THE WISDOM OF CROWDS? GROUPTHINK AND NONPROFIT GOVERNANCE

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Abstract

Scandals involving nonprofit boards and conflicts of interest continue to receive considerable public attention. Earlier this year, for example, musician Wyclef Jean's Yele Haiti charity became the target of intense criticism after the charity disclosed that it had regularly transacted business with Jean and entities controlled by Jean and other directors. Although scandals caused by self-dealing undermine public confidence in the charitable sector, they continue to erupt. Why do charitable boards sanction transactions with insiders?

This Article argues that much of the blame lies with the law itself. Because fiduciary duty law is currently structured as a set of fuzzy standards that focus on outcome rather than procedure, it facilitates groupthink. Groupthink occurs when directors place allegiance to fellow board members ahead of the nonprofit's best interests, and it can undermine social norms that facilitate sound governance procedures. Groupthink blinds directors to conflicts of interest and may also induce directors to refrain from adequately monitoring ongoing business relationships with board members. When groupthink occurs, boards can convince themselves that their conduct falls within the law's murky limits. As a result, charitable assets are diverted from the charities' intended beneficiaries and into directors' pockets.

Social norms against self-dealing are the primary tool for combating harmful groupthink. The law should be reformulated to support and reinforce fiduciary duties as social norms. Restructuring laws against self-dealing as a set of clear rules would give needed direction to confused boards and would entrench social norms against self-dealing. A flat prohibition on self-dealing and conflict of interest transactions would be the most effective way to ensure that fiduciaries place the best interests of the nonprofit ahead of self-interest. Short of that, clear directives requiring disclosure of conflicts, investigation of alternatives, and proof that inside transactions are clearly below market would do much to counter the damaging impact of groupthink.

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INTRODUCTION

On December 11, 2008, legendary Wall Street trader Bernard L. Madoff was arrested and accused of operating a Ponzi scheme that caused losses estimated at more than $50 billion.[1] Among his many victims were important charities and educational institutions, a few of which lost their entire endowments.[2] While some nonprofits had invested directly with Madoff, others were unaware that money they had entrusted to other financial advisors and hedge funds had been funneled to Madoff to invest. For example, Yeshiva University had invested approximately $15 million with Ascot Partners, an investment firm run by Ezra Merkin, a prominent financial advisor with an impressive track record.[3] Merkin, who charged Yeshiva an annual management fee of 1.5%,[4] simply handed the funds to Madoff and reported annual returns ranging between 10% and 15%.[5]

Yeshiva's board of directors appears to have been unaware that the funds were invested with Madoff,[6] and the board seems not to have questioned how Ascot Partners could generate such strong returns irrespective of market conditions. Although Yeshiva's board was certainly not alone in its failure to detect Madoff's fraud, Yeshiva's failure to monitor Ascot Partner's performance might be attributable to two unfortunate facts: Merkin sat on Yeshiva's board of trustees,[7] and was the head of the investment committee, and Madoff was Yeshiva's treasurer.[8]

Why did the Yeshiva trustees engage in a business relationship with the Chair of the Investment Committee? How did the board fail to detect Merkin's abdication of responsibility? Yeshiva's board's behavior, though extreme, is not rare. Many nonprofits regularly engage in transactions with their directors.[9] Although many charities report that

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1. Diana B. Henriques & Zachery Kouwe, *Prominent Trader Accused of Defrauding Clients*, N.Y. TIMES, Dec. 12, 2008, at A1.

2. *See* Liz Rappaport, *Financier Charged in Madoff Fraud*, WALL ST. J., Apr. 7, 2009, at A1; Stephanie Strom, *Giant Wall St. Fraud Leaves Charities Reeling*, N.Y. TIMES, Dec. 16, 2008, at A1.

3. Jason Zweig, *The Intelligent Investor: Where Ezra Merkin Lost His Way*, WALL ST. J., Jan. 10, 2009, at B1.

4. *Id.*

5. David Segal & Alison Leigh Cowan, *Madoffs Shared Much; Question is How Much*, N.Y. TIMES, Jan. 15, 2009, at A1.

6. *See* Rappaport, *supra* note 2.

7. Javier C. Hernandez, *Betrayed by Madoff, Yeshiva U. Adds a Lesson*, N.Y. TIMES, Dec. 23, 2008, at A1.

8. Zweig, *supra* note 3.

9. *See infra* text accompanying notes 118–25 (discussing findings in FRANCIE OSTROWER, THE URBAN INST., NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY

these deals are on terms that are "below market," a substantial number disclose that many deals with directors are no better than the nonprofit could have obtained by transacting in the marketplace. More troubling, charities' determinations that these insider deals are "below market" or "at market" often turn out to be based on nothing more than board members' intuitions or guesses about prevailing market rates. Recently, for example, musician Wyclef Jean's Yele Haiti charity became the target of intense criticism after the revelation that the charity transacted business with Jean and entities controlled by Jean and other directors. In one such deal, the charity paid Jean $100,000 to perform at a fundraiser.[10] Although the charity reported that Jean's fee was "'substantially less' than his market value,"[11] evidence suggests it greatly exceeded both the fee that Jean could realistically command[12] and the price the charity would have had to pay to entice a different musician to perform at the fundraiser.[13]

