any of the insurance laws of this State may not be organized under this Act.²⁸

22. DEL. CODE ANN. tit. 8 (1974); GA. CODE ANN. tit. 22 (1977); HAWAII REV. STAT. tit. 23 (1976); KAN. STAT. ANN. tit. 17 (1974); MD. CORPS. & ASS'NS CODE ANN. tit. 2 (1975); MICH. STAT. ANN. tit. 21 (Callaghan 1983); MISS. CODE ANN. tit. 79 (1972); N.H. REV. STAT. ANN. tit. 27 (1978); S.C. CODE ANN. tit. 33 (Law Co-op 1976); TENN. CODE ANN. tit. 48 (1979); W.VA. CODE ANN. Ch. 31 (1982); WYO. STAT. ANN. tit. 17 (1977 & Supp. 1983).

23. OLECK, *supra* note 2, § 4 at 25. However, charitable corporations may jeopardize their exemptions from property and income taxes by income-making activities. *See, e.g.*, Camden Lodge No. 111 Loyal Order of Moose v. City of Camden, 135 N.J.L. 532, 53 A.2d 341 (1947) (property used for bar and grill not exempt). Organizations exempt from taxation under § 501(c)(3) of the Internal Revenue Code are taxed on the income from business not related to the purpose of the exemption under I.R.C., § 511, Reg. 1.511-1-1.511-3.

24. "Non-profit corporation" means a corporation no part of the income or profit of which is distributable to its members, directors, or officers." MODEL NON-PROFIT CORP. ACT § 2 (1973).

25. "Each corporation shall have power . . . [t]o elect or appoint officers and agents of the corporation, who may be directors or members, and define their duties and fix their compensation." *Id.* at § 5(k).

26. *See Stern*, 381 F. Supp. at 1003; *Queen of Angels Hosp. v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977); *cf. Old Settlers Cub of Milwaukee County, Inc. v. Haun*, 245 Wis. 213, 13 N.W.2d 913 (1944).

27. MODEL NON-PROFIT CORPORATION ACT § 1 *et seq.* (1973).

28. *Id.* at § 4. The exclusion of insurance corporations is found in many acts. *See, e.g.*, KY. REV. STAT. ANN. § 273.167 (Baldwin 1983); MASS. ANN. LAWS ch. 180, § 4 (Michie/Law Co-op 1977 & Supp. 1984) (lists exclusive purposes). The exclusion of "cooperative organizations" is not found in many acts. Illinois permits not-for-profit corporations to be formed for the purposes of

The term "charitable," used in the statute, in its legal sense is generally held to denote a purpose serving the public, though laymen tend to use it in the narrower sense of dispensing alms to the poor.²⁹ "A nonprofit corporation is not necessarily a charitable corporation; but a charitable corporation necessarily is a nonprofit corporation."³⁰

In short, all not-for-profit corporations share three general characteristics. They are specifically designated as not-for-profit upon formation, no profits earned by them may be paid to directors or members as such and they must pursue purposes permitted to such corporations by statute. There are three categories of not-for-profit corporations, however, with differences which have important implications regarding the liability of their directors, officers and employees; they are public benefit, mutual benefit and private benefit corporations. The important differences are in whom the corporations serve and the sources of their funding.

As the term implies, a public benefit corporation exists to serve the community at large, or a segment of the community

electrification on a co-operative basis; telephone service on a mutual or co-operative basis; ownership and operation of water supply facilities for drinking and general domestic use on a mutual or co-operative basis; ownership of residential property on a co-operative basis; administration and operation of property owned on a condominium basis; and administration and operation of an organization on a co-operative basis producing or furnishing goods, services, or facilities primarily for the benefit of its members who are consumers of such goods, services or facilities.

ILL. REV. STAT. ch. 32, § 163a3 (1982).

29. G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 369 (rev. 2d ed. 1977). A comprehensive description of "charities" is found in Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960), in which "charity" is used to describe

all forms of organized philanthropic activity, including, without limitation: (1) large endowed funds, which make grants for education, research, etc., such as the Ford and Rockefeller Foundations, the various Carnegie endowments and the Twentieth Century Fund; (2) smaller foundations which are primarily instruments for channeling the annual giving of their founders during their lives, and of their families thereafter—sometimes called "family foundations"; (3) operating charities such as hospitals, youth centers, settlement houses, schools, museums, the Red Cross—frequently dependent on public contributions for their support; (4) fund-raising organizations which solicit public contributions and then make distributions to worthy causes, such as the cancer, polio, and heart funds; (5) community trusts, which are organizations formed to give centralized administration to separate charitable funds—a form of pooling for investment and management purposes; (6) company foundations (other than those formed for purely commercial purposes); and (7) small funds formed for particular purposes (such as scholarship funds which are separately administered).

Id. at 30 n.2.

30. H. OLECK, *supra* note 2, at 8.

defined by criteria such as need, religious affiliation, or academic interest and ability.³¹ Examples are museums, libraries, civil groups, hospitals and schools. Most offer benefits only to those who seek them but some, such as civic and ecological organizations, claim to benefit the general populace within their areas of operation. Although many such corporations offer memberships to the public for a fee, they also benefit persons who are not members; furthermore, "membership" is often nominal, consisting merely of a right to use the facilities of the corporation without further charge, or a grant of limited special privileges not enjoyed by non-members. Thus, it is difficult or impossible to identify all persons who have an interest in the efficient and honest operation of these corporations.³²

Public benefit corporations receive funds from a much broader range of sources than do the other two categories of not-for-profit corporations. Because of their dedication to the common good, foundations, corporations, agencies of all levels of government and public-spirited individuals provide money. In addition, many public benefit corporations charge for their services; for instance, museums sell memberships to users and charge admission to non-members, schools charge tuition and hospitals assess a myriad of charges. All sources of funding, whether beneficiaries of the corporations' services or not, have an interest in their operations.

Mutual benefit corporations are formed to serve their members. Included within this category are trade associations, credit card service organizations, cooperatives, social organizations and athletic clubs.³³ They are often open to all those who seek membership, or all those who possess certain qualifications. The parties who are interested in the quality and cost of the services of these corporations are easily identified from the

31. See, e.g., *California v. Larkin*, 413 F. Supp. 978 (N.D. Cal. 1976) (ranches for poor, homeless children); *Brown v. Memorial Nat'l Home Found.*, 162 Cal. App. 2d 513, 329 P.2d 118 (1958) (home for needy mothers whose children were killed in the service of the United States); *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 72 (1974) (hospital to provide medical treatment to railroad workers); *Midlantic Nat'l Bank v. Frank G. Thompson Found.*, 170 N.J. Super. 121, 405 A.2d 866 (1979) (scholarships for young men; the court permitted a broadening of purpose to include young women); *Eurich v. Korean Found., Inc.*, 31 Ill. App. 2d 474, 176 N.E.2d 692 (1961) (scholarships for Korean students).

32. See, e.g., *Miller v. Alderhold*, 228 Ga. 85, 87, 184 S.E.2d 172, 175 (1971); *Weigand v. Barnes Found.*, 374 Pa. 149, 150-51, 97 A.2d 81, 82-3 (1953).

33. Examples of mutual benefit corporations include the Associated Press, Association of American Law Schools, Gay Rights National Lobby, Mastercard International, National Association of Quick Printers, Polish-American Congress, United Buying Service of Illinois, Veterans of Foreign Wars, and Women in Communications. Many conduct substantial activities in the public interest in addition to serving the interests of their members.

membership rolls. The sources of funds for mutual benefit corporations are almost invariably the recipients of their services and thus, unlike the funders of public benefit corporations, do not constitute a separate class of parties in interest.

The third category of not-for-profit corporations is the private benefit corporation. Such corporations are usually formed to obtain federal and state income tax benefits, by devoting the funds committed to them to non-taxable purposes. Because all parties to these corporations share the same goal, tax saving, they do not generate much internecine litigation.

Special Legal Considerations

There has been a tendency to apply stricter standards of care and loyalty to directors of not-for-profit corporations than those imposed upon their counterparts in business corporations.³⁴ This seems to be based on a belief that they are entrusted with assets for the benefit of people who have little or no voice in selecting the management of the enterprise.³⁵ While this position may have a factual basis in the case of public benefit corporations, it does not when applied to the directors of mutual benefit corporations, whose members have the right to vote.

Another principal area in which not-for-profit corporations present different legal problems than do business corporations is the determination of who has standing to sue for breach of duty. In a business corporation the real parties in interest are the shareholders, who may sue directly if injured in their personal capacities or derivatively if the injury is to the corporation; the shareholders are both the sources of the corporation's capital and the ultimate beneficiaries of its operations. This is true also of mutual benefit corporations. The sources of funds and the beneficiaries of public and private benefit corporations are usually not identical, although there may be some overlap between the two classes.

STANDARDS OF CARE AND LOYALTY APPLICABLE TO DIRECTORS AND OFFICERS OF NOT-FOR-PROFIT CORPORATIONS

Directors, officers, and employees of not-for-profit corporations may encounter personal liability in four principal areas. The first is a conflict of interest or self-benefit at the expense of

34. "A director of a charitable corporation is held to the highest degree of honor and integrity . . ." W.M. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1042, at 48 (1975).

35. See Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 568 (1981).

the corporation, those who fund it, and those it serves. Second, personal liability may be imposed for mismanagement and nonmanagement, or harm done to the corporation, those who fund it, and those it serves in the absence of benefit to the offending person. Harm done to third parties through tort and breach of contract may also result in liability. Finally, personal liability may be imposed for offenses against taxing authorities.

In the first two areas a question arises as to what standards should be applied in determining whether liability exists. In the third, general principles of tort and contract law govern the outcome, although the courts must consider whether it is appropriate to reach directors and officers personally because of their participation in the tortious conduct or breach of contract or because circumstances indicate that the corporate veil should be pierced. In the fourth area, the liability of officers and directors is generally determined in accordance with criteria established by the taxing statutes.

As to liability for conflict of interest, mismanagement and nonmanagement, the problem of the governing standard is often put in terms of whether trust law or corporate law should be applied.

The applicable law is unsettled. The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. . . . [H]owever, the modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their "pure" corporate counterparts.³⁶

The assumption of such reasoning is that there is a unified body of law which imposes stricter standards upon trustees than upon officers and directors. The famous dictum of Justice Cardozo in *Meinhard v. Salmon*³⁷ is often quoted in support of that conception. He said:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honestly alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. (Citation omitted) Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the common crowd.³⁸

36. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

37. 249 N.Y. 458, 164 N.E.545 (1928).

38. *Id.* at 464, 164 N.E. at 546.

No doubt these words would long since have been forgotten had Justice Cardozo not used "trustee" in the second sentence, yet the party to whom he referred was not a trustee, but the managing coadventurer in a commercial real estate project. The court was of the opinion that his status imposed fiduciary obligations upon him and that "[a] constructive trust is, then, the remedial device through which preference of self is made subordinate to loyalty to others."³⁹ Had Cardozo used the more accurate term "fiduciary" in the second sentence of his famous statement, the meaning would be clear; "the punctilio of an honor the most sensitive" is imposed not only upon trustees, but upon some participants in business relationships as well.

Directors and officers are fiduciaries but they are not trustees in the traditional sense.⁴⁰ Although they manage and control the assets of the corporation, they have no property interest in or title to those assets.⁴¹ This is not to say that the fiduciary standards applicable to trustees should not be applied to the directors and officers of not-for-profit corporations, and in particular of those corporations which have charitable purposes, even though they are not trustees.⁴² To make that determination, an understanding of the standards which apply to trustees, and those which apply to directors and officers of business corporations, is necessary.

Duties of Care, Diligence and Skill

"The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property. . . ."⁴³ This standard has been said to require the care that the prudent person would exercise in managing his

39. *Id.* at 467, 164 N.E. at 548.

40. Some statutes which impose substantive duties upon "trustees" define the term to include directors of charitable corporations. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 7549 (Purdon Supp. 1983) ("The board of directors or other body of the corporation (holding property for charitable purposes) shall, as trustees of such property, be held to the same degree of responsibility and accountability as if not incorporated. . . .")

41. RESTATEMENT (SECOND) OF TRUSTS § 16A (1957); G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 16, at 97 (rev. 2d ed. 1977); A. SCOTT, THE LAW OF TRUSTS § 16A (3d ed. 1967).

42. "Even in the case of a charitable corporation the members of the board of management, whether called directors or trustees, are not trustees in the strict sense. The title to the property is in the corporate entity and not in the individuals who constitute the board." A. SCOTT, *supra* note 41, at § 16A.

43. RESTATEMENT (SECOND) TRUSTS § 174 (1957).

own property for purposes similar to those of the trust.⁴⁴ The fact that the care he exercises in his personal affairs, and the skill he has, are less than those of a prudent person will not afford him a defense when charged with mismanagement or non-management.⁴⁵ If, however, he has greater skill than the ordinarily prudent person he will be held to the higher standard consistent with his skill.⁴⁶ Furthermore, if he represents himself as having skill greater than that of the ordinarily prudent person he will be required to live up to his claim,⁴⁷ and perhaps he will impose a higher standard upon himself simply by holding himself out as a professional trustee.⁴⁸

A trustee may not avoid liability for negligence by delegating his responsibilities to others if he can reasonably be expected to perform them himself.⁴⁹ In other words, he will be held liable for the negligence of others to whom he delegates his responsibilities.

The rules are sometimes restated or altered by statute. For instance, the Uniform Trustees' Power Act⁵⁰ permits a trustee

to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary. . . .⁵¹

To prevent application of the traditional trust standard to members of the "governing board" of "an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary pur-

44. "A trustee with a duty to provide an income for a widow for her life, and to conserve the principal for children until they reach 21, should use the same care that a husband and father would normally take in investing and managing his own property to assure his family of an income during the lives of the parents and to conserve the principal for distribution to the children at their maturities. He would not satisfy the court by showing merely that prudence which a business man would exercise in trade or speculation. BOGERT, *supra* note 41, § 541, at 161-62.

45. *Id.* at § 541, at 161.

46. RESTATEMENT (SECOND) OF TRUSTS § 174 (1957); SCOTT, *supra* note 41, § 174, at 1410.

47. RESTATEMENT (SECOND) OF TRUSTS § 174 (1957); SCOTT, *supra* note 41, at § 174, at 1411.

48. SCOTT, *supra* note 41, §§ 174, 174.1, at 1411-12.

49. RESTATEMENT (SECOND) OF TRUSTS § 171 (1957).

50. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS § 1 *et seq.* (1964). The Act has been adopted in eleven states.

51. *Id.* at § 3(24).

poses" the Uniform Management of Institutional Funds Act⁵² confers similar powers of delegation⁵³ upon them. The Act also provides that

[i]n the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.⁵⁴

The Commissioners' prefatory note ascribes these provisions to the concern of board members that they might be held to the standards which govern "private trustees."⁵⁵

The duty of care expected of directors and officers of business corporations has been stated in a number of different ways. The view which has prevailed recently is that expressed in the Model Business Corporation Act as to directors; there is no similar language regarding officers. The Act provides:

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements and other financial data, in each case prepared or presented by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or

52. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS § 1 *et seq.* (1972). The Act has been adopted in 26 states and the District of Columbia.

53. *Id.* at § 5.

54. *Id.* at § 6.

55. **AUTHORITY TO DELEGATE.** In the absence of clear law relating to the powers of governing boards of eleemosynary institutions, some boards have been advised that they are subject to the nondelegation strictures of professional private trustees. The board of an eleemosynary institution should be able to delegate day-to-day investment management to committees or employees and to purchase investment advisory or management services. The Act so provides.

STANDARD OF CARE. Fear of liability of a private trustee may have a debilitating effect upon members of a governing board, who are often uncompensated public-spirited citizens. They are managers of nonprofit corporations, guiding a unique and perhaps very large institution. The proper standard of responsibility is more analogous to that of a director of a business corporation than that of a professional private trustee. The Act establishes a standard of business care and prudence in the context of the operation of a nonprofit institution.

Id. at 409.

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.⁵⁶

The words "in a like position" impose the "prudent director" standard, which has been used in recent enactments⁵⁷ instead of the "prudent man" standard applied to trustees⁵⁸ and used in many older statutes:

Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs.⁵⁹

Some authorities distinguish the two standards, finding the prudent man standard to be more demanding because they believe it to require continuous attention to the corporation⁶⁰ or because they believe it imposes liability for ordinary negligence while the prudent director standard offers protection for all but gross negligence,⁶¹ others ignore it.⁶² The distinction may be too fine not to be eclipsed by the facts of the particular case, given the limitless varieties of action and inaction which confront the courts in negligence cases brought against directors and officers. It is, however, an indication of the higher expectations which society and the courts have of trustees than they do of corporate officials.

56. ABA Comm. on Corporate Laws (Section of Corporation, Banking and Business Law) § 35 (1969).

57. See, e.g., NEW YORK NOT-FOR-PROFIT CORPORATION LAW § 717 (1969). Cf. CAL. CORPS. CODE § 9241 (1979) (a director of a nonprofit corporation shall perform his duties "with such care, including reasonable inquiry, as is appropriate under the circumstances") As late as 1959 a leading authority stated that the prudent man standard had "prevailed over a lesser standard—the care which an ordinarily prudent *director* would use ('usages of the business')" in modern decisions. HORNSTEIN, CORPORATION LAW AND PRACTICE § 446, at 565 (1959).

58. See *supra* note 43 and accompanying text.

59. *Pennsylvania Business Corp. Law of 1933*, Art. IV, § 408. When the statute was reenacted in 1968, the words "in their personal business affairs" were deleted. PA. CONS. STAT. § 1408. Thus the new statute does not clearly choose between the two standards.

60. See, e.g., L. OLECK, *supra* note 2, § 224, at 611-12.

61. See, e.g., HORNSTEIN, *supra* note 57, § 446, at 565-66.

62. See, e.g., HENN & ALEXANDER, LAWS OF CORPORATIONS § 234, at 622 (3d ed. 1983).

The Model Non-Profit Corporation Act does not contain a provision as to the standard of care expected of directors and officers, leaving the courts free to impose the trust, business corporation or some other standard. Nevertheless, the Act like most statutes governing business⁶³ and not-for-profit⁶⁴ corporations, permits delegation to committees of directors.

If the articles of incorporation or the by-laws so provide, the board of directors, by resolution . . . may designate and appoint one or more committees . . . which . . . shall have and exercise all the authority of the board of directors, except that no such committee shall have the authority of the board of directors in reference to (the by-laws; election, appointment, or removal of committee members, officers, and directors; the articles of incorporation; mergers and consolidations; sale, lease, exchange, or mortgage of substantially all assets; dissolution and distribution of assets) or amending, altering or repealing any resolution of the board of directors which by its terms provides that it shall not be amended, altered, or repealed by such committee. The designation and appointment of any such committee and the delegation thereto of authority shall not operate to relieve the board of directors, or any individual director, of any responsibility imposed upon it or him by law.⁶⁵

This provision does not address the extent of liability the directors may incur if those to whom the board delegates breach their duties of care and loyalty, thus leaving to the courts the decision as to whether to impose liability as they do upon trustees or to apply the corporate rule that only when directors breach their duty to supervise are they liable for the actions or nonactions of their delegates.⁶⁶

Much attention has been given to distinguishing the standards of care applicable to corporate officers and directors as opposed to trustees. Perhaps the primary reason that the former are less likely to be found liable is that the fictional corporate entity stands between them and plaintiffs.⁶⁷ In contrast, individual trustees themselves hold title to the assets they manage.⁶⁸

63. *See, e.g.*, ILL. REV. STAT. ch. 32, § 157-8.05 (1984).

64. *See, e.g.*, OHIO REV. CODE ANN. § 1702.33 (Page 1978).

65. MODEL NON-PROFIT CORP. ACT § 21 (1973).

66. *See, e.g.*, *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013-14 (D.D.C. 1974).

67. W.M. FLETCHER, *CYCLOPEDIA OF CORPORATIONS* 33 (Perm. ed. 1983). "Corporate shield protects those parties who would otherwise be vicariously liable, but not those parties whose own conduct is called into question." *Id.* at § 33, at 361. *See Hanmer v. State of Wisconsin*, 92 Wis. 2d 90, 284 N.W.2d 587 (1979). "At common law a corporate officer, stockholder, director, agent, or employee is not personally liable for the torts of a corporation or of any other agent merely because of his office or holdings; some additional connection with the tort is required." W. FLETCHER, at § 33, p. 358-59. *See Bowling v. Haldeman* 413 N.E.2d 1010 (Ind. App. 1980).

