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A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations

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"The days when you could agree to be a [nonprofit] director because it was an honor, then not show up for board meetings and never read the minutes, are over."[1]

INTRODUCTION

Nonprofit corporations ("nonprofits") proliferate in American life. Some examples include churches, soup kitchens, charities, political associations, business leagues, fraternities and sororities, sports leagues,[2] colleges and universities, hospitals, museums, television stations, symphonies, and public interest law firms. These nonprofits provide numerous services and opportunities that most people take for granted.

Like for-profit corporations ("for-profits"), nonprofits have boards of directors that manage the business and affairs of the corporation. But unlike for-profits, the board of many nonprofits consists of uncompensated volunteers. These volunteer directors are usually very busy people who hold other full-time jobs and simply do not have as much time to devote to their duties as most inside directors of for-profits. Nonetheless, the law usually subjects these volunteer directors to the same liability standards as for-profit directors.

This Note focuses on statutory standards of behavior to which directors of nonprofit corporations should be held. State courts and state legislatures hold a wide range of views on these standards. These views fall into three major categories. One view holds directors of nonprofits to trustee standards.[3] A second view holds directors of nonprofits to much more lenient standards[4] because of a concern that volunteers might not want to take directorships due to a fear of liability. Finally, the third view simply applies the same standards to nonprofit directors that apply to for-profit directors.[5]

Arguments in favor of holding nonprofit directors to higher standards than for-profit directors usually center around a concern for the public trust. This position argues that since most nonprofits generally are not monitored as closely as for-profits and the general

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1. Katharine Fraser, *Insurance Policies Protect Directors from Lawsuits*, BALT. BUS. J., Dec. 16, 1994, § 1, at 20 (quoting Bob Waldman, partner at a Baltimore law firm).

2. Local sports programs such as Little League are not the only nonprofit sports leagues. In addition, many professional leagues such as the National Football League and the Professional Golf Association Tour are nonprofit corporations.

3. *See, e.g.*, Samarkand of Santa Barbara, Inc. v. County of Santa Barbara, 31 Cal. Rptr. 151, 159 (Dist. Ct. App. 1963).

4. *See* Lizabeth A. Moody, *State Statutes Governing Directors of Charitable Corporations*, 18 U.S.F. L. REV. 749, 754 n.19 (1984).

5. *See, e.g.*, CAL. CORP. CODE § 204(a)(10) (West 1990); CONN. GEN. STAT. ANN. § 33-313(d) (West Supp. 1995); DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994) (eliminating or limiting personal liability of directors but specifying that "[a]ll references in this paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock"); IND. CODE § 23-1-35-1 (1993); 15 PA. CONS. STAT. ANN. § 5713 (1995); REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1991).

public often trusts directors of nonprofits with their charitable donations, higher standards are therefore necessary to control directors of nonprofits.[6] Supporters of this position point to past instances when directors of nonprofits abused their positions for personal financial gain. For example, in 1992, the United Way of America President, William Aramony, resigned in the wake of mounting allegations of self-dealing. He allegedly spent United Way funds lavishly and promised contracts to firms managed by relatives. Aramony was convicted in April, 1995, of twenty-five counts of conspiracy, mail and wire fraud, filing false income tax returns, and engaging in criminal property transactions. The convictions carried a seven-year prison sentence.[7] In another example, the president of the U.S. Olympic Committee resigned in 1991 after allegedly receiving $127,000 in consulting fees from clients pursuing Olympic contracts.[8]

Despite these two incidents and others like them, heightened standards for directors of nonprofits is not the answer. Many state legislatures have passed laws that hold directors of nonprofits to the same standards as directors of for-profits.[9] But such statutes do not necessarily support the argument for equal treatment of directors of for-profits and nonprofits.

This Note argues that states first should enact separate laws for nonprofit corporations, including separate and distinct standards for their directors. Several states have already done so,[10] but even these efforts are not enough. States need to go further, taking two particular things into account: the size of the nonprofit and the particular type of activity in which it partakes. The standards which states currently use work well for certain nonprofits—most notably large nonprofits—but many small nonprofits need separate laws that are better suited to the way they operate.

In particular, this Note emphasizes small, charitable nonprofits, which should be the beneficiaries of more lenient standards for director conduct.[11] Part I begins by providing some brief background information about nonprofits, explaining how they differ from for-profits. It then examines two important issues in detail: First, do nonprofits face a serious and disproportionate threat of suit, or has the risk been simply exaggerated because of a few isolated incidents? Second, what effect has the insurance industry had on nonprofits? Part II then examines four different statutory schemes for dealing with for-profit and nonprofit corporations, including the corporate laws of Delaware and Indiana, the Revised Model Business Corporation Act, and the Revised Model Nonprofit Corporation Act. Part III then proposes that most state legislatures need to do two things

6. *See, e.g.*, James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 676 (1985) (arguing that general corporate standards "ignore[] the special public purposes and public trust of the nonprofit corporation, the nature of the nonprofit board, and the inadequacy of internal control and enforcement").

7. Karen W. Arenson, *Ex-United Way Leader Gets 7 Years for Embezzlement*, N.Y. TIMES, June 23, 1995, at A14; Felicity Barringer, *United Way Head is Forced Out in a Furor Over His Lavish Style*, N.Y. TIMES, Feb. 28, 1992, at A1.

8. Mark Asher & Christine Brennan, *Helmick Quits as President of USOC*, WASH. POST, Sept. 19, 1991, at B1; Rachel Shuster & Mike Dodd, *Helmick Dealings Raise Questions*, USA TODAY, Sept. 5, 1991, at 1C.

9. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994).

10. *See, e.g.*, ALA. CODE §§ 10-3A-1 to 10-3A-225 (1994); IND. CODE §§ 23-17-1-1 to -30-4 (1993); MICH. COMP. LAWS ANN. §§ 450.2101-.3192 (West Supp. 1995); MINN. STAT. §§ 317A.001-317A.909 (Supp. 1995); N.J. REV. STAT. ANN. §§ 15A:1-1 to 15A:16-2 (West Supp. 1995); OHIO REV. CODE ANN. §§ 1702.01-1702.99 (Anderson Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1396-1.01 to 1396-11.01 (West Supp. 1996); WYO. STAT. §§ 17-19-101 to 17-19-1807 (Supp. 1995) (stating specifically that the Wyoming nonprofit law is based on the Revised Model Nonprofit Corporation Act).

11. This is not to imply that changes do not need to be made for other nonprofits. But it would be beyond the scope of this Note to describe and analyze adequately the many different categories of nonprofits and the particular standards to which each should be subjected.

in order to improve the way the law treats nonprofits: First, create a separate law for nonprofits; and second, distinguish between the different sizes of nonprofit corporations and enact lower standards for directors of small, charitable nonprofits.

I. BACKGROUND ON NONPROFITS

This Part seeks to explain that nonprofits, especially smaller charitable organizations, are very different from for-profits and therefore should be subject to separate laws. Part I.A provides statistics about nonprofits, explains their internal structure, and briefly explains the major legal differences between nonprofits and for-profits. Part I.B then attempts to dispel the myth that nonprofts are as susceptible to suit as for-profits, and explains the consequences of continued belief in this myth.

A. How Are They Different?

Like for-profits, nonprofit corporations range in size from those as large as Fortune 500 companies[12] to those as small as a soup kitchen run by a husband and wife. In the aggregate, nonprofits are a major part of the overall corporate picture. Over 1.2 million charitable organizations (a subset of nonprofit corporations) operate in this country, a number currently rising at a rate of about 29,000 per year.[13] In 1990, nonprofit organizations employed approximately 7.8 million Americans.[14] These nonprofits annually generate revenues exceeding $750 billion, approximately fifteen percent of the United States' gross national product.[15] In 1993, Americans strongly supported nonprofits to the tune of $126.5 billion.[16]

Some regional studies have shown that nonprofits play a significant economic role at the local level. For example, the Boston Office of Cultural Affairs and the National Assembly of Local Arts Organizations conducted a survey that measured the economic effect of Boston cultural organizations to be $740 million per year.[17] A study by the Maryland Association of Nonprofit Organizations found that 180,000 citizens of the State of Maryland work for Maryland nonprofits, and that these Maryland nonprofits spend over $6.1 billion annually.[18] Underscoring the strength of Maryland's nonprofit sector, the study concluded that "[e]mployment growth in the nonprofit sector has substantially outpaced growth in the for-profit and government sectors in recent years."[19]

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12. For example, the United Way of America raised $3.05 billion in 1993. *United Way Giving Increased in 1993: Americans Nationwide Contributed $3.05 Billion*, PR NEWSWIRE, Aug. 3, 1994, *available in* LEXIS, News Library, PRNEWS File.

13. *Id.*

14. Ronald A. Zumbrun, *National Service Is Not the American Way*, BUS. WIRE, Apr. 29, 1993, *available in* LEXIS, News Library, BWIRE File (citing U.S. Census Bureau statistics).

15. *See Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1581 (1992).

16. Larry Witham, *Could Charity Make up for Federal Welfare Cuts?*, WASH. TIMES, Dec. 25, 1994, at A1, *available in* LEXIS, News Library, WTIMES File. This 1993 figure increased from $124.3 billion in 1992, which was 2.1% of the gross domestic product. *See The 'Me' Generation Turns to Philanthropy*, SEATTLE TIMES, June 5, 1994, at B10.

17. Maureen Dezell, *Local Arts Outdraw Sports, Survey Finds*, BOSTON GLOBE, Nov. 28, 1994, at 29. In arriving at this figure, the two groups included both direct and indirect effects. Indirect effects, sometimes called "ripple" effects, include money spent on things like restaurants, hotels, and traveling expenses.

18. *Letters to the Editor*, BALTIMORE SUN, Nov. 17, 1994, at 18A, *available in* LEXIS, News Library, BALSUN File.

19. *Id.*

From a national perspective, nonprofits dominate particular industries. Charities that collect money to fund social programs are obvious examples. Industries such as the arts and symphonies are more nontraditional examples. For instance, in the arts industry, the National Assembly of Local Art Agencies calculated the total direct and indirect economic impact of nonprofits on the art industry. The study found that the industry supports 1.3 million full-time jobs.[20]

Examining the internal structure of nonprofits reveals that their boards of directors are similar to for-profits, but they differ in important ways. In particular, nonprofit boards tend to be larger in proportion to the size of the nonprofit corporation itself. Further, nonprofit directors are generally uncompensated and dominated by outsiders, while for-profit directors are generally compensated insiders. Thus, nonprofit boards tend to function via committees to a greater extent than for-profit boards.[21]

The most fundamental difference between nonprofits and for-profits is that for-profits can distribute funds to shareholders, whereas nonprofits cannot distribute funds to anybody.[22] Although the inability to distribute funds is a major constraint for nonprofits, nonprofits enjoy a number of benefits, such as numerous tax exemptions[23] and some statutory limited liability protection for volunteers.[24]

The federal tax exemption under § 501(c)(3) of the Internal Revenue Code is one of the strongest incentives for an entity to incorporate as a nonprofit corporation. Many lay persons call § 501(c)(3) the "legal name for nonprofits";[25] however, this is incorrect. Section 501(c)(3) simply grants tax-exempt status to an organization. It does not concomitantly incorporate that organization, as the power to grant corporate status is a matter of state law. The lay person's mistake is perfectly understandable, however, because a very large number of organizations that qualify for the § 501(c)(3) exemption are nonprofit corporations.[26]

Many have criticized the fact that such a large number of nonprofits receive the § 501(c)(3) federal tax exemption.[27] During a time of budget cuts, it is interesting to note

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20. Barbara Koostra & Patricia Abdou-Diefenderfer, *Artful Business: Economic Impact of Local Nonprofits*, MONT. BUS. Q., Summer 1994, at 2, 5.

21. *See* Lizabeth A. Moody, *Board Liability: Guide for Nonprofit Directors by Daniel L. Kurtz*, 43 BUS. LAW. 1605, 1606 (1988) (book review).

22. *E.g.*, ARK. CODE ANN. § 4-33-1301 (Michie Supp. 1995); N.M. STAT. ANN. § 53-8-28 (Michie Supp. 1995); 15 PA. CONS. STAT. § 5551 (1995); UTAH CODE ANN. § 16-6-42 (1995); VA. CODE ANN. § 13.1-814 (Michie 1993).

It should be noted that nonprofits do not have shareholders. Instead, many have "members," although this is not a requirement. The role of a member varies widely depending on the particular type of nonprofit.

23. For example, I.R.C. § 501(c)(3) (1994), exempts many nonprofit corporations from paying federal income tax.

24. *See, e.g.*, DEL. CODE ANN. tit. 10, § 8133 (Supp. 1994); D.C. CODE ANN. § 29-599.15 (Supp. 1995); FLA. STAT. ANN. § 768.1355 (West Supp. 1996); KAN. STAT. ANN. § 60-3601 (Supp. 1994); ME. REV. STAT. ANN. tit. 14, § 158-A (West Supp. 1995); N.H. REV. STAT. ANN. § 188-F:32-c (Supp. 1995); N.D. CENT. CODE § 32-03-45 (Supp. 1995); OHIO REV. CODE ANN. § 2305.38 (Anderson 1995); OR. REV. STAT. § 30.480 (Supp. 1994); S.D. CODIFIED LAWS ANN. § 47-23-29 (Supp. 1994); UTAH CODE ANN. § 78-19-2 (1992); WYO. STAT. § 1-1-125 (Supp. 1995).

Despite these statutes, many people are afraid to volunteer because the protection is limited. Statutes vary greatly, so a volunteer who wants to know about possible liability must check the local statute.