(2007), *available at* http://www.urban.org/UploadedPDF/411479_Nonprofit_Governance.pdf). In 2009 alone, the country witnessed several notable examples of self-dealing by nonprofit directors. In April of 2009, for example, a local newspaper reported that Hackensack University Medical Center's board routinely engaged in major transactions with board members, often without the advance approval of the full board. Mary Jo Layton, *Hospital's Influence Reaches Far; Tangled Web of Power*, THE RECORD (Bergen County, N.J.), Apr. 26, 2009, at A1. In response to the newspaper article, the hospital hired two major law firms to "review its governance policies." Mary Jo Layton, *Firms Hired to Review Hospital's Policies; Hackensack's Move in Wake of Influence Peddling Conviction*, THE RECORD (Bergen County, N.J.), Apr. 30, 2009, at L3. On June 11, 2009, the *Los Angeles Times* reported that Tarzana Treatment Center Inc., a nonprofit with a $45 million annual budget that provides public health services, paid unusually high salaries to senior executives and that two of the board members purchased real estate and leased it back to the nonprofit. Alan Zarembo, *Execs Earn Big Money at Drug Treatment Center; Salaries at a Tarzana Nonprofit Far Exceed Others in the Field*, L.A. TIMES, June 11, 2009, at A1. A follow up report by the Center for Public Accountability estimated that transactions between the nonprofit and directors cost the nonprofit an extra $22 million during the past eleven years. *See* CTR. FOR PUBLIC ACCOUNTABILITY, SELF DEALING BY EXECUTIVES AND BOARD MEMBERS OF THE NONPROFIT TARZANA TREATMENT CENTER: REPORT TO CALIFORNIA ATTORNEY GENERAL EDMUND G. BROWN JR. 1 (2009), *available at* http://accountablecalifornia.org/2009/09/report-self-dealing-by-tarzana.html.

10. *See* Shelly Banjo, *Wyclef Jean Charity to Receive MTV Telethon Funds, Still Under Scrutiny by Watchdogs*, SPEAKEASY, Jan. 22, 2010, http://blogs.wsj.com/speakeasy/2010/01/22/wyclef-jean-charity-to-receive-mtv-telethon-funds-still-under-scrunity-by-watchdogs/.

11. *See Wyclef's Funny Money Part II*, THE SMOKING GUN (Jan. 19, 2010), http://www.thesmokinggun.com/archive/years/2010/0119101wyclef1.html.

12. The peak of Jean's career occurred in 1996, when he was a member of The Fugees. *Id.* Contracts obtained by the website The Smoking Gun reveal that Jean commanded $40,000 to perform at a festival in 2002 (in a stadium with 10,000 seats). *Id.* In early 2008, Jean toured with his band mates in clubs averaging 1,000 seats. *Id.* It is unlikely that he was paid substantially more than $100,000 for these performances. *Id.*

13. The Smoking Gun examined the tax returns of forty charities founded by or closely affiliated with celebrities, including Leonardo DiCaprio, Justin Timberlake, Angelina Jolie, Brad Pitt, Will Smith, Bruce Springsteen, Britney Spears, Jay-Z, Madonna, Tiger Woods, Alicia

When transactions with directors cost the nonprofit even slightly more than market rates or provide goods or services that the nonprofit does not truly need, they siphon the nonprofit's resources away from the mission and towards insiders. It is all too easy to understand the motivations of the Madoffs, Merkins, and Jeans, who directly profit from these transactions. But why do well-intentioned board members, who do not stand to profit, authorize or participate in these transactions?

At least part of the reason is that nonprofit boards are extraordinarily vulnerable to "groupthink"[14]—a phenomenon that occurs when members of a cohesive group, such as a corporation's board of directors, place the desire for group unity ahead of the best interests of the nonprofit corporation.[15] Board members' preferences for consensus, approval, and group solidarity can intensify the effect of pre-existing biases that impede rational decision-making, such as confirmation bias,[16] ingroup bias,[17] and overconfidence in one's ability to act fairly.[18] The chances that groupthink will occur increase in the absence of

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Keys, Derek Jeter, David Letterman, LeBron James, Jay Leno, Michael J. Fox, Barbra Streisand, Bill Gates, Sean "Diddy" Combs, Martin Scorsese, Michael Douglas, Steven Spielberg, Snoop Dogg, Lenny Kravitz, Danny DeVito, Russell Simmons, Dave Matthews, Richard Gere, Ron Howard, Edward Norton, Jane Fonda, Stevie Nicks, Sharon Stone, Kirk Douglas, Bruce Willis, Peyton Manning, Kelsey Grammer, David Geffen, Gloria Estefan, Stephen King, and Tom Brokaw. *Id.* Not one of these charities ever paid a celebrity for services rendered, even at a discounted rate. *Id.*

14. Professor Irving L. Janis appears to have first coined the term in his book *Victims of Groupthink*. IRVING L. JANIS, VICTIMS OF GROUPTHINK 9 (1972). *See also* CASS R. SUNSTEIN, GOING TO EXTREMES 85 (2009) [hereinafter SUNSTEIN, GOING TO EXTREMES]; Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 85–86 (2000) [hereinafter Sunstein, *Deliberative Trouble?*] (explaining how group dynamics can lead to groupthink, which leads people to adopt positions just because other members of their group have adopted them).

15. *See* James D. Cox & Harry L. Munsinger, *Bias In the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 88–91 (1985) (discussing extensive behavioral research studies supporting this point).

16. *See* Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 REV. GEN. PSYCHOL. 175, 175 (1998) (defining confirmation bias as "the seeking or interpreting of evidence in ways that are partial to existing beliefs, expectations, or a hypothesis in hand"); J. Edward Russo et al., *The Distortion of Information During Decisions*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 102, 107–08 (1996) (discussing the results of an experiment indicating that individuals distort new information to conform to their pre-existing preferences); David M. Sanbonmatsu et al., *Overestimating Causality: Attributional Effects of Confirmatory Processing*, 65 J. PERSONALITY & SOC. PSYCHOL. 892, 892–93 (1993).

17. Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 249–53 (2009) (providing a thorough review of the psychological studies establishing ingroup bias).

18. *See* Dolly Chugh et al., *Bounded Ethicality as a Psychological Barrier to Recognizing Conflicts of Interest*, *in* CONFLICTS OF INTEREST: CHALLENGES AND SOLUTIONS IN BUSINESS, LAW, MEDICINE AND PUBLIC POLICY 74, 81 (Don A. Moore et al. eds., 2005).

methodical decision-making procedures[19] if the leader exhibits a "closed" leadership style[20] or if decision-makers lack sufficient information to enable them to arrive at an independent decision.[21]

The more cohesive the group—that is, the more group members view group membership as an important component of their identity—the more fertile the ground for groupthink.[22] When groupthink occurs, group members' desire to confirm their place in the group may lead them to presume that the views of the majority or dominant group members are sound and fair, and they may ignore or fail to seek out information that contradicts those views. This misplaced loyalty to the group is often unconscious. The result is that group members may ignore or minimize the dangers of conflict of interest transactions.