68. RESTATEMENT (SECOND) OF TRUSTS § 16A, (1959); A. SCOTT, *SCOTT ON TRUSTS* § 16A, at 162 (1967).

Duty of Loyalty

The duty of loyalty weighs more heavily upon trustees than corporate directors.

A trustee is in a fiduciary relation to the beneficiary and as to matters within the scope of the relation he is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court.⁶⁹

If the beneficiary does not consent, he may avoid the transaction even if the transaction was fair to him and the trustee acted in good faith in entering into it. If the beneficiary has consented, he may avoid the transaction only if it was unfair or the trustee withheld material facts or used the influence of his position to obtain the consent.⁷⁰

This rule stems from the fact that a trustee is obliged by his position to act solely in the best interests of the beneficiary, as defined by the trust instrument,⁷¹ and the belief that one person cannot act on behalf of two interests in the same transaction without tending to favor one of them, especially when one of the interests is his own.⁷² If the trustee learns before or after the trust commences that his interests conflict with those of the beneficiary, he must either refuse the trust or resign.⁷³ Of course, if a trustee believes that a transaction between himself in his trust and personal capacities will be in the best interest of the beneficiary, he may apply to a court for approval of the transaction. The impartiality of the court obviates any temptation of the trustee to favor himself.

While transactions between a corporation and its directors and officers are subject to scrutiny, they are not forbidden⁷⁴ and a corporate official need not resign his position when a potential

69. RESTATEMENT (SECOND) OF TRUSTS § 170, (1959). See also A. SCOTT, *supra* note 68, § 170, at 1297-98; G. BOGERT, *supra* note 41, § 543, at 197-98. Examples of forbidden transactions from these sources and others include sale of trust property to the trustee individually; purchase of the trustee's individual property for the trust; use of trust property for the trustee's individual purposes; acceptance by the trustee of bonuses, commissions, or other compensation for transactions involving trust property; competition with the trust or beneficiary; actions favoring third persons at the expense of the beneficiary; disclosure to third persons of information the trustee has gained as a consequence of that position; commingling of funds; deposit by a corporate trustee of trust funds in its banking department; loans of trust funds to the trustee individually; and purchase by a corporate trustee of its own or an affiliated company's stock for a trust.

70. A. SCOTT, *supra* note 41, § 170, at 1298.

71. *Id.*

72. G. BOGERT, *supra* note 41, § 543, at 205-06.

73. *Id.* § 543, at 213-14.

74. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1014 (D.D.C. 1974).

conflict arises. The Model Business Corporation Act provides guidelines for approval of self-dealing transactions:

No contract or other transaction between a corporation and one or more of its directors . . . shall be either void or voidable because of such relationship . . . or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:

(a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction . . . ; or

(c) the contract is fair and reasonable to the corporation.

Interested directors may be counted in determining the presence of a quorum. . . .⁷⁵

The Model Non-Profit Corporation Act is silent on this subject, as it is on the duty of care.

Thus, the Model Business Corporation Act validates a conflict of interest transaction if any one of three situations exists: (1) the board or committee knows of the conflict, either through disclosure by the interested director or otherwise, and approves it without counting the vote of the interested director; or (2) the shareholders know of the conflict, either through disclosure by the interested director or otherwise, and approve it even though any votes the interested director may have must be counted to achieve that result; or (3) the transaction is fair and reasonable to the corporation. The exertion of influence by the interested director is not forbidden and the provision that he may attend the meeting might be viewed as approval of the use of such influence. This provision is in strong contrast to the right of a trust beneficiary, who has consented to a conflict of interest transaction, to obtain avoidance of the transaction if any one of three things occur: unfairness to the beneficiary, failure to disclose material information or exertion of undue influence, as it is with the rule that a beneficiary who has not consented may avoid a fair transaction.⁷⁶

The omission to mention officers in the conflict of interest provision of the Model Business Corporation Act might be

75. MODEL BUSINESS CORP. ACT, § 41, at 841-42 (West 1971). The author points out that the Model Non-Profit Corporation Act is silent on this subject, as it is on the duty of care.

76. A. SCOTT, *supra* note 41, § 170, at 1298.

viewed as allowing courts to apply different standards to them. Indeed a stricter standard might be justified in the case of someone who spends full time on the corporation.⁷⁷ Nevertheless, the courts tend to apply the same standard to officers as they do to directors, even in the absence of statutory authority to do so.⁷⁸

Other statutes and opinions are less generous to directors, and sometimes officers, than is the Model Business Corporation Act. Some demand both fairness and informed consent.⁷⁹ Still others allow avoidance based on influence exerted by the interested official,⁸⁰ others simply apply a strict trust rule to a director of a not-for-profit corporation and hold that he cannot benefit in any way at the expense of the corporation.⁸¹

In short, there may be little practical difference in the standards of care applied to trustees and directors, but the rules regarding delegation and loyalty weigh much more heavily against trustees.

Choice of Standard of Care

There are several matters of concern regarding the breach of the duty of care. They include failure to manage and supervise the activities of the corporation,⁸² neglect and waste of assets including improper investment⁸³ and improper delegation of authority.⁸⁴ The principal debate has been whether to apply the standards which govern trustees of charitable trusts or those

77. "A director is not required to give continuous attention to his charge . . . [but] when he is also an officer in receipt of a salary, his responsibility approaches that of a trustee." G. HORNSTEIN, CORPORATION LAW AND PRACTICE, § 446, at 565-566 (1959).

78. See, e.g., *Mile-O-Mo Fishing Club, Inc. v. Noble*, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965); *Societa Operaia Di Mutuo Soccorso Villalba v. Di Maria*, 40 N.J. Super. 344, 122 A.2d 897 (1956).

79. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1014 (1974); CAL. CORP. CODE §§ 5233, 9243 (West Supp. 1984) (public benefit corporations and religious corporations, respectively).

80. See, e.g., *Gilbert v. McLeod Infirmary*, 219 S.C. 174, 64 S.E.2d 524 (1951).

81. See, e.g., *Old Settlers Club of Milwaukee County, Inc. v. Haun*, 245 Wis. 213, 13 N.W.2d 913 (1944).

82. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974).

83. *Lynch v. John M. Redfield Found.*, 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970); *George Pepperdine Found. v. Pepperdine*, 126 Cal. App. 2d 154, 271 P.2d 600 (1954); *People ex rel Scott v. Silverstein*, 86 Ill. App. 3d 605, 408 N.E.2d 243 (1980).

84. *Midlantic Nat'l Bank v. Frank G. Thompson Found.*, 170 N.J. Super. 128, 405 A.2d 866 (1979).

governing directors of business corporations.⁸⁵

*Stern v. Lucy Webb Hayes National Training School for Deaconesses & Missionaries*⁸⁶ was the first case to examine public policy and practical differences between the functions of the traditional trustee and the corporate director when determining whether to apply the corporate or trust standard to directors of not-for-profit corporations.⁸⁷ Patients of a hospital had brought a class action against members of its board of directors ("trustees"), the hospital and financial institutions with which some directors were affiliated, alleging that the directors had conspired to enrich themselves and the institutions, and that the directors had breached their fiduciary duties of care and loyalty in managing the hospital's funds. For almost two decades, two directors dominated the board and executive committee, managing the hospital almost exclusively, and the finance and investment committees had not met for eleven years after their creation. The executive committee and board routinely approved the financial, investment and management decisions of the two directors. The plaintiffs alleged that the defendant directors had breached their duties to the hospital through "mismanagement, nonmanagement, and self-dealing."⁸⁸

As to mismanagement, the court commented:

Both trustees and corporate directors are liable for losses occasioned by their negligent mismanagement of investments. However, the degree of care required appears to differ in many jurisdictions. A trustee is uniformly held to a high standard of care and will be held liable for simple negligence, while a director must often have committed "gross negligence" or otherwise be guilty of more than mere mistakes of judgment.⁸⁹

The court speculated that the difference in standards might result from the broader responsibilities of directors, who are in charge of all aspects of an operating concern, whereas "the traditional trustee is often charged only with the management of the trust funds and can therefore be expected to devote more time and expertise to that task."⁹⁰ The opinion noted that because the board members of "large" charitable corporations manage "ongoing businesses" authorities have said that their performance should be measured by the corporate standard. "More specifically, directors of charitable corporations are re-

85. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

86. 381 F. Supp. 1003 (D.D.C. 1974).

87. *Id.* at 1013.

88. *Id.*

89. *Id.*

90. *Id.*

quired to exercise ordinary and reasonable care in the performance of their duties, exhibiting honesty and good faith."⁹¹

Regarding nonmanagement, the court noted allegations that some individual defendants had failed to supervise management or even to attend meetings:

Trustees are particularly vulnerable to such a charge, because they not only have an affirmative duty to "maximize the trust income by prudent investment," [citation omitted] but they may not delegate that duty, even to a committee of their fellow trustees. [Citation omitted] A corporate director, on the other hand, may delegate his investment responsibility to fellow directors, corporate officers, or even outsiders, but he must continue to exercise general supervision over the activities of his delegates. [Citation omitted] Once again, the rule for charitable corporations is closer to the traditional corporate rule: directors should at least be permitted to delegate investment decisions to a committee of board members, so long as *all* directors assume the responsibility for supervising such committees by periodically scrutinizing their work.⁹²

Turning to the corporate rule regarding nonmanagement, the court goes on to state that "[t]otal abdication of the supervisory role . . . is improper," adding,

[a] director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation. [Citation omitted] While a director is, of course, permitted to rely upon the expertise of those to whom he has delegated investment responsibility, such reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with or ignoring such reports. [Citation omitted] A director whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent wrong against the corporation; he is not merely an accessory under an attenuated theory of *respondeat superior* or constructive notice.⁹³

The District of Columbia, which has adopted the Model Non-Profit Corporation Act,⁹⁴ has not inserted provisions regarding the standard of care for directors, and its Business Corporation Act contains no such standard.⁹⁵ Therefore, in a case of first impression, the court felt free to roam the country in its search for precedent. It settled upon *Beard v. Achenbach Memorial Hospital Association*,⁹⁶ a Tenth Circuit case which applied Kansas law, for the proposition that "[s]ince the board members of most large charitable corporations fall within the corpo-

91. *Id.*

92. *Id.* See also RESTATEMENT (SECOND) OF TRUSTS § 379 comment b (1959).

93. *Stern*, 381 F. Supp. at 1014.

94. D.C. CODE ANN. §§ 29-501-29.399.5 (1981).

95. *Id.* §§ 29-201, 29-301-29.399.5.

96. 170 F.2d 859 (10th Cir. 1948).

rate rather than the trust model, being charged with the operation of ongoing businesses, it has been said that they should only be held to the less stringent corporate standard of care.⁹⁷ Nevertheless, the court in the *Beard* case did not consider whether trust law might apply to a director of a not-for-profit corporation but merely stated that "[t]he directors of a corporation . . . must exercise ordinary and reasonable care in the performance of their duties."⁹⁸ This is not surprising because at the time Kansas only had one corporation act which governed both business and not-for-profit corporations.⁹⁹ In other words, *Beard* was based on an assumption that there was only one standard, which applied to all directors, as is evidenced by the citation of cases involving business corporations in the opinion.¹⁰⁰

Thus, while *Stern* may be the leading case for the proposition that the directors of charitable corporations are governed by the standard of care applicable to directors of business corporations, it rests on flimsy precedent. It is of value primarily because of the reasons stated for the choice of standard made by the court. That reasoning, however, may render *Stern* of doubtful precedent in cases dealing with small charitable corporations, in that it seems to be based upon the notion that directors of "large charitable corporations," like the directors of business corporations, are "charged with the operation of ongoing businesses."¹⁰¹ It should be noted, however, that the business corporation standard of care applies to the directors of all business corporations. If that standard is chosen for directors of charitable corporations it seems reasonable to apply it to all charitable corporations, regardless of size.

Choice of Standard of Loyalty

The duty of loyalty applies to self-dealing, taking of corporate opportunities, and other conflict of interest transactions. Of concern are purchases of corporate property by directors and officers;¹⁰² sales of goods to the corporation by officers and directors, and fees and commissions paid to brokerage firms, banks, and other suppliers of services with which directors and officers

97. *Stern*, 381 F. Supp. at 1013.

98. *Beard*, 170 F.2d at 862.

99. KANS. STAT. ANN. §§ 17-1 to 17-75 (1974).

100. *Beard*, 170 F.2d at 859.

101. *Stern*, 381 F. Supp. at 1013.

102. See, e.g., *Mile-O-Mo Fishing Club, Inc. v. Noble*, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965); *Gilbert v. McLeod Infirmary*, 219 S.C. 174, 64 S.E.2d 524 (1951).

have proprietary or employment relationships,¹⁰³ and other situations involving conflicts of interest. Museums, whose boards usually include collectors, present many situations of self-dealing.¹⁰⁴

Although the Model Non-Profit Corporation Act does not address these issues, other statutes covering not-for-profit corporations do.¹⁰⁵ The Model Act does forbid loans by a corporation to its directors and officers,¹⁰⁶ as do other statutes.¹⁰⁷ In addition, the Internal Revenue Code defines self-dealing by "disqualified persons" with foundations, and imposes penalties.¹⁰⁸

For case law considering in detail the duty of loyalty for directors of charitable and other not-for-profit corporations, one must again look to *Stern*. The opinion states that although District of Columbia law does not forbid trustees or corporate directors to place funds in banks with which they are affiliated, "such transactions will be subjected to the closest scrutiny to determine whether or not the duty of loyalty has been violated." At the other extreme, clear evidence of wrongdoing, such as a conspiracy to enrich the bank, will result in liability for both trustees and directors.¹⁰⁹ As to the middle ground, the court commented:

Trustees may be found guilty of a breach of trust even for mere negligence in the maintenance of accounts in banks with which they are associated, [citations omitted] while corporate directors are generally only required to show "entire fairness" to the corporation and "full disclosure" of the potential conflict of interest to the Board.

Most courts apply the less stringent corporate rule to charitable corporations in this area as well. *See, e.g.*, *United States v. Mount Vernon Mortgage Corp.* . . . ; *Gilbert v. McLeod Infirmary* . . . ; *Fowle Mem. Hospital Co. v. Nicholson* . . . * * * It is, however, occasionally added that a director should not only disclose his interlocking responsibilities but also refrain from voting on or otherwise influencing a corporate decision to transact business

103. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); *Queen of Angels Hospital v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977); *Old Settlers Club of Milwaukee v. Haun*, 245 Wis. 213, 13 N.W.2d 913 (1944).

104. *See, e.g.*, *Attorney General v. Olson*, 346 Mass. 190, 191 N.E.2d 132 (1963) (museum was organized as a trust).

105. *See, e.g.*, CAL. CORP. CODE § 9243 (West Supp. 1984); CONN. GEN. STAT. § 33-457 (West 1983); N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1980-81); PA. STAT. ANN. tit. 15, § 7728 (Purdon 1983).

106. MODEL NON-PROFIT CORP. ACT § 27 (1973).

107. *See, e.g.*, OHIO REV. CODE ANN. § 1702.55(B)(3) (Page 1978).

108. I.R.C. § 4941 (1976).

109. *Stern*, 381 F. Supp. at 1014.

with a company in which he has a significant interest or control.¹¹⁰

The cases cited for use of the corporate standard of loyalty provide scant support for the conclusion of the court. *United States v. Mount Vernon Mortgage Corporation*,¹¹¹ also a District of Columbia case, seems to have applied trust law to the transactions at issue; the court spoke frequently of "breach of trust," although it did not discuss its choice of standard.¹¹² *Fowle Memorial Hospital Co. v. Nicholson*¹¹³ applied corporate law without discussing possible alternatives. *Gilbert v. McLeod Infirmary*¹¹⁴ spoke of the duties of directors, but the court gave indications that it believed those duties to be governed by trust law.¹¹⁵

However unwilling the *Stern* court may have been to confront the issue of choice of standards without seeking the support of doubtful authority, its selection of the corporate standard of loyalty because of the similarity between the duties of the directors of charitable corporations and those of their business counterparts seems realistic. This is especially true when it is remembered that the directors of charitable corporations more often than not serve without pay and that they, unlike many unpaid trustees, are not serving out of a sense of family obligation. The more stringent standard would no doubt deter able, intelligent, careful people from serving on the boards of charitable corporations.¹¹⁶

110. *Id.* The concepts of "entire fairness" and "full disclosure" are embodied in the MODEL BUSINESS CORP. ACT, § 41, *supra* note 75. There is no similar provision in the MODEL NON-PROFIT CORP. ACT. *Stern* presents a different view than Section 41, which states the requirements of disclosure and fairness in the disjunctive, so that either will prevent avoidance of a transaction.

111. 128 F. Supp. 629 (D.D.C. 1954), *aff'd*, 236 F.2d 724 (D.C. Cir.), *cert. denied*, 352 U.S. 988 (1956).

112. *Id.*

The trustees of the Foundation occupied a fiduciary relationship to it and its known beneficiaries. In negotiating the sale . . . said trustees failed to inform themselves of the value of the stock and failed to exercise the caution, care and skill which a man of ordinary prudence would exercise in dealing with his property . . . and they thereby breached their trust.

Id. at 636. This is a recital of the prudent man standard applicable to trustees. See *supra* notes 57-62 and accompanying text.

113. 189 N.C. 44, 126 S.E. 94 (1925).

114. 219 S.C. 174, 64 S.E.2d 524 (1951).

115. *Id.* "The foundation of suits such as this is the relation in the nature of an express trust between a director and his corporation, which is also similar in this quality to that of principal and agent." G. BOGERT, *supra* note 41, at § 61.

116. See *supra* note 3.

STANDING TO SUE FOR BREACHES OF CARE OR LOYALTY ON THE
PART OF DIRECTORS AND OFFICERS OF NOT-FOR-PROFIT
CORPORATIONS

There are eight general categories of persons who assert causes of action against the directors and officers of not-for-profit corporations. They are: (1) the corporation itself; (2) other directors; (3) members of the corporation; (4) beneficiaries of the corporation's services; (5) donors; (6) outsiders; (7) the general public; (8) Attorneys General representing the public interest; and (9) government agencies asserting tax claims and other violations of the law. Not surprisingly, the issue of standing to sue is usually determined by examining the interest of the plaintiff in the operations and the assets of the corporation.¹¹⁷

The Corporation

The courts of most jurisdictions accept without question the right of a not-for-profit corporation to sue for wrongs done to it, whether by outsiders or its own directors and officers.¹¹⁸ A recovery by a corporation is shared by all persons interested in it, in accordance with their interests.¹¹⁹ As a consequence, the standing of a not-for-profit corporation to sue its officers and directors is not usually challenged.¹²⁰

Of course, when a majority of the board are alleged to be the wrongdoers, the necessary corporate authority to sue may be lacking. It has been held that the corporation may sue on the authorization of its board, president or managing officer.¹²¹ Nev-

117. See *American Center for Educ., Inc. v. Cavnar*, 80 Cal. App. 3d 476, 498, 145 Cal. Rptr. 736, 750 (1978) (former officer has no right to sue on behalf of the corporation.); *Wiegand v. Barnes Found.*, 374 Pa. 149, 97 A.2d 81 (1953) (member of public had no right to compel performance of corporation's duty to public).

118. *E.g.*, *Societa Operaia Di Mutuo Soccorso Villalba v. Di Maria*, 40 N.J. Super. 344, 122 A.2d 897 (1956); *New York Medical College & Hosp. for Women v. Dieffenbach*, 125 Misc. 698, 211 N.Y.S. 799 (1925); *Mountain Top Youth Camp, Inc. v. Lyon*, 20 N.C. App. 694, 202 S.E.2d 498 (1974).

119. See Note, *Distinguishing Between Direct and Derivative Shareholders Suits*, 110 U. PA. L. REV. 1147 (1962).

120. Even in California, where the authority of the Attorney General to correct breaches of trust respecting charitable trusts was once held to be exclusive (*George Pepperdine Found. v. Pepperdine*, 126 Cal. App.2d 154, 271 P.2d 600 (1954), disapproved in that regard by *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964)), it is now provided that the corporation, a member suing derivatively, and certain other parties, in addition to the Attorney General, may sue. CAL. CORP. CODE, §§ 5142, 7142 (West Supp. 1984).