25. *See, e.g.*, Ian Olgeirson & Shannon Quinn, *How Colo.'s Charities Rate: Survey of 50 Nonprofits Offers Peek at Spending*, DENV. BUS. J., Dec. 2, 1994, at 1A, 37A (specifically referring to § 501(c)(3) as the "legal name for nonprofits").

26. In fact, the number of organizations granted the § 501(c)(3) exemption is increasing rapidly. From 1980 to 1990, the number of organizations qualifying for the exemption jumped from 320,000 to 500,000, a rise of 56%. Sandy Graham, *Corporate Largess*, COLO. BUS., Dec. 1994, at 17.

27. A number of organizations, writers, authors, and others have complained that too many organizations are granted the § 501(c)(3) exemption. The most common complaint is that § 501(c)(3) is used by some organizations to gain an unfair advantage against a competitor who offers the same product or service, but is hampered by having to pay income tax. *See, e.g.*, *Hearing on Unfair Competition from the Federal Government and Its Effect on Small Business, Before the Subcomm. on Procurement, Taxation, and Tourism of the House Comm. on Small Business*, 103d Cong., 2d Sess. 48-49 (1994)

that tax exemptions for nonprofits cost federal, state, and local governments an estimated $36.5 billion annually, a figure that does not include lost tax revenue from churches and religious groups.[28] The large number and diversity of nonprofits receiving this exemption demonstrates that nonprofits cannot all be treated under one set of laws. Instead, size and other characteristics should be taken into account in deciding how to regulate nonprofits. In particular, as this Note advocates, laws governing nonprofits should efficiently regulate behavior of their directors.

B. Do People Really Sue Nonprofits?

In calling for more lenient liability standards for directors of small, charitable nonprofits, one might assume that the main reason for doing so is simply to reduce the number of lawsuits filed against nonprofits. But, as this subsection explains, actual lawsuits are not the major problem. A few recent, highly publicized suits against nonprofits created the impression that nonprofits are widely sued. However, a look at available data shows people do not sue nonprofits as frequently as for-profits. Despite the data, many people refuse to serve as directors of nonprofits because they incorrectly perceive that doing so will subject them to a lawsuit for even a minor error in judgment. Therefore, it is important for nonprofits and others to spread the message that this perceived threat of nonprofit director liability is unfounded. Doing so will hopefully convince more bright minds to serve as nonprofit directors. Moreover, if this perceived myth is successfully overcome, liability insurance rates for nonprofits might stop skyrocketing, allowing directors even more protection when their nonprofit actually faces a lawsuit. However, overcoming this myth will be very difficult, which is another strong argument in favor of implementing the more lenient director liability standards for small, charitable nonprofits.

1. The Media Blitz

As stated above, a few recent suits against charitable nonprofits received substantial media attention, leading many to believe that nonprofits are just as susceptible to suit as for-profits. For example, a 1989 sexual molestation case against the Boy Scouts of America sought thirty million dollars. The national organization successfully defended itself against the claim that sought mainly punitive damages, but the judge ordered the local chapter to pay $45,000 in compensatory damages, a penalty that the Boy Scouts hailed as a victory.[29] Other examples include: a five-million-dollar fine imposed on

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(statement of Doc Milner, President, National Tour Association) (arguing on behalf of the National Tour Association that nonprofit, tax-exempt travel companies enjoy unfair competitive advantages because they do not pay taxes like the for-profit travel companies despite offering the same services); John D. Colombo, *Why is Harvard Tax-Exempt? (and Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 842 (1993) (arguing that private educational institutions should not be tax-exempt because they are in the market of "selling" education, just like private corporations sell their products); Jay Wolfson & Scott L. Hopes, *What Makes Tax-Exempt Hospitals Special? Differences Between Not-for-Profit and For-Profit Healthcare Providers*, HEALTHCARE FIN. MGMT., July 1994, at 56 (arguing that there is no substantive difference between nonprofit and for-profit healthcare providers).

28. Gilbert M. Gaul & Neill A. Borowski, *Nonprofits: America's Growth Industry*, PHILA. INQUIRER, Apr. 18, 1993, at A1.

29. Kristen A. Goss, *Boy Scouts of America Win Victory in Sex Abuse Case; Jury Fails to Find Negligence by National Organization*, CHRON. PHILANTHROPY, Jan. 24, 1989, at 15; Thomas Heath, *$45,000 Award to Molested Va. Youth Hailed as Victory by Scouts*, WASH. POST, Jan. 12, 1989, at D1.

Goodwill after an employee committed murder after being paroled in 1987;[30] another sexual molestation case in Illinois in which the claimant sought $3.5 million from a Catholic priest and his diocese;[31] and the YMCA being held liable for an accident in one of its pools.[32]

As these and other stories grabbed national headlines, people began to believe that plaintiffs frequently won suits against charitable organizations.[33] People also began to feel sympathy for nonprofits that were facing these lawsuits.[34] The perception created by this media coverage that lawsuits against charitable nonprofits are widespread will be discussed extensively below, but first some data will try to put the misperception in context.

2. The Data

Media accounts often confuse people on a variety of issues. In the context of lawsuits against charitable nonprofits, however, the problem is exacerbated by the absence of complete, accurate, and publicly available data to challenge the belief that these suits are so widespread.[35] The data that is available paints a somewhat confusing picture, but one that at least seems to show that suits against nonprofits are not nearly as widespread as they are against for-profits.[36] This, of course, does not mean that the number of suits against nonprofits is not too high, or that such suits are not a problem. It only means that they occur less frequently than suits against for-profits.

One regional study surveyed all insurance claims filed in Texas during four months of 1983. It found 10 claims filed against nonprofits, resulting in payments of $4,646,885.[37] Another general survey questioned 153 executives of large, national nonprofits. It found only three lawsuits had been filed against directors or executives of these nonprofits that directly implicated director or executive actions. Two of the three resulted in settlements, and the nonprofit won the third suit at trial.[38]

Two other analyses provide very close comparisons between the nonprofit and for-profit sectors. The first analysis tracked between 150 and 200 nonprofit foundations insured by Huntington T. Block insurance brokerage from 1983 to 1987, years when insurance premiums were soaring.[39] During that time, only two claims were filed against any of the foundations, with both claims resulting in successful defenses.[40] In contrast, a separate study by the Wyatt Company surveyed 1708 for-profits about their director and

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30. Gary Taylor, *Goodwill Must Pay $5 M in Murder by Parolee-Employee*, NAT'L L.J., June 8, 1987, at 22.

31. Tim Poor, *Man Sues Priest, Alleges Sexual Abuse in 1981*, ST. LOUIS POST DISPATCH, Aug. 20, 1993, at 1B.

32. David Rohn, *YMCA, Pool Victim Settle*, WASH. POST, May 17, 1978, at A4.

33. Charles R. Tremper, *Compensation for Harm from Charitable Activity*, 76 CORNELL L. REV. 401, 402 (1991).

34. *Id.* at 412-13.

35. *Id.*

36. Conditional language is necessary here for two reasons. First, it is impossible to define what one means by "widespread." For example, one who feels that almost all suits against nonprofits should be dismissed might believe that just a few suits constitute "widespread." Second, as will be seen throughout the rest of this section and this Note, there are major differences between nonprofits and for-profits such that comparisons are very difficult to make. As this Note concentrates in part on charitable organizations, one must keep in mind that many charitable organizations are very small, paling in comparison to the average for-profit.

37. TEX. LIABILITY INS. CLOSED CLAIM SURV. (Feb. 1987).

38. PEAT, MARWICK, MITCHELL & CO., DIRECTORS' AND OFFICERS' LIABILITY: A CRISIS IN THE MAKING: A STUDY OF NATIONAL NOT-FOR-PROFIT VOLUNTARY ORGANIZATIONS 6 (1987).

39. For a discussion of these soaring premiums and their implications, see *infra* part I.B.4.

40. *Who Needs D&O Insurance?*, FOUND. NEWS, July/Aug. 1988, at 52, 53.

officer liability for the years 1982-1986, finding that 759 of those companies had been sued within those years.[41]

For several reasons, however, one should not place much faith in the foregoing studies. In addition to numerous methodological deficiencies in these studies, they simply asked nonprofits for the information. Problems such as nonresponse rates and inadequate records immediately come to mind. Examining insurance records directly rather than asking the nonprofits to search their own memories and records for information could probably eliminate these concerns. However, insurance companies refuse access to such information to help maintain a competitive advantage.[42]

One organization does possess the wide variety of information and statistics about the insurance industry needed to make some general conclusions. The Insurance Services Office ("ISO") collects and analyzes general liability claims on behalf of the insurance industry.[43] Since the ISO works on behalf of the insurance industry, only general data is reported, so no insurance companies get a free ride from their competitors. However, insurance companies do not differentiate between for-profits and nonprofits when they report to the ISO. Thus, the ISO also fails to provide useful statistics.

Notwithstanding these studies' numerous statistical flaws, their results imply that directors of nonprofits are exaggerating the risk of suit. But several possible explanations for the statistics exist.

First, one must think about the differences between nonprofits and for-profits. This Note argues for more lenient liability standards for directors of small, charitable nonprofits, mainly because of the big differences between them and for-profits. For example, many nonprofits, especially the smaller charitable organizations, survive almost exclusively on donations of time and money. Thus, they do not have cash reserves or extensive assets. So, when people contemplate suing the nonprofit and its directors, they may conclude that such a suit would be a waste of time and money because they would be unable to recover much; in other words, many charities are judgment-proof.[44]

Second, public sentiment seems to consider it improper to sue nonprofits.[45] Many people realize that charitable organizations are very valuable to society, offering many services that are irreplaceable. Therefore, people frown on others who attempt to sue a nonprofit, especially people who bring frivolous suits or suits asking for outrageous amounts of money relative to the harm involved.[46] This is not to say that people should not and do not sue charities when the charities act egregiously, but many people at least think twice before suing a charity because of the strong public appreciation of the work that charities do.[47]

41. *See* Mark A. Hofmann, *D&O Costs Up, Claims Frequency Increasing: Study*, BUS. INS., Dec. 19, 1988, at 1, 64-65.

42. Tremper, *supra* note 33, at 413. The words "competitive advantage" should be emphasized. Insurance companies might not object if all insurance companies revealed this information, but the likelihood of this happening is virtually nonexistent. Thus, it is important to understand that insurance companies are not hiding the information so that the public cannot know the truth about suits against nonprofits. Instead, they simply realize that they would in essence be handing over to competitors information that they spent large sums of money collecting and organizing, ultimately allowing their competitors to offer cheaper premiums.

43. *See* Fannie Weinstein, *The New ISO-metrics*, INS. REV., July 1990, at 26.

44. Tremper, *supra* note 33, at 415.

45. *Id.* (discussing the "propriety of suing" nonprofits).

46. For some examples of what most people would probably consider outrageous lawsuits, see *supra* part I.B.1.

47. For support of this argument, see Daniel W. Fessler, *Codification and the Nonprofit Corporation: The Philosophical Choices, Pragmatic Problems, and Drafting Difficulties Encountered in the Formulation of a New Alaska Code*, 33 MERCER L. REV. 543 (1982); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980). *But see* Steven E. Permut, *Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann*, 90 YALE L.J. 1623

3. Threat of Suit

Despite the statistical misgivings, the data indicates that directors of nonprofits, and nonprofits in general, do not face lawsuits nearly as often as directors of for-profits. If one looked at the raw data and nothing else, it would be easy to conclude that nonprofits do not deserve any special legal protection. One must go further, however, and analyze the data to see if there is more than just the numbers.[48]

When the data is analyzed, the most important discovery is that nonprofits live with the fear of being sued. As one commentator put it: "Irrespective of the statistical likelihood of a volunteer actually being sued, *the perception of the threat* remains and may be more important than the reality."[49] Such a perception of threat follows from the discussion about the media blitz,[50] which leaves people with the impression that nonprofits are sued on a regular basis. The perception could potentially deter all volunteers, not just directors, but it certainly is valid for directors as many bright people refuse to serve because of the fear of liability.

Another commentator argues that the number of suits against officers and directors is artificially low and also raises another reason for such a belief:

> While experienced commentators note that the danger of liability to well-intentioned, ordinarily diligent directors and officers of nonprofit entities is probably fairly low, it must also be said that a desire both to protect the good name of the nonprofit organization and to avoid personal notoriety has probably encouraged the settlement of most such actions and contributed to the sketchiness and uncertainty of the law in this area.[51]

Thus, in addition to selfish concerns, many directors and officers undoubtedly settle suits to preserve the nonprofit's reputation.

The supply of volunteers is very sensitive to a number of variables.[52] People who choose to be volunteer directors often suffer a number of other demands on their time. In considering an opportunity to be a volunteer director, they look at things like personal satisfaction, the opportunity costs of time spent fulfilling director obligations, and the financial impact of serving. In general, people are risk averse and do not like to do things that will jeopardize their financial security.[53] Consequently, those people who see the risk to their financial security as more than nominal will bypass the opportunity to serve as a volunteer director.[54]

(1981).

48. *See also supra* notes 43-47 and accompanying text.

49. Joseph H. King, Jr., *Exculpatory Agreements for Volunteers in Youth Activities—The Alternative to "Nerf®" Tiddlywinks*, 53 OHIO ST. L.J. 683, 734 (1992) (emphasis added).

50. *See supra* part I.B.1.

51. 1 JOHN F. OLSON & JOSIAH O. HATCH III, DIRECTOR & OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 11.01, at 11-5 (Supp. 1994) (citation omitted).

52. Economists use the term "elasticity" to describe this "sensitivity" to different variables.

53. *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 27, 57 (1983).