As currently structured, the law governing nonprofit fiduciaries exacerbates rather than counteracts harmful groupthink. Psychological studies indicate that an awareness that the decision-maker will be held accountable for failing to engage in an adequate decision-making process may correct for certain cognitive biases.[23] But the law governing nonprofit conflict of interest transactions fails to require any such procedure. State fiduciary duty law that instructs boards how to handle self-dealing and conflict of interest transactions is vague, essentially communicating to boards that these problematic transactions are appropriate if they are "fair."[24] This standard fails to correct for

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19. *See* Christopher P. Neck & Gregory Moorhead, *Groupthink Remodeled: The Importance of Leadership, Time Pressure, and Methodical Decision-Making Procedures*, 48 J. HUM. REL. 537, 549–50 (1995); Philip E. Tetlock et al., *Assessing Political Group Dynamics: A Test of the Groupthink Model*, 63 J. PERSONALITY & SOC. PSYCHOL. 403, 404 (1992).

20. Neck & Moorhead, *supra* note 19, at 550–53.

21. Sunstein, *Deliberative Trouble?*, *supra* note 14, at 82–83.

22. *See* Michael A. Hogg & Sarah C. Hains, *Friendship and Group Identification: A New Look at the Role of Cohesiveness in Groupthink*, 28 EUR. J. SOC. PSYCHOL. 323, 337 (1998); Marlene E. Turner et al., *Threat, Cohesion, and Group Effectiveness: Testing a Social Identity Maintenance Perspective on Groupthink*, 63 J. PERSONALITY & SOC. PSYCHOL.781, 789 (1992).

23. *See generally* Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOL. BULL. 255 (1999) (thoroughly describing the psychological research on accountability); *see generally also* Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 508–26 (2002) (applying the psychological literature on accountability to determine the impact of standards of judicial review on agencies).

24. The 1987 version of the Revised Model Nonprofit Corporation Act provides that a conflict of interest transaction is not void or the basis for imposing liability if it is either (1) fair to the corporation, (2) was approved by a majority of the disinterested directors, or (3) after full disclosure, a committee of the board and the voting board members "in good faith reasonably believe[d]" that the transaction was fair. REVISED MODEL NONPROFIT CORP. ACT § 8.31 (1987). The Revised Model Nonprofit Corporation Act has been adopted in full or in part by twenty-three states. *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, AND ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 76 (June 2005), *available at*

board members' cognitive defects, including the tendency to overestimate their abilities to act fairly. It allows directors to convince themselves that they are furthering the charities' best interests when they are in fact placing self-interest or the interests of board members ahead of the nonprofit corporation's interest. Lack of meaningful enforcement at the state level further compounds the problem; there is little case law to give meaning to standards, and directors are often unsure whether and to what extent particular decisions may have legal consequences.[25]

Although the Internal Revenue Code (Code) requires nonprofits to comply with certain fiduciary duties as a condition of tax-exempt status, it also exacerbates groupthink. And while the Code creates some incentives to engage in sound decision-making procedures,[26] it too employs fuzzy standards that fail to correct for cognitive biases. Consequently, the Code, like state law, enables directors to convince themselves that questionable decisions are in the nonprofit's best interest. Embedded in the Code are three different doctrines addressing board transactions with interested directors, all articulated in terms at least as fuzzy as state law.[27] The IRS rarely enforces the rules on dealing with insiders,[28] leaving nonprofits with little guidance about how the IRS might apply code provisions in any particular case.

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http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf.

25. *See infra* Part IV.

26. Treasury Regulation § 53.4958-6 directs that a nonprofit can gain the presumption that an insider transaction was "reasonable" if the transaction is approved by a board entirely made up of independent directors who make a determination based on comparability data, such as that obtained through their own research, expert opinions, and actual competing offers, and the board adequately documents the basis for its determination. 26 C.F.R. § 53.4958-6 (2010).

27. The private benefit doctrine requires charities to abstain from conferring more than an incidental private benefit on individuals other than insiders. I.R.C. § 501(c)(3) (2006); 26 C.F.R. § 1.501(c)(3)–1(d)(1)(ii) (2006); *see also* I.R.S. Gen. Couns. Mem. 39598, 1987 GCM LEXIS 2, at *13–16 (Jan. 23, 1987); John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1064–67 (2006). 26 C.F.R. § 1.501(c)(3)–1(d)(1)(ii). I.R.C. § 501(c)(3) prohibits charities from engaging in transactions that result in more than incidental "inurement" of charitable funds to insiders. *See* I.R.C. § 501(c)(3) (2006); 26 C.F.R. § 1.501(c)(3)–1(c)(2). I.R.C. § 4958(c)(1)(A) imposes penalties on "disqualified person[s]" who engage in "excess benefit" transactions, and the managers who approve them. The Code defines an "excess benefit transaction" as

> any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

I.R.C. § 4958(c)(1)(A) (2006).

28. Jay Hancock, *Nonprofits Seem in No Big Hurry to Fix Their Problems*, BALT. SUN, Mar. 2, 2005, at 1D.

This Article argues that the law governing fiduciary conduct can and should be reformulated to counteract groupthink and encourage the development of sound decision-making procedures with respect to conflict of interest transactions. Reform should have two goals: increasing the specter of accountability and clearly communicating whether and in what circumstances conflict of interest transactions are justifiable.

Given that we are unlikely to see significant increases in funding to enable state and federal actors to increase enforcement efforts, increasing accountability is a serious challenge. This Article argues that the key to increasing accountability lies in understanding that fiduciary duties are social norms as well as legal principles. Breach of social norms generates social sanctions. When group membership is an important part of a group member's self-identity, the threat of reputational sanctions, which may affect status in the group and larger community, can be a powerful force.[29] The key, then, is to reshape the law so that it strengthens fiduciary duties as social norms. To accomplish this, the law should move away from fuzzy standards and towards more "rule-like" articulations. These legal rules should be simple and procedural in nature to increase the chance that they will impact the behavior of over-committed and under-resourced board members. By clearly communicating that self-dealing transactions are inherently problematic and prohibiting or, at the very least, prescribing a procedure for responsibly handling them, the law can bolster fiduciary duties as social norms to benefit all nonprofits.