121. *American Center for Educ., Inc. v. Cavnar*, 80 Cal. App. 3d 476, 145 Cal. Rptr. 736 (1978).

ertheless, a president who has been removed from office has no authority to cause the corporation to sue.¹²²

Members of not-for-profit corporations have been held to be analogous to shareholders of business corporations. Consequently, they have the right to sue derivatively to cause the corporation to enforce its rights.¹²³ Members, however, are sometimes permitted to sue as a class in situations where shareholders of a business corporation could not do so and would be forced to sue derivatively.¹²⁴

Often a corporation will sue adverse claimants to corporate authority,¹²⁵ the Attorney General as representative of the public interest,¹²⁶ directors¹²⁷ or beneficiaries,¹²⁸ to ask for a judgment declaring the rights of the parties or the authority of the corporation to take certain actions, particularly with respect to investments.¹²⁹ While these cases are normally prospective and do not involve accomplished abuses of power,¹³⁰ they are instructive on the question of activities which may result in liability. The corporation may seek permission to sell property given to it for a particular purpose,¹³¹ to deviate from investment policies prescribed by a will or trust instrument,¹³² to broaden the class aided by its benefaction,¹³³ to employ financial counselors

122. *Id.* at 498, 145 Cal. Rptr. at 750.

123. *Valle v. North Jersey Auto. Club*, 74 N.J. 109, 376 A.2d 1192 (1977) (mutual benefit corporation); *Leeds v. Harrison*, 7 N.J. Super. 558, 563, 72 A.2d 371, 377 (1950) (public benefit corporation).

124. *Beard v. Achenbach Memorial Hosp. Ass'n*, 701 F.2d 859 (10th Cir. 1948); *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 692 (Mo. App. 1974).

125. *Westlake Hosp. Ass'n v. Blix*, 13 Ill. 2d 183, 148 N.E.2d 471, *appeal dismissed*, 358 U.S. 43 (1958).

126. *Queen of Angels Hosp. v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977); *John A. Creighton Home for Poor Working Girls' Trust v. Waltman*, 140 Neb. 3, 299 N.W. 261 (1941).

127. *New York Medical College & Hosp. for Women v. Dieffenbach*, 125 Misc. 698, 211 N.Y.S. 799 (1925).

128. *John A. Creighton Home for Poor Working Girls' Trust v. Waltman*, 140 Neb. 3, 299 N.W. 261 (1941).

129. *Id.*

130. *See, e.g., John A. Creighton Home*, 140 Neb. 3, 299 N.W. 261 (1941); *Queen of Angels Hosp.*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977).

131. *See, e.g., Holden Hosp. Corp. v. Southern Illinois Hosp. Corp.*, 22 Ill. 2d 150, 174 N.E.2d 793 (1961).

132. *John A. Creighton Home for Poor Working Girls' Trust v. Waltman*, 140 Neb. 3, 299 N.W. 261 (1941), (permitting deviation because changes in the economic climate rendered investments specified by the will unavailable or of doubtful value).

133. *Midlantic Nat'l Bank v. Frank G. Thompson Found.*, 170 N.J. Super. 128, 405 A.2d 866 (1979). The Attorney General did not oppose a request to include young women, as well as young men, in the class to which scholarships might be awarded.

and custodians,¹³⁴ to seek a declaratory judgment as to which competing directors are authorized to act,¹³⁵ or to abandon the purpose for which it was formed and to pursue a related purpose.¹³⁶

Directors

It has been stated that a director of a not-for-profit corporation has standing to sue fellow directors. Often the complaint alleges violation of the directors' duties to the corporation¹³⁷ or seeks enforcement of the purposes of the corporation.¹³⁸ Indeed, the duties of directors to the corporation may compel them to sue in such circumstances.¹³⁹

Members

In considering the standing of members of a not-for-profit corporation to sue directors and officers for breach of their duties of care and loyalty, it must be observed that the term "member" denotes different things in different corporations. Some corporations have more than one class of members.¹⁴⁰ Membership is analogous to shareholding in a business corporation, insofar as the right to vote is concerned,¹⁴¹ although there is, of course, no right to dividends.¹⁴²

In many jurisdictions, a not-for-profit corporation need not have members¹⁴³ but, if it does, the governing documents of the corporation may give all, some, or none of the members the right to vote for directors and the related right to remove them.¹⁴⁴ Often membership in a not-for-profit corporation confers no

134. *Id.* Permission was granted provided that the counselor/custodian would agree to certain conditions.

135. *Westlake Hosp. Ass'n v. Blix*, 13 Ill. 2d 183, 148 N.E.2d 471 (1958).

136. *Queen of Angels Hosp. v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977) (denying permission although the proposed purpose would be a worthy use of charitable funds).

137. *Alvin C. Eurich v. Korean Foundation, Inc.*, 31 Ill. App. 2d 474, 176 N.E.2d 692 (1961); *Gilbert v. McLeod Infirmary*, 219 S.C. 174, 64 S.E.2d 524 (1951).

138. *Newman v. Forward Lands, Inc.*, 430 F. Supp. 1320 (E.D. Pa. 1977); *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

139. *See, e.g.*, *Francis v. United Jersey Bank*, 87 N.J. 15, 34, 432 A.2d 814, 823 (1981) (reinsurance brokerage corporation).

140. MODEL NON-PROFIT CORPORATION ACT § 11 (1973).

141. *Beard v. Achenbach Memorial Hosp. Ass'n*, 170 F.2d 859 (10th Cir. 1948); *Valle v. North Jersey Auto. Club*, 74 N.J. 109, 376 A.2d 1192 (1977); *Leeds v. Harrison*, 7 N.J. Super. 558, 570, 72 A.2d 371, 377 (1950).

142. MODEL NON-PROFIT CORP. ACT § 2(c) (1973).

143. *See, e.g.*, MODEL NON-PROFIT CORPORATION ACT, § 11 (1973).

144. *Id.* §§ 15, 18.

rights in the management or operation of the corporation, but is a device to stimulate interest in its activities and to raise funds. Museums, in particular, sell memberships which carry no voting rights, but which entitle the members to enter the building at no additional charge, to receive calendars of events and reports and to preferential admission to special events.

Not surprisingly, recognition by courts of the right of members to sue directors and officers tends to follow roughly the rights of the members to participate in the election of directors and other aspects of management.¹⁴⁵ Courts have ruled that members have standing to sue directors and officers for deprivation of their rights as members, including the right to an effective vote,¹⁴⁶ the right to have new members chosen in accordance with the certificate of incorporation,¹⁴⁷ the right to have the purposes of the corporation fulfilled,¹⁴⁸ the right to have the corporation continue in existence,¹⁴⁹ and the right to have the corporation managed free of conflict of interest.¹⁵⁰ However, although members may sue to protect their special interests, they may not sue for correction of corporate mismanagement because protection of the public interest is the exclusive province of the state Attorney General.¹⁵¹

With the exception of the cases in which members are recognized as having standing to sue to protect their voting rights, standing in these cases seems to be conferred not so much because of the status of the plaintiffs as members, but because they are beneficiaries of the services of the corporation or have other special interests.¹⁵²

Beneficiaries

Complaints by recipients of the services of not-for-profit corporations against directors and officers for redress of grievances receive widely varying treatment by the courts. This ranges

145. See, e.g., *Jessie v. Boynton*, 372 Mass. 293, 361 N.E.2d 1267 (1977).

146. *Lopez v. Medford Community Center*, 384 Mass. 163, 424 N.E.2d 229 (1981); *Jessie v. Boynton*, 372 Mass. 293, 361 N.E.2d 1267 (1977).

147. *Leeds v. Harrison*, 7 N.J. Super. 558, 72 A.2d 371 (1950).

148. *Beard v. Achenbach Memorial Hosp. Ass'n*, 170 F.2d 859 (10th Cir. 1948); *Denckla v. Independence Found.*, 41 Del. Ch. 247, 252, 193 A.2d 538, 541 (1963).

149. *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 752 (Mo. App. 1974).

150. *Valle v. North Jersey Auto. Club*, 74 N.J. Super. 109, 376 A.2d 1192 (1977).

151. *Lopez v. Medford Community Center, Inc.*, 384 Mass. 163, 424 N.E.2d 229 (1981).

152. *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 752 (Mo. App. 1974).

from tacit acceptance of the standing of the plaintiffs¹⁵³ to denial of standing on the ground that recipients of services do not have a vested financial interest in the corporation.¹⁵⁴ In cases falling between these two extremes, the courts decide standing questions on the basis of allegations that the plaintiffs have been affected personally by the alleged wrongs¹⁵⁵ or limit standing to beneficiaries who are members of a small, definable class.¹⁵⁶

Thus, active and retired employees of a railroad had standing to sue the board of trustees of a hospital association established for the benefit of such employees, to prevent dissolution of the association.¹⁵⁷ On the other hand, an editorial writer for *The Philadelphia Inquirer* had no standing to compel the officers of a museum to admit the public because his interest was "only that held in common with other members of the public. . . ."¹⁵⁸ Where the purpose of the corporation is to benefit the public at large, or a large segment of the public, standing is conferred by courts¹⁵⁹ or statutes¹⁶⁰ upon governmental agencies to represent the beneficiaries.

Donors

Jurisdictions differ on whether a donor to a charitable corporation has standing to sue the directors for misapplication of his gift or for departing from the stated purposes of the corporation. It has been held that unrestricted contributions to charitable corporations do not give donors standing to challenge ultra vires acts.¹⁶¹ Even in some jurisdictions where "gifts to charitable corporations are deemed given in trust to carry out the objects of the corporation, and the assets of charitable corporations are deemed to be impressed with a charitable trust

153. *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); *Mullins v. Pine Manor College*, 389 Mass. 47, 449 N.E.2d 331 (1983).

154. *Miller v. Alderhold*, 228 Ga. 65, 184 S.E.2d 172 (1971).

155. *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 752 (Mo. App. 1974).

156. *American Center for Educ., Inc. v. Cavnar*, 80 Cal. App. 3d 476, 498, 145 Cal. Rptr. 736, 750 (1978) (dictum).

157. *McDaniel v. Frisco Employes' Hosp. Ass'n*, 510 S.W.2d 752 (Mo. App. 1974).

158. *Wiegand v. Barnes Found.*, 374 Pa. 149, 153, 97 A.2d 81, 82 (1953); see also *Greene v. Art Inst. of Chicago*, 16 Ill. App. 2d 84, 147 N.E.2d 415, cert. denied, 358 U.S. 838 (1958).

159. See, e.g., *United States v. Mount Vernon Mortgage Corp.*, 128 F. Supp. 629, 630 (D.D.C.), cert. denied, 352 U.S. 988 (1954).

160. See, e.g., *People ex rel. Scott v. George F. Harding Museum*, 58 Ill. App. 3d 408, 374 N.E.2d 756 (1978); ILL. REV. STAT., ch. 14, §§ 51-64 (1983).

161. *Holden Hosp. Corp. v. Southern Ill. Hosp. Corp.*, 22 Ill. 2d 150, 174 N.E.2d 793 (1961).

by virtue of the declaration of corporate purposes,"¹⁶² it has been said that a donor does not have standing to enforce the trust.¹⁶³ In *Denckla v. Independence Foundation*¹⁶⁴ the Supreme Court of Delaware held:

It is sometimes important to determine whether or not a gift to a charitable corporation is an absolute gift to be used by the corporation for one or more of its corporate purposes, or whether it is a gift of such nature as to make the charitable corporation trustee of a charitable trust. If the gift is outright to the corporation to be used for its corporate purposes no trust is involved in a technical sense. The resulting duty on the part of the corporation is to use the property solely for its corporate purposes and not to do an *ultra vires* act. 2 Bogert, Trusts and Trustees, § 324; 3 Scott on Trusts, § 348.1. In a loose sense, therefore, the assets of a charitable corporation are trust funds, but the extent and measure of that trust with respect to assets given outright to it are to be determined by the Certificate of Incorporation and By-Laws of the charitable corporation. Unless assets are given it upon express limitations and conditions, no charitable trust has been created in the technical sense.¹⁶⁵

A less absolute position is taken in some jurisdictions which recognize the general rule that contributors cannot maintain actions against trustees of charitable trusts or directors of charitable corporations for misapplication of funds or breaches of trust.

There must be something peculiar in the transaction, beyond the mere fact of contribution, to give a contributor to a charitable fund a foothold in court to enable him to question the disposition of the fund.

A person who comes into a court of equity for such a purpose must have some interest in the trust. In general, he must be a trustee, or *cestui que trust*, or have some reversionary interest in the trust fund.¹⁶⁶

Even when a contract through which a gift is made to an educational institution provides that the gift will revert to the donor upon the occurrence of a condition subsequent, it has been noted:

162. *American Center for Educ., Inc. v. Cavnar*, 80 Cal. App. 3d 476, 486, 145 Cal. Rptr. 736, 742 (1978).

163. In *Brown v. Memorial Nat'l Home Found.*, 162 Cal. App. 2d 513, 538, 329 P.2d 118, 133, *cert. denied*, 358 U.S. 943 (1958) the court stated: "The law is well settled that when property has become fully vested in trustees for a valid charitable purpose, neither the creator of the trust nor his heirs or assigns have any standing in court in a proceeding to compel the proper execution of the trust, except as relators." *Id.*, quoting *O'Hara v. Grand Lodge*, 213 Cal. 131, 139, 2 P.2d 21, 24 (1931). This rule is followed in other jurisdictions. *See, e.g.*, *Skokie Valley Professional Bldg., Inc. v. Skokie Valley Community Hosp.*, 74 Ill. App. 3d 569, 393 N.E.2d 510 (1979).

164. 41 Del. Ch. 247, 193 A.2d 538 (1963).

165. *Id.* at 251-52, 193 A.2d at 541.

166. *Leeds v. Harrison*, 7 N.J. Super. 558, 575, 72 A.2d 371, 380 (1950); RESTATEMENT (SECOND) OF TRUSTS, § 1183 (1957).

The mismanagement of a trust fund, however, does not work a reverter to the donor, but entitles both the donor and the beneficiary to their joint or several action in equity to enforce the trust. [Citations omitted] But in this case the beneficiary has rendered it impossible to enforce the trust. . . .¹⁶⁷

In view of the impossibility of confining use of the gift to the purposes for which it was made, due to the change in nature of the donee, the court departed from the general rule and ordered judgment for the donor.

On the other hand, some courts seem to recognize without comment the right of a donor or his heirs to sue to enforce the purposes of the gift.¹⁶⁸ Applying these principles in *Denckla v. Independence Foundation*,¹⁶⁹ the Supreme Court of Delaware found that there had not been a misapplication of funds, but did not question the standing of the plaintiffs. The plaintiffs were daughters of the donor and members of the corporation.

Outsiders

Of course, plaintiffs who allege that they have been harmed in their personal capacities by the actions of directors of not-for-profit corporations are generally held to have standing to sue. Thus, in *Macaluso v. Jenkins*,¹⁷⁰ where it was found that a corporation organized not-for-profit was a "business conduit" through which the chairman of the board, who was also treasurer, profited himself, the corporate veil was pierced to permit a creditor to recover from him.¹⁷¹ On the other hand, a federal district court applying Pennsylvania law refused to pierce the corporate veil to reach the chief executive and directors ("trustees") of a charitable corporation where there was no evidence that they had abused the corporate form.¹⁷²

Public

It is generally held that a member of the public has no standing to sue directors of a charitable corporation for breach of their fiduciary duties to the corporation. In *Leeds v. Harri-*

167. *Graham Bros. Co. v. Galloway Woman's College*, 190 Ark. 692, 697, 81 S.W.2d 837, 839 (1935).

168. *Denckla v. Independence Found.*, 1 Del. Ch. 247, 193 A.2d 538 (1963).

169. *Id.*

170. 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981).

171. *Id.* at 466, 420 N.E.2d at 256.

172. *Newman v. Forward Lands, Inc.*, 430 F. Supp. 1320 (E.D. Pa. 1977). The court was willing, however, to hear evidence that the plaintiff had a special interest in a contract with the corporation which would allow enforcement of a charitable trust that might have been created by the contract. *Id.*

son,¹⁷³ the court commented: "Generally, a member of the public has no standing to question the administration of a charitable trust. In the absence of some special interest, a private citizen cannot file a suit where the sole object is the vindication of a public right in a charity."¹⁷⁴

Attorney General

As early as the sixteenth century, the common law recognized the power and duty of the Attorney General to enforce charitable trusts. "The community has an interest in the enforcement of such trusts and the Attorney General represents the community in seeing that the trusts are properly performed."¹⁷⁵ This rule is recognized in the United States and some states have statutes to that effect. The Uniform Supervision of Trustees for Charitable Purposes Act¹⁷⁶ sets forth rules for the registration of and reporting by charities and provides that "[t]he Attorney General may institute appropriate proceedings to secure compliance with this act and to secure the proper administration of any trust or other relationship to which this act applies. The powers and duties of the Attorney General provided in this act are in addition to his existing powers and duties."¹⁷⁷ Thus, enactment of the statute is generally held not to deprive the Attorney General of any of his traditional common law powers and duties even though they are not mentioned in the statute.¹⁷⁸

It is often said that a gift to a corporation which was organized for charitable purposes creates a trust, if not in the technical sense.¹⁷⁹ Some states have adopted statutes to that effect.¹⁸⁰ In *Denckla*, the court noted that

[i]f the gift is outright to the corporation to be used for its corporate purposes no trust is involved in the technical sense. The resulting duty on the part of the corporation is to use the property

173. 7 N.J. Super. 558, 72 A.2d 371 (1950).

174. *Id.* at 575, 72 A.2d at 380 (1950); *see also* *Greene v. Art Inst. of Chicago*, 16 Ill. App. 2d 84, 147 N.E.2d 415 (1958); *Wiegand v. Barnes Found.*, 374 Pa. 149, 97 A.2d 81 (1953).

175. 4 A. SCOTT, *THE LAW OF TRUSTS* § 391, at 3002 (1967).

176. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, (1954).

177. *Id.* at § 11.

178. *Brown v. Memorial Nat'l Home Found.*, 162 Cal. App. 2d 513, 537, 329 P.2d 118, 132, *cert. denied*, 358 U.S. 943 (1958); *cf.* *State v. Hollingsworth*, 193 Tenn. 491, 246 S.W.2d 345 (1952).

179. *Denckla v. Independence Found.*, 41 Del. Ch. 247, 193 A.2d 538 (1963); *Taylor v. Baldwin*, 362 Mo. 1224, 247 S.W.2d 741, 749 (1952); *Cody v. Buffalo Bill Memorial Ass'n*, 64 Wyo. 468, 196 P.2d 369 (1948).

180. *See, e.g., Holt v. College Osteopathic Physicians & Surgeons*, 61 Cal.2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

solely for its corporate purposes and not to do an *ultra vires* act. [Citation omitted] In a loose sense, therefore, the assets of a charitable corporation are trust funds, but the extent and measure of that trust with respect to assets given outright to it are to be determined by the Certificate of Incorporation and By-Laws of the charitable corporation. Unless assets are given it upon express limitations and conditions, no charitable trust has been created in the technical sense.¹⁸¹

The Uniform Supervision of Trustees for Charitable Purposes Act has recognized the power and duty of the Attorney General to supervise the activities of charitable corporations and to enforce their purposes and proper administration.¹⁸² The right of the Attorney General to represent the public interest in litigation involving charitable corporations has been recognized in states which have adopted that act,¹⁸³ in states with similar statutes¹⁸⁴ and under the common law.¹⁸⁵ The rationale behind the grant of power to Attorney General to represent the public interest in litigation involving charitable corporations is the indefiniteness of the class which benefits from the operation of charitable trusts. In *Holt v. College of Osteopathic Physicians & Surgeons*,¹⁸⁶ the California Supreme Court reasoned:

Beneficiaries of a charitable trust, unlike beneficiaries of a private trust, are ordinarily indefinite and therefore unable to enforce the trust in their own behalf. [Citations omitted] Since there is usually no one willing to assume the burdens of a legal action, or who could properly represent the interests of the trust or the public, the Attorney General has been empowered to oversee charities as the representative of the public, a practice having its origin in the early

181. *Denckla*, 41 Del. Ch. at 252, 193 Ad. 2d at 541; see also *Taylor*, 362 Mo. at 1224, 247 S.W.2d at 749; *Cody*, 64 Wyo. at 491, 196 P.2d at 377.

182. "Trustee' means (a) any individual, group of individuals, corporation, or other legal entity holding property in trust pursuant to any charitable trust, (b) any corporation which has accepted property to be used for a particular charitable corporate purpose as distinguished from the general purposes of the corporation, and (c) a corporation formed for the administration of a charitable trust, pursuant to the directions of the settlor or at the instance of the trustee." UNIFORM SUPERVISION OF TRUSTEES FOR CHARITABLE PURPOSES ACT § 2 (1972).