54. King, *supra* note 49, at 734; *see also* PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 164 (1988). Huber notes that "the bold innovators are the most fleet-footed of potential defendants." *Id.* at 155. In other words, the brightest minds are the quickest to make the calculation that the risk of serving is too great for their personal taste, so they should not serve as a general volunteer or a volunteer director. This is a huge loss to society, especially when such individuals decide not to volunteer. Society is deprived of the wonderful ideas that these people might have implemented had they served.

The disincentive to serve makes it particularly important to consider the threat of lawsuits in the nonprofit sector. Since it appears that people overestimate the actual incidence of lawsuits, they need to be made aware of the true statistics. If people realize that the risk is not as high as they think, then maybe more people will serve. Of course, changing the perception is much more easily said than done; but, if more lenient standards for small, charitable organizations became law, they would be much more likely to receive publicity than a law review article or a speech by a businessperson or insurance agent telling people that the risk is not as high as they perceive.

People often believe that even if volunteer directors are sued, they generally can successfully defend themselves and thus not be liable for paying any money. They point not only to society's disdain for people frivolously suing charities, but also to several cases where volunteers escaped liability.[55] However, this belief ignores the fact that every time a suit or claim is filed or even threatened, these volunteers usually must consult with an attorney. Attorney fees can add up quickly, even to defend frivolous lawsuits. Further, once the lawsuit becomes complicated, attorney fees can easily financially ruin someone who is in no way indemnified by the nonprofit.

4. The Effect of Liability Insurance

Since many directors fear that they and others within the organization might be sued, they have taken steps to protect themselves. Those nonprofits that can afford it[56] generally purchase some type of liability insurance, which strains the budgets of many nonprofits. Insurance is not cheap, and it is hard to predict what type of coverage a nonprofit can receive. In the mid-1980's, insurance premiums skyrocketed and coverage diminished.[57] For example, the Boy Scouts saw their insurance premiums increase from $2 million to $10 million in 1986.[58] Further, annual insurance premiums covering little league programs shot up more than tenfold between 1984 and 1989, going from $75 to $795 per program.[59] Several surveys found that the average nonprofit saw its director and officer insurance rates more than double.[60]

Commentators disagree as to whether premiums have gone back down and whether availability has increased after the problems of the 1980's. While some seem to imply that premiums are now more affordable and coverage is now easier to find,[61] others seem to be more skeptical. For example, some say that many director and officer insurers completely withdrew from the market in the 1980's, while others dramatically altered their policies to decrease available coverage, increase premiums, and increase deductibles.[62] Further, no mention is made of other insurers completely replacing those

55. *See, e.g.*, Big Brother/Big Sister of Metro Atlanta, Inc. v. Terrell, 359 S.E.2d 241 (Ga. Ct. App. 1987).

56. It cannot be emphasized enough that many nonprofit corporations are very small and operate from donations and volunteer time. Thus, some could not afford to operate if they were forced to purchase liability insurance.

57. Tremper, *supra* note 33, at 402.

58. Letter to the Editor by James K. Coyne, President of American Tort Reform Association, WASH. POST, Aug. 11, 1986, at A14.

59. David O. Weber, *A Thousand Points of Fright?*, INS. REV., Feb. 1991, at 40.

60. *See, e.g.*, THE FOUNDATION OF THE AMERICAN SOC'Y OF ASS'N EXECUTIVES, THE LIABILITY CRISIS AND THE USE OF VOLUNTEERS BY NON-PROFIT ASSOCIATIONS 8 (1988) (reporting an average increase of 155% between 1984 and 1987); PEAT, MARWICK, MITCHELL & CO., *supra* note 38, at 5 (reporting that at least 25% of nonprofits that responded to its survey had seen increases of at least 300%).

61. *See, e.g.*, Tremper, *supra* note 33, at 421.

62. 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.19, at 4-358 to 4-359 (2d ed. Supp. 1996) (citations omitted).

that left the market, nor is there any mention of an improved 1990's market.[63] Even assuming a partial recovery in the insurance picture in the 1990's, the cyclical nature of the market makes it very difficult for nonprofits to plan their expenditures.[64] For small, charitable nonprofits, it is not a matter of making lower profits in years where insurance premiums are dramatically or unexpectedly increased; it is generally a matter of either receiving more donations or cutting services if they expect to maintain the same level of insurance coverage. Another option that for-profits have that nonprofits generally do not is passing these higher premium costs on to their customers.

Despite their legal status, most nonprofits pay very high insurance rates when one accounts for the number of claims and the magnitude of those claims filed against nonprofits. Numerous studies support this claim, despite the limitations of those studies. In fact, the studies, which have generally concentrated on charitable organizations, suggest that "charitable organizations suffer below average losses for the coverages examined."[65] In other words, nonprofits do not receive the same bang for their insurance buck that for-profits receive.

There are a couple of reasons why nonprofits—especially small, charitable organizations—do not get their money's worth when they pay insurance premiums. First, premiums are partly based on worst case scenarios,[66] and in theory the potential damage by directors of nonprofits equals the potential damage by directors of for-profits. Second, the uncertainty associated with nonprofits' activities hurts them when it comes to calculating insurance premiums. The cost of insurance increases as the uncertainty increases because the insurance company essentially takes on a riskier investment.[67] Third, charitable organizations are particularly disadvantaged because they make up only one percent of the liability insurance market. Thus, insurance companies probably do not spend a large amount of time researching and doing actuarial work to calculate the appropriate premium levels for charitable policyholders.[68] Larger nonprofits do not face these same types of problems, as they are more like for-profits.

While it may seem perfectly clear that nonprofits who can afford it need to take out some type of liability coverage to protect at least their directors, unfortunately many directors have not received the message. Many directors do not buy insurance coverage to protect themselves because they wrongly believe that they are immune from liability.[69] This is a dangerous belief, making it that much more important both to educate directors of nonprofits about their potential liability and to provide directors who believe they are

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63. *See id.*; *see also* Daniel L. Kurtz, *Protecting Your Volunteer: The Efficacy of Volunteer Protection Statutes and Other Liability Limiting Devices*, *in* NOT-FOR-PROFIT ORGANIZATIONS: THE CHALLENGE OF GOVERNANCE IN AN ERA OF RETRENCHMENT 265, 268 (ALI-ABA Course of Study 1992) [hereinafter NOT-FOR-PROFIT ORGANIZATIONS] (stating that the 1980's featured sharply increased director and officer insurance rates and curtailed coverage but not mentioning a reversed trend in the late 1980's or early 1990's).

64. Tremper, *supra* note 33, at 421.

65. *Id.* at 414. Tremper made this conclusion based on several studies, including those cited *supra* note 60.

66. *See* ROBERT I. MEHR, FUNDAMENTALS OF INSURANCE 579-83 (2d ed. 1986).

67. *Id.* at 27.

68. *See* Charles R. Tremper, *Does Your Organization Scare Insurance Companies?*, NON-PROFIT TIMES, June 1989, at 27.

69. Fraser, *supra* note 1, at 20. For a thorough discussion of the current state of the law of director liability, see *infra* part II. Many people wrongly believe that since a corporation enjoys limited liability, there is no way to sue the directors personally. But as Part II explains, most jurisdictions generally hold all directors (of both for-profits and nonprofits) to a gross negligence standard of liability.

immune—most of whom are directors of small, charitable nonprofits—with more lenient director liability standards.[70]

Boards of directors that decide to purchase some type of insurance need to be very careful. Although many nonprofits buy insurance for their directors or officers, insurance companies sell policies developed with for-profits in mind.[71] Thus, directors of nonprofits need to study any potential policies to make sure that they meet the needs of the corporation, as these policies often exclude numerous items from coverage. One important exclusion found in many policies is legal defense costs.[72] As most small, charitable organizations are usually conservative with their money, they need to shop around to try to find a policy that would cover at least part of their legal defense bills should they get hit with a lawsuit.

II. CORPORATE STATUTORY SCHEMES

This Part examines and analyzes the statutory schemes that govern the behavior of directors in Delaware, Indiana, and in states that adopt the Model Acts. Although each jurisdiction uses a slightly different approach, there are two important common themes. First, a corporation's limited liability does not shield directors from liability for their actions. Second, although Indiana and the Model Acts have an entirely separate set of statutes for their nonprofits, in both cases directors of for-profits and nonprofits are subject to the same culpability standard for determining director liability. This second point deserves additional emphasis: in neither case are any directors of nonprofits subject to lower standards than for-profit directors—all directors face the same standards.

A. Delaware Statutes on Director Liability

When looking at Delaware's corporate code, one immediately notices that Delaware differs from Indiana and the Model Acts in that Delaware does not have separate statutes governing nonprofits. Delaware does, however, have a few statutory provisions that grant immunity to directors of nonprofits and that treat nonprofits differently, in at least a few respects.

In addition to not having separate statutes that govern nonprofits, Delaware differs from Indiana and the Model Acts in that its director liability statutes are not as clearly codified. In fact, Delaware takes an entirely different approach. Director conduct used to be based almost exclusively on case law. The few relevant statutory provisions simply helped to guide directors. But in 1986, mainly in response to the business community's fears about increasing director liability,[73] Delaware promulgated section 102(b)(7) of Title 8,[74] a provision that allows a Delaware corporation to insert a provision into its

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70. Tracy Brunoli & Joanne Gundersen, *Non-profits Can Protect Themselves; Directors and Officer Liability Insurance*, FUND RAISING MGMT., May 1994, at 16 (arguing that director and officer liability insurance is very important because laws are not adequate to protect nonprofits). The law's inadequacy to protect directors of nonprofits and proposals to change it are discussed extensively *infra* part III.

71. 1 OLSON & HATCH, *supra* note 51, § 11.03[2], at 11-20.

72. *Id.* § 11.03[2], at 11-20 to 11-21.

73. *See, e.g., Business Bulletin—Corporate Directors Become Harder to Recruit*, WALL ST. J., Apr. 18, 1985, at 1; *Directors Consider Resigning in Liability Crisis*, A.B.A. BANKING J., Feb. 1987, at 108.

74. DEL. CODE ANN. tit. 8, § 102(b)(7).

certificate of incorporation that eliminates or limits the personal liability of the corporation's directors.

1. The Law Without Section 102(b)(7)

Section 102(b)(7) will be examined in detail, but first, a clear understanding of director liability without such a provision is necessary. Absent section 102(b)(7), Delaware directors typically rely on the business judgment rule as a shield against liability. *Aronson v. Lewis*[75] is probably the most widely quoted Delaware Supreme Court pronouncement of the business judgment rule. *Aronson* holds that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[76]

To put it differently, *Aronson* and other cases interpreting the business judgment rule in Delaware entitle directors to protection from the business judgment rule if they meet their two duties to the corporation—the duty of loyalty and the duty of care.[77] Each of the two duties is necessarily treated and analyzed independently of the other, because a violation of either duty means that a director loses protection from the business judgment rule.[78] Since the duties are treated independently, the distinction between the two is very important. Unfortunately, someone trying to define precisely either duty is often stymied, because Delaware is one of the states that has not codified the duty of care and the duty of loyalty.[79]

Turning then to a careful examination of both duties under Delaware case law, this Note first explains that the Delaware courts basically have said that protection under the business judgment rule is predicated upon a director not violating either duty. In *Unocal Corp. v. Mesa Petroleum Co.*,[80] the court summarized dozens of Delaware cases by stating that there are *generally* three preconditions that must be satisfied before a director can claim protection under the business judgment rule:[81] (1) absence of personal interest or

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75. 473 A.2d 805 (Del. 1984).

76. *Id.* at 812 (citations omitted).

77. *See, e.g.*, Cede v. Technicolor, Inc., 634 A.2d 345 (Del. 1993). For a more in-depth textual account of the business judgment rule and these two duties, see 1 ERNEST L. FOLK III ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2 (3d ed. Supp. 1994); 1 OLSON & HATCH, *supra* note 51, § 1.03, at 1-10 to 1-12.

78. *Cede*, 634 A.2d at 367.

79. OLSON & HATCH, *supra* note 51, § 1.06[5], at 1-35 (citing other states that also have refused statutory definition of the two director duties). Despite not codifying these duties, Delaware has promulgated some statutory language that tells directors on what types of things they may rely when making a corporate decision. *See* DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1994).

80. 493 A.2d 946 (Del. 1985).

81. I use the word "generally" because *Unocal* actually identified four preconditions. However, the fourth element, the "element of balance," which requires directors to implement defensive measures that are "reasonable in relation to the threat posed" and which do not constitute an abuse of discretion, *id.* at 955, is only relevant in a case involving takeovers. As this Note concentrates on a comparison of for-profits with nonprofits, takeovers are outside its scope and irrelevant because they do nothing but confuse the analysis. Further, takeovers in the for-profit context bear no similarity to the nonprofit context because takeover battles for nonprofits never occur. For these reasons, I have chosen to omit the fourth precondition to a director invoking the business judgment rule. Delaware has, however, seen a rash of lawsuits in the takeover area in the last several years. The interested reader should see, for example, Paramount Communications, Inc. v. QVC Network, 637 A.2d 34 (Del. 1993); Gilbert v. El Paso Co., 575 A.2d 1131 (Del. 1990); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

self-dealing; (2) due care (an informed decision by the directors after reasonably familiarizing themselves with the facts); and (3) good faith.[82]

It is safe to say that the first two preconditions are the duty of loyalty and the duty of care. Good faith, the third precondition, seems to be a category by itself. However, "good faith" in fact can be an element of both duties.[83] Thus, the best way to understand this third precondition is that it is usually subsumed into both the duty of care and the duty of loyalty tests.