I. The Puzzle of the Nonprofit Corporation

The nonprofit corporation presents a puzzle for scholars and policy makers. Although nonprofits share structural similarities with their for-profit counterparts, such as a board of directors and a chief executive, the central dilemma for nonprofit law is that nonprofit fiduciaries are not accountable to a principal.[30] In the for-profit context, shareholders have standing and a financial incentive to sue for egregious breaches of fiduciary duties. Perhaps more importantly, shareholders can object to poor management decisions by simply selling their shares. Share price can therefore serve as a measuring stick for fiduciaries' performance.

But the nonprofit corporation is largely immune from the market pressures faced by its for-profit counterpart. By definition, the nonprofit

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29. Tom R. Tyler, Why People Obey the Law, 22–27 (Princeton Univ. Press 2006) (1990). Professor Tom Tyler explains that when an extremely high level of societal investment, in such activities as policing and monitoring is necessary to induce people to obey the law, normative values and social relations may be more effective means for inducing compliance. *Id.*

30. *See* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 458, 465–66 (1996).

lacks residual stakeholders who will monitor fiduciary performance.[31] Donors generally do not have standing to sue for breach of fiduciary duty.[32] Thus, it is often said that nonprofit fiduciaries owe their duties to the nonprofit itself or to the public at large. Although the attorney general has standing to enforce the public's interest, state attorneys general have neither the resources nor the inclination to focus on monitoring nonprofit fiduciaries.[33] And when they do detect breaches of fiduciary duty, litigation is rarely the result; instead, attorneys general often choose to work quietly with the nonprofit to reform its governance procedures.[34] While the motivation is laudable, the result is that other charities are unaware of what acts can lead to trouble.

The Code also attempts to constrain fiduciary behavior. As a condition of tax-exempt status, the Code requires 501(c)(3) nonprofits to ensure that all charitable funds are spent to accomplish the charity's mission, instead of enriching insiders—the same concept the state law duty of loyalty captures.[35] But the IRS devotes relatively few resources to auditing charities' compliance with these tax code provisions.[36]

Thus, neither law nor markets put pressure on directors to work diligently and refrain from authorizing or engaging in conflict of

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31. The defining characteristic of the nonprofit corporation is the "nondistribution constraint"; by adopting the nonprofit form, the corporation agrees that profits shall not be distributed to equity owners. *See* Henry Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980). The rule protects donors and potential beneficiaries of nonprofit corporations. *Id.* at 845; *see also* Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 616 (1999) ("Any person served by the entity has an interest in seeing that it is run properly, but no one person is likely to have the incentive, the ability, or the information necessary to monitor the charity. Further, beneficiaries are unlikely to have standing to enforce their rights as beneficiaries.").

32. Gary, *supra* note 31.

33. *See* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 938–39 (2004); *see also* Gary, *supra* note 31, at 623 (noting that even in those states where the attorney general's office has an active enforcement division, most enforcement efforts occur in response to complaints by whistleblowers or the press).

34. As Professor Evelyn Brody explains, much (if not most) charity enforcement activity occurs below the radar screen of court decisions. A case that does go to court might result in no written or reported opinion, and published decisions occur so sporadically in most jurisdictions that it is risky to read them as considered state law and policy. More commonly, cases arise and settle without any public attention. Even when one side or the other seeks publicity, news stories might serve as the only source of information. Unfortunately, press accounts sometimes oversimplify (if not contain factual and legal mistakes) and appear only if editors and publishers deem them newsworthy. Brody, *supra* note 33, at 942; *see also* James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 268 (2003) ("[S]tate attorney general offices have neither the person-power, nor sometimes the will, to monitor nonprofits effectively.").

35. *See supra* note 27.

36. *See* Roger C. Siske & Pamela Baker, *Executive Compensation: Strategy, Design and Implementation: Tax Exempt Organizations Compensation Audits:403(B) and 457(B) and (F)*, SK091 A.L.I.–A.B.A. 77, 79 (2005) (stating that the IRS audits fewer than 1% of the 990 Forms filed each year).

interest transactions. It is up to boards of directors to police themselves—to ensure that the nonprofit is run effectively and that charitable assets go towards the mission and not into the pockets of insiders. Whether this policing mechanism is effective depends on the degree to which board members are committed to honoring fiduciary duties as social norms. When nonprofit boards govern effectively, and a great many of them do, it is because fiduciaries are morally committed to abiding by fiduciary duties, regardless of whether the law enforces them. Directors prevent self-dealing and conflict of interest transactions that divert assets from the charitable mission because they believe it is the right thing to do.

Norms and law, however, do not occupy separate, airtight compartments. Even though fiduciary duty law is not predictably nor regularly enforced, it can still play a role in helping boards govern. The law also performs an expressive function. It can communicate norms of behavior to fiduciaries.[37] Unfortunately, the law articulating nonprofit directors' fiduciary duties does a poor job of directing how boards should approach self-dealing and conflict of interest transactions. Most states simply transplant the standards applicable to for-profit corporations into nonprofit law. In these states, a transaction with a board member that is "fair" to the nonprofit is not void and furnishes no basis for imposing personal liability.[38] These statutes presume that a transaction is "fair" if a majority of disinterested directors approved the transaction after full disclosure.[39] If a transaction so approved is later challenged, it is unclear whether a reviewing court will apply the business judgment rule or a higher standard of scrutiny.[40] In the end, the message that state law sends to a nonprofit board is simple, though problematic: self-dealing and conflict of interest transactions are allowable if they are "fair."

37. *See* Cass R. Sunstein, *On the Expressive Function of the Law*, 144 U. PA. L. REV. 2021, 2025–26 (1996) [hereinafter Sunstein, *Expressive Function*] (arguing that the way in which a legal rule is framed can influence social norms); *see also* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PENN. L. REV. 1735, 1796–97 (2001); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1253, 1265–66 (1999); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 54–55 (2000); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 907, 910 (1996) [hereinafter Sunstein, *Social Norms*].