183. See, e.g., *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964); *People ex rel. Scott v. Silverstein*, 86 Ill. App. 3d 605, 609, 408 N.E.2d 243, 246-47 (1980).

184. See *Miami Retreat Found. v. Ervin*, 62 So.2d 748 (Fla. 1952); *Miller v. Alderhold*, 228 Ga. 65, 184 S.E.2d 172 (1971) (in dissent); *Lopez v. Medford Community Center, Inc.*, 384 Mass. 163, 424 N.E.2d 229 (1981); *Lefkowitz v. Lebensfeld*, 51 N.Y.2d 442, 415 N.E.2d 919, 434 N.Y.S.2d 929 (1980).

185. See *United States v. Mount Vernon Mortgage Corp.*, 128 F. Supp. 629 (D.D.C. 1954) (recognizing similar right in United States as *parens patriae*), *aff'd*, 236 F.2d 724 (1956), *cert. denied*, 352 U.S. 988 (1957); *Midlantic Nat'l Bank v. Frank G. Thompson Found.*, 170 N.J. Super. 128, 405 A.2d 866 (1979); *Commonwealth v. Barnes Found.*, 398 Pa. 458, 159 A.2d 500 (1960); *Samuel & Jessie Kenney Presbyterian Home v. State*, 174 Wash. 19, 24 P.2d 403 (1933).

186. 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

common law.¹⁸⁷

Ordinarily, the power of the Attorney General to bring an action to enforce the purposes or proper administration of a charitable trust is not exclusive.¹⁸⁸ It is commonly stated, however, that other parties may sue only as relators of the Attorney General,¹⁸⁹ or as relators in the absence of a special interest.¹⁹⁰ The consent of the Attorney General to an action by a private party may be implied from the lack of objection by that officer when made a party to the action.¹⁹¹

In many jurisdictions where the power of the Attorney General to bring an action to enforce a charitable trust is not exclusive, it is held that others with a special interest may do so as well.¹⁹² Justification for this position may be found in the fact that a multiplicity of other duties commands the attention of the Attorney General, more often than not resulting in sporadic activity with respect to trusts.¹⁹³ The *Holt* court noted that

part of the problem of enforcement is to bring to light conduct detrimental to a charitable trust so that remedial action may be taken. The Attorney General may not be in a position to become aware of wrongful conduct or to be sufficiently familiar with the situation to appreciate its impact, and the various responsibilities of his office may also tend to make it burdensome for him to institute legal actions except in situations of serious public detriment.¹⁹⁴

In response to the argument that protection of charities from harassing litigation required that only the Attorney General be permitted to bring an action on their behalf, it was held that the directors of the charitable corporation were few enough in number and had sufficient interest in the litigation to present little danger of harassment.¹⁹⁵

The courts are concerned that the public interest be represented adequately. Thus, where the Attorney General was neutral on the issues in litigation, it was held proper for the court to appoint an *amicus curiae* to represent the interests of the pub-

187. *Holt*, 61 Cal. 2d at 754, 394 P.2d at 935, 40 Cal. Rptr. at 247.

188. *Cf.*, *Wiegand v. Barnes Found.*, 374 Pa. 149, 97 A.2d 81 (1953) (private person not permitted to sue even with consent of Attorney General).

189. *See, e.g.*, *Brown v. Memorial Nat'l Home Found.*, 162 Cal. App. 2d 513, 538-39, 329 P.2d 118, 133 (1958).

190. *Leeds v. Harrison*, 7 N.J. Super. 558, 190, 72 A.2d 371, 380 (1950).

191. *Brown*, 162 Cal. App. 2d at 539, 329 P.2d at 133-34.

192. *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964). *See also* *Holden Hosp. Corp. v. Southern Illinois Hosp. Corp.*, 22 Ill. 2d 150, 174 N.E.2d 793 (1961); *Wiegand v. Barnes Found.*, 374 Pa. 149, 97 A.2d 81 (1953); *Gilbert v. McLeod Infirmary*, 219 S.C. 174, 64 S.E.2d 524 (1951).

193. 4 A. SCOTT, *supra* note 175, § 391, at 3005.

194. *Holt*, 61 Cal. 2d at 754-55, 394 P.2d at 935, 40 Cal. Rptr. at 247.

195. *Id.* at 755, 394 P.2d at 936, 40 Cal. Rptr. at 248.

lic, even when private parties lacked standing to represent those interests; the amicus was the lawyer who had represented the private parties who were denied standing.¹⁹⁶ For similar reasons, it has been held that the proper administration of a charitable trust is of such importance to the public as to preclude application of laches or estoppel, particularly in an action by the Attorney General.¹⁹⁷

A statute which empowered an Attorney General to enforce gifts, both in trust and absolute, to charities was held not to extend to rights arising from ownership of stock by charities; thus, he could not maintain a suit to enforce the obligations of business corporations to pay dividends to a charitable corporation.¹⁹⁸ To the extent that this decision reflects more than a recognition of a limitation in a statutory grant of power, it seems unwise. The duty of the Attorney General to enforce the proper administration of charitable trusts extends to nonfeasance by the governing body.¹⁹⁹ If the directors of a charitable corporation are remiss in enforcing the rights of the corporation against third persons, it would seem that the Attorney General would be obliged to act in their stead.

Other Government Officials

Of course, when directors and officers of not-for-profit corporations violate statutory prohibitions, the appropriate government official may bring suit. It is not within the scope of this article to examine all such exposure to liability, which varies extensively from state to state. It should be recognized, however, that directors and officers of not-for-profit corporations enjoy no more immunity from liability than do their counterparts in business corporations.²⁰⁰

CAUSES OF ACTION AGAINST DIRECTORS AND OFFICERS PERSONNALLY

It is not surprising that the greatest number of complaints asking relief against officers and directors of not-for-profit corporations as individuals allege conflict of interest, such as self-

196. *Pollack v. Peterson*, 271 A.2d 45 (Del. Ch. 1970).

197. *Brown*, 162 Cal. App. 2d at 534-35, 329 P.2d at 131.

198. *Lefkowitz v. Lebensfeld*, 51 N.Y.2d 442, 415 N.E.2d 919, 434 N.Y.S. 2d 929 (1980).

199. *Lynch v. John M. Redfield Found.*, 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970).

200. As to that immunity, see *supra* note 67.

dealing²⁰¹ or wrongful taking of a corporate opportunity.²⁰² The second most numerous class of cases involves mismanagement or nonmanagement.²⁰³ Other cases naming officers and directors as defendants involve claims that the purposes of the corporation, or of a gift to the corporation, have been violated,²⁰⁴ that directors and officers have exceeded their authority or powers,²⁰⁵ or that the corporation is a sham and the directors and officers have been doing business in their personal capacities.²⁰⁶

This part is concerned with cases in which the relief requested would result in pecuniary loss, a diminution of power or some measure of adverse publicity to directors and officers. It should be noted that it has been held that directors are not necessary parties to actions which may result in significant diminution of their power or reputations, for example when the corporation is removed as trustee of a charitable trust.²⁰⁷

Conflict of Interest

Some cases involve wrongful transfers of corporate property to officers or directors without consideration or for inadequate consideration. *Mountain Top Youth Camp, Inc. v. Lyon*,²⁰⁸ was an action brought by a charitable corporation against its former president and his wife and daughter. The corporation sought to have set aside deeds by which it had conveyed land to the president and his wife and they had reconveyed it to their daughter. The trial court found that the defendants had given no valuable consideration for the land, that the transactions had been concealed, and that the conveyance had not been ratified or acquiesced in by the directors, officers, or any other persons authorized to act for the corporation. The court of appeals stated:

The purchase or lease of the property of a corporation by an officer or director . . . renders the transaction voidable, not void, and such

201. See, e.g., *Mountain Top Youth Camp, Inc. v. Lyon*, 20 N.C. App. 694, 202 S.E.2d 498 (1974).

202. See, e.g., *Mile-O-Mo Fishing Club, Inc. v. Noble*, 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965).

203. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); *McArthur v. Corbally*, No. 84 CH1345 (Cir. Ct. Cook County, Ill. filed Feb. 15, 1984).

204. See, e.g., *Holt v. College of Osteopathic Physicians & Surgeons*, 61 Cal. 2d 670, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

205. See, e.g., *Burnett v. Barnes*, 546 S.W.2d 744 (Mo. App. 1977).

206. See, e.g., *Macaluso v. Jenkins*, 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981).

207. See, e.g., *Brown v. Memorial Nat'l Home Found.*, 162 Cal. App. 2d 513, 329 P.2d 118 (1958).

208. 20 N.C. App. 694, 202 S.E.2d 498 (1974).

transaction will be upheld only when open, fair, and for sufficient consideration. . . .

The law presumes that such conveyances are invalid and imposes upon the purchaser the burden of establishing that the purchase is fair, open, and free from imposition, undue advantage, actual or constructive fraud.²⁰⁹

The court affirmed the conclusion of the trial court that the conveyances were null and void and should be set aside. In view of the fact that over three years had passed between the conveyance by the corporation and its discovery, it is surprising that no mention is made of further relief, such as a return of the profits of the land or payment by the defendants for its use,²¹⁰ but perhaps the defendants had not made use of the land.

*United States v. Mount Vernon Mortgage Corp.*²¹¹ involved, among other things, a transfer of stock owned by the corporation to one of its directors ("trustees"), the widow of its principal founder, without consideration, simultaneously with the transfer to her of a much larger number of identical shares which had been lent by her husband to the corporation for use as collateral. The court ordered that the transfer of the shares owned by the corporation be set aside, that the shares be returned to the corporation, and that the director pay the corporation the amounts she had received as dividends on the stock.²¹²

In *Eurich v. Korean Foundation, Inc.*,²¹³ the court considered an attempt by a director ("trustee") of a charitable corporation to seize control of it and to invest its assets in his troubled businesses. The plaintiffs, who were fellow directors, had asked that the transaction be enjoined or that the corporation be dissolved. The trial court chose the latter course, and the appellate court affirmed, noting that

[t]he possibility of the [corporation] ever being able to successfully raise additional funds with its history of litigation and mismanagement by [the defendant director] is remote. The decree is based upon the total frustration of the [corporation's] purpose by the totality of the various individual acts. Only through dissolution can there be any possibility that some Koreans may benefit by what remains of the funds²¹⁴

The trial court's order that the assets of the corporation be turned over to another foundation with similar purposes was af-

209. *Id.* at 697, 202 S.E.2d at 500. *But see Model Business Corp. Act* § 41 (1971) (providing that such a transaction will not be avoided if it is open and the interested director's vote was not needed to pass it, or if it is fair).

210. *See, e.g., United States v. Mount Vernon Mortgage Corp.*, 128 F. Supp. 629 (D.D.C. 1954).

211. 128 F. Supp. 629 (D.D.C. 1954).

212. *Id.* at 636.

213. 31 Ill. App. 2d 474, 176 N.E.2d 692 (1961).

214. *Id.* at 489, 176 N.E.2d at 699.

firmed. The effect of the dissolution was thus to prevent the defendant trustee from controlling the funds of the corporation and from misapplying them, although no relief was had against him personally.²¹⁵

Courts have been willing to look beyond direct pecuniary profit to a director of a not-for-profit corporation in awarding relief against him. In *New York Medical College & Hospital for Women v. Dieffenbach*²¹⁶ a not-for-profit corporation which had operated both a medical school and a hospital sued its former directors ("medical trustees") and a hospital the directors had caused to be formed. The corporation sought to set aside the transfer of the real and personal property of the plaintiff corporation to the defendant hospital. The court found that the institution had experienced financial difficulties, that its hospital component was self-supporting but the college was not, and that "[i]f the college could be eliminated, the hospital would remain, and leave to the medical trustees the benefits which hospital connections were likely to bring them in their private practice."²¹⁷ Accordingly, the board of directors voted to discontinue the school and arranged a collusive foreclosure of a second mortgage on the real property of the corporation. The purchaser at the foreclosure sale was controlled by the directors of the plaintiff, and through similar collusive machinations he also came into possession of all the personal property of the plaintiff corporation. The former directors of the plaintiff then caused a new hospital corporation to be formed and all the real and personal property of the plaintiff was transferred to it without consideration.

The court pointed out that the defendants received benefits from their association with a hospital, both in attracting patients to their private practices and avoiding "the responsibility of carrying on the public duty of medical education imposed upon them by the charter"²¹⁸ The state education department had removed the defendants as directors of the plaintiff corporation "by reason of their failure to continue to carry out the purpose with which they were solemnly entrusted," and appointed a new board which caused the action to be brought.²¹⁹

No doubt the actions of the former directors would be deemed wrongful under either trust or corporate law, and the court does not really state which body of law it finds to be appli-

215. *Id.* at 490, 176 N.E.2d at 700.

216. 125 Misc. 698, 211 N.Y.S. 799 (1925).

217. *Id.* at 701, 211 N.Y.S. at 801.

218. *Id.* at 703, 211 N.Y.S. at 803.

219. *Id.*

cable. Although the defendants are referred to as "trustees" throughout the opinion, it is not entirely clear whether this is a reference to the titles of the members of the corporation's board or to their legal status as perceived by the court.

The defendants argued that they had acted in good faith and that the new hospital benefitted the public and was "a realization of some of the beneficent purposes for which the [plaintiff] was established."²²⁰ The court pointed out that the defendants had proper avenues to pursue if the purposes of the corporation could no longer be carried out, by seeking dissolution under the educational statute of the state, but that this might have cost them control of the hospital aspects of the corporation.

It was ordered that the property taken be restored to the plaintiff and that the defendants render an accounting. While permitting the defendants to recover the principal amount of any of the plaintiff's debts they might have paid, the court stated that they were entitled to interest only up to the time of the foreclosure sale, concluding that any interest paid by the defendants thereafter was not recoverable because it was paid from the income their use of the property.²²¹ The court mentioned that at some point some directors, "very likely for valid reason and in recognition of good conscience, saw fit to disassociate themselves from" the faithless directors.²²² Several directors were dismissed out and it is reasonable to assume that these were the directors who had disassociated themselves from the venture at an early stage.

Even where the corporate standard is explicitly applied, directors of charitable corporations are often held to a high standard of conduct. *Gilbert v. McLeod Infirmary*²²³ concerned a hospital corporation that sold a parcel of land adjacent to the hospital to a corporation owned by one of its directors ("trustees"). The purchaser intended to build an apartment and office building on the land. The lawyer for the purchasing corporation was also a director of the hospital. The sale was considered at several meetings of the board and executive committee, culminating in a board meeting at which the sale was ratified by a vote of six to four, with the lawyer for the purchasing corporation voting with the majority and the owner of the purchaser and the chairman of the hospital board abstaining. The court noted that the lawyer should have disqualified himself, which would have

220. *Id.* at 704, 211 N.Y.S. at 804.

221. *Id.* at 707, 211 N.Y.S. at 807.

222. *Id.* at 702, 211 N.Y.S. at 802.

223. 219 S.C. 174, 64 S.E.2d 524 (1951).

produced a vote of five to four, a bare majority of those entitled to vote and less than a majority of the board.

The complaint brought by two dissenting directors asked for avoidance of the proposed conveyance. The court said, "[t]he foundation of suits such as this is the relation in the nature of an express trust between a director and his corporation which is also similar in this quality to that of principal and agent."²²⁴ The court then stated that

when a director, in selling corporate property to himself, represents or joins in the representation of the corporation, the transaction is voidable at the option of the corporation, or others suing in its behalf, merely upon proof of the fact stated; but when the purchasing director abstains from participation in behalf of the corporation and it is properly represented by others who are personally disinterested, the transaction will stand under attack if the director made full disclosure, paid full value, and the corporation has not been imposed upon; and the burden is upon the director to establish these requisites by evidence.²²⁵

The court cited evidence that the director who owned the purchasing corporation "overshadows the most of his fellow-directors in business stature and vision" and seemed to have done everything he could to further the transaction other than to vote²²⁶. The court also noted that the attorney for the purchaser "was unrestrained in his activity in the corporate meetings in favor of the sale," and that the corporation was thus deprived of "the untrammelled reason and judgment of the Board of Trustees" to which it was entitled.²²⁷ Moreover, the court found that the purchasing director had failed to establish that the sale price represented full value. In the court's words:

We are constrained to hold that the facts which have been stated are amply sufficient to invalidate in equity the close corporate result, and avoid the sale. There is no finding of actual fraud or fraudulent intent; indeed, we think [the purchasing director] was innocent of that; but his conduct failed to measure up to the high standard required by the law of one in his fiduciary relation to the hospital.²²⁸

The court seems to have given considerable weight to evidence that the defendant had procured options on "comparable properties" at a price forty percent greater than that set for the hospital property, and that the hospital might have needed the property for expansion, which would negate the requisites that full value be given and that the hospital would suffer no imposi-

224. *Id.* at 185, 64 S.E.2d at 528.

225. *Id.* at 186-87, 64 S.E.2d at 529 *citing* 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS § 913 (rev. ed. 1975).

226. *Id.* at 189, 64 S.E.2d at 530.

227. *Id.*

228. *Id.* at 191, 64 S.E.2d at 531.

tion. The major thrust of the opinion, however, seems to be the influence the defendant had upon the other directors.

Other cases of self-dealing involve transactions entered into openly and in apparent good faith between directors and their corporations. These cases often concern transactions in which the director's employer receives a commission or other payment from the corporation. For instance, *Stern v. Lucy Webb Hayes National Training School for Deaconesses & Missionaries*,²²⁹ involved allegations that, among other things, directors ("trustees") of a not-for-profit corporation had participated in decisions to place business with financial institutions with which they were affiliated, sometimes failing to notify corporate officials that better terms were available elsewhere. The court held that

[a] director or so-called trustee of a charitable hospital . . . is in default of his fiduciary duty to manage the fiscal and investment affairs of the hospital if it has been shown by a preponderance of the evidence that: . . .

he knowingly permitted the hospital to enter into a business transaction with himself or with any corporation, partnership or association in which he then had a substantial interest or held a position as trustee, director, general manager or principal officer without having previously informed the persons charged with approving that transaction of his interest or position and of any significant reasons, unknown to or not fully appreciated by such persons, why the transaction might not be in the best interests of the hospital; or . . .

he actively participated in or voted in favor of a decision by the Board or any committee or subcommittee thereof to transact business with himself or with any corporation, partnership or association in which he then had a substantial interest or held a position as trustee, director, general manager or principal officer . . .²³⁰

While noting that many of the self-dealing transactions were "of relatively minor significance" in that the interested director was only one vote of many which approved the transaction, the court found that in other cases the interested director had a "crucial" role, or "principal responsibility," or had "personally negotiated" the arrangement.²³¹ Nonetheless, the court found that it would be "unduly harsh" to remove the directors from the board in view of their long years of service and the fact that they would soon become less active because of age or illness. Moreover, in the court's judgment, removal would disrupt the hospital's operations.²³² The court "limited" injunctive relief, noting that voluntary steps had been taken to prevent recurrence, that the entire board shared some responsibility with the defend-

229. 381 F. Supp. 1003 (D.D.C. 1974).

230. *Id.* at 1015.

231. *Id.* at 1016.

232. *Id.* at 1019.

ants, and that this was something of a case of first impression.²³³ Accordingly, the court ordered that the corporation adopt "a written policy statement governing the utilization and investment of [its] liquid assets," that each director disclose his affiliations with financial institutions and keep that disclosure up to date, that the treasurer and auditors take certain steps to disclose transactions between the corporation and financial institutions with which its directors were affiliated, and that each present and future director read the order and opinion of the court and signify in writing that he had done so.²³⁴

It is significant that no damages were assessed against the defendant directors, although the court found that in some instances the corporation could have obtained better terms from financial institutions other than those with which they were affiliated. Also significant is the fact that the defendants' failure to supervise properly worked to the financial disadvantage of the corporation. Thus, while this opinion has been recognized as a leading case on the duties of care and loyalty of directors of not-for-profit corporations, and is somewhat strict in the standards it imposes, the relief granted is remarkably lenient. The court justified this lenience in part, as noted above, by pointing out that this was a case of first impression in the jurisdiction. There is reason to believe that future courts in the District of Columbia and elsewhere will not be as solicitous of defendants in fashioning relief.