Now that it has been established that directors are entitled to the protection[84] of the business judgment rule if they do not violate either duty, the specifics of both duties must be examined. Looking first at the duty of loyalty, several authors and cases have promulgated sufficient definitions. Two different definitions, one simplistic and another more complex, explain this duty. The simple definition is that the duty of loyalty "mandates that the director refrain from self-dealing."[85] A slightly more complex definition sees the duty of loyalty as "the obligation to give primacy to the interests of the corporation rather than personal concerns—to avoid self-dealing at the corporation's expense."[86] In other words, a director's duty of loyalty requires her to do her best to think about what is in the best interest of the corporation; in doing so, her personal interests should be set aside.

Examples of the duty of loyalty help to explain it. The corporate opportunity doctrine is the first example.[87] This doctrine states that if a director discovers an opportunity in his capacity as a director, he has to give the corporation the opportunity to take advantage of the deal instead of hiding the opportunity from the corporation and taking advantage of it himself. These types of opportunities arise frequently in both for-profits and nonprofits. While doing business for the corporation, either type of director can easily encounter an opportunity that he can take advantage of without the corporation knowing. A specific example would be the opportunity for the corporation to participate in a fundraising event. If a nonprofit director, for example, hears of this in his capacity as director of the nonprofit but takes personal advantage of the opportunity or takes advantage of the opportunity on behalf of another corporation with which he is associated, he has violated the duty of loyalty.

Another example is a director's "improper use of corporate . . . property or information."[88] Specifically, a director violates the duty of loyalty by divulging the corporation's sales strategy for next year or giving out names of people who donated to the corporation so another corporation might solicit from those same people.

"The duty of care is the obligation to exercise reasonable prudence—to investigate and to deliberate adequately—in making business judgments for the corporation or its stockholders."[89] Previously, corporate directors tended to be very passive, especially in

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82. *Unocal*, 493 A.2d at 954-55.

83. *See* FOLK III ET AL., *supra* note 77, at § 141:13.

84. I have not yet established to what extent these directors will receive protection. That topic is discussed later in this Note. See *infra* part II.C.2.

85. 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.9, at 4-220.

86. 1 OLSON & HATCH, *supra* note 51, § 1.02, at 1-5.

87. 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.10, at 4-237 (stating that the corporate opportunity doctrine is part of a director's duty of loyalty).

88. *Id.* § 4.10, at 4-234 (giving numerous other examples which have been omitted here in order to keep the examples within the framework of both for-profits and nonprofits); FOLK III ET AL., *supra* note 77, at § 141:13 (providing other examples that are also more relevant to for-profits).

89. 1 OLSON & HATCH, *supra* note 51, § 1.02, at 1-5.

the nonprofit context. Many felt that they did not have to attend board meetings regularly, and when they did show up they did not feel the need to be well prepared since they usually followed the lead of the corporation's officers.[90]

This attitude has quickly changed in the last decade or so.[91] *Smith v. Van Gorkom*,[92] a 1985 Delaware Supreme Court case, bears the most responsibility for this change. In that case, Van Gorkom was the CEO of a company trying to arrange a deal to sell the company. He quickly struck a deal to sell the company's shares for fifty-five dollars per share and orally presented it to the board. The company's CFO did not conduct an in-depth study to value the company, but estimated that fifty-five dollars was "at the beginning of the range" of a fair price.[93] The rest of the board, thinking that Van Gorkom knew what he was doing, approved the deal. The whole transaction took place in a matter of days.[94]

The Delaware Supreme Court shocked the business and legal communities by holding the directors liable for breaching their fiduciary duties. The court found that gross negligence was the correct standard for determining whether the directors' action was appropriate, and they found that the directors did not meet that standard.[95] The court emphasized that there was no protection for directors who made an "unadvised judgment."[96] The point here is not to debate the soundness of the decision, but to point out that *Smith v. Van Gorkom* was a well-publicized case. Directors thereafter began to take their duties much more seriously.[97]

To understand fully these duties, directors and others must know exactly what they need to do and how the law judges their actions. A detailed explanation of a plaintiff's suit against a director of a Delaware for-profit or nonprofit corporation[98] is necessary for illustration. Directors generally claim protection under the business judgment rule when a lawsuit challenges one of their decisions. The business judgment rule creates a presumption that directors are not liable for their actions as long as a particular director has not violated either the duty of loyalty or the duty of care.[99] The plaintiff can defeat this presumption, but overcoming the presumption is often confused with the analysis of the duty of care. A plaintiff's alternative to showing a violation of one of the two duties

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90. This statement is probably more true for directors of for-profits and directors of large nonprofits, since some nonprofits simply do not have many, if any, officers to rely on. With many nonprofits, the board basically runs the corporation. Nonetheless, some nonprofit directors remain quite passive.

91. *See, e.g.*, 1 OLSON & HATCH, *supra* note 51, § 11.02[1][b], at 11-9 (stating that "abdication of responsibilities by nonattendance at meetings or passivity in the face of wrongful conduct by other directors may result in the imposition of liability for breach of the duty of care") (citations omitted); Fraser, *supra* note 1, at 20.

92. 488 A.2d 858 (Del. 1985).

93. *Id.* at 869.

94. *Id.* at 869-70. There were other irregularities, such as Van Gorkom not using his company's regular lawyers or their normal investment broker for advice. Further, Van Gorkom had a personal conflict of interest, as he stood to gain an additional $2 million if the deal went through.

95. *Id.* at 873. Despite what many might have thought, gross negligence was not a new standard required by the Delaware Supreme Court. In fact, the court had stated that gross negligence was the standard in its previous term. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). What *was* such a shock in *Van Gorkom* was that the court found these directors liable at all.

96. *Van Gorkom*, 488 A.2d at 872.

97. It is also not simply coincidence that the Delaware state legislature responded to this decision by changing statutory provisions for director conduct. Section 102(b)(7) was promulgated in 1986. DEL. CODE ANN, tit. 8, § 102(b)(7); *see infra* part II.A.2.

98. At this point it is imperative to remember that the for-profit and nonprofit analyses are synonymous because Delaware does not have separate laws for nonprofits. Delaware does have one statutory provision that protects some directors of nonprofits, but certainly not all nonprofits. *See infra* part II.A.3 (discussing DEL. CODE ANN. tit. 10, § 8133).

99. *See* 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.6, at 4-60 (citing Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 64 (Del. 1989)).

is to show that the directors' decision can be attributed to no "rational business purpose."[100] This is not an easy task for a plaintiff, as the case law fails to define clearly a rational business purpose. In fact, there are no cases directly on point. Probably the closest statement of a rational business purpose came in a lower court decision in *Lewis v. Aronson*.[101] The court stated that a decision would be unrelated to a rational business purpose only if no ordinary observer with sound business judgment would find the decision to be rational.[102]

The confusion normally lies in the misunderstanding of the difference between the decisionmaking process and the substantive decision itself. This distinction is important because each receives a different level of judicial scrutiny. Delaware courts clearly use the gross negligence standard in judging the process by which the decision was made.[103] Gross negligence is not, however, the standard of review for the substantive decision itself, and "[i]t is doubtful that the courts would extend the concept of gross negligence" to the substantive decision.[104]

The above discussion of director liability in the absence of section 102(b)(7) of Title 8 of the Delaware Code—the provision allowing a Delaware corporation to insert a provision into its certificate of incorporation eliminating or limiting the personal liability of the corporation's directors—is important for three reasons. First, some corporations may not have this provision in their certificate of incorporation. If so, then the above analysis is appropriate to determine the liability of a director. Second, the distinction between the duty of loyalty and the duty of care becomes important in section 102(b)(7) analysis. Finally, the discussion provides another example of the often equal treatment of nonprofits and for-profits, something against which this Note argues.[105]

2. The Addition of Section 102(b)(7)

This Note now turns to a careful examination of section 102(b)(7).[106] As noted above, the business community's concerns about increased litigation and damage awards against directors motivated the Delaware legislature to promulgate section 102(b)(7).[107] The *Van*

100. *Id.*

101. No. 6919, 1985 WL 11553 (Del. Ch. May 1, 1985).

102. *Id.* at *6.

103. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); *see also* 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.6, at 4-60 n.203 (citing *Van Gorkom*); 1 OLSON & HATCH, *supra* note 51, § 1.04, at 1-12.

104. 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.6, at 4-60 n.203 (stating that "[g]ross negligence should not be the touchstone of judicial review of the substantive business decision, rather, irrationality of business purpose which equates to an abuse of discretion should be the limit of judicial review of the business decision itself").

105. I use the word "often" because even if a § 102(b)(7) provision is inserted into a nonprofit's certificate of incorporation, its directors may still receive some protection that a for-profit does not receive via § 8133 of Title 10. For a fuller discussion of § 8133, see *infra* part II.A.3.

106. *See* DEL. CODE ANN. tit. 8, § 102(b)(7). The relevant portion of the statute allows a corporation to insert the following into its certificate of incorporation:

> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.

107. *See supra* note 74 and accompanying text; *see also* David B. Hilder, *Risky Business: Companies Are Finding It Difficult Now to Obtain Liability Insurance for Their Directors*, WALL ST. J., July 10, 1985, at 1 (discussing that even liability insurance for directors was becoming increasingly difficult to obtain as insurance carriers were having to pay so many claims).

Gorkom case—a case that shocked many people when the directors were held liable—ultimately ended in the plaintiffs receiving a $23 million dollar settlement.[108] Unfortunately, that settlement paled in comparison to other settlements and jury verdicts, some of which soared into the hundreds of millions of dollars.[109]

Section 102(b)(7) is an enabling provision, meaning that Delaware corporations must take affirmative steps to take advantage of its protection from liability.[110] As is evident from a quick glance at the statute, the legislature listed four exceptions, circumstances under which Delaware corporations could not eliminate or limit director liability. These exceptions can be dissected into five separate categories. The plain meaning of the statute makes some exceptions clear, while others require careful study.[111]

First, corporations cannot eliminate or limit liability where there has been a "breach of the director's duty of loyalty."[112] Although not a straightforward exception, it previously received attention in this Note.[113]

Second, directors' "acts or omissions not in good faith"[114] cannot be exempted from liability. Acting in good faith is part of a director's duty of loyalty. Directors who make the conscious decision to put their personal interests ahead of the corporation's interests are certainly not acting in good faith. No one disputes this contention; thus some argue that good faith is merely a part of the duty of loyalty.[115]

"However, the more conservative view is that 'good faith' is violated at least by actions taken in conscious disregard of a known risk and may even entail a duty of reasonable inquiry in some circumstances . . . ."[116] In other words, acting in good faith is part of the duty of loyalty, but it *can* also include circumstances that are normally thought of as being encompassed within the duty of care.[117] A gray area exists between the duty of loyalty and the duty of care; one cannot separate the two in every case.

Third, liability cannot be eliminated or limited for "intentional misconduct or a knowing violation of law."[118] This obvious exemption requires little discussion. It would be unthinkable to allow exemptions from liability in instances where directors know that they are acting unlawfully.

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108. John F. Olson & J. Keith Morgan, *D & O Exclusions Extend to Takeover Context*, LEGAL TIMES, Mar. 10, 1986, at 23, 28.

109. One example was Chase Manhattan paying a $32.5 million settlement in a securities fraud case. Fox v. Chase Manhattan Corp., No. 8192-85, 1986 WL 673 (Del. Ch. Dec. 9, 1985). These huge settlements and jury verdicts did not occur only in Delaware. In Maryland, for example, a jury awarded a $387 million verdict against a group of officers and directors, the highest jury verdict ever entered in the state. Maryland Deposit Ins. Fund Corp. v. Seidel, No. 13408 (Cir. Ct. Jan. 19, 1987).

110. It would be hard to understand why an entity would be incorporated without having this provision in its certificate of incorporation. In fact, attorneys who file a certificate without this protection should probably be subject to malpractice if they do not at least ask the client if it wishes this protection.

To take advantage of the enabling provision, an attorney forming a new corporation would simply insert language similar to § 102(b)(7) in the new corporation's certificate of incorporation. Then-existing corporations would have to amend their certificate and add such a provision.

111. If a statutory provision is clearly understood by simply reading the statutes, the Delaware courts have consistently ruled that this is sufficient to interpret the provision. In such a case, an examination of the legislative history is unnecessary. *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp, 650 A.2d 1270, 1287 (Del. 1994) (citations omitted).

112. DEL. CODE ANN. tit. 8, § 102(b)(7)(i).

113. *See supra* part II.A.1.

114. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).

115. 1 OLSON & HATCH, *supra* note 51, § 1.07[1], at 1-39.

116. *Id.*

117. This assertion should sound familiar as it is the same assertion that was made previously in connection with the business judgment rule. *See supra* notes 76-77 and accompanying text.

118. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).

Fourth, section 102(b)(7) does not supersede violations of section 174 of Title 8 of the Delaware Code,[119] which prohibits directors from making unlawful distributions, dividend payments, and stock purchases or disbursements.[120] This exception comes as no surprise. While nonprofits are generally not allowed to make distributions, these types of actions by for-profit directors constitute egregious behavior that clearly shows directors' disregard for the corporation's best interests.

Finally, no exemption is allowed "for any transaction from which the director derived an improper personal benefit."[121] This is probably the most unclear of the five exceptions. Unfortunately, the infancy of the statute means that there is little case law interpreting the statute. At first glance, one would think that taking an "improper personal benefit" is a violation of the duty of loyalty and the duty to act in good faith. However, such a conclusion would not explain why the Delaware legislature decided to place this provision in the statute. If it was simply a part of those two duties, then this final exception is superfluous.[122] Therefore, the legislature must have meant this provision to do something more than reinforce the duty of loyalty and the duty to act in good faith.