38. REVISED MODEL NONPROFIT CORP. ACT § 8.31(a) (1987); *see also* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 215, 221–22 (2004).

39. Thirty-five states have adopted this standard. FREMONT-SMITH, *supra* note 38, at 220; *see, e.g.*, FLA. STAT. § 617.0832 (2010). Of the thirty-five states, seven states and the RMNCA further require that the disinterested directors "reasonably believe that the transaction is fair to the corporation." REVISED MODEL NONPROFIT CORP. ACT § 8.31(b)(1)(i)-(ii) (1987); FREMONT-SMITH, *supra* note 38, at 220–21. Still others require that the disinterested board members approve the self-dealing transaction "in good faith." *See, e.g.*, COLO. REV. STAT. § 7-128-501 (West 2010).

40. *See* FREMONT-SMITH, *supra* note 38.

The Code contains several provisions that target self-dealing and conflicts of interest. As a condition of 501(c)(3) status, and the variety of tax benefits that come with it, the Code directs that the nonprofit shall be run for public, as opposed to private, benefit.[41] The Code also prohibits private inurement[42] and penalizes boards for approving "excess benefit" transactions—transactions that grant insiders more consideration than the insider could receive for the goods or services in a market transaction.[43] Although the Code uses different terminology than state law, these doctrines communicate the same message: self-dealing transactions are permitted so long as they are "fair."

II. BOARDS OF DIRECTORS AND AGENCY COSTS

A fiduciary's task is to manage assets for the benefit of the principal, often in exchange for some agreed-upon compensation. The essence of the fiduciary arrangement is the fiduciary's promise to subordinate self-interest and place the interest of the principal first. Agency costs arise because of the potential that the agent will act out of self-interest by shirking, acting negligently, or extracting value from the relationship that exceeds the agreed-upon compensation amount.[44]

When fiduciaries act as a group, such as a board of directors, self-interest can generate agency costs in additional ways. For example,

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41. *See supra* note 27.

42. I.R.C. § 501(c)(3) prohibits charities from engaging in transactions that result in inurement of charitable funds to insiders. *See* I.R.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3)–1(c)(2).

43. I.R.C. § 4958(c)(1)(A) (2006) (imposing penalties on "disqualified persons" who engage in "excess benefit" transactions and the manager who approves them and defining "excess benefit transaction" as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit").

44. Professor Michael C. Jensen and Dean William H. Meckling define agency costs as "the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, and (3) the residual loss." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). Jensen and Meckling explain:

> If both parties to the [agency] relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.

Id.

shirking may intensify because over-committed board members may be tempted to free-ride off the efforts of other directors. Or a director's desire to curry favor with another board member may lead her to acquiesce in the director's self-dealing behavior. Finally, the social norms of reciprocity and cooperation that facilitate group functioning may lead groups to engage in groupthink.[45] Although groupthink does not necessarily lead to poor decisions, it often leads group members to adopt beliefs that are contrary to fact or make decisions that damage the principal's interest, even if none of the individual group members would have made the decision acting alone. In particular, groupthink often blinds group fiduciaries to conflicts of interest and related ethical dilemmas. The following sections explain how groupthink works, and explore the psychology of group dynamics to illustrate how group decision-making processes can lead fiduciaries to place the interests of members of the group ahead of the interest of the principal, creating serious damage to the principal.

A. *Explaining Groupthink*

Ideally, group decisions will be qualitatively better than individual ones because group deliberation will compensate for the bounded rationality of individual members. Individuals have cognitive limitations that can impede rational and efficient decision-making, such as deficits in memory and computation skills, limits on the amount of information they can process, or overestimation of their own judgment or abilities.[46] People have distinctive areas of expertise and different life experiences. The diversity of talents and strengths among group members can compensate for individual weaknesses, producing decisions that are synergistically better than those any one member of the group might have made acting alone.[47] Corporate law scholars have used this insight, gleaned from early psychological studies on group dynamics, to explain why U.S. corporations are governed by boards of directors.[48]

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45. As Janis explains: "I use the term 'groupthink' as a quick and easy way to refer to a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' strivings for unanimity override their motivation to realistically appraise alternative courses of action." JANIS, *supra* note 14.

46. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 12–31 (2002) (discussing experiments by Shaw, Blinder & Morgan, Miner, and the Hiltz Group and arguing that their findings are applicable to corporate boards); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 9–12 (1981) (exploring a variety of behavioral science studies and concluding that group deliberation has a synergist effect which results in better decisions than individuals would have made).

47. Bainbridge, *supra* note 46, at 12–19; Haft, *supra* note 46.

48. *See, e.g.*, Haft, *supra* note 46 (exploring a variety of behavioral science studies and

Yet, more recent psychological research has established that group dynamics often undermine the advantages traditionally associated with group decision-making. Group members often value group cohesion and consensus more than the superior results that the deliberative process is designed to produce.[49] The desire to be a valued member of the group and the corresponding—and often unconscious—fear of the disapproval that might result from challenging the predominant view within the group can lead group members to short circuit the decision-making process and reflexively follow the lead of the dominant group member or members.[50] Instead of engaging in a thorough decision-making process involving questioning, open discussion and seeking out and evaluating conflicting evidence, individuals engage in "groupthink," which may lead them to adopt views or concur in decisions that contradict their independent judgment, experience, intuition, or perception.[51] Groupthink also leads group members to adopt a "quid pro quo" mentality; the reciprocity norm leads group members to confer reciprocal benefits on one another.

Individual cognitive limitations facilitate groupthink. For example, when faced with complicated issues, people exhibit "confirmation bias."[52] People will seek out information that confirms their beliefs, interpret neutral information as confirming their beliefs, and will fail to seek out or ignore information that challenges their instincts.[53] In group

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concluding that group deliberation has a synergist effect which results in better decisions than individuals would have made).

49. *See supra* note 14.