The *Stern* court was applying corporate standards to the directors of charitable corporations. When trust standards are used, the results are not so generous to the defendants. In *Old Settlers Club of Milwaukee County v. Haun*,²³⁵ a director ("trustee") of a not-for-profit corporation formed for social purposes was an officer of two securities dealers and majority shareholder of one of them. Those dealers did business with the not-for-profit corporation and received profits from it. The trial court found that the director had not been disloyal or acted in bad faith. The Supreme Court of Wisconsin found that the director was obligated to pay to the corporation "any profit or compensation that he personally . . . received" as a consequence of the transactions. The court cited section 203 of the Restatement (Second) of Trusts for the proposition that "the trustee is accountable for any profit made by him through or arising out of the administration of the trust, although the profit does not re-

233. *Id.* at 1018.

234. *Id.* at 1020-21.

235. 245 Wis. 213, 13 N.W.2d 913 (1944).

sult from a breach of trust."²³⁶

The court also quoted section 388 of the Restatement (Second) of Agency, which provides:

Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal . . . even though otherwise he has acted with perfect fairness to the principal and violates no duty of loyalty in receiving the amount.²³⁷

The defendant was ordered to pay over commissions he received from one of the securities firms but, as to amounts received by the other firm, the court held that merely pointing out that he was a stockholder of and got a salary from that firm did not constitute proof that he had benefitted personally from the transactions with the not-for-profit corporation.²³⁸

In *Queen of Angels Hospital v. Younger*,²³⁹ the court considered the claim of the Attorney General that a finder's fee paid to a trustee of a not-for-profit hospital corporation, who was also the corporation's lawyer, was a real estate broker's fee to a person who did not hold a broker's license. Citing statutes providing that a lawyer performing services as a lawyer is not a broker²⁴⁰ and noting that "professional protocol—such as disclosure, disqualification as trustee when called for—appears to have been scrupulously observed,"²⁴¹ the court refused to invalidate the fee agreement. Although California imposes strict standards on corporate directors generally, and directors of charitable corporations particularly, the court did not consider whether liability might arise out of the defendant's status as a director.

In some jurisdictions, a similar result can be obtained by the application of the law of trusts. In *Samuel & Jessie Kenney Presbyterian Home v. State*,²⁴² it was claimed that a not-for-profit corporation should not have purchased fire insurance from one member of its board of directors ("trustees") and mortgages from another. The court pointed out that fire insurance premium rates are uniform, that it would be illegal for the insurance broker to share his commissions with the corporation, that the mortgages had been investigated and passed upon by the

236. *Id.* at 215-16, 13 N.W.2d at 914, citing RESTATEMENT (SECOND) OF TRUSTS § 203, at 455 (1959).

237. *Id.* at 216, 13 N.W.2d at 914, citing RESTATEMENT (SECOND) OF AGENCY § 388 at 203 (1958).

238. *Id.* at 217, 13 N.W.2d at 914.

239. 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977).

240. *Id.* at 374, 136 Cal. Rptr. at 44-45, citing CAL. BUS. & PROF. CODE, §§ 10130-10133 (West 1964).

241. *Id.* at 374, 136 Cal. Rptr. at 45.

242. 174 Wash. 19, 24 P.2d 403 (1933).

other directors and that the defendant director's commissions on the sale of the mortgages to the corporation had been paid by the sellers.²⁴³ Quoting from an earlier opinion involving a testamentary trust, the court held that "[w]here, the trustee personally performs services in their nature properly chargeable as current expenses of the estate, and for which he might have employed another, there is no good reason why he should not receive reasonable pay for such services when and as they are performed."²⁴⁴

On the other hand, it has been held that benign motive is irrelevant in determining whether those who control a charitable corporation have misapplied its assets, even though the transaction may have been intended for the ultimate benefit of the charity. *People v. Larkin*²⁴⁵ was a case against the parents of a retarded child; they had established a not-for-profit corporation to own and operate ranches for poor and homeless children, providing all funds and acting as the directors ("trustees") of the corporation from its inception. The principal source of funds for the charity was a business corporation owned by the husband. A bank from which the business corporation requested a loan required a guaranty by the Small Business Administration which in turn required that collateral be given to the bank. The couple caused the charitable corporation to give a loan guaranty and real estate mortgage to the bank. Two years later, the Attorney General of California sued the charity, its trustees, the business corporation and the bank, claiming that the hypothecation was a breach of trust. Six months after the action was filed, there was a default on the loan and the Small Business Administration became holder of the mortgage upon paying the outstanding balance of the loan to the bank. The Attorney General then joined the Small Business Administration and its Administrator and sought recovery of the real estate for the charity.²⁴⁶

In opposition to the Attorney General's motion for summary judgment, the Small Business Administration contended that the good faith of the trustees in pledging the real estate was a defense to the claim of breach of trust. The court noted that a statute provided that "[a] trustee may not use or deal with the trust property for his own profit, or for any other purpose unconnected with the trust, in any manner."²⁴⁷ The Small Business Administration urged flexibility in trust administration and the

243. *Id.* at 59-60, 24 P.2d at 418.

244. *Id.* at 60, 24 P.2d at 418, citing *In re Cornett's Estate*, 102 Wash. 254, 173 P. 44, 46 (1918).

245. 413 F. Supp. 978 (N.D. Cal. 1976) (applying California law).

246. *Id.* at 980.

247. *Id.* at 981, quoting CAL. CIV. CODE § 2229 (West 1954).

trustees suggested that "overly-zealous enforcement of fiduciary obligations against philanthropists may ultimately work a disservice on the public by drying up sources of private giving."²⁴⁸ The court stated that Section 2229 of the California Civil Code²⁴⁹ evidenced the legislature's rejection of those arguments. The court concluded that "the legislative judgment is not unreasonable, and may reflect a determination that the risks inherent in gambling with foundation assets, and the administrative cost of policing such transactions, outweigh the potential benefits to the trust."²⁵⁰ Despite testimony that the purpose of the loan "was to generate profits which could be rechanneled into" the charitable corporation,²⁵¹ the court held that the hypothecation of its "assets constitutes a breach of trust under California's strict rules of fiduciary duty."²⁵²

The Small Business Administration argued that, despite the breach of trust, its position was superior to that of the beneficiaries of the trust because a statute provided that "[e]veryone to whom property is transferred in violation of a trust, holds the same as an involuntary trustee under such trust, unless he purchased it in good faith, and for a valuable consideration."²⁵³ The Administration had actual knowledge that the real estate was a foundation asset at the time it accepted it as collateral, and one of its employees had expressed doubt about the transaction. The court stated, "[t]he statutory term 'good faith' does not mean absence of evil motive, or, as here, absence of profit; rather, the critical factor is absence of knowledge."²⁵⁴ Because the Administration had knowledge that the real estate was a foundation asset, the Small Business Administration and its Administrator were ordered to hold the assets of the foundation in their possession as constructive trustees for the charitable purposes of the foundation.

A special type of self-dealing is that created by Section 4941 of the Internal Revenue Code.²⁵⁵ The term includes any direct or indirect sale or exchange of property between a "private foundation"²⁵⁶ and a "disqualified person."²⁵⁷ Section 4941 imposes a

248. *Id.* at 982.

249. CAL. CIV. CODE § 2229 (West 1954).

250. 413 F. Supp. 978, 982 (N.D. Cal. 1976) (applying California law).

251. *Id.* at 981.

252. *Id.* at 982.

253. *Id.*, quoting CAL. CIV. CODE, § 2243 (West 1954).

254. *Id.* at 983.

255. I.R.C. § 4941(d)(1)(A) (1976).

256. Private foundation is defined as any organization described in § 501(c)(3) other than those described in § 501(a)(1), (2), (3), or (4). I.R.C. § 509(a) (1976). The excluded organizations generally have broad public support.

tax on acts of self-dealing equal to fifty percent of the amount involved in the self-dealing and an additional tax of 200 percent if the self-dealing is not corrected within the period allowed. Another section provides a penalty equal to the amount of the tax for willful and flagrant or repeated acts of self-dealing.²⁵⁸ Thus, Congress has provided considerably harsher consequences for the effects of self-dealing upon the public revenue than the courts impose for its effects on not-for-profit corporations.

The foregoing cases all involve actions which may be categorized as improper self-dealing. Other cases are concerned with wrongful taking of corporate opportunities. For instance, *Valle v. North Jersey Automobile Club*,²⁵⁹ was a derivative action²⁶⁰ by a member of a nonprofit automobile club against its directors who had purchased an insurance agency and operated it for profit "as a virtual department" of the club. Although the court found that the defendants were not guilty of actual fraud, believing that their breach of trust had been ratified by the members of the club,²⁶¹ they were ordered to pay to the club their salaries received from the agency.²⁶² They had turned the agency over to the club following commencement of the litigation.²⁶³

Another case concerning improper taking of a corporate opportunity was *Mile-O-Mo Fishing Club, Inc. v. Noble*.²⁶⁴ The former president of a not-for-profit corporation had taken steps toward the purchase by the corporation of the real estate on which its clubhouse was located. After he had been defeated for reelection, he purchased the land for himself. The court imposed a constructive trust upon the property, noting that although the consummation of the breach occurred after the fiduciary relationship had terminated the transaction had its genesis, and was based on information received by the former

257. Disqualified persons are described in section 4946 as including substantial contributors, foundation managers, the owners of more than twenty percent of the voting power of a corporation, and members of their families. I.R.C. § 4946 (1976).

258. I.R.C. § 6684 (1976).

259. 141 N.J. Super. 568, 359 A.2d 504 (1976), *rev'd in part*, 74 N.J. 10, 376 A.2d 1192 (1977).

260. In a previous decision the court had found that a procedural rule (R.4:32-5) which conferred upon shareholders the right to sue derivatively applied to members of not-for-profit corporations as well. *Valle v. North Jersey Automobile Club*, 125 N.J. Super. 302, 308, 310 A.2d 518, 521 (1973).

261. *Id.* at 312, 310 A.2d at 523.

262. 141 N.J. Super. 268, 288, 359 A.2d 504, 511 (1976), *rev'd in part*, 74 N.J. 109, 376 A.2d 1192 (1977).

263. *Id.* at 286, 359 A.2d at 510.

264. 62 Ill. App. 2d 50, 210 N.E.2d 12 (1965).

president, during his term in office.²⁶⁵ Noting that the defendant, "prior to acquiring the property owed the duty to plaintiff to ascertain that it has no desire or intent to purchase," and that he knew that the contrary was true,²⁶⁶ the court remanded the case for a determination of the amount the former president had expended to buy the property and ordered that the property be conveyed to the corporation after it had paid that sum to the defendant.²⁶⁷

In *Societa Operaia Di Mutuo Soccorso Villalba v. Di Maria*,²⁶⁸ relief was granted to a not-for-profit corporation in the absence of direct pecuniary benefit to the defendant. A mutual benefit fraternal corporation brought suit against its treasurer for recovery of rents he failed to collect from its president, an in-law of the defendant, who operated a tavern on the plaintiff's property. The defendant entered the rents in the corporate books as collected and reported at meetings of the membership that they had been collected. The court stated: "As agent of the plaintiff, defendant was its fiduciary and owed it the duty of good faith and loyalty,"²⁶⁹ thereupon commencing a discussion of trust law on the apparent assumption that a fiduciary relationship creates a trust.²⁷⁰ The court said:

A primary incident of the obligation of the agent or trustee is the duty of prompt, full and frank disclosure and account. . . .

Whenever an accounting by a trustee is false or deficient, all presumptions are against the trustee, and obscurities and doubts will be resolved adversely to him, not in his favor [citation omitted]. No reason is perceived for not applying these principles in the present case to require defendant to show that the loss did not flow from his malefaction rather than require plaintiff to establish with certainty that the unpaid rents could not have been recovered from the apparently insolvent tenant.²⁷¹

The court concluded that the same result would be reached by the application of estoppel *in pais* and that the "[d]efendant should be held to the satisfaction of the account he deliberately rendered."²⁷² The result is based solely on the failure to collect rent and the concealment of that failure. Although the relationship between the defendant and the tavern owner might give

265. *Id.* at 57-58, 210 N.E.2d at 15-16.

266. *Id.* at 58, 210 N.E.2d at 16.

267. *Id.* at 58-59, 210 N.E.2d at 16.

268. 40 N.J. Super. 344, 122 A.2d 897 (1956).

269. *Id.* at 348, 122 A.2d at 899.

270. As to why this is not so, see *supra* text accompanying notes 39-41.

271. *Societa Operaia Di Mutuo Soccorso Villalba v. Di Maria*, 40 N.J. Super. 344, 348-49, 122 A.2d 897, 899-900 (1956).

272. *Id.* at 350, 122 A.2d at 900.

rise to a finding that the defendant benefitted personally from his actions the court does not discuss the issue.

Mismanagement and Nonmanagement

As might be expected, courts are less willing to find liability against directors and officers of not-for-profit corporations in cases where there is no indication that the defendants benefitted themselves or may have done so, than in the conflict of interest cases. This unwillingness is sometimes revealed in terms of the business judgment rule applicable to corporations in general,²⁷³ and sometimes in expressions of sympathy for public-spirited citizens.²⁷⁴

One case in which relief was had is *Lynch v. John M. Redfield Foundation*.²⁷⁵ The Attorney General of California brought an action against the directors of a charitable corporation for permitting dividends to remain in a noninterest-bearing checking account for five years, during which the balance in the account increased from \$4,928.47 to \$47,099.64. In the past the funds in the account had been distributed to donees regularly, but disputes among directors as to selection of donees and the management of the corporation resulted in a deadlock.

The court noted that under California law a trust is imposed upon the assets of a charitable corporation, and that therefore the directors, although "exempt from personal liability for the debts, liabilities or obligations of the corporation, . . . are not immune from personal liability for their own fraud, bad faith, negligent acts or other breaches of duty."²⁷⁶ Stating that it is a breach of trust to delay unreasonably to invest funds, the court held the directors liable for failure to measure up to the prudent man investment rule²⁷⁷ even though there was substantial evidence of their good faith. The directors were surcharged jointly and severally for interest.²⁷⁸

On the other hand, in *Massachusetts Charitable Mechanic*

273. See, e.g., *Beard v. Achenbach Memorial Hospital Association*, 170 F.2d 859, 862 (5th Cir. 1948) (applying Kansas law).

274. See, e.g., *George Pepperdine Foundation v. Pepperdine*, 126 Cal. App. 2d 154, 271 P.2d 600 (1954).

275. 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970).

276. *Id.* at 298, 88 Cal. Rptr. at 89, quoting 26 SO. CAL. L.R. 80, 85.

277. CAL. CIV. CODE § 2261, subd. (1) (West 1981).

278. CAL. CIVIL CODE § 2262 provides liability for simple interest from the time of breach of trust at seven percent per annum in such circumstances, but common law in other jurisdictions provides a surcharge at the usual rate of return on trust investments, the legal rate, or a rate determined by the court. See A. SCOTT *supra* note 41, § 270.1; RESTATEMENT (SECOND) OF TRUSTS § 207 (1965).

Association v. Beebe,²⁷⁹ relief was granted against members of the investment committee of a not-for-profit corporation on the ground that they were *not* trustees. The corporation brought a bill in equity seeking to require them to turn over to its treasurer certain funds which would then be used to pay overdue real estate taxes and for the general purposes of the corporation. The members of the investment committee defended on the ground that they held the funds in trust to be applied only to the charitable work of the corporation. The court found that the legislature in chartering the corporation had made it the sole custodian of its funds and thus the corporation had no authority to delegate that responsibility to others.²⁸⁰ Therefore, it was held that the investment committee was not an independent body of trustees, and that its members were mere officers and agents of the corporation and subject to its control.²⁸¹

*Mullins v. Pine Manor College*²⁸² was an action by a student against her college and its vice-president of operations for damages suffered when she was raped on campus. The evidence was found sufficient to support a verdict that the college was negligent in providing security and judgments against both defendants were sustained.²⁸³ Massachusetts had abolished the doctrine of charitable immunity by a statute which provided that liability was limited to \$20,000 "if the tort was committed in the course of any activity carried on to accomplish directly the charitable purposes," but was unlimited if connected with commercial activities to raise funds.²⁸⁴ The officer sought to obtain the benefit of his employer's limited liability, but the court stated that "[t]he general rule . . . is that an agent is not entitled to the protection of his principal's immunity even if the agent is acting on behalf of his principal."²⁸⁵ The officer also sought to extend the Massachusetts rule that a government official should be immune from liability for negligence, in activity involving the exercise of judgment and discretion, to his status as an officer of a private college. The court declined to do so, noting that the rule "rested on overriding considerations of public policy affecting the very quality and efficiency of government itself."²⁸⁶

Stern v. Lucy Webb Hayes National Training School for Dea-

279. 320 Mass. 601, 70 N.E.2d 825 (1947).

280. *Id.* at 611, 70 N.E.2d at 831.

281. *Id.*

282. 389 Mass. 47, 449 N.E.2d 331 (1983).

283. *Id.* at 64, 449 N.E.2d at 341-42.

284. MASS. ANN. LAWS ch. 231, § 85K (Michie/Law Co-op 1974).

285. 389 Mass. at 63, 449 N.E.2d at 341, *citing* RESTATEMENT (SECOND) AGENCY § 347(1) (1958).

286. *Id.* at 65, 449 N.E.2d at 342.

conesses & Missionaries,²⁸⁷ considered directors charged with a duty to supervise the management of investments and to attend meetings at which such management was discussed. The court found that the directors had "failed to exercise even the most cursory supervision over the handling of Hospital funds and failed to establish and carry out a defined policy."²⁸⁸ In its order the court

[d]eclared that each director or trustee of a charitable hospital . . . has a continuing fiduciary duty of loyalty and care in the management of the hospital's fiscal and investment affairs and acts in violation of that duty if:

(1) he fails, while assigned to a particular committee of the Board having stated financial or investment responsibilities under the by-laws of the corporation, to use diligence in supervising and periodically inquiring into the actions of those officers, employees and outside experts to whom any duty to make day-to-day financial or investment decisions within such committee's responsibility has been assigned or delegated, or . . .

(4) he fails to perform his duties honestly, in good faith, and with reasonable diligence and care.²⁸⁹

The defendants were also ordered to establish policies governing the corporation's liquid assets, and to review the assets to determine whether they conform to those policies.²⁹⁰

In *United States v. Mount Vernon Mortgage Corp.*²⁹¹ some of the plaintiff's allegations concerned mismanagement on the part of directors ("trustees"). Specifically, it was claimed that the directors breached their duty of care in three respects: by transfers of stock owned by the not-for-profit corporation to secure a loan, because the value of the stock exceeded the amount of the loan; by a later sale of the stock for an inadequate consideration; and by the transfer of a few shares of the stock to a director without consideration. The latter two transfers occurred in the process of winding up the corporation, whose operations had been severely hampered by World War II, in a manner which ignored the fact that its charter gave it perpetual duration.²⁹²

The court held that the transfer of security was for adequate consideration. The court noted, however, that the second transfer, which was for about seven percent of what the corporation had paid for the stock, was for "shockingly inadequate" consid-

287. 381 F. Supp. 1003 (D.D.C. 1974) (discussed above in connection with choice of standard and also conflict of interest).

288. *Id.* at 1016.

289. *Id.* at 1020.

290. *Id.*

291. 128 F. Supp. 629 (D.D.C. 1954) (discussed above in connection with the self-dealing of one of the directors).

292. *Id.* at 631.

eration and that "said trustees failed to inform themselves of the value of the stock and failed to exercise the caution, care and skill which a man of ordinary prudence would exercise in dealing with his property."²⁹³ While this is the language of the prudent man rule applicable to trustees and less frequently to corporate directors, the court does not discuss its choice of standard. Because the consideration was "shockingly inadequate" the transfer would seem to violate both the prudent man and prudent director rules.²⁹⁴

Far more numerous than the cases in which directors have been found to have violated their duties of care and loyalty in the management of not-for-profit corporations are those in which the directors have been exonerated. Interesting because it exemplifies the attitudes which have led to the feeling of invulnerability directors of such corporations often possess, is *George Pepperdine Foundation v. Pepperdine*.²⁹⁵ The complaint was brought by a not-for-profit corporation against its former directors, one of whom was its principal benefactor and president. The corporation demanded damages for "dissipation of its assets through illegal and speculative transactions and mismanagement of its affairs."²⁹⁶ The amounts asked of the defendants ranged from \$823,013.49 from the president down to \$174,833.81 from another former director. Two basic theories of liability were alleged. The first was the issuance to the public of promissory notes "without first obtaining a permit . . . and for considerations of no value or of less value than the principal amounts of the notes involved." The other was mismanagement "in dissipating all the assets of plaintiff over a period of years in speculative transactions and by making gifts of its assets after it became insolvent."²⁹⁷ It was further alleged that the president and principal benefactor dominated the other directors, who violated their fiduciary duties by acquiescing in the transactions.