Although it is hard to speculate about this exception's meaning, the most plausible interpretation is that the legislature wanted to emphasize that directors must be very careful not to receive any personal benefits. This is not to say that directors will be held liable if they receive a personal benefit without any knowledge of it, but that a successful plaintiff will not have to prove bad faith or some similar standard. Directors are put on notice that they should go to great lengths to avoid personal benefits.

The final sentence of section 102(b)(7)[123] makes two things clear. First, section 102(b)(7)(x) in essence states that section 102(b)(7) applies to nonprofit corporations. Second, section 102(b)(7)(y) refers to section 141(a) and states that those taking advantage of that provision are also entitled to the partial liability protection under section 102(b)(7). Section 141(a) allows the corporation, either for-profit or nonprofit, to designate persons other than those serving as formal directors to exercise the same powers as formal directors.[124]

In-depth knowledge of the exceptions and their application to a wide range of people in both for-profits and nonprofits is helpful, but this knowledge alone leaves a cloudy picture in most people's minds. Fortunately, one can draw a clearer conclusion about what the exceptions mean. Drawing on this Note's analysis of the duty of care and duty of loyalty, one can conclude that section 102(b)(7) allows directors' *duty of care*

119. *Id.* § 102(b)(7)(iii).

120. *Id.* § 174 (1991).

121. *Id.* § 102(b)(7)(iv).

122. This is not to suggest, however, that receiving an "improper personal benefit" is not a violation of the duty of loyalty or the duty to act in good faith. *See* 1 OLSON & HATCH, *supra* note 51, § 1.07[1], at 1-40 (stating that § 102(b)(7)(iv) suggests that the duty of loyalty and the duty to act in good faith "must comprise something more than refraining from the receipt of improper personal benefits").

123. The final sentence reads as follows:

> All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

DEL. CODE ANN. tit. 8, § 102(b)(7).

124. *Id.* § 141(a). "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, *except as may be otherwise provided* in this chapter or in its certificate of incorporation." *Id.* (emphasis added).

violations to enjoy either exempted or limited liability. Many commentators[125] and Delaware courts[126] agree on this point.

3. Delaware Provisions for Nonprofits

This Section will describe the one important statutory provision that applies only to nonprofits: Title 10, section 8133.[127] Awareness of section 8133 is important, although section 102(b)(7) generally provides directors with *more* protection than does this statute. Because section 8133 provides protection for "volunteers," not just directors, nondirectors will enjoy the most protection from this provision.

First, the term "volunteer" covers a wide range of people, not just the directors. The term has a wide scope in that it protects from liability volunteers who are "engaged in an activity without compensation."[128] Combining this with the definition of "activity," it is apparent that volunteers fall within the scope of this statutory provision anytime they do something that furthers the stated purpose or purposes of the nonprofit.[129]

Finally, it is important to note that subsections (b) and (d), when taken together, combine to protect volunteers only against negligent acts or omissions; anything that constitutes at least gross negligence will not receive protection. Thus, this section offers no more protection than the business judgment rule, which also has a gross negligence standard.[130] In any event, section 102(b)(7) provides more expansive protection than the business judgment rule, and thus, more expansive protection for directors than does section 8133.

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125. *See, e.g.*, 1 BALOTTI & FINKELSTEIN, *supra* note 62, § 4.19, at 4-331 ("In essence, Section 102(b)(7) permits a corporation, by a provision in its certificate of incorporation, to protect its directors from monetary liability for duty of care violations, i.e., liability for gross negligence." (citing Rothenberg v. Santa Fe Pac. Corp., No. 11749, 1992 WL 111206 (Del. Ch. May 8, 1992))); 1 OLSON & HATCH, *supra* note 51, § 1.07[1], at 1-40 (noting that the "scope of the immunity provided in this respect appears comprehensive, eliminating liability for gross as well as simple negligence").

126. *See, e.g.*, Zirn v. VLI Corp., 621 A.2d 773 (Del. 1993); *Rothenberg*, 1992 WL 111206 at *4 (stating that "since the purpose of § 102(b)(7) is to enable corporations to eliminate director liability for money damages for duty of care violations, it follows that the statutory exceptions to § 102(b)(7) concern director conduct that involves other than breaches of the duty of care").

127. The relevant portions of § 8133 for purposes of this discussion are as follows:

> (a) For purposes of this section, the following terms shall have the meanings ascribed herein:
>
> (1) "Volunteer" is any trustee, ex officio trustee, *director*, officer, agent or worker who is engaged in an activity without compensation.
>
> (2) "Activity" is any decision, act or event undertaken by an organization in furtherance of the purpose or purposes for which such organization was organized . . . .
>
> . . . .
>
> (5) "Organization" shall include:
>
> (a) Any not-for-profit organization exempt from federal income tax under § 501(c) of the Internal Revenue Code . . . or other act of Congress, and engaged in any activity within the State in furtherance of a purpose for which it was organized . . . .
>
> . . . .
>
> (b) No volunteer of an organization shall be subject to suit . . . resulting from any negligent act or omission performed during or in connection with an activity of such organization.
>
> . . . .
>
> (d) The immunity granted in subsection (b) of this section shall not extend to any act or omission constituting willful and wanton or grossly negligent conduct.

DEL. CODE ANN. tit. 10, § 8133 (Supp. 1994) (emphasis added).

128. *Id.* § 8133(a)(1).

129. *See id.* § 8133(a)(2). This is one reason why the nonprofit might consider specifically defining the purpose of the corporation. Although the law does not require a specific purpose, those associated with a nonprofit might be better off having one because they would then know that § 8133 protects them as long as they stay within the defined purpose. The drawback to specifically defining a purpose, however, is that it greatly restricts what the nonprofit may do.

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

While section 8133 is generally of little use to directors of nonprofits, it should not be ignored and is certainly a place where directors can turn as a matter of last resort, especially if their nonprofit has not taken advantage of section 102(b)(7). Further, it is Delaware's only separate provision for directors of nonprofits that offers them any protection.

B. Indiana Statutes on Director Liability

Indiana corporate law, like the Model Acts and unlike Delaware corporate law, has separate sets of laws for nonprofits and for-profits. But despite having separate laws governing nonprofits, the laws governing director behavior in Indiana are almost identical for nonprofits and for-profits. This Section begins with an examination of the statute governing directors of for-profits because the statute governing directors of nonprofits basically repeats the for-profits provision and then adds a subsection of its own. Further, it is easy to understand the section of the statute governing for-profits in the abstract, whereas the statute governing nonprofits cannot be understood without an extensive introduction to the way Indiana law treats nonprofits.

1. Indiana Law Governing For-Profit Corporations

Indiana Code section 23-1-35-1 governs the conduct of directors of for-profit corporations,[131] and its key section, 23-1-35-1(e), presents two basic requirements. First, a director must either breach or fail to perform one of the office's duties listed in the preceding subsections (a) through (d). Second, this breach or failure to perform must "constitute[] willful misconduct or recklessness" before a director becomes liable.[132]

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131. The relevant portions of the Indiana law governing directors of for-profits are as follows:
23-1-35-1 Standards of conduct; liability

Sec. 1(a) A director shall, based on facts then known to the director, discharge the duties as a director, including the director's duties as a member of a committee:
(1) in good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner the director reasonably believes to be in the best interests of the corporation.
(b) In discharging the director's duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
(1) one (1) or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.
(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.
(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.
(e) A director is not liable for any action taken as a director, or any failure to take any action, unless:
(1) the director has breached or failed to perform the duties of the director's office in compliance with this section; and
(2) the breach or failure to perform constitutes willful misconduct or recklessness.

IND. CODE § 23-1-35-1 (1993).

132. *Id.* § 23-1-35-1(e)(2).

Directors' duties are presented in subsection (a), with subsections (b) through (d) providing further explanation of subsection (a). Subsection (a), in fact, contains two distinct duties—the duty of loyalty and the duty of care. These two codified duties are commonly known as the business judgment rule. Indiana thus differs from Delaware in that the Indiana Code clearly codifies the business judgment rule, whereas Delaware relies almost solely on case law.

The Indiana statute is written such that the duty of loyalty comprises a combination of subsections (a)(1) and (a)(3). Thus, the duty of loyalty requires directors to discharge their duties "in good faith . . . in a manner the director reasonably believes to be in the best interests of the corporation."[133] The duty of care requires directors to discharge their duties "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[134]

This distinction is more than merely semantic for one important reason: many jurisdictions, in contrast to Indiana,[135] treat duty-of-loyalty and duty-of-care violations separately.[136] Because this Note advocates carefully distinguishing between different types and sizes of nonprofit corporations, one might think that the duty-of-loyalty/duty-of-care distinction is also helpful. However, while distinguishing between the two duties is easy in theory, it is difficult in practice and consequently not helpful for liability purposes. On this particular statutory point, the Author sides with Indiana in believing that the distinction between the duty of loyalty and the duty of care is useless.[137]

2. Indiana Laws Governing Nonprofit Corporations

Unlike its for-profit laws, Indiana's provisions for nonprofit corporations are more complicated. In order to support this Note's suggestions, this Part begins with a survey of Indiana provisions dealing with nonprofits. As mentioned above, Indiana has separate laws for its nonprofits—known as the Indiana Nonprofit Corporation Act of 1991 ("Indiana Nonprofit Act" or "Nonprofit Act").[138] One of the first provisions of the Indiana Nonprofit Act requires nonprofits to designate in their articles of incorporation[139] that they are either a "public benefit corporation," a "mutual benefit corporation," or a "religious corporation."[140] In other words, all nonprofits must qualify under one of these three classifications in order to incorporate legally as a nonprofit in the State of Indiana.

Qualifying under one of the three classifications is rather simple. As the name implies, public benefit corporations operate for the public benefit or for charitable purposes. There are only two specific additional requirements in Indiana. First, the corporation must be "[r]estricted so that on dissolution the corporation must distribute the

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133. *Id.* § 23-1-35-1(a).

134. *Id.* § 23-1-35-1(a)(2).

135. It is clear in subsection (e)(1) that Indiana does not distinguish, as far as director liability is concerned, between the duty of loyalty and the duty of care when it says that a director is liable if, inter alia, "the director has breached or failed to perform the *duties* of the director's office." *Id.* § 23-1-35-1(e)(1) (emphasis added). By using the plural "duties," the Indiana Code clearly combines these two.

136. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7).

137. My aversion to the distinction between the duty of care and the duty of loyalty is set forth in *infra* part III.C. Although I agree with Indiana's decision not to make this distinction, I do not agree that recklessness is the appropriate standard for liability of directors of small, charitable nonprofits. *See infra* part III.F.

138. IND. CODE § 23-17-1-1 to -30-4 (1993).

139. The difference between Indiana's term "articles of incorporation" and Delaware's term "certificate of incorporation" is purely semantic.

140. IND. CODE § 23-17-3-2(2).

corporation's assets to an organization organized for a public or charitable purpose, a religious corporation, the United States, a state, or a person that is recognized as exempt under Section 501(c)(3) of the Internal Revenue Code of 1986."[141] Second, a public benefit corporation cannot be a religious corporation.[142]

Qualifying under the other two types of nonprofits is even more simple. In fact, an entity legally forms a mutual benefit corporation or a religious corporation merely by stating in its articles of incorporation that it is one of the two forms.[143] But despite the ease of forming these two types of nonprofits, the distinctions among the three types of Indiana nonprofits are important.

At least one commentator has said that it is best to think of these three classifications as based on the particular nonprofit's goals rather than on its activities.[144] Religious corporations obviously have some type of religion-related goals in mind when incorporating,[145] while mutual benefit corporations have the goal of benefiting their members or persons they represent.[146] The mutual benefit classification also serves as a catch-all for nonprofit corporations that do not fit either of the other two categories. Public benefit corporations obviously have a "public benefit" goal.

Now that the basic structural differences between for-profits and nonprofits have been explained, this Note turns to director liability. Indiana Code section 23-17-13-1 describes the duties for directors of nonprofits. For better or for worse, this section of the Nonprofit Act is almost identical to section 23-1-35-1, the section governing standards of conduct for directors of for-profits.

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141. *Id.* § 23-17-2-23(2).

142. *Id.* § 23-17-2-23(3).

143. *Id.* § 23-17-2-19. A "mutual benefit corporation" means a domestic corporation that: "(1) is formed as a mutual benefit corporation under this title; (2) is designated a mutual benefit corporation by another law; or (3) is not a public benefit corporation or religious corporation." *Id.* § 23-17-2-19.

A "religious corporation" means a domestic corporation that is: "(1) formed as a religious corporation under this title; (2) designated a religious corporation by another law; or (3) organized primarily or exclusively for religious purposes." *Id.* § 23-17-2-25.

144. Kevin M. Boyle, *Nonprofit Corporation Act of 1991: Introduction to Significant Changes*, 35 RES GESTAE 462, 462 (1992).

145. *Id.* Further, religious corporations, which can vary greatly in activities given the vast numbers and different types of religions, are given more flexibility than the other two types of Indiana nonprofits because of the Establishment Clause. *See id.*

146. *Id.* Examples of mutual benefit corporations include homeowners' associations, social clubs, fraternities, and credit unions.

The text above mentioned that mutual benefit corporations strive to benefit their members or persons they represent. In the articles of incorporation, all Indiana nonprofits must state "[w]hether or not the corporation will have members." IND. CODE § 23-17-3-2(5). The Code goes on to define a member very carefully:

> 23-17-2-17 "Member" defined
>
> Sec. 17. (a) "MEMBER" means a person who, on more than one (1) occasion, has the right to vote for the election of a director under a CORPORATION'S articles of incorporation or bylaws.
>
> (b) A person is not a MEMBER because of any of the following:
>
> (1) Any rights the person has as a delegate.
>
> (2) Any rights the person has to designate a director.
>
> (3) Any rights the person has as a director.