50. Janis explains the studies:

> Whenever a [group] member says something that sounds out of line with the group's norms, the other members at first increase their communication with the deviant. Attempts to influence the nonconformist member to revise or tone down his dissident ideas continue as long as most members of the group feel hopeful about talking him into changing his mind. But if they fail after repeated attempts, the amount of communication they direct toward the deviant decreases markedly. The members begin to exclude him, often quite subtly at first and later more obviously, in order to restore the unity of the group.
>
> . . . [Experiments show that] the more cohesive the group and the more relevant the issue to the goals of the group, the greater is the inclination of the members to reject a nonconformist. Just as the members insulate themselves from outside critics who threaten to disrupt the unity and esprit de corps of their group, they take steps, often without being aware of it, to counteract the disruptive influence of inside critics who are attacking the group's norms.

JANIS, *supra* note 14, at 5.

51. *Id.*

52. *See* sources cited *supra* note 16.

53. Page, *supra* note 17, at 265; *see* Cox & Munsinger, *supra* note 15 (discussing

situations, this editing impulse can lead them to turn a blind eye to information that challenges the majority view of the group and to absorb only the information that supports it.

Another documented cognitive limitation many people share is an overestimation of their own objectivity. Most individuals view themselves as more fair and moral than other people, and this self-conception causes them unconsciously to favor interpretations of reality that confirm that view.[54] Individual members of a cohesive group may extend this bias to other group members, adopting a belief that the abilities and opinions of group members are superior to those of nongroup members.[55] This "ingroup bias" causes group members to favor other group members in a variety of ways, for instance, in rating performance, assigning financial benefits, or in a willingness to advocate on behalf of other group members.[56] Ingroup bias is often automatic and unconscious.[57] Studies have shown that individuals easily form allegiances to groups, and that ingroup bias occurs even when members share only superficial factors in common, such as the same birthday or fingerprint type.[58] But the more group members have in common—socially, economically, or otherwise—the stronger the ingroup bias and the more vulnerable the group is to groupthink.[59]

In group experiments, this unconscious bias often causes group members to judge an act that gives an advantage to one group member as "fair" even when it is not. This tendency blinds group members to the ethical issues implicit in decisions involving a conflict of interest. In

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extensive behavioral research studies supporting this point); *see also* Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2101–04 (1979) (establishing that people tend to interpret ambiguous information to confirm their initial point of view).

54. *See* Chugh et al., *supra* note 18, at 84. That is, in addition to "bounded rationality," group members suffer from "bounded ethicality": a limited ability to recognize ethical challenges inherent in a decision involving a conflict of interest. *Id.* at 75.

55. In a recent article, Professor Antony Page provides a thorough review of the social psychology literature establishing ingroup bias. *See* Page, *supra* note 17.

56. *Id.* at 249–52.

57. *Id.* at 249–50.

58. Page summarized several experiments showing that people formed allegiances to other people even when group membership was based on a coin toss, the same fingerprint type, the same birthdate, or the final digit of a social security number. *See id.* at 249 (citing the following studies: Michael Billig & Henri Tajfel, *Social Categorization and Similarity in Intergroup Behaviour*, 3 EUR. J. SOC. PSYCHOL. 27, 37–48 (1973); Jerry M. Burger et al., *What a Coincidence! The Effects of Incidental Similarity on Compliance*, 30 PERSONALITY & SOC. PSYCHOL. BULL. 35, 35 (2004); John. F. Finch & Robert B. Cialdini, *Another Indirect Tactic of (Self-) Image Management: Boosting*, 15 PERSONALITY & SOC. PSYCHOL. BULL. 222, 228–30 (1989); Henri Tajfel et al., *Social Categorization and Intergroup Behavior*, 1 EUR. J. SOC. PSYCHOL. 149, 172–77 (1971); Henri Tajfel, *Cognitive Aspects of Prejudice*, 25 J. SOC. ISSUES 79, 83–86 (1969)).

59. Cox & Munsinger, *supra* note 15, at 105–08; Page, *supra* note 17, at 251.

evaluating conflicts of interest, group members either tend to believe that the conflict will not affect their judgment[60] or they entirely fail to perceive the conflict at all.[61] In fact, instead of appreciating the ethical and legal issues presented by a conflict of interest transaction, group members often view the transaction as an opportunity to reward particular group members for loyalty to the group. Some group members may even feel obliged to confer such rewards.[62] These findings have led at least one group of researchers to argue that the most pervasive and dangerous types of ethical breaches are the result of unconscious behavior.[63]

Although there is not, as of yet, a fully developed account of or consensus about why groupthink occurs, psychological studies pinpoint several factors or variables that can increase the likelihood that groupthink will transpire. The first, and perhaps most important, variable is the level of group cohesiveness. A second group of variables concern decision-making procedures: whether and to what extent decision-making occurs against a background group norm favoring thorough decision-making processes, whether group members are sufficiently informed to enable them to make a particular decision, whether the group has obtained information about a particular decision from sources outside the group, and the extent to which group members feel pressure to make a quick decision. A third variable relates to leadership. If there is no organizational norm of impartial leadership and if the leader adopts a "closed" leadership style in a particular instance, groupthink may result.

First, groupthink occurs when groups exhibit a high level of cohesiveness. A cohesive group is one where group members view group membership as an important element of individual identity.[64] As two researchers explain:

> [A] cohesive group is one in which the process of self-categorization has produced, through depersonalization, a constellation of effects that include intragroup conformity, intergroup differentiation, stereotypic perception, ethnocentrism, and positive inter-member attitude. Positive

60. Chugh et al., *supra* note 18, at 82.

61. Page, *supra* note 17, at 259.

62. Chugh et al., *supra* note 18, at 76.

63. *See id.*

64. Hogg & Hains, *supra* note 22, at 337. Early critics of Janis's description of groupthink conducted studies that cast doubt on whether cohesiveness facilitated groupthink. *See* Tetlock et al., *supra* note 19, at 404 (surveying studies casting doubt on whether cohesiveness is a principal antecedent to groupthink). Those studies, however, failed to distinguish between friendship and cohesiveness; in none of those studies was membership in the particular group an important part of group members' self-identity.