The court found that no cause of action was stated.²⁹⁸ It summarized the series of transactions as "dissipation of the \$3,000,000 (given by the donor) and the incurring of a debt of \$551,300 for which it had received property worth no more than \$120,900."²⁹⁹ The court justified its conclusion as follows:

293. *Id.* at 636.

294. *See supra* text accompanying notes 57-62.

295. 126 Cal. App. 2d 154, 271 P.2d 600 (1954).

296. *Id.* at 155, 271 P.2d at 601.

297. *Id.*

298. *Id.* at 161, 271 P.2d at 606.

299. *Id.* at 158, 271 P.2d at 603.

A regrettable situation! but is it one that requires a burnt offering or that demands the swinging of human forms from the gibbet to gratify the rancor of intimate observers? . . .

It was an enterprise created by the brain and brawn of one only George Pepperdine. He had the vision, the industry, the thrift and the charitable instincts to accumulate a fortune and to dedicate it to the public good and his services to its expansion and increment and to the disbursement of its revenues and corpus to deserving charitable, benevolent or religious institutions. Had he confined his investments to his own field in which he accumulated his millions, or had he with wizard-like precision so invested the corpus of the trust as to reap more millions for the public benefit through his very own corporation, he would now walk in a wilderness of praises of himself and of the foundation's memorials unto his saint-like character. But now, after he and his friends have without promise or hope of reward unsuccessfully attempted to steer the institution of his creation to a harbor of safety and properly to dispense its charities to worthy causes, the current directorate seek to reduce them all to penury for ill-conceived plans, unwisely pondered and hastily executed. Each director sought only the public good. Not a chirp in the voluminous pleading intimates that a corrupt motive marred the character or inspired the acts of any one of them. Aside from President Pepperdine, all directors were evidently devoting their time to the enterprise primarily for the purpose of acquiring an intimacy with the institution and of gaining knowledge of methods of dispensing charity. Inasmuch as the foundation was the progeny of the president's imagination, they naturally deferred to his judgment or his wishes in weighing the merits of proposals submitted to the board. With the exception of a financial genius who might arise, how could one of his appointees resist his conclusion upon facts pertaining to the art of investing wealth for gain? He had been educated in the school of hard knocks [footnote omitted], and by virtue thereof, and of his success as a man of practical affairs, it was protocol to defer to his judgments. Now, an adverse judgment entered against such directors would operate a gross injustice for no crime but nonfeasance or neglect.³⁰⁰

Having thus set the stage, the court proceeded in no less grandiloquent language to absolve the defendants from liability. It noted that although directors of charitable corporations are to be "held to the highest degree of honor and integrity" they are not personally liable for mistakes of judgment.³⁰¹ The court rejected the idea that the benefactor could "have purposed to sabotage his own enterprise." The court summarized its ruling:

If Mr. Pepperdine had never organized the Foundation, but had set himself up to bestow his fortune on deserving charities and had at the same time continued to "invest and reinvest" his own moneys and properties and finally by miscalculations have lost it all, would any one be so crazy and cruel as to assert a claim against him for his carelessness in not holding intact the fortune which he intended to bestow on others? Who is "Foundation" otherwise than

300. *Id.* at 158-59, 271 P.2d at 603-04.

301. *Id.* at 159, 271 P.2d at 604.

the shadow of George Pepperdine, if not his alter ego? If he as an individual could not be sued for negligently investing his own moneys intended for charitable uses, why should his own "Foundation" under the management of strangers prosecute an action to recover from the original doner (*sic*) and his friends what, through negligence, they lost for the Foundation?³⁰²

Stripped of its passionate verbiage this reasoning has some appeal to logic and compassion, at least as it applies to Mr. Pepperdine, but the law of California was otherwise. In *Holt v. College of Osteopathic Physicians & Surgeons*,³⁰³ the California Supreme Court pointed out:

It is true that trustees of a charitable corporation do not have all the attributes of a trustee of a charitable trust. * * * The individual trustees in either case, however, are the ones solely responsible for administering the trust assets [citation omitted], and in both cases they are fiduciaries in performing their trust duties. (Citation omitted). Rules governing charitable trusts ordinarily apply to charitable corporations.³⁰⁴

In addition, California cases holding that a donor, who has made an unconditional gift to a charitable corporation, no longer has standing to sue to enforce the purposes of the gift or of the corporation are in accord with the view that the donor's status confers no special privileges.³⁰⁵ Moreover, the fiduciary status of the other directors obliged them to inform themselves as to the activities of the corporation and its president, and to take steps to prevent what they had reason to perceive as imprudent acts.³⁰⁶ This is consistent with the rule that each director of a charitable corporation is liable for the negligent acts of his fellow directors and that "liability of trustees for negligence is joint and several."³⁰⁷

Other opinions denying relief against directors are not as adamant in their language or as openly biased in favor of the defendants. This may be because the directors were not donors or were not as generous as Mr. Pepperdine. Nevertheless, there seems to be a pattern of sympathy toward directors of charitable corporations.

302. *Id.*

303. 61 Cal. 2d 670, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

304. *Id.* at 674-75, 394 P.2d at 936-37, 40 Cal. Rptr. at 248-49. See also *St. James Church of Christ Holiness v. Superior Court*, 135 Cal. App. 2d 352, 357, 287 P.2d 387, 392 (1955).

305. See, e.g., *O'Hara v. Grand Lodge, Indep. Order of Good Templars of State of Cal.*, 213 Cal. 131, 2 P.2d 21 (1931).

306. "Directors and officers are required to act carefully in the light of their actual knowledge and such knowledge as they should have gained by reasonable care and skill." HENN & ALEXANDER, LAW OF CORPORATIONS § 234, at 623 (3d ed. 1983).

307. *Lynch v. John M. Redfield Found.*, 9 Cal. App. 3d 21, 25, 88 Cal. Rptr. 86, 92 (1970).

In *Beard v. Achenbach Memorial Hospital Association*,³⁰⁸ the complaint sought appointment of a receiver and personal judgments against directors. It was alleged that the hospital corporation's funds were being misapplied to the advantage of certain individuals. Citing cases involving business corporations and using the language of the business judgment rule, the court said, that "ill success or bad judgment not so reckless or extravagant as to amount to bad faith or gross or wilful negligence on the part of directors in the discharge of their duties do (sic) not warrant the appointment of a receiver for the corporation or the rendition of a personal judgment against the directors."³⁰⁹

*MacArthur v. Corbally*³¹⁰ is of interest because of the trial court's treatment of nonaction by directors as a basis of liability and because of the staggering amounts involved. The fifty-one page complaint was brought by one of the eleven directors of the John D. and Catherine T. MacArthur Foundation, a not-for-profit corporation; the plaintiff was the only son of its founder and only significant contributor. The defendants were eight other directors, five of whom were also directors and/or officers of the Foundation's principal asset, Bankers Life and Casualty Co., alleged to have gross assets of over one billion dollars. The complaint stated that under federal and state law,³¹¹ and its articles of incorporation and by-laws, the Foundation was obligated to divest itself of the insurance operations of Bankers Life within five years of receipt thereof. The plaintiff alleged that "the primary financial obligation of the Board . . . was to sell these operations before December 1, 1983 and, in the interim, to manage them so as to create the highest divestiture value."³¹² The complaint stated that, instead, the dual directors altered the insurance operations in ways that diminished the value of Bankers Life, unreasonably delayed divestiture until the five years had nearly passed, and "then attempted to stampede the Foundation into an ill-conceived sale at less than even the diminished value of Bankers Life."³¹³ It was also alleged that the other three defendants acquiesced in these actions. Finally, it was alleged that the defendants paid themselves excessive compensation and other benefits from the Foundation.³¹⁴ The complaint stated that studies by outside advisors indicated that "the fair market

308. 170 F.2d 859 (10th Cir. 1948) (applying Kansas law).

309. *Id.* at 862.

310. No. 84-Ch-1345 (Cir. Ct. of Cook County, Ill., filed Feb. 15, 1984).

311. I.R.C. § 4943(c)(6) (West Supp. 1983).

312. Complaint at 2, *MacArthur v. Corbally*, No. 84-Ch-1345 (Cir. Ct. of Cook County, Ill., filed Feb. 15, 1984).

313. *Id.* at 2-3.

314. *Id.* at 6-10.

value of Bankers Life's Insurance operations under the dual directors' stewardship has decreased by some \$200 million. . . ."³¹⁵ The plaintiff prayed for the following relief: (1) a declaration that the defendants breached their fiduciary duties and that the Foundation would be unable to carry out its charitable purposes while the defendants were directors; (2) dissolution of the Foundation and conveyance of its assets to a new corporation with the same charitable purposes, with the plaintiff, but none of the defendants, on the board of directors; (3) appointment of a receiver to carry on the Foundation's affairs during the litigation; (4) preliminary and permanent injunctions against the defendants with regard to management and disposal of assets, withholding of information from the plaintiff, making changes on the board other than acceptance of resignations, and paying their expenses of litigation out of Foundation assets; (5) an accounting as to compensation; (6) restitution of excessive compensation and all losses resulting from waste, mismanagement, and other breaches of fiduciary duty; and (7) costs and attorney fees.³¹⁶

The Foundation and defendants filed motions to dismiss. The court found that the complaint intermingled a non-derivative cause of action with derivative causes. The request for dissolution could not be derivative because it was not on behalf of the corporation but rather against it.³¹⁷ As to the requests for derivative relief, the court held that no demand had been made on the board that it pursue them, and that such a demand was a prerequisite for suit,³¹⁸ at least in the absence of a specific pleading that such a demand would be futile.³¹⁹ Therefore, the derivative causes of action were dismissed with prejudice and the request for dissolution was dismissed without prejudice³²⁰ so that the plaintiff would have an opportunity to fashion a new complaint if anything was left after the derivative causes were stricken.³²¹ The court expressed the belief that the sole reason for naming the three outside directors and charging them with a breach of fiduciary duty in acquiescing in the action of the dual directors was "to create a majority which the Plaintiff thinks is necessary to his cause of action here without demand."³²² Yet,

315. *Id.* at 14.

316. *Id.* at 49-51.

317. Transcript at 74, 80, *MacArthur v. Corbally*, No. 84-ch-1345 (Cir. Ct. of Cook County, Ill., 1984).

318. *Id.* at 76.

319. *Id.* at 77.

320. *Id.* at 86.

321. *Id.*

322. *Id.* at 78.

the failure of directors to inquire into suspicious activities and to take corrective action when warranted has been held to be an independent wrong which justifies relief.³²³ As this article goes to press, this is the status of the case. In view of the amounts involved one would expect the plaintiff to pursue the matter further.

In *Newman v. Forward Lands, Inc.*,³²⁴ the court considered an action by a Pennsylvania corporation against a Delaware not-for-profit corporation and its directors. The complaint alleged that the defendants tortiously and in breach of contract turned over money and land to the plaintiff's executive director who diverted them to his own use. The court granted the directors' motion to dismiss; it rejected the plaintiff's contention, based on *Stern v. Lucy Webb Hayes National Training School for Deaconesses & Missionaries*,³²⁵ that officers and directors of a not-for-profit corporation may be liable to third parties for breaching their duties to the corporation. In so doing, the court noted that the plaintiffs in the *Stern* case were permitted only to maintain an action similar to a shareholders' derivative suit, in which the relief allowed benefitted the corporation itself.

The plaintiff in *Newman* also sought to pierce the corporate veil to reach the directors. The court refused to do so "since the plaintiff fails to allege any misuse of the corporate form, that the individual defendants used [the corporation] as their alter ego, or anything else that would justify disregarding the corporate entity."³²⁶ Finally, the plaintiff also contended that the directors were not entitled to dismissal because the complaint alleged that they acted fraudulently. The court rejected that argument as well, commenting that

[the] thrust of [the plaintiff's] claim is that they failed to perform their duties and exhibited an indifferent attitude in the management of that corporation. Such conduct may amount to negligence or perhaps even recklessness, but it hardly can be characterized as fraudulent. There is thus no basis for distinguishing this case from the general rule contained in *Restatement (Second) of Agency* § 352.³²⁷

323. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013-14 (D.D.C. 1974); *Francis v. United Jersey Bank*, 162 N.J. Super. 335, 392 A.2d 1233 (1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (1979).

324. 430 F. Supp. 1320 (E.D. Pa. 1977) (applying Pennsylvania law).

325. 381 F. Supp. 1003 (D.D.C. 1974).

326. *Newman*, 430 F. Supp. at 1322.

327. *Id.* Restatement (Second) of Agency § 352 provides that

[a]n agent is not liable for harm to a third person other than his principal because of his failure adequately to perform his duties to his principal, unless physical harm results from reliance upon performance of

Under special circumstances the directors of not-for-profit corporations may be held liable for torts committed by their corporations. In *Tillman v. Wheaton-Haven Recreation Association, Inc.*,³²⁸ the court considered this issue in connection with the adoption and enforcement of corporate policies which excluded blacks from a community swimming pool. The directors had been advised by counsel, who relied on decisions of the United States District Court for the District of Maryland and a majority of the Court of Appeals for the Fourth Circuit, that the exclusionary policy was legal. The District Court had awarded compensatory damages against the corporation under Sections 1981 and 1982 of the Civil Rights Acts, but "held that proof of the directors' knowledge of the wrongfulness of the corporation's act was necessary to establish their personal liability."³²⁹ The Fourth Circuit stated that the corporation's tort was intentional and held that "a complainant relying on § 1981 or § 1982 need not prove that the defendant knew the duties these statutes impose."³³⁰

The opinion then moved on to consider whether the directors were shielded from personal liability for the tort of the corporation. The Fourth Circuit held that Sections 1981 and 1982 neither enlarged nor diminished the liability of directors under general corporation law for torts committed by their corporations. The court then turned to an examination of that general law, saying

[i]f a director does not personally participate in the corporation's tort, general corporation law does not subject him to liability simply by virtue of his office. . . [citations omitted].

In contrast, a director who actually votes for the commission of a tort is personally liable, even though the wrongful act is performed in the name of the corporation. [citation omitted] Proof that the director voluntarily and intentionally caused the corporation to act is sufficient to make him personally accountable. . . [citation omitted]. Only when wrongful intent is an element of a tort can a director who acted innocently escape liability. Even in such instances, the defense does not arise from the peculiar nature of a director's office, but rather from the elements of the tort.³³¹

The court ordered the case remanded for proceedings consistent with its opinion, stating, "[o]f course, the directors are not liable for damages and costs already paid by the corporation.

the duties by the agent, or unless the agent has taken control of land or other tangible things.

RESTATEMENT (SECOND) OF AGENCY § 352 (1980).

328. 517 F.2d 1141 (4th Cir. 1975).

329. *Id.* at 1143.

330. *Id.*

331. *Id.* at 1144.

They are, however, jointly and severally liable with the corporation for additional attorney's fees."³³² It would seem to follow from this order that the directors would be liable to the corporation for the damages it had already paid, but this subject is not discussed in the opinion.

In *Miami Retreat Foundation v. Ervin*,³³³ the court considered a complaint by the Attorney General of Florida to annul the franchise of a not-for-profit corporation. The state alleged that the corporation operated a private sanatorium for profit and that it had amassed a great deal of property that was controlled by the founder and not used for charitable purposes. The court noted that the corporation's purposes made it impossible for the founder, who was a defendant, "except for acts of dishonesty, . . . to personally secure for himself the assets of the corporation, and the Master definitely found that the corporation had been in the past honestly administered."³³⁴ The Master had found that the corporation was operated for profit because it had accumulated considerable amounts of cash and other property, but the court stated:

There is nothing inconsistent with the character of a corporation not for profit, that profits result from its operations, if such profits are devoted to the charitable purpose for which it was organized, and the Master specifically found that . . . [the] founder of the charitable trust here involved, did not profit from its operation beyond a reasonable salary as its operating executive.³³⁵

In recommending relief, the Master found that only two and one-half percent of the patients received charity; the court held this to be irrelevant because the charges for many patients who would otherwise require charity from the hospital were paid by the county.

As to the allegation that the founder dominated the corporation, the court said that

human nature being what it is, this is not unusual, or necessarily reprehensible. The sole founder of a charity should certainly be accorded considerable latitude in its administration, and may, without too many strictures, select as his associates persons of his own bent and inclination in regard to the conduct of its affairs. If we are unduly euphemistic in our appraisal of the situation, we qualify such euphemism by our conviction that the conduct of the affairs of the Corporation, though subject to criticism, are not so evil or abhorrent as to warrant the intervention of the Attorney General with his powers of visitation.³³⁶

332. *Id.* at 1148.

333. 62 So.2d 748 (Fla. 1952).

334. *Id.* at 751.

335. *Id.* at 751-52.

336. *Id.* at 752.

When the cases in which lack of standing in the plaintiff resulted in judgment for defendant directors and officers are added to the cases where an equivalent result was reached for other reasons, it becomes apparent that it is difficult to obtain relief in mismanagement or nonmanagement cases.

Violation of Corporate Purposes

In cases in which the complaint alleges that directors are acting contrary to the purposes of the corporation, plaintiffs tend not to seek damages or other relief against the directors as individuals. For example, in *Holt v. College of Osteopathic Physicians and Surgeons*,³³⁷ three directors ("trustees") of a charitable corporation sued the Attorney General and their twenty-three fellow directors. The plaintiffs asked for declaratory relief and an injunction regarding certain acts which the plaintiffs alleged would convert the corporation into a school teaching nonosteopathic medicine in contravention of its charitable purpose. The court held that the complaint stated a cause of action, and that a question of fact existed as to whether the teaching of courses in allopathic medicine would be contrary to the charitable purposes of the corporation.³³⁸

In *Commonwealth v. Barnes Foundation*,³³⁹ the court considered a petition brought by the Attorney General of Pennsylvania calling upon a charitable corporation and its directors ("trustees") to show cause why the museum they operated should not be open to the general public. The indenture of trust by means of which a valuable art collection was deeded to the corporation spoke of an "art gallery" and declared that "[t]he purpose of this gift is democratic and educational in the true meaning of those words, and special privileges are forbidden."³⁴⁰ It appears that the directors were operating a school on the premises and the general public was not admitted to view the collection. The court reversed the dismissal of the complaint, stating that the corporation "may not exclude the public from the art gallery without offering explanation as to why it ignores the expressed intention of Dr. Barnes that the gallery shall, with certain restrictions, be open to the public."³⁴¹

The complaint in *Denckla v. Independence Foundation*,³⁴² questioned a grant of a substantial portion of the assets of one

337. 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964).

338. *Id.* at 760, 394 P.2d at 939, 40 Cal. Rptr. at 251.

339. 398 Pa. 458, 159 A.2d 500 (1960).

340. *Id.* at 467, 159 A.2d at 505.

341. *Id.* at 469, 159 A.2d at 506.

342. 41 Del. Ch. 247, 193 A.2d 538 (1963).

charitable corporation to another. The defendants were the transferor corporation and two directors who were not served. The certificate of incorporation of the defendant corporation provided that its assets were to be used "exclusively in such charitable (sic) benevolent, scientific and educational activities as will promote the well-being of mankind and the alleviation of human suffering, and without in any way intending to limit such general purposes by any of the specific objects and powers hereinafter referred to . . ." ³⁴³ There followed a list of powers which were themselves quite broad and general. The court upheld a grant by the corporation of fifty-five percent of its assets to a corporation with similar purposes formed to settle a dispute among the members of the grantor as to its donative policies. ³⁴⁴ The plaintiffs charged that the lower court abused its discretion in refusing them permission to file an amended complaint alleging a conspiracy among officers of the granting corporation and others to appropriate its funds for speculation causing it and the individual plaintiff substantial losses, and a scheme by the directors who were not served to take over absolute control of the corporation. The plaintiffs also requested an accounting by the officers, removal of certain officers and directors, and appointment of a receiver. The court affirmed the refusal to permit the amended complaint to be filed, accepting the reasons given by the lower court, including the fact that the plaintiff did not allege "facts which would demonstrate the alleged 'conspiracy' to be fraudulent or illegal." ³⁴⁵

In *Rowan v. Pasadena Art Museum*, ³⁴⁶ the plaintiffs alleged that the directors of a charitable corporation now known as the Norton Simon Art Museum at Pasadena had caused the museum to breach the trust by which it held works of art and other property, by deaccessioning ³⁴⁷ works in its collection, failing to display others, refusing to lend works which were not currently on display and in other respects. The court held that under the articles of incorporation the directors had broad discretion with respect to the maintenance, display, and disposal of works of art and absolved the museum of any breach of trust. ³⁴⁸ It was noted that even if the museum had breached its trust by the acts al-

343. *Id.* at 253, 193 A.2d at 542.