Id. § 23-17-2-17.

Sections 23-17-13-1(a) to 23-17-13-1(c) are almost identical to for-profit sections 23-1-35-1(a) to 23-1-35-1(c).[147] One difference between the law for for-profits and the law for nonprofits is that there is no counterpart in the Nonprofit Act to section 23-1-35-1(d), which allows directors to consider several outside effects that their actions would have—such as effects on customers, employees, and communities—when considering what is in the best interest of the corporation.

Most importantly for the purposes of this Note, the Nonprofit Act and the for-profit provision both require "willful misconduct or recklessness," in addition to a director failing to perform his or her duty of loyalty or duty of care, before a director can be held liable.[148] Some courts and statutes hold directors of nonprofits to trustee standards.[149] The Indiana legislature, however, flatly rejected this notion by adding subsection (e), which states that "[a] director is not considered to be a trustee with respect to a corporation or with respect to any property held or administered by the corporation, including property that may be subject to restrictions imposed by the donor or transferor of the property."[150] Further, despite Indiana having three different classifications of nonprofits, *all* directors of *all* nonprofits are held to the willful misconduct or recklessness standard.

Before moving to a discussion of the Model Acts, a few more important points follow directly from the examination of director liability. The first point concerns the number of directors on the board. Indiana has decided that a nonprofit's board "must consist of at least three (3) individuals."[151] Although some might see this requirement as trivial, this policy decision represents one of many examples where state legislatures take sometimes excruciating pains in trying to fit all nonprofits under one or a small set of statutes.[152]

Second, there are a few provisions outside of the Nonprofit Corporation Act itself that are important. Indiana Code section 34-4-11.5 governs the limitations on volunteer directors' civil liability. The statute calls those who receive protection "qualified directors." Qualified directors are people who serve without compensation as directors or officers in managing the business and affairs of the nonprofit corporation.[153] The

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147. Thus, the reader should simply refer to *supra* note 131 when thinking about the liability of both nonprofit and for-profit directors, bearing in mind the few exceptions that are mentioned herein.

The only substantive difference between the statutes governing nonprofits and for-profits is in subsection (b) of each. The Nonprofit Act added the following provision to the end of subsection (b): "In the case of religious corporations, religious authorities and ministers, priests, rabbis, or other persons whose position or duties in the religious organization the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented." IND. CODE § 23-17-13-1(b)(4). This addition reflects the roles particular to religious corporations.

148. IND. CODE § 23-17-13-1(d); *id.* § 23-1-35-1(e). The two statutes are also identical with respect to duty of loyalty and duty of care. For a full discussion of duty of loyalty and duty of care, see *supra* notes 133-37 and accompanying text.

149. *See supra* note 3 and accompanying text.

150. IND. CODE § 23-17-13-1(e).

151. *Id.* § 23-17-12-3(a).

152. As noted in the opening, this Note argues that state legislatures need to take size into account when writing laws for nonprofits. Part III explains this idea and provides additional examples in which courts and state legislatures show ignorance of the fact that a "one-size-fits-all" approach to nonprofit law simply does not work.

153. IND. CODE § 34-4-11.5-1 (1993). It would, however, be a mistake to assume that one is entitled to protection simply because he or she meets these criteria. In an effort to show the scope of persons entitled to protection, the relevant portions of the statute are reproduced below.

> 34-4-11.5-1. "Qualified director" defined
>
> Sec. 1. (a) As used in this chapter, "qualified director" means any of the following individuals:
>
> ....
>
> (2) An individual who serves without compensation for personal services as a director or an officer for the purpose of setting policy, controlling, or otherwise overseeing the activities or functional responsibilities of a nonprofit corporation operating under IC 12-29 . . . or a nonprofit corporation that has one (1) of the following purposes:
>
> (A) Religion.
>
> (B) Charity.

significance of being a qualified director is that the director is "immune from civil liability arising from the negligent performance of the director's duties."[154] In 1994, the Indiana legislature extended this immunity to any volunteer directors who might not have met the definition of qualified director.[155]

These provisions are not central to this Note because they really do not give directors of Indiana nonprofits any greater degree of protection than can be found in section 23-17-13-1. In fact, that section's requirement of willful misconduct or recklessness actually affords a director greater protection than does immunity from negligent conduct. The real importance of Indiana Code section 34-4-11.5 is that the term "qualified director" encompasses more people than those actually sitting on the nonprofit's board of directors.

C. Model Act Provisions on Director Liability

The Model Acts—the Revised Model Business Corporation Act ("Model Corporation Act") and the Revised Model Nonprofit Corporation Act ("Model Nonprofit Act")—serve as a third and final example of statutory treatment of for-profits and nonprofits. The analysis here will be somewhat different from the analysis of Delaware and Indiana legislation for two reasons. First, this Note has already thoroughly examined two different approaches taken by two different state legislatures, and the Model Acts are not so dramatically different that they require the same in-depth analysis. Second, as these Model Acts simply represent American Bar Association suggestions as to what state laws should look like, there is no case law interpretation to examine as there is when looking at a particular state's statutes. For these reasons, this subsection will simply highlight portions of the two Model Acts and compare them to the Delaware and Indiana legislation.

1. General Standards for Directors

Both Model Acts have an almost identical provision that guides director conduct, both of which are labeled "Section 8.30 General Standards for Directors." This provision is the first place to look in deciding whether a director has legally upheld his or her duties to either a for-profit or nonprofit corporation. As the provisions are extremely similar, this Part will analyze both simultaneously.

> (C) Benevolence.
> (D) Providing goods or services at no charge to the general public.
> (E) Education.
> (F) Scientific activity.
> (G) Developing or providing hospital services.
> (H) Medical research.
> (I) Developing or providing ambulance services or emergency medical treatment services.
> ....
> (4) An individual who serves without compensation for personal services as a director of a national, regional, or local fraternity or sorority that is connected with, and under the supervision of, a college, university, or other educational institution located within Indiana.

Id.

154. *Id.* § 34-4-11.5-2(b).

155. IND. CODE § 34-4-11.5-2(c) (Supp. 1995) (stating that a volunteer director who, inter alia, "exercises reasonable care . . . is immune from civil liability arising out of the performance of those duties").

Section 8.30 of each Act has two provisions that first deserve attention—subsections (a)[156] and (d).[157] Subsection (a) gives the Acts' version of the duty of loyalty and the duty of care. Both of these contain standard language that is similar to the Delaware and Indiana statutes. Subsection (d) then states that directors who follow subsections (a) through (c) in taking actions as a director will not be held liable for those actions. Subsection (b) allows directors to rely on various reports, opinions, and information from people such as lawyers, accountants, and committees of the board.[158] Subsection (c) then states that a director cannot rely on information otherwise permitted in subsection (b) if he or she has reason to believe that such reliance would be "unwarranted."[159] Thus, subsection (d) of the Model Act in essence establishes gross negligence as the culpability standard for directors of Model Act corporations.

This analysis covers section 8.30 as it relates to for-profit corporations. The Model Nonprofit Act added another provision, subsection (e),[160] making it clear that directors of nonprofits should not be held to trustee standards.[161] Nevertheless, directors of nonprofits are left with the same gross negligence culpability standard.

As neither Model Act is the law of any particular jurisdiction, there is no case law that directly interprets them. However, there is more to an analysis of director liability than simply looking at the statute.[162] The particular jurisdiction's own case law will interpret section 8.30, as well as the rest of that jurisdiction's corporate laws. Part of that case law, at least with respect to the Model Corporation Act, is aimed at the jurisdiction's version of the business judgment rule.[163] Although some may see section 8.30 as the drafters' view of the business judgment rule, "section 8.30 does not try to codify the business

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156. Section 8.30(a) of the Model Nonprofit Act reads as follows:

> (a) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
> (3) in a manner the director reasonably believes to be in the best interests of the corporation.

REVISED MODEL NONPROFIT CORP. ACT § 8.30(a) (1987); *see also* REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (1994) (containing the same language but with only masculine pronouns).

157. Section 8.30(d) of the Model Business Corporation Act reads as follows: "(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section." REVISED MODEL BUSINESS CORP. ACT § 8.30(d).

158. *See id.* § 8.30(b).

159. *Id.* § 8.30(c).

160. Subsection (e) reads as follows: "(e) A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property." REVISED MODEL NONPROFIT CORP. ACT § 8.30(e).

161. For a brief discussion of the debate as to whether directors of nonprofits should be held to the same, greater, or lesser standards than directors of for-profits, see *supra* notes 3-9 and accompanying text.

162. Of course, assuming that a jurisdiction did adopt the Model Acts, a director who complies with § 8.30 does not have to worry about other statutes or cases as § 8.30 clearly states that a director who complies with § 8.30 "is not liable for any action taken as a director." REVISED MODEL NONPROFIT CORP. ACT § 8.30(d); *see also id.* § 8.30 cmt. 3 ("If a director has met the standards of section 8.30, there is no need to apply the business judgment rule."). But since directors do not always comply with the section, it is necessary to describe other places that a director might look for protection.

163. It is not clear that the business judgment rule applies to nonprofits. The official comments to the Model Nonprofit Act even admit that it may seem "anomalous" to think that it would apply. However, the comments go on to say that "its use is consistent with section 8.30." § 8.30 cmt. 3. Further, there have been several reported cases that have applied the business judgment rule in the nonprofit context. *E.g.*, Oberly v. Kirby, 592 A.2d 445 (Del. 1991); Yarnall Warehouse & Transfer Inc. v. Three Ivory Bros. Moving Co., 226 So.2d 887 (Fla. Dist. Ct. App. 1969). It should be emphasized that the *Oberly* case was a decision of the Delaware Supreme Court, which is generally considered to be the leading judicial authority on the business judgment rule.

judgment rule."[164] Thus, the drafters left this to the adopting jurisdictions since the adopting jurisdictions generally have large bodies of case law interpreting the business judgment rule.

Despite being an additional possibility for escaping liability, the business judgment rule analysis will probably not offer directors any additional protection. As Daniel Kurtz, a leading commentator on nonprofits, has written, "In reality, there may be little practical difference between application of the business judgment rule and a gross negligence standard of conduct."[165]

2. Additional Protection for Directors of For-Profits

Following Delaware's lead,[166] the Model Corporation Act added section 2.02(b)(4), a provision that allows corporations to add a clause to their articles of incorporation that greatly limits director liability. It certainly does seem strange that the Model Nonprofit Act does not have a similar provision, but there is an explanation. The Model Corporation Act added the provision with a 1990 amendment. In contrast, the Model Nonprofit Act has not been revised since 1987. As for-profits receive much more attention, the Model Nonprofit Act is not as regularly amended as the Model Corporation Act. Instead, the Model Nonprofit Act must generally wait for major revisions to incorporate changes. However, this does not mean that nonprofits themselves must wait for the changes in the Model Nonprofit Act. They could certainly borrow this provision from the Model Corporation Act, unless the governing jurisdiction does not allow them to do so.

Section 2.02(b)(4)[167] has many similarities to, but also many differences from, Delaware's section 102(b)(7).[168] For example, both provisions eliminate liability only when directors act in their official capacities as directors. Perhaps the most important difference is that the Model Corporation Act is carefully worded so that conduct is not separated into the duty of loyalty, the duty of care, and other miscellaneous conduct.[169] The Delaware provision requires one to make this difficult distinction, and mere duty-of-care violations do not lead to director liability. Instead, the Model Corporation Act eliminates or limits liability for all but four things. First, there is liability for the "amount

164. REVISED MODEL BUSINESS CORP. ACT § 8.30 cmt. 3.

165. Daniel L. Kurtz, *Safeguarding the Mission: The Duties and Liabilities of Officers and Directors of Nonprofit Corporations*, *in* NOT-FOR-PROFIT ORGANIZATIONS, *supra* note 63, at 17, 31.

166. The drafters as much as admitted that they based this provision on Delaware's § 102(b)(7) by discussing how difficult it has been recently to get people to serve as directors because of increasing fear of liability, and by citing the Delaware Supreme Court decision of Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), as a prime example. REVISED MODEL BUSINESS CORP. ACT § 2.02 cmt. 3.i; *see also* Lizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 264-65 (1988) (implying that the provisions of the Model Corporation Act are basically the same as § 102(b)(7) of the Delaware Code).

167. Section 2.02 (b)(4) reads as follows:

> (b) The articles of incorporation *may* set forth:
>
> ....
>
> (4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law.

REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(4) (emphasis added).

168. For a comprehensive discussion of Delaware's § 102(b)(7) on which the Model Corporation Act's provision is based, see *supra* part II.A.2.

169. *See* 1 OLSON & HATCH, *supra* note 51, § 1.07[1][a], at 1-45.

of a financial benefit received by a director to which he is not entitled."[170] So instead of an abstract requirement like the duty of loyalty, the Model Corporation Act provides a clear and simple standard by protecting a director from liability arising out of a nonmonetary benefit that the director legitimately received.

Second, the statute states that liability cannot be eliminated or limited for "an intentional infliction of harm on the corporation or the shareholders."[171] This is very significant as it represents a policy choice by the drafters to change from the gross negligence level of culpability in section 8.30 to a requirement that directors intentionally harm the corporation before they are liable.

Third, a director who violates section 8.33 cannot escape liability.[172] This should come as no surprise as section 8.33 holds directors liable for making unlawful distributions. If section 8.33 were not exempted from section 2.02, it would have no bite and directors would be able to do as they please with the corporation's money.