> inter-member attitude produced thus is *social attraction*, wherein group members are liked not as unique individuals but as embodiments of the group—the more prototypical they are perceived to be, the more they are liked.[65]

Cohesiveness should not be confused with friendship:

> Depersonalized social attraction can be distinguished from *personal attraction* based on idiosyncratic preferences grounded in personal relationships. . . . Social attraction . . . is influenced by identification with the group, while personal attraction is associated with interpersonal similarity and is influenced by interpersonal relations not group identification.[66]

Thus, friendship among group members does not necessarily set the stage for groupthink. Because people view friends as individuals, disagreement and discussion between friends may not threaten one friend's sense of personal identity. In a cohesive group, however, the reverse is true: A group member's desire to be a valued member of the group and the corresponding fear—often unconscious—of the disapproval or rejection that might result from challenging the predominant view within the group can lead a group member to value group cohesion and consensus more than a deliberative decision-making process.[67]

Factors related to a group's decision-making process can also tip the balance toward groupthink. Psychologists suggest that an absence of a group norm of methodical decision-making procedures can enhance the possibility of groupthink.[68] Vulnerability to groupthink also intensifies when individual group members lack sufficient knowledge to make an informed decision. In this instance, the uninformed group members can be strongly influenced by the views of the majority; if several group members share an opinion, other members may interpret that fact as both evidence of the validity of the opinion and as a signal of what the group expects from them.[69] The result can be an "informational

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65. Hogg & Hains, *supra* note 22, at 326 (internal citation omitted).

66. *Id.*

67. *See* sources cited *supra* note 14; *see also* Neck & Moorhead, *supra* note 19, at 548 (suggesting that members of cohesive groups are often reluctant to respond honestly to other members for fear of endangering the group's sense of solidarity); Turner et al., *supra* note 22 (announcing study's conclusion that, "Our overall pattern of data reinforces Janis's view of groupthink as a process in which group members attempt to maintain a shared, positive view of the functioning of the group or as social identity maintenance." (internal citation omitted)).

68. Neck & Moorhead, *supra* note 19, at 550 (recounting psychological studies that support this point).

69. Sunstein, *Deliberative Trouble?*, *supra* note 14, at 83 (citing TIMUR KURAN, PRIVATE

cascade": a critical mass is reached where even large groups of people "end up believing something—even if that something is false—simply because other people seem to believe that it is true."[70] Moreover, the lack of outside information can intensify the pressure to conform, lead to a loss of perspective and objectivity, and negatively impact the quality of the decision.[71]

Finally, some studies suggest that the leadership style of the group leader can determine whether groupthink occurs. These studies distinguish between an "open" leadership style—one that encourages discussion, dissent, and investigation—with a "closed" style, in which the group leader telegraphs her position at the outset of deliberations, discourages views or information that conflict with her position, and deemphasizes the importance of making a wise decision.[72]

As Professor Cass Sunstein has recently shown, when groupthink occurs, group members who are initially inclined toward a particular view will become more committed to that view after group discussion.[73] During discussion, group members hear new arguments that support their initial inclination, members interpret others' adoption of the same view as corroboration of the correctness of the position, and members may seek validation or admiration for the force of their conviction.[74] This process can cause group members to adopt riskier or more cautious positions than they otherwise would.[75]

In sum, groupthink can create various defects in the group decision-making process that have been shown to lead to poor decision-making: the group may fail to express dissent,[76] ask questions or consider the full range of alternative options;[77] may decline to re-examine the decision initially preferred by a majority of group members in light of changing events; make little effort to obtain information by asking questions or

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TRUTH, PUBLIC LIES 16–21 (1995)).

70. *Id.* at 82.

71. Neck & Moorhead, *supra* note 19, at 548.

72. *Id.* at 551–53 (using various psychological studies to support this point).

73. Sunstein, *Deliberative Trouble?*, *supra* note 14, at 85; SUNSTEIN, GOING TO EXTREMES, *supra* note 14, at 90.

74. SUNSTEIN, GOING TO EXTREMES, *supra* note 14, at 21–30.

75. *Id.* at 6–7.

76. *See* Samuel N. Fraidin, *Duty of Care Jurisprudence: Comparing Judicial Intuition and Social Psychology Research*, 38 U.C. DAVIS L. REV. 1, 50–58 (2004) (considering a number of psychological studies that establish that group decisions are better when group members express dissent).

77. Studies show that groups that consider multiple alternatives have a greater chance of arriving at a decision that represents the best course of action. *See id.* at 42–46 (summarizing the following psychological studies: Michael Diehl & Wolfgang Stroebe, *Productivity Loss in Brainstorming Groups: Toward the Solution of A Riddle*, 53 J. PERSONALITY & SOC. PSYCHOL. 497, 501 (1987); Richard P. McGlynn et al., *Brainstorming and Task Performance in Groups Constrained by Evidence*, 93 ORG. BEHAV. & HUM. DECISION PROCESSES 75, 84–85 (2004)).

consulting experts or outsiders with information;[78] and exhibit bias in their reactions to information, focusing on facts or opinions that confirm the group's initial inclination and ignoring those that do not.[79] Finally, groupthink may lead members to spend too little time exploring how their course of action might later be derailed by opponents, accidents, or future occurrences.[80]

B. *Fiduciaries and Groupthink*

A number of scholars have argued that groupthink is quite pronounced in the boardrooms of corporate America, and recent corporate scandals such as Enron, WorldCom, and credit-default swaps provide strong evidence for their position.[81] Boards are generally extremely cohesive groups[82]—directors often come from the same social or economic class and often have personal and business relationships.[83] Moreover, directors have strong incentives to remain directors; in addition to the paycheck, directorships confer prestige and increase self-esteem. Directors take pride in belonging to a group of accomplished and influential people, and directorships increase the director's reputation in his larger social community. Behaving in a confrontational or disruptive manner may threaten a director's standing with other board members; moreover, because directors play a role in nominating other directors, reciprocity norms may dominate, resulting in a reluctance to challenge powerful directors.[84] The desire for approval and consensus combined with the fear of group censure that might result from disagreement facilitate a norm of conformity over

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78. JANIS, *supra* note 14, at 12; Fraidin, *supra* note 76, at 42–46 (discussing this study: Garold Stasser & Dennis Stewart, *Discovery of Hidden Profiles By Decision-Making Groups: Solving A Problem Versus Making A Judgment*, 63 J. PERSONALITY & SOC. PSYCHOL. 426, 432 (1992)).