344. *Id.* at 256-57, 193 A.2d at 544.

345. *Id.* at 258, 193 A.2d at 545.

346. No. 66689, slip op. at 3337 (Cal. App. 1983).

347. "Deaccessioning" is an inelegant term of art in favor in the museum world meaning the disposition by sale or otherwise of objects in a collection. It is not found in Webster's Third International Dictionary, let alone the Oxford English Dictionary.

348. *Rowan*, No. 66689, slip op. at 3337.

leged, the individual directors would be immune from liability by virtue of a statute³⁴⁹ if their decision which caused the breach "was made in good faith and after reasonable and prudent inquiry."³⁵⁰

The complaint in *Graham Brothers Co. v. Galloway Woman's College*³⁵¹ asked recovery from a college and the individual members of its finance committee of a grant. The plaintiffs alleged that it had been conditioned on the college remaining a four-year institution and that the college had converted to a two-year program. A judgment against the college was affirmed, but the members of the finance committee were absolved of liability. The court reasoned

[i]f . . . a trustee has exercised the proper care and diligence, he is not responsible for mere error or mistake of judgment; but if he acted in good faith and with reasonable diligence and prudence, he is free from personal responsibility. . . .

The proof shows that the members of the finance committee were men of business ability and their honesty of purpose is not questioned. Instead of business conditions improving as it was hoped and believed, they grew worse, finally ending in the financial collapse of the college, with almost the same result throughout the state and nation. This evidence, under the rule we have stated, relieved the individual members of the finance committee of liability . . .³⁵²

Once again a predisposition of a court to absolve the pillars of the community appears, although the business judgment rule may provide proper support for the ruling.

Exceeding Authority or Powers

Complaints alleging that directors have exceeded their authority or powers, more often than those alleging violation of purpose, tend to seek relief against individual directors. For instance, the court in *Burnett v. Barnes*³⁵³ considered the request of members of a not-for-profit corporation for a determination against the corporation and the members of its board of directors ("trustees") that the board had exceeded its powers in amending the bylaws to eliminate all membership and provide that the board would be self-perpetuating. The articles of incorporation provided that the corporation should admit members, that the members should elect the board of directors and that the directors had power to make bylaws. Even if, as urged by

349. CAL. CORP. CODE § 5231 (Deering 1979).

350. *Jessie v. Boynton*, No. 66689, slip op. at 3337 (Cal. App. 1983).

351. 190 Ark. 692, 81 S.W.2d 837 (1935).

352. *Id.* at 698-99, 81 S.W.2d at 840.

353. 546 S.W.2d 744 (Mo. App. 1977).

the defendants, the members had little or no power to govern the corporation, the court declared the amendments to the bylaws to be void and of no effect, because they conflicted with the purpose of admitting members as stated in the articles.³⁵⁴

In *Jessie v. Boynton*,³⁵⁵ the court considered the dismissal of a complaint which challenged bylaw amendments which the plaintiffs claimed had been pushed through a members' meeting by officers and directors through fraud and in violation of their fiduciary duties. The plaintiffs alleged that they were "employee members" and "employee-family members" of a hospital corporation who had enjoyed the full privileges of membership before the amendments. The notice of the meeting at which the amendments were approved stated that the recipient could request a copy of the proposed bylaws. Many of the provisions of the bylaws furnished in response to requests differed substantially from the proposed bylaws distributed at the meeting; consequently, some members did not bother to attend the meeting and others did not take the bylaws offered them at the meeting, assuming that they were the same as those they had already received. Furthermore, the old bylaws provided that the right to vote accrued only after sixty days of membership, and no notice was sent to persons who would have been members for less than sixty days on the day of the meeting. The officers were evasive when questioned at the meeting about the contents of the amendments and did not mention that employees and their families would no longer be full members but would become a "separate class designated as hospital members . . . [who would] have the same rights as regular members, except that hospital members shall be ineligible to vote."³⁵⁶ When the plaintiffs later learned the true import of the amendments they demanded that they be declared null and void and, when this was not done, they sued asking that the new bylaws be declared null and void and for an injunction protecting their voting rights.

The plaintiffs objected only to the manner in which the amendments were adopted, acknowledging that, because a member of a charitable corporation has no ownership interest, he "is not deprived of any vested interest when he is deprived of his right to vote."³⁵⁷ The court held that the notice was not defective for failure to mention everything which would be voted on at the meeting, because this was not required by the law per-

354. *Id.* at 748.

355. 372 Mass. 293, 361 N.E.2d 1267 (1977).

356. *Id.* at 297, 361 N.E.2d at 1270.

357. *Id.* at 298, 361 N.E.2d at 1270.

taining to charitable corporations.³⁵⁸ Further, the court found that the notice was not worded in a manner that indicated that it mentioned everything to be considered, and that the employee and family members were not entitled to vote as a class although the business corporation law required a class vote of shareholders under similar circumstances.³⁵⁹

The court, however, held that "certain of the plaintiffs have alleged facts which . . . might justify relief in their favor" in connection with the activities of the officers at the meeting.³⁶⁰ The court cited cases involving for-profit corporations and noted that

the directors of a corporation have a fiduciary duty of fair dealing with its members or shareholders in situations where corporate action is being proposed which may affect one or more shareholders adversely . . . [citations omitted].

The allegations of the complaint are sufficient to put the defendants on notice that the plaintiffs are claiming that, in seeking to disenfranchise the employee members of the corporation, some or all of the officers and directors of the corporation failed to meet their fiduciary obligations to the plaintiffs. The claim rests in part on the assertion that the defendants did not disclose the proposal to create a class of nonvoting members, even when the question of significant changes was inquired about at the meeting.³⁶¹

The plaintiff submitted an amended complaint and the court found that its allegations showed "sufficient aspects of reliance and damage to meet the [statutory] requirement . . . that the circumstances constituting fraud be stated with particularity."³⁶² As to the argument of the defendants that "a member of a charitable corporation sustains no actionable damage in losing his right to vote," the court concluded that the "right to vote should not be taken away except in accordance with lawful procedures and practices."³⁶³

In *McDaniel v. Frisco Employes' Hospital Association*,³⁶⁴ the court held that the action of the trustees of a hospital corporation in amending the charter and attempting to dissolve the corporation, "without any showing of good cause and not made in good faith, was a breach of trust, wrongful, and highly improper."³⁶⁵ This decision appears to be based on corporate law. Setting aside the amendments and the dissolution, the court

358. *Id.* at 299, 361 N.E.2d at 1271.

359. *Id.* at 301-02, 361 N.E.2d at 1272.

360. *Id.* at 302-03, 361 N.E.2d at 1273.

361. *Id.* at 303-04, 361 N.E.2d at 1273.

362. *Id.* at 304, 361 N.E.2d at 1273-74.

363. *Id.* at 305, 361 N.E.2d at 1274.

364. 510 S.W.2d 752 (Mo. App. 1974), discussed *supra* in the text accompanying note 155 in connection with the standing to sue of beneficiaries of a corporation's services.

365. *Id.* at 759.

awarded the plaintiff members costs and attorney's fees to be paid by the corporation and its directors.³⁶⁶

In *Leeds v. Harrison*,³⁶⁷ the court denied a motion to dismiss the complaint of the member plaintiffs alleging breach of contract and violation of their rights. The court noted that "[t]he certificate of incorporation, constitution and bylaws of a corporation constitute a contract between the corporation and the members as well as between the members inter sese, and the trustees or directors bear a fiduciary relationship to the members which requires them to comply with said certificate and bylaws."³⁶⁸

Lopez v. Medford Community Center,³⁶⁹ involved allegations that the directors were managing a not-for-profit corporation in violation of bylaws which provided that anyone who contributed two dollars to the corporation was entitled to be enrolled as a member and to vote. The court overturned the appointment of a receiver by the lower court as unnecessarily drastic, but commented:

It is evident from the judge's order that . . . he sought . . . to return the corporation to a system of governance in accord with its bylaws. This objective is perfectly proper in light of the judge's finding, supported by abundant evidence, that since 1972 no members had been added to the corporation and that since 1970 there had been no annual meeting of the members nor any valid election of officers and directors. . . .

A more limited remedy should be fashioned to ensure compliance with the provisions of MCC's constitution and bylaws. . . . Such relief should deal specifically with the recruitment of new members by MCC and the scheduling of an annual meeting at which corporate officers may be elected.³⁷⁰

Disregard of the Corporation in Order to Reach Officers and Directors

The equitable remedy of piercing the corporate veil has been applied to reach those who control not-for-profit corporations as well as business corporations. Of course, in cases involving business corporations courts normally say that the remedy is available to reach shareholders although the parties reached are more often than not influential or controlling of-

366. *Id.*

367. 7 N.J. Super. 558, 72 A.2d 371 (1950), discussed *supra* in the text accompanying notes 141 & 147 in connection with the standing of a member to sue.

368. *Id.* at 570, 72 A.2d at 377.

369. 424 N.E.2d 229 (Mass. 1981), discussed *supra* in the text accompanying note 151 in connection with the standing of members to sue.

370. *Id.* at 234.

ficers and directors as well.³⁷¹ When dealing with not-for-profit corporations the courts may find that an officer or director is deriving economic benefits equivalent to those enjoyed by shareholders and that, in itself, may be cited as the reason for piercing the veil.

The plaintiffs in *Macaluso v. Jenkins*,³⁷² sued a not-for-profit corporation, its chairman of the board-treasurer, and its secretary, who was also a director. Prior to and after the formation of the not-for-profit corporation, the chairman operated a security guard service, and the secretary a cleaning service, out of the offices which became those of the not-for-profit corporation as well. The plaintiffs contracted to, and did, provide printed material to the not-for-profit corporation, but were not paid. Judgment was entered against the not-for-profit corporation and its chairman and the complaint against the secretary was dismissed.³⁷³ On appeal, the chairman did not contest the judgment against the corporation, but only his personal liability, and the plaintiffs appealed the dismissal of the complaint against the secretary.

The court found indications that the chairman exercised "ownership control" over the not-for-profit corporation, including a lack of evidence that the president, vice-presidents and six other directors took any part in management. The court also considered testimony by the chairman that he made most or all of the decisions concerning the corporation and that the defendant secretary made none; that the chairman alone negotiated the contract with the plaintiffs; that the chairman had the power to authorize borrowing by the corporation; that the chairman unilaterally started and then dissolved a Florida office; that it was intended that the not-for-profit corporation pay all the rent for the offices of the three corporations; and that, although the organization provided some services to its members, the chairman "created the organization with an eye towards the profitable fringe benefits which might befall him as chairman of the board and treasurer of the corporation."³⁷⁴

In establishing the rule under which it examined the conduct of the chairman, the court quoted from a case involving a business corporation:

For the doctrine of [*sic*] traditionally known as 'the piercing of the corporate veil' to apply two requirements must be met: first, there must be such unity of interest and ownership that the separate per-

371. See, e.g., *Zaist v. Olson*, 154 Conn. 563, 227 A.2d 552 (1967).

372. 95 Ill. App. 3d 461, 420 N.E.2d 251 (1981).

373. *Id.* at 464, 420 N.E.2d at 254.

374. *Id.* at 467, 420 N.E.2d at 256.

sonalities of the corporation and the individual no longer exist; and, second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.³⁷⁵

The court was of the opinion that the first requisite was met and stated that

a jury could have found that, even though [the chairman] did not and could not own shares of [the corporation], he did exercise ownership control over the corporation to such a degree that the separate personalities of [the corporation] and [the chairman] did not exist, and that [the corporation] was a business conduit of [the chairman].³⁷⁶

The court also found evidence of the second requisite for piercing the veil. While he was treasurer, the chairman kept no books or financial records. The corporate formalities were not followed; the chairman was solely responsible for receipts and disbursements. Funds of the not-for-profit corporation were commingled with those of the businesses of the chairman and the secretary's cleaning firm and it was planned that the not-for-profit corporation would pay the rent and phone bills for all the businesses. The chairman treated the assets of the not-for-profit corporation as his own, paying personal car repair and restaurant bills, obtaining cash, reimbursing himself for charitable donations and helping a friend financially from corporate funds. The court concluded that the jury was entitled to find that the chairman exercised control over the corporation to such an extent that it became his alter ego and thus that the verdict piercing the veil was not against the manifest weight of the evidence.³⁷⁷

On the other hand, the court found that the evidence indicated that the secretary was only a part-time voluntary clerical worker who had no responsibility for keeping financial records, and had little or no part in corporate decisions, and that no evidence indicated that she "exercised sufficient ownership and control to be the alter ego" of the corporation.³⁷⁸ The court stated that in the absence of exceptional circumstances corporate officers have no fiduciary duty to creditors of the corporation, that no assets of the plaintiffs had been converted and that there was no evidence of gross negligence on the part of the secretary. Therefore, the court held that she had breached no duty to the plaintiffs.³⁷⁹

375. *Id.* at 468, 420 N.E.2d at 255.

376. *Id.* at 469, 420 N.E.2d at 256.

377. *Id.* at 469, 420 N.E.2d at 257.

378. *Id.*

379. *Id.* at 468, 420 N.E.2d at 258.

Aside from the remarks about the absence of duty to capitalize a non-profit corporation, the entire *Macaluso* opinion is premised on general corporate law developed in connection with business corporations. The court did not find it necessary to mention that fact. It simply assumed that all corporations are governed by the same principles in the absence of differences in the statutes under which they were created.

In *Northwest Suburban Congregation Beth Judea, Inc. v. Rosen*,³⁸⁰ other justices of the same court made a similar assumption in piercing the corporate veil under much different circumstances. An incorporated religious congregation had been dissolved for failure to file an annual report with the secretary of state. The rabbi and some members of the corporation formed a new congregation with the same corporate name, Congregation Beth Judea, Inc. Shortly thereafter, the original corporation sought reinstatement and, because the new congregation had been incorporated under the old name, was reinstated as Northwest Suburban Congregation Beth Judea, using the name Congregation Beth Judea in newspaper listings and advertisements. The new corporation used that name in an advertisement and the other sued to enjoin its use. Finding that confusion was likely, the trial court issued a preliminary injunction against the new corporation and its directors.³⁸¹ On appeal, the individual defendants argued that they should "have been dismissed as they should not have been liable for acts of defendant corporation either as incorporators or as directors."³⁸² There was evidence that there had never been a meeting of the board of the new corporation or an election of officers. The court held that an injunction could be issued against the individual defendants, citing the *Macaluso* case and stating that "[a] 'corporate veil' may be pierced when the persons directing it do not comply with the corporate formalities."³⁸³

The equitable remedy of piercing the corporate veil is normally applied to shareholders of business corporations who are using the corporations in a manner which is misleading, and ultimately harmful, to the public or to creditors. In that sense, the *Macaluso* case does not depart significantly from the general rule; the court simply uses the "ownership control" concept to demonstrate that the chairman obtained benefits from his corporation similar to those enjoyed by shareholders of business corporations. Although it is not stated in the opinion, the indi-

380. 103 Ill. App. 3d 1137, 432 N.E.2d 335 (1982).

381. *Id.* at 1138, 432 N.E.2d at 337.

382. *Id.* at 1142, 432 N.E.2d at 340.

383. *Id.*

vidual defendants in the *Northwest Suburban* case obtained benefits from their membership in the corporation, albeit of a less tangible nature and therefore quite proper and within the law. Their position was more analogous to that of the corporate secretary in the *Macaluso* case; they violated no fiduciary duty to the plaintiff and thus the injunctive relief against them is an extension of the ordinary principles governing the piercing of the corporate veil. It would perhaps be more appropriate to say that no corporation existed, due to the failure to hold board meetings, so that the individual defendants were operating as individuals in promoting the congregation, than to say that grounds existed for piercing the veil.

Statutes Imposing Liability for Specified Conduct

In addition to breaches of fiduciary duty considered in the cases discussed in this part of the article are specific acts forbidden by statute. Directors and officers may incur civil liability, and sometimes criminal penalties, for (1) exceeding their authority;³⁸⁴ (2) participating in the making of loans to officers or directors;³⁸⁵ (3) distribution of assets contrary to law;³⁸⁶ (4) distribution of assets to noncreditors during dissolution without paying all known debts;³⁸⁷ (5) making distributions to members when the corporation is, or which cause the corporation to be, insolvent;³⁸⁸ (6) violation of duty in managing and disposing of corporate assets;³⁸⁹ (7) making false entries in books and records;³⁹⁰ (8) preparation, delivery, or publication of false documents;³⁹¹ (9) preparing or signing false documents filed with the

384. See, e.g., MODEL NON-PROFIT CORP. ACT § 6(b) (1980); D.C. CODE ANN. § 29-506 (1981); OR. REV. STAT. § 61.065 (1983); PA. STAT. ANN. tit. 15, § 7303 (Purdon 1967); TEX. CORPS. & ASS'NS CODE ANN. art. 1396-2.03(2) (Vernon 1980).

385. See, e.g., MODEL NON-PROFIT CORP. ACT. § 27; KY. REV. STAT. § 273.241 (1981); OHIO REV. CODE ANN. § 1702.55(B)(3) (page 1978); TENN. CODE ANN. § 48-814(3) (1979); WIS. STAT. § 181.29 (West 1957).

386. See, e.g., Cal. Corp Code § 9245(a)(1) (West Supp. 1984); CONN. GEN. STAT. § 33-455 (Supp. 1983); IDAHO CODE § 30-322(a) (1979); MICH. COMP. LAWS § 21.197(551)(1)(a) (Supp. 1983); OHIO REV. CODE ANN. § 1702.55(B)(1) (Page 1978).

387. See, e.g., CAL. CORP. CODE § 9245(2) (West Supp. 1984); MICH. COMP. LAWS § 21.197(551)(c) (1983); OHIO REV. CODE ANN. § 1702.55(B)(2) (Page 1978); TEX. CORPS. & ASS'NS CODE ANN. 1396-2.26 (Vernon 1980).

388. See, e.g., IND. CODE ANN. § 23-78-1.1-62(1) (Burns 1984); OKLA. STAT. tit. 18, § 433 (1982).

389. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW, § 720(a)(1) (McKinney 1970).

390. See, e.g., ARIZ. REV. STAT. ANN. § 10-1087 (1983); OHIO REV. CODE § 1702.54(A)(2) (Page 1978).

391. See, e.g., ARIZ. REV. STAT. ANN. § 10-1086 (1983); OHIO REV. CODE § 1702.54(A)(1) (Page 1978).

state,³⁹² and (10) failure to answer interrogatories propounded by state officials.³⁹³ A director who believes that board or committee action may violate the law should have his dissent entered in the minutes of the meeting or other corporate records to avoid a presumption that he acquiesced in the action.³⁹⁴

Many statutes specifically provide that directors and officers are not liable for the debts, obligations or liabilities of the corporation.³⁹⁵ If they "assume" to act as a corporation, however, before a corporation is formed or after it is dissolved, they will be jointly and severally liable for resulting debts and liabilities.³⁹⁶

CHARITABLE IMMUNITY AND INDIVIDUAL LIABILITY

Despite the fact that the doctrine of charitable immunity had only a brief existence in England,³⁹⁷ courts in this country adopted it over a hundred years ago³⁹⁸ and have alternately embraced it and discarded it ever since.³⁹⁹ Reasoning as to why charities should not be held liable for their torts has varied from

392. See, e.g., MODEL NON-PROFIT CORP. ACT, § 86 (1980); IOWA CODE ANN. § 504A.88 (West, 1982); ME. REV. STAT. ANN. tit. 13-A § 1304 (1981); MICH. COMP. LAWS § 21.197(932) (1983); UTAH CODE ANN. § 16.6-107 (1953).

393. See, e.g., MODEL NON-PROFIT CORP. ACT § 86 (1980); COLO. REV. STAT. § 7-24-112 (1973); MINN. STAT. ANN. § 317.29 (West 1969); N.C. GEN. STAT. § 55A-80(b) (1982); S.D. CODIFIED LAWS ANN. § 47-28-16 (1983).