Fourth, an "intentional violation of criminal law" leads to liability.[173] This provision also is no surprise. However, its inclusion is important to make the statute clear and complete. The statute lays out exactly what is not exempted from liability, so one can safely assume that anything that is not listed is exempted.

3. Classification of Nonprofits Under the Model Nonprofit Act

The Model Nonprofit Act has the same three classifications of nonprofits as Indiana has—public benefit corporations, mutual benefit corporations, and religious corporations. Nonprofits organizing under the Act must make one of the three designations.[174] Despite this requirement, the text of the Act does not contain definitions of the three types of nonprofits;[175] incorporators are supposed to choose the type of nonprofit that best suits their particular activities and purpose. The rules provide an incentive to make sure that the nonprofit chooses the appropriate category.[176] For example, nonprofits wishing to have the § 501(c)(3) federal tax exemption must form as either public benefit or mutual benefit corporations.[177]

While section 8.30 of the Model Nonprofit Act does not distinguish between the three types of nonprofits, it does attempt to classify nonprofits instead of simply treating them all the same, an approach advocated in Part III of this Note.

170. REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(4)(A).

171. *Id.* § 2.02(b)(4)(B).

172. *Id.* § 2.02(b)(4)(C).

173. *Id.* § 2.02(b)(4)(D).

174. REVISED MODEL NONPROFIT CORP. ACT § 2.02(a)(2).

175. The Model Nonprofit Act's introduction does give the following cursory views on the classifications: "1. Operating for public or charitable purposes—*public benefit corporations*; 2. Benefitting their members or a group of people they serve or represent—*mutual benefit corporations*; and 3. Operating primarily or exclusively for religious purposes - *religious corporations*." *Id.* at xxii (Introduction) (emphasis in original). See also *id.* at xxiv-xxx for an extended discussion of the three classifications.

176. *Id.*

177. *See id.* § 17.07 & cmt.

III. THE NEED FOR CHANGES IN DIRECTOR LIABILITY STATUTES FOR SMALL, CHARITABLE NONPROFITS

The preceding statutory analysis should provide helpful background for the proposed changes in this final Part. The way different jurisdictions treat directors of both for-profits and nonprofits is not difficult to decipher after carefully reading and analyzing the statutes. But, the statutes are long and detailed, requiring a careful analysis of each statutory provision. Further, it is important to remember that each of the three jurisdictions examined in this Note requires reading more than one provision, as there are cross-references to other provisions, some of which define important terms.

This Part of the Note endeavors to explain specifically the argument for lower legal standards for directors of small charitable nonprofits. It first briefly reviews the standards to which directors of for-profits and nonprofits are held in each of the three jurisdictions, pointing out that each jurisdiction treats directors of *all* nonprofits the same for liability purposes. Second, additional evidence is provided to explain why only directors of small, charitable organizations should be the beneficiaries of these relaxed standards. Third, it argues that the duty of care versus the duty of loyalty distinction which many jurisdictions find important[178] is not very helpful. Fourth, it discusses director and officer insurance, providing another reason for these relaxed standards. Fifth, it briefly notes that nonprofits face the added possibility of liability on federal claims, something from which no state statutes can immunize them. Finally, there is a specific proposal for more relaxed standards for directors of small, charitable organizations.

A. All Directors of All Nonprofits Treated the Same

There is a wide variety of nonprofits; just as for-profits cannot be correctly depicted as a single type of entity, nonprofits come in numerous sizes and partake in a wide array of activities. Despite this diversity, states and the Model Acts treat directors of all nonprofits the same for liability purposes.

In Indiana, directors are liable if their actions violate either their duty of loyalty or duty of care and constitute "willful misconduct or recklessness."[179] In Delaware, directors of corporations with the section 102(b)(7) provision are liable if they breach their duty of loyalty, intentionally harm the corporation, or act without good faith.[180] In Model Nonprofit Act jurisdictions, directors are held to a gross negligence standard.[181]

Indiana and Delaware utilize a few other provisions aimed only at directors of nonprofits,[182] but they offer even less protection than do the aforementioned statutes because they were not enacted specifically for directors. Thus, *all* directors of *all* nonprofits in each of the three jurisdictions that this Note has examined are held to the same standards. To put this into perspective, directors of a multibillion dollar nonprofit, such as the United Way, are held to the same standards as Mom & Pop's Soup Kitchen,

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178. The importance of this distinction is evidenced by the extent to which this Note has detailed the difference between the two duties and how each is treated for liability purposes. *See supra* parts II.A.1, II.B.1.

179. IND. CODE § 23-17-13-1(d).

180. DEL. CODE ANN. tit. 8, § 102(b)(7).

181. *See* REVISED MODEL NONPROFIT CORP. ACT § 8.30(d).

182. DEL. CODE ANN. tit. 10, § 8133; IND. CODE § 34-4-11.5-2(c).

a nonprofit which has virtually no assets and relies entirely on donations and volunteered time.

B. Small, Charitable Nonprofits Are Different[183]

"[T]he image of officials of nonprofit organizations as low-paid, self-sacrificing managers is woefully out of date."[184]

> Today, *many large nonprofits are indistinguishable from for-profit companies.* They make millions of dollars in profits. They have millions of dollars in stocks, bonds and other investments. And instead of relying on donations, they charge for their services, *just like any other business,* or are reimbursed by the government. Often they provide little or no charity.[185]

The *Philadelphia Inquirer*, from which the above quotations are taken, conducted an eighteen-month study of nonprofits. As is evident from the quotations, the series of stories[186] that followed the investigation is highly critical of nonprofits.

One area upon which the stories focused was executive compensation. In coming to the conclusion that nonprofits are not run by "low-paid, self-sacrificing managers" anymore, the authors cited several examples of executives and other employees, many of whom serve on their organization's board of directors, who had astronomical salaries. For example, after examining IRS tax returns, they found that almost half of the 25,000 executives and other employees listed on the forms had salaries of at least $100,000 a year. More than 200 of these people earned more than $450,000 annually, and nine made in excess of $1 million.[187]

The *Inquirer* also had figures for specific people and industries. For example, William Aramony, president of the United Way of America until he resigned in February 1992,[188] received a $463,000 annual salary. Further, "[a]t a time when 37 million Americans cannot afford health insurance, more than 1,000 executives and doctors at nonprofit hospitals were paid salaries ranging from $200,000 to $1.2 million."[189]

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183. I chose to address this topic in a separate subsection to emphasize two points. First, small, charitable organizations are quite different from other nonprofits, which is the main reason why they deserve more lenient standards. Second, this Note only argues for more lenient standards for directors of these small, charitable organizations. Directors of large, charitable organizations often structure their organizations in a manner similar to for-profit organizations. Since these directors of large, charitable organizations operate at a more sophisticated level, they do not deserve more lenient standards.

184. Gilbert M. Gaul & Neill A. Borowski, *In High-Level Jobs at Nonprofits, Charity Really Pays*, PHILA. INQUIRER, Apr. 23, 1993, at A1.

185. *Id.* (emphasis added).

186. Of the ten stories that I found from the *Philadelphia Inquirer* investigation, only two are relied upon in this part of the Note. However, the other stories provide very useful background information on a variety of nonprofit issues. *See generally* Gilbert M. Gaul & Neill A. Borowski, *Charity Ends When It Comes to Transplants*, PHILA. INQUIRER, Apr. 19, 1993, at A12; Gilbert M. Gaul & Neill A. Borowski, *For Nonprofits Only: A Cheap Pool of Money*, PHILA. INQUIRER, Apr. 23, 1993, at A1; Gilbert M. Gaul & Neill A. Borowski, *Museums-Turned-Merchandisers: Where Does Tax Exemption End?*, PHILA. INQUIRER, Apr. 22, 1993, at A19; Gaul & Borowski, *supra* note 28, at A1; Gilbert M. Gaul & Neill A. Borowski, *Nonprofits Lobby Like Everyone Else*, PHILA. INQUIRER, Apr. 23, 1993, at A27; Gilbert M. Gaul & Neill A. Borowski, *Phila. Looks for Ways to Make Up Lost Taxes*, PHILA. INQUIRER, Apr. 18, 1993, at A11; Gilbert M. Gaul & Neill A. Borowski, *The Rise of Medical Empires*, PHILA. INQUIRER, Apr. 19, 1993, at A1; Gilbert M. Gaul & Neill A. Borowski, *They May Say It's a Secret, But You Have a Right to Know*, PHILA. INQUIRER, Apr. 24, 1993, at A6.

187. Gaul & Borowski, *supra* note 184, at A1.

188. For additional information on Aramony and the alleged scandal that led to his resignation and eventual criminal convictions, see *supra* note 7 and accompanying text.

189. Gaul & Borowski, *supra* note 184, at A1.

Large nonprofits have defended these high salaries, saying that they now compete with private firms for the executive talent that is required to run large, sophisticated nonprofits. They say that unless they offer competitive salaries and benefits, they will be unable to attract the type of people needed to succeed.[190] One result of these higher salaries is that many people now move between the for-profit and nonprofit sectors, a phenomenon that did not exist only a few years ago.[191]

The other major point that the series of stories brought out is how different nonprofits and for-profits used to be, a difference that the authors found no longer evident. For-profits used to launch their products into the market and make money, while nonprofits provided "important community services that would otherwise fall on the government."[192] Thus, the authors saw nonprofits generally as social welfare providers. Now, the authors argue, that distinction is becoming blurred as "many *large* nonprofits are indistinguishable from for-profit companies"[193] because, among other things, they have multimillion dollar investments and they charge for their services.

After reading this excellent series of articles, it is easy to become cynical about nonprofits. But one should keep in mind, despite the fact that the authors themselves seemingly forgot the point at times, that these articles spoke solely of large nonprofits. Examples include the United Way, Harvard University, the Ford Foundation, the National Geographic Society, the National Football League, the National Collegiate Athletic Association, and several large hospitals.[194]

Small, charitable nonprofits, the focus of this Note, are different. They survive almost solely on volunteered time and the public's donations. They do not make money, but instead serve worthy causes such as feeding and housing the poor, providing a safe haven for battered women, providing free counseling, and providing holiday presents for children who otherwise would go without. Their boards of directors consist of people who volunteer their time and energy.

C. The Duty of Care / Duty of Loyalty Distinction Is Not Helpful

Delaware's section 102(b)(7) champions this distinction, saying that although both for-profits and nonprofits can eliminate or limit the personal liability of their directors for a breach of the duty of care, such a provision cannot cover breaches of a director's duty of loyalty.[195] For a number of reasons, many have argued that this is a helpful distinction. For example, at least one commentator has argued that this provision was an excellent response to the director and officer liability insurance crisis because corporations now know that they no longer have to obtain insurance to cover duty of care violations.[196]

This assertion, however, is unsound because distinguishing between the duty of loyalty and the duty of care in an actual case is much more difficult than it might seem. Plaintiffs

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190. *Id.*
191. *Id.*
192. *Id.*
193. *Id.* (emphasis added).
194. *See id.*; Gilbert M. Gaul & Neill A. Borowski, *Foundations Build a Giant Nest Egg*, PHILA. INQUIRER, Apr. 24, 1993, at A1; Gilbert M. Gaul & Neill A. Borowski, *A Tax Break Colleges Can Bank*, PHILA. INQUIRER, Apr. 20, 1993, at A1.
195. DEL. CODE ANN. tit. 8, § 102(b)(7)(i).
196. Karen Leigh Chapman, Note, *Statutory Responses to Boardroom Fears*, 1987 COLUM. BUS. L. REV. 749, 754.

know that they must show a duty of loyalty violation to win, so they often twist the facts in such a way that duty-of-care cases are recast as duty-of-loyalty cases.[197] Defendants are thus faced with the unenviable task of establishing that they are protected because the case contains only a duty of care violation. Commentators call this type of case a "pure" duty of care case.[198]

"Pure" duty of care cases are very difficult to find because plaintiffs are often successful at recasting the duty that has been violated. Plaintiffs have successfully recast duty of care violations as duty of loyalty violations because Delaware courts have sent confusing signals in defining the duty of loyalty.[199]

Revlon v. MacAndrews & Forbes Holdings[200] is an excellent example of the confusion. The case, one of the Delaware Supreme Court's worst performances, misled directors and attorneys about a director's duty of loyalty by blurring the distinction between it and the duty of care. The *Revlon* case scrutinized the conduct of Revlon's board of directors during a bidding competition to take over the Revlon corporation.[201] Pantry Pride and Forstmann Little & Co. ("Forstmann") each entered bids for Revlon, with Pantry Pride announcing that it would engage in fractional bidding—a practice in which a business tops any competitor's bid with a slightly higher one.[202] Little did Pantry Pride know that Revlon was disclosing certain of its financial data to Forstmann, but not to Pantry Pride.[203] The Revlon board eventually accepted a bid from Forstmann. A lock-up option was included in the takeover agreement which allowed Forstmann to purchase additional Revlon holdings if another group acquired more than forty percent of Revlon's shares.[204]

Near the beginning of its analysis, the court said that "obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action."[205] So "when the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders, the directors breached their primary *duty of loyalty*."[206]

Near the end of the opinion, the court says: "The principal object, contrary to the board's *duty of care*, appears to have been protection of the noteholders over the shareholders' interests."[207] Lest one think that one of these two statements was simply a slip of the pen, the court's concluding paragraph states: "No such defensive measure can be sustained when it represents a breach of the directors' fundamental *duty of care*."[208]

Thus, the court called this financial transaction both a breach of the duty of care *and* a breach of the duty of loyalty. It is not certain that such a lock-up provision is clearly one or the other, so it is impossible to say that one approach is right and the other is wrong. A similar situation could easily face directors of a small, charitable nonprofit. For

197. Kurtz, *supra* note 63, at 280.
198. *See, e.g., id.*
199. 1 OLSON & HATCH, *supra* note 51, § 1.06[5], at 1-35 to 1-36.
200. 506 A.2d 173 (Del. 1986).
201. One should not assume that this case is irrelevant to this Note simply because it involves a hostile takeover of a for-profit. Instead, this case, as in all cases involving the duty of loyalty, is precedent for any duty-of-loyalty action in Delaware. It is true that a nonprofit scenario might be distinguished on its facts, but a nonprofit scenario similar to *Revlon* would certainly be governed by this precedent.
202. *Revlon*, 506 A.2d at 178.
203. *Id.*
204. *Id.* at 178-79.
205. *Id.* at 182.
206. *Id.* (emphasis added).
207. *Id.* at 184 (emphasis added). The noteholders were partially financing the deal.
208. *Id.* at 185 (emphasis added) (citing Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985)).

example, suppose the board of directors at Mom & Pop's Soup Kitchen receives an offer from Teddy's Bread to buy bread for the Soup Kitchen at a substantial discount. If someone associated with Teddy's Bread was on the board of directors—which would clearly lead to a claim of a duty of loyalty violation—*Revlon* would confuse the board. *Revlon* seems to say that approving such a contract might lead to a duty of care or a duty of loyalty claim if it later turns out that the board excluded other bread suppliers that would have provided the soup kitchen with higher quality bread at a better price.