394. See, e.g., DEL. CODE ANN. tit. § 174 (1983); LA. REV. STAT. ANN. § 12:226G (West 1969); MICH. COMP. LAWS § 21.197(553) (1983); OHIO REV. CODE § 1702.55(C) (Page 1978).

395. See, e.g., IOWA CODE ANN. § 504A.101 (West Supp. 1982); MO. ANN. STAT. § 355.107 (Vernon 1966); MONT. CODE ANN. § 35-2-411 (1983); *Pa. Cons. Law* § 7502 (1966).

396. See, e.g., MODEL NON-PROFIT CORP. ACT § 96 (1980); D.C. CODE ANN. § 29-599.2 (1981); GA. CODE ANN. § 22-2204 (Supp. 1981); IND. CODE ANN. § 23-7-1.1-64 (Burns 1984); MONT. CODE ANN. § 5-2-109 (1983).

397. The genesis of this doctrine is generally attributed to *Feoffees of Heriot's Hosp. v. Ross*, 8 Eng. Rep. 1508 (1846), which held that funds for maintaining a hospital were trust funds which could not be diverted to any other purpose than that to which they had been dedicated. This theory had been previously adopted in *Duncan v. Findlater*, 7 Eng. Rep. 934 (1839), but was rejected in *Mersey Docks Trustees v. Gibbs*, 11 H.L. Cas. 686 (1866) and never resurrected.

398. The doctrine was first adopted in 1876 in *McDonald v. Massachusetts Gen. Hosp.*, 120 Mass. 432, 21 Am. Rep. 529 (1876) citing *Holliday v. Parish of St. Leonard*, 142 Eng. Rep. 769 (1861). The doctrine was first applied in this country to hold charities immune from their negligence or from the negligence of their employees on the grounds that the courts should not deplete assets which had been devoted to the public benefit. By that time, *Holliday* had been expressly overruled in *Foreman v. Mayor of Canterbury*, 6 L.R.Q.B. 214 (1871).

399. For a discussion of the history of charitable immunity in this country and the "welter of conflict" surrounding it, see *Georgetown College v. Hughes*, 130 F.2d 810 (D.D.C. 1942).

jurisdiction to jurisdiction,⁴⁰⁰ but each rationale seems to reflect a public policy based on the greatest good for the greatest number.⁴⁰¹ The rule has been recognized in almost every jurisdiction at one time or another, either by case law or by statute, but controversy over the meaning of the rule and its proper application has flourished for the entire century. Some forty years ago, the maxim that equity will not suffer a wrong to be without a remedy was applied to cases involving charities,⁴⁰² and the doctrine began to fall from favor.⁴⁰³ Currently, only a handful of

400. There have been a number of theories advanced to support the doctrine of charitable immunity. One of the theories is the so-called trust fund theory that funds are held in trust for charitable purposes and are therefore immune from judgment. This theory was first enunciated in this country in *McDonald v. Massachusetts Gen. Hosp.*, 120 Mass. 432, (1876), and has been the basis of numerous other cases. *E.g.*, *Brown v. St. Luke's Hosp. Ass'n*, 85 Colo. 167, 274 P. 740 (1929); *Gamble v. Vanderbilt Univ.*, 138 Tenn. 616, 200 S.W. 510 (1918). A second theory is the implied waiver theory which holds that the beneficiary of a trust impliedly waives the trust's liability. This theory was used in such cases as *Powers v. Massachusetts Homeopathic Hosp.*, 10 F. 294 (1st Cir. 1901), *cert. denied*, 183 U.S. 695 (1902) and *Bruce v. YMCA*, 51 Nev. 372, 277 P. 798 (1929), though some decisions have held that if the beneficiary has paid for the benefits, the beneficiary can recover: *Nicholson v. Good Samaritan Hosp.*, 145 Fla. 360, 199 So. 344 (1940); *Henderson v. Twin Falls County*, 56 Idaho 124, 50 P.2d 597 (1935). Some cases hold a charitable institution completely immune as to strangers, that is, those who are neither beneficiaries nor employees. *See Saint Mary's Academy v. Solomon*, 77 Colo. 463, 238 P.22 (1925); *Vermillion v. Woman's College*, 140 S.C. 197, 88 S.E. 649 (1916); while others hold that only strangers can recover: *Cohen v. General Hosp. Soc'y of Conn.*, 113 Conn. 188, 154 A. 435 (1931); *Marbel v. Nicholas Sen Hosp. Ass'n*, 102 Neb. 343, 167 N.W. 208 (1918). There are holdings that if the charitable institution is protected by insurance, it is liable for its negligence, *McLeod v. St. Thomas Hosp.*, 170 Tenn. 423, 95 S.W.2d 917 (1936), while other decisions disagree: "[A] doctrine which limits the liability of charitable corporations to the amount of liability insurance that they see fit to carry permits them to determine whether or not they will be liable for their torts and the amount of that liability, if any." *Darling v. Charleston Memorial Hosp.*, 33 Ill.2d 326, 211 N.E.2d 253 at 260 (1965), *cert. denied*, 383 U.S. 946 (1966). *See also Enman v. Boston Univ.*, 170 Mass. 299, 170 N.E. 43 (1930); *Herndon v. Massey*, 217 N.C. 610, 8 S.E.2d 914 (1940).

401. *See, e.g.*, *Thomas v. Broadlands Community Consol. School Dist.*, 348 Ill. App. 567, 572, 109 N.E.2d 636, 640 (1952) in which the court said "it is the public policy to protect public funds and public property."

402. The rule of immunity is out of step with the general trend of legislative and judicial policy in distributing losses incurred by individuals through the operation of an enterprise among all who benefit by it rather than in leaving them wholly to be borne by those who sustain them. . . . It does not recompense injured persons that the loss is inflicted by charitable institutions, nor should they alone bear it. . .

President & Directors of Georgetown College v. Hughes, 130 F.2d 810, 827 (D.D.C. 1942).

403. The first limitation on the doctrine occurred in *Glavin v. Rhode Island Hosp.*, 12 R.I. 411, (1879) which subjected the general funds of the hospital to a judgment in tort. By 1966, Justice Frantz, dissenting in *Hemenway v. The Presbyterian Hosp. Ass'n of Colo.*, 161 Colo. 42, 47 419 P.2d 312, 314 (1966), states, "Charitable tort immunity has been completely rejected in

states recognize the doctrine; yet, of those states which have rejected it, some seem to have done so somewhat reluctantly.⁴⁰⁴

Despite the confusion surrounding the rule as to charitable organizations themselves, the rule does not protect officers, directors and employees of charities from liability for their own tortious conduct. The Supreme Judicial Court of Massachusetts held recently that "[w]e reject the contention that an officer of a charitable institution may not be held liable for the negligent performance of a discretionary function without evidence of bad faith."⁴⁰⁵ The court held that a corporate officer in charge of campus security did not enjoy the statutory limitation of liability which applied to his employer when he and it breached their duty to provide security for students.⁴⁰⁶

On the other hand, the governing boards of charitable institutions are said not to be liable for decisions made "in good faith." In deciding that the use of an incorporated museum's assets in contravention of corporate purposes would be a breach of trust, a California court said:

We note that such a breach of trust would expose a charitable corporation (acting as trustee), *qua* corporation, to liability. (Civ. Code §§ 2228, 2258.) However, if the decision which lead [*sic*] to the breach was made in good faith and after reasonable and prudent inquiry, the individual director . . . would be immune from liability. (§ 5231).⁴⁰⁷

We note that Corp. Code § 5230 relieves the individual directors of nonprofit public benefit corporations, which includes defendant corporation's directors (who are confusingly designated trustees), of the duty to comply with the traditional obligations of trustees, which are specified in Civil Code §§ 2228-2240 and 2258-2264, and imposes upon the individual directors the more lenient standards of conduct specified in Corp. Code §§ 5231, et seq. However the nonprofit public benefit corporation itself, as trustee of the trust property, remains responsible for fulfilling the purposes and conditions of the trust.⁴⁰⁸

While corporate directors and officers do not enjoy freedom from liability for their tortious acts performed in connection

twenty-three states, the District of Columbia, and Puerto Rico. . . . At least nineteen other states have recognized a qualified liability. . . ." *Hemenway*, 161 Col. at 48, 419 P.2d at 315.

404. For example, Illinois still holds trust funds, although not other assets of charities, immune, *Tidwell v. Smith*, 27 Ill. App. 2d 63, 169 N.E.2d 157 (1960), as does Colorado. *Michard v. Myron Stratton Home*, 144 Colo. 251, 355 P.2d 1078 (1960).

405. *Mullins v. Pine Manor College*, 389 Mass. 47, 53, 449 N.E.2d 331, 342 (1983).

406. *Id.*

407. *Rowan v. Pasadena Art Museum*, No. 66689, slip op. at 13 n.5 (Cal. App. 1983).

408. *Id.* at 15 n.7.

with their duties to their corporations, neither are they immune from liability for breaches of trust in the absence of statutory protection. The California statute reflects the business judgment rule which is universally applicable to corporate directors and the reasoning which engendered that rule. If directors are to be held liable for mere errors in judgment, it will be more difficult to find prudent persons who are willing to serve in that capacity, and those who do serve will hesitate to take bold and innovative action as directors.

INDEMNIFICATION, INSURANCE AND CONTRIBUTION

The Model Non-Profit Corporation Act empowers a corporation to indemnify directors and officers against expense reasonably incurred in connection with the defense of civil and criminal actions arising out of such status unless they are adjudged liable for negligence or misconduct in performing their duties to the corporation, "and to make any other indemnification that shall be authorized by the articles of incorporation or by-laws, or resolution adopted . . . by the members. . . ." ⁴⁰⁹ An alternative section grants courts the power to assess indemnity against the corporation for judgments, expenses and costs. ⁴¹⁰ Oddly, the Act does not provide that the corporation may purchase insurance to protect officers and directors in such circumstances, unlike the Model Business Corporation Act. ⁴¹¹ It is also odd that the Model Non-Profit Corporation Act makes no provision for indemnification of employees and agents; its business counterpart does. ⁴¹²

No statute explicitly governs the matter of contribution or indemnification of a not-for-profit corporation by officers and directors when it has incurred liability by reason of their actions or failure to act, although section 96 of the Model Non-Profit Corporation Act is susceptible to such an interpretation. ⁴¹³ In *McDaniel v. Frisco Employes' Hospital Association*, ⁴¹⁴ the court found the corporation and its directors liable for costs and attorney's fees, but did not discuss the directors' liability to the corporation.

409. MODEL NON-PROFIT CORP. ACT § 5(n) (rev. ed. 1964).

410. *Id.* at § 24A.

411. MODEL BUSINESS CORP. ACT § 5 (rev. ed. 1979).

412. *Id.* at § 5(i)(1).

413. "All persons who assume to act as a corporation without authority to do so shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof." *Id.* at § 96.

414. 510 S.W.2d 752 (Mo. App. 1974).

There are few cases involving claims, by corporations against their officers, directors or employees to recover damages and expenses incurred by the corporations as a consequence of wrongful conduct caused or carried out by such individuals. In *Wilshire Oil Company v. Riffe*,⁴¹⁵ a business corporation sought to recover such expense arising from antitrust violations. The court said:

This type of contest between corporation and employee is unusual because generally the wrongdoing employees also possess a control over the corporation that allows them to suppress any attempt to rectify the wrong done. (Citation omitted) Accordingly, the corporate loss is traditionally remedied in these situations through the employment of the device of a stockholder's derivative action. But the right asserted in such action belongs to the corporation, with the result that derivative suits involving these same issues are clearly analogous here. (Citation omitted)⁴¹⁶

In the case of a not-for-profit corporation, it would seem that suit is even less likely. Not only are those powerful enough to cause the corporation to violate the law also powerful enough to forestall attempts at recovery, but cases denying beneficiaries,⁴¹⁷ donors⁴¹⁸ and members⁴¹⁹ standing to sue limit the opportunity of those who do not control it to cause the corporation to enforce any rights it may have. Of course, the Attorney General ordinarily has standing to bring such actions, but limited staffs and conflicting responsibilities⁴²⁰ may cause such claims to go unprosecuted.

In *Wilshire* the corporation sued its former vice president, who had also been a director, and two former salesmen to recover criminal fines, civil damages, settlements, expenses, and attorney's fees alleged to have been incurred as a result of the defendant's breaches of fiduciary duty in causing the corporation to violate the federal antitrust laws. The court looked to the laws of Delaware, the state of the plaintiff's incorporation, to determine the defendants' liability. In response to the defendants' contention that relief should be denied because the claim was based on the illegal conduct of the plaintiff, the court stated:

Here the criminal liability of the corporation is purely vicarious. It results solely from the activity of the corporate employees. To allow those employees to assert that their own unlawful conduct operates to defeat the right of their corporation to recover for the

415. 409 F.2d 1277 (10th Cir. 1969).

416. *Id.* at 1285.

417. *Miller v. Alderhold*, 228 Ga. 65, 184 S.E.2d 172 (1971).

418. *Holden Hosp. Corp. v. Southern Illinois Hosp. Corp.*, 22 Ill. 2d 150, 174 N.E.2d 793 (1961).

419. *Lopez v. Medford Community Center, Inc.*, 384 Mass. 163, 424 N.E.2d 229 (1981).

420. *A. SCOTT supra* note 55, § 391, at 3005.

injury caused by the same conduct, is an exercise in circuitous reasoning.⁴²¹

The defendants argued that established public policy prevents the recovery of attorney's fees and related expenses as an element of damages. The court noted that this rule applies in cases where the successful party seeks fees and expenses from the loser, and in subsequent actions between the same parties, but commented:

Nevertheless, where a party was involved in previous litigation with others because of some wrongful act of the defendant, reasonable compensation for expenses attributable to the former suit is recoverable where such expenses are the natural consequences of the defendant's wrongful act. [footnote omitted] Clearly then there appears little reason to distinguish counsel fees from the other financial outlays suffered by Wilshire as a result of its involvement in antitrust litigation.⁴²²

If recovery from employees, officers and directors is permitted to a business corporation, where the recovery will ultimately benefit its shareholders, public policy would seem to dictate that a not-for-profit corporation should also be permitted to recover, as the benefits will accrue to the public or to beneficiaries who have not participated in the wrongdoing which depleted the assets of the corporation.

SUMMARY AND CONCLUSION

The reported cases in which relief has been sought against officers and directors of not-for-profit corporations for violation of their duties of care and loyalty are so few that any attempt to project trends would be statistically suspect. Nevertheless, it appears that in the decade from 1974 through 1983 there has been an increase in the number of such cases, and in cases in which officers and directors have been found to have violated their duties to not-for-profit corporations. Possible explanations for the increase are: the abolition or abridgment of the doctrine of charitable immunity in most jurisdictions in the preceding decade; the change in attitude toward charitable institutions which led to that action; an increase in litigiousness and search for wrongs where none were seen previously; a lessening of respect for pillars of the community accompanied by an increased interest in their deep pockets; dispersion of control in such institutions; growth in the assets devoted to not-for-profit causes and in the amounts at stake when such assets are misused; and increased concern with the public interest.

421. *Wilshire*, 409 F.2d at 1283.

422. *Id.* at 1285.

Whatever the causes may be, it is clear that not-for-profit corporations, and their officers and directors, have ample reason to review their policies and their practices. Directors and officers should be made aware of the responsibilities their positions entail. This will enable them to serve the corporations better and also protect themselves against liability.

It seems that courts will apply corporate standards to directors of not-for-profit corporations, drawing freely from cases involving business corporations. This use of traditional corporate cases may be due as much to the paucity of published opinions in the not-for-profit area as to the reasoning that the responsibility of directors to manage or supervise complex going concerns entitles them to some relaxation of the strict standards which apply to trustees, who are often called upon only to manage funds. Thus, a director of a not-for-profit corporation shares with his counterpart in business the obligation to perform his duties "in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances . . . [and] shall be entitled to rely on information, opinions, reports or statements . . . prepared or presented by" persons as to whom he has a reasonable basis for reliance.⁴²³ Of course, the determination of the degree of care a "prudent person" would exercise, and of what constitutes "similar circumstances," are in the eye of the beholder, and courts have a great deal of latitude in applying those criteria. While it is clear that gross negligence or wilful misconduct will result in liability, the degree of diligence that will exonerate a director is not nearly as evident. Nevertheless, courts continue to be lenient to directors. If a director attends most meetings of the board and of committees on which he sits, reads financial statements and other reports, questions them when obvious inconsistencies or other problems appear, and takes steps to investigate and rectify those problems which come to his attention, the business judgment rule will afford him protection.

As to transactions involving a conflict between the source of a director's livelihood and his duties to the corporation, the courts are also understanding. A director of a not-for-profit corporation, or a business organization by which he is employed or in which he has a financial interest, may receive fees, commissions, or other compensation from the not-for-profit corporation he serves, provided that he discloses his interest in the compensation, that he does not unduly influence, by vote or otherwise, the decision to deal with him or his organization, and that the

423. MODEL BUSINESS CORP. ACT § 35 (rev. ed. 1979).

transaction is fair to the not-for-profit corporation. A transaction will be considered fair to the corporation if the fees, commissions, or other compensation received by the director or his source of livelihood are proven to be at rates generally prevailing in the area at the time they are received.

Jurisdictions differ as to who may bring an action against the directors or officers of a not-for-profit corporation. It is likely, however that all jurisdictions would recognize the standing of the corporation itself, its directors, and the Attorney General to seek rectification of wrongs to the corporation, of those wronged or injured in their personal capacities to seek redress no matter what their relationship to the corporation may be, and of taxing authorities and other governmental agencies to sue for offenses against the public interest. Some jurisdictions will entertain actions by members, beneficiaries, and donors who can show that they have a special interest in the corporation. All authority indicates that a member of the general public may not sue a not-for-profit corporation or its officers and directors over matters of public concern.

The relief imposed upon faithless or negligent officers and directors has taken many forms. In self-dealing cases involving conveyance of property, it is customary to avoid the conveyance and to return the parties to the *status quo ante*. If it is found that an officer or director wrongfully received fees or commissions from the corporation, the court will order that they be returned, although the corporation retains the benefits of the services performed.

Where the wrongful taking of a corporate opportunity occurs, as in the purchase of property by the officer or director when he knows that the corporation desires to buy it, courts have ordered that the property be conveyed to the corporation at the defendant's cost. Although there are no reported cases in which a director or officer has purchased property and then resold it to a not-for-profit corporation at a profit, it would seem appropriate to apply the remedy which is available to business corporations, an order on the defendant to turn over his profits to the corporation.

In mismanagement and nonmanagement cases, directors have been found liable for interest on uninvested funds and required to reimburse the corporation for uncollected rents. By extension it would appear appropriate to hold directors liable for the difference between amounts they have caused the corporation to pay and the prevailing market prices. Where the negligence of an officer results in injury to a specific beneficiary of his corporation's services, he may be held liable in damages.

When directors are found to have violated the corporation's purposes, the relief normally is to set aside their actions and to enjoin future violations. Similar relief is granted when directors exceed their authority or violate the rights of members.

Further relief may be dictated by the seriousness of the breach of duty. Thus courts may remove directors or officers or order them to pay attorney's fees and costs when the primary relief benefits the corporation. If there is little hope that the corporation can continue to fulfill its purposes the court may order it dissolved.

If the plaintiff establishes that the corporation is a sham created or operated to permit its officers or directors to earn a profit while avoiding personal liability for services or goods, the court may pierce the corporate veil. Failure to follow corporate formalities may also provide grounds for relief against the directors personally.

Furthermore, when the corporation suffers expense as a result of the wrongful acts of its directors, officers, or employees, it may be incumbent upon the directors to seek indemnity from the wrongdoers, as failure to do so may be considered an independent wrong on their parts. On the other hand, while a corporation may indemnify directors and officers for expense incurred in defending actions growing out of their status with the corporation, the giving of indemnity is discretionary with the corporation, and is forbidden when the defendants are found to have violated their duty to the corporation. Directors and officers liability insurance is subject to similar restrictions.

With the more or less general acceptance of the fact that not-for-profit corporations are not much different than other corporations, the courts, like Dr. Johnson, are ready to call a person a good person upon easier terms than they were formerly. Nevertheless, there are more plaintiffs willing and able to test that tolerance, and we can expect to see a growing number of cases against officers and directors of not-for-profit corporations, seeking to apply theories of liability borrowed from the business world. The result may well be the disappearance of distinctions between business and not-for-profit corporations, and mixed blessings for the officers and directors of the latter. While they may enjoy the security of the business judgment rule and more liberal standards of care and loyalty, they may find themselves in court more often.