A second difficulty defendant corporations have in demonstrating a "pure" duty of care is illustrated by *Leslie v. Telephonics Office Technologies, Inc.*[209] In *Leslie*, a group of minority shareholders brought a derivative suit against the directors of Telephonics Office Technologies ("TOT") after TOT sold a substantial portion of its assets to Precision Interconnect Conversions Corporation ("Precision"). As part of the sale, the defendant directors signed a noncompetition agreement with Precision and agreed to act as consultants for Precision for six months after the sale.[210] Plaintiffs claimed that the directors violated their fiduciary duties for two reasons. First, plaintiffs alleged that the noncompetition and consulting agreements were actually an attempt by the directors to divert corporate assets for their personal use.[211] Second, plaintiffs alleged that the directors failed to call a shareholders meeting to approve the sale as required by the company's certificate of incorporation.[212]

The court correctly noted section 102(b)(7)'s importance since defendants were insulated from a duty of care claim, but instead of conducting a complete analysis, the court simply concluded in a footnote: "In this case, where the claim is that defendants embarked on an intentional scheme to divert corporate assets, a *duty of loyalty* analysis is more appropriate."[213]

The court's reasoning in this case is sorely inadequate. First, it fell into the trap of lumping both duties together. It seems evident that failing to call a shareholders meeting surely cannot be considered a duty of loyalty claim. It is simply directors breaching the guidelines set forth in their certificate of incorporation. Despite the fact that one could conceivably hide a personal gain by not allowing the shareholders to approve a deal, a court must properly look at the cause of action, which was based on the directors' failure to follow the established guidelines.

Second, the court assumed that the plaintiffs' claim fell under the rubric of the duty of loyalty simply because of the way plaintiffs stated the claim. However, the opinion contained no reference to any evidence that the corporation would have obtained more money from Precision had the directors not signed these individual deals. It is evident that both the noncompetition and consulting agreements were very important to Precision because they wanted the same advantage that the directors had—a market essentially free of competition. On their face, payments ranging from $30,000 to $250,000 in exchange for noncompetition for five years and acting as consultants for six months do not seem outrageous.

Again, directors of nonprofits trying to determine the boundaries of their duty of loyalty will find themselves confused. Does *Leslie* mean that directors of nonprofits, even

209. No. 13045, 1993 WL 547188 (Del. Ch. Dec. 30, 1993).
210. *Id.* at *2 (paying $30,000 each to four of the six directors, $80,000 to another, and $250,000 to a final director).
211. *Id.* at *1.
212. *Id.* at *7.
213. *Id.* at *14 n.17 (emphasis added).

if they happen to be owners or founders, cannot receive any compensation if they sell the nonprofit to someone else? For example, suppose that Mom & Pop's Soup Kitchen wants to sell its kitchen, pots and pans, and other items to someone else because the founders have become too old to operate the soup kitchen themselves. Does this opinion allow them to do so if they are directors? This decision does not even give them guidance as to whether they can sell any assets, even if they plan to maintain ownership of the soup kitchen.

So directors are left with an unclear picture. They might know the theoretical distinction between the duty of loyalty and duty of care, but this case exposes the difficulty courts have in distinguishing the two duties in actual cases. Consequently, directors who want to be on the safe side must use the following as their guide: "When there is no adverse financial or personal interest, a question as to whether the directors have exercised good faith and requisite care implicates only the duty of care, not the duty of loyalty."[214] In other words, a director who doubts whether someone might be able to twist *any* type of financial or personal benefit that the director is about to receive into a claim that the director received such a benefit to the detriment of the corporation, should decline such a benefit. Even this conservative approach is not a complete solution, especially for small, charitable nonprofits that could easily be ruined by one plaintiff recasting a duty-of-care claim as a violation of the duty of loyalty.

D. The Insurance Industry Needs to Pay More Attention to Nonprofits

As discussed above,[215] many nonprofits buy insurance for their directors to insulate them partially from liability. However, many directors, especially those of small, charitable nonprofits—at the heart of this Note's argument—believe they are immune from liability simply because of their nonprofit or charitable status. Unfortunately, this is not the case.[216] This is very troubling, especially when directors of small, charitable organizations are faced with lawsuits alleging only negligence or gross negligence. It would be ideal if the problem could be solved by telling these organizations to insulate their directors from negligence liability by purchasing liability insurance. However, this solution is *not* possible for a couple of reasons.

First, this type of information regarding insulation from liability is not easily and effectively communicated to those who need to know it. The occasional newspaper or magazine article will not get the job done. Maybe over a long period of time these charitable organizations would get the message, after enough of them are put out of business by damages that insurance could have covered. Such a scenario is speculative at best, and there is no reason to wait for such an awakening when insurance companies can respond now with better policies for nonprofits and legislatures can respond with more protective laws for small, charitable organizations.

Insurance companies need to wake up and realize that they are writing policies for for-profits that are not suitable for nonprofits.[217] Simply because a nonprofit and a for-profit are both corporate forms does not mean that they need and deserve the same types of

214. 1 FOLK, III ET AL., *supra* note 77, at § 141.2.1, at 141:13.
215. *See supra* part I.B.4.
216. *See supra* note 69 and accompanying text.
217. *See supra* text accompanying note 71.

policies. Directors of these small, charitable organizations are almost always volunteers, bringing varying degrees of business knowledge to the table. Insurance companies need to recognize this and make coverage available for nonprofit directors for mistakes unique to small nonprofits, such as financial miscalculations that a director of a for-profit Fortune 500 company would never make because he or she does such calculations every day.

Further, legislatures could provide nonprofit directors with the lower standards for which this Note argues. As a result, insurance companies would probably be more willing to lower premiums and increase the scope of their coverage for nonprofits. Insurance companies take less of a risk if nonprofit directors no longer faced the number and types of suits that they currently face.

E. Federal Claims Also Require Attention

Even if state legislatures do change their laws and offer more protection to directors of small, charitable nonprofits, these organizations would still be left unprotected against federal claims because state law does not cover federal causes of action. Employment-related suits are an example of federal claims for which state laws offer no protection.[218] Unfortunately, small, charitable organizations probably face employment-related suits more than any other type of suit.[219]

Two possible courses of action could help protect nonprofits against employment-related claims. First, insurance companies could recognize that nonprofits need added protection. Insurance companies could offer policies to nonprofits with some type of protection from employment-related and other federal claims. Second, Congress could enact legislation exempting or limiting liability for directors of small, charitable organizations.[220] Many of the services that charitable organizations provide and many of the activities in which they participate will disappear unless the states or the federal government steps in and provides them. Even if government does step in, it could only provide a fraction of the services and activities that are provided by the endangered nonprofit organizations.

F. What Should the Standards Be?

Having pointed out the enormous problem with the director liability laws with respect to small, charitable organizations, this subsection sketches out some appropriate solutions. While these solutions are fairly simple, they would go a long way toward solving many of the problems.

First, jurisdictions that have not already done so need to enact separate laws for nonprofits. Although this Note has concentrated solely on director liability laws, vast differences between nonprofits and for-profits exist. All nonprofits are important and different enough to deserve separate laws. Even a huge nonprofit like the United Way is

218. *Serving on a Board May Be Hazardous to Your Financial Health*, PR NEWSWIRE, July 23, 1993, *available in* LEXIS, News Library, PRNEWS File.

219. Kurtz, *supra* note 63, at 290-91; Kurtz, *supra* note 165, at 49.

220. Much could be said about the federal side of this issue, but I have endeavored to limit the scope of this Note by concentrating on state laws.

considered a charitable organization, meaning that they should at least receive tax and other advantages that for-profits do not receive.

The three classifications used in the Indiana Nonprofit Act[221] and the Model Nonprofit Act[222] are an excellent start in drafting separate laws. They are, however, a long way from the law to which states should ultimately aspire. Dividing nonprofits into three large groups does not distinguish at all between the very large nonprofits like the United Way and the tiny ones like Mom & Pop's Soup Kitchen. The differences are so great that more subclassifications are needed within these three major classifications to account for the size of the nonprofit and its type of activities and services. Director liability is a perfect example of an area where similar standards for the United Way and Mom & Pop's Soup Kitchen are unwarranted.

Finally, what is the appropriate culpability standard for liability? One of the few commentaries available that argues for different standards depending on the classification of the nonprofit states that Indiana's recklessness standard might be the correct one for mutual benefit corporations.[223] The commentator argues that the mutual benefits do not need a tougher standard because their members can monitor the corporation. Public benefits and religious corporations, however, deserve stricter standards because they do not have anyone besides the attorney general to oversee their activities.[224]

This is a shortsighted approach. This commentator's framework might succeed if one were to think about the word "corporation" in the large sense (*e.g.*, the Wall Street for-profit and the United Way). However, the small, charitable organization—which falls into the public benefit classification—does not need monitoring the way the larger public benefit does. The small charity operates mostly on donations and volunteer time, and does not deal with hundreds of millions of dollars in donations for which careful accounting is necessary. A few simple financial declarations can trace the donations and ensure that they are being used for the charitable purposes.

After rejecting at least part of every existing scheme, this Note proposes that state legislatures adopt a provision holding directors of small, charitable nonprofits liable in two main instances: First, for *intentionally* inflicting harm on the corporation; and second, for *intentionally* violating a criminal law. This is similar to the Model Corporation Act's provision allowing corporations to eliminate director liability in most instances. Although the Model Act's provision has additional exceptions, it does not allow liability to be eliminated if a director intentionally inflicts harm on the corporation[225] or if a director intentionally violates a criminal law.[226]

Critics might say that this standard of allowing directors to escape liability for any act or omission that is not "intentional" is too lenient, and would instead propose a recklessness or similar standard. However, a recklessness or gross negligence standard is about as clear as mud to the average volunteer director of a charitable organization; but an "intentional" standard is very clear. It would reduce actual litigation against directors as well as the perceived threat of litigation that keeps insurance premiums out of reach for most directors of nonprofits. Further, it would allow directors of these small,

221. IND. CODE § 23-17-3-2(2).
222. REVISED MODEL NONPROFIT CORP. ACT § 2.02(a)(2).
223. Paul J. Galanti, *Indiana Nonprofit Corporation Act*, 25 IND. L. REV. 999, 1006 (1992).
224. *Id.*
225. REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(4)(B).
226. *Id.* § 2.02(b)(4)(D).

charitable nonprofits to concentrate on improving their organization, taking their minds off the legal ramifications of every single decision they make.

One notable portion of the Model Corporation Act that should not become part of the standard for directors of small, charitable nonprofits is the provision which disallows directors to be insulated from liability for "the amount of a financial benefit received by a director to which he [or she] is not entitled."[227] This provision would be troubling because a broad reading would allow plaintiffs and courts to recast duty of care violations into duty of loyalty violations. Further, if the director has intentionally diverted money or other assets to his or her personal use, then this action falls under the two exceptions that this Note proposes.

CONCLUSION

Nonprofits are very different from for-profits. They face unique problems, and they deserve unique laws to deal with those problems. This Note has focused on one particular type of nonprofit—the small, charitable organization. In doing so, it has tried to reinforce the above assertion that nonprofits and for-profits are very different, but has also gone further and demonstrated the finer distinction between small and large charities. Legislatures need to realize that small nonprofits cannot exist under the same laws as larger nonprofits, and design separate laws for different groups of nonprofits.

Director liability laws have proven to be an excellent example of an area where different laws are needed to address different needs of the various sizes of nonprofits. Small, charitable organizations are not run with presidents, officers, directors, and others who are paid six-figure salaries and come to work everyday in their BMW's. These officers and directors operate the nonprofit for one purpose: to address social needs that otherwise would go unaddressed. They operate with low overhead and depend on volunteers and donations. Therefore, they need every advantage that they can get, because one lawsuit could easily put them out of business.

It is not too much to ask to pass laws providing that nonprofit directors cannot be held liable unless they intentionally harm the corporation or intentionally violate a criminal law. It is a clear standard that would allow small, charitable organizations to do what they do best—provide needed and helpful services—without having to second guess their every move for fear of a lawsuit alleging a director breached his or her duty of loyalty or acted in a grossly negligent manner.

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227. *Id.* § 2.02(b)(4)(A).