79. JANIS, *supra* note 14, at 10. Janis explains that each of these defects may be caused by other factors, such as fatigue, prejudice, stupidity, or ignorance. *Id.* at 10–11.

80. *Id.*

81. Cox & Munsinger, *supra* note 15, at 105–08. To quote:

> [T]he value or strength of the member's attraction to the group acts as a multiplier on the directional causes of conformity. This motivational multiplier creates an even stronger tendency for the individual to conform his personal goals, opinions, and acts to the goals, norms, and actions of highly valued groups.

Id. at 92.

82. *Id.* at 98–99.

83. Indeed, the *New York Times* reported that a majority of foundations that invested 30% or more of their endowments with Bernie Madoff had small, homogeneous boards of four or fewer directors. Stephanie Strom, *Study Ties Madoff Loss To Charity's Board Size*, N.Y. TIMES, June 25, 2009, at B3.

84. Haft, *supra* note 46, at 12, 19–21.

dissent.[85]

Complexity and information asymmetries can compound the problem. When those factors are present, board members may edit information by absorbing only those facts and opinions that support the general consensus. Groupthink may lead to information cascades and polarization, in particular the "risky shift," which occurs when directors make decisions that are far riskier than any of them would have made acting alone.[86] When the CEO chairs the board, the potential for groupthink increases dramatically.[87] Because the CEO is of higher status (and often has a strong personality) and controls the agenda and the flow of information, board members are often motivated to support him, which may generate an information cascade.

Groupthink may have the most pronounced negative effect when directors consider whether to engage in, or approve of, transactions involving a conflict of interest between the corporation and a board member. Recall that people unconsciously believe themselves to be more fair and objective than they actually are. This tendency, combined with the effects of ingroup bias, often causes individual group members to characterize acts that confer a significant benefit on one group member as "equal" or "fair."[88] Group members are blinded to conflicts or minimize the dangers inherent in a conflict of interest transaction. When groupthink occurs, all group members unconsciously concur in the result, which eliminates the reputational sanctions that might have been generated by acquiescence in self-dealing behavior. The only individuals who are aware of the conflict of interest transaction approve of it. For this reason, several corporate scholars have questioned whether independent directors are truly capable monitors.[89]

85. Cox & Munsinger, *supra* note 15, at 92.

86. Sunstein, *Deliberative Trouble?*, *supra* note 14.

87. Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CINN. L. REV. 1233, 1245 (2003); *see also* SUNSTEIN, GOING TO EXTREMES, *supra* note 14, at 66 ("Group polarization occurs because of the informational and reputational signals given by others. When an authority tells people to do something, both of those signals can be very loud.").

88. Page, *supra* note 17, at 249.

89. *See, e.g.*, Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 612 (1982) ("In sum, the ambiguity of the standards of fairness, the difficulty in ascertaining and weighing the relevant facts, the psychological and social pressure on independent directors, and the limited incentives and weak sanctions available suggest that to elicit disapproval from outside directors would take a transaction so grossly overreaching as not often to be proposed by management.").

III. NONPROFIT BOARDS AND GROUPTHINK

A. *Nonprofit Boards are Uniquely Vulnerable to Groupthink*

Several characteristics of the nonprofit board render it uniquely vulnerable to groupthink. First, nonprofit directors may regard the board's role as more supportive than supervisory, and some executive directors encourage this conception by adopting closed leadership styles. Second, nonprofit directors are more likely than their for-profit counterparts to lack information necessary to make sound decisions. Third, the non-profit sector is characterized by a pronounced lack of accountability mechanisms. In the for-profit sector, market and shareholder monitoring—with the ever-present threat of the derivative suit—creates an accountability mechanism to counter the pull of group bias. Indeed, scholars who justify corporate law's relatively relaxed fiduciary duty rules emphasize the role that market monitoring plays in disciplining behavior.[90] No comparable forces operate in the nonprofit arena. In addition, neither the positive law nor the entities responsible for enforcing it create a beneficial accountability mechanism. As a result, the nonprofit board room is especially fertile ground for groupthink.

1. Differences in Perception of the Board's Role

Board members join boards out of some mix of altruism and belief in the nonprofits' mission and a desire for the social connections, prestige, and positive self-image that come with group membership. Similar to for-profit boards, nonprofit boards are often composed of people from similar social, professional, or economic backgrounds.[91] The same desire for cooperation and cohesion exist as in the for-profit context, but nonprofit boards are more vulnerable because board members may be

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90. Corporate scholars argue that the market creates significant pressures that minimize agency costs regardless of whether management is bound by fiduciary duties. Managers' compensation might be linked to performance. The threat of a takeover of corporate control, the need to succeed in product markets, and the job market provide additional incentives for managers to perform in shareholders' best interests. Moreover, a well-developed information market helps shareholders monitor management's performance. If shareholders learn of managements' opportunistic behavior, they will exit, causing stock prices to fall. Thus, although market forces may be inadequate to curb one-shot breaches of the "take the money and run" sort, for the most part, fiduciaries will tend to minimize agency costs even if the corporate charter does not require them to do so. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 101–03 (1991).

91. Kathleen Fletcher, *Building Diverse Boards*, *in* PERSPECTIVES ON NONPROFIT BOARD DIVERSITY, 15, 15 (1999), *available at* http://www.transformativegovernance.org/Perspectives %20on%20Nonprofit%20Board%20Diversity.pdf ("First, new board members are typically recruited from among the friends, acquaintances, and business associates of those already on the board. This system, of course, tends to make boards homogeneous.").

less likely than for-profit board members to view themselves as responsible for monitoring the Executive Director (ED).[92] Unlike the members of the for-profit board, who understand that the CEO operates from self-interest, members of a nonprofit board may (justifiably) attribute altruistic motivations to the ED. Nonprofit directors are more likely to view the board as performing a supportive function, with the goal of assisting the ED in accomplishing the nonprofit's goals. This view might be encouraged by the ED, who may view the role of board members as to fundraise or to lend their name to a cause but may resent "meddling" by the board in substantive decisions. Because board members are volunteers, they may be even less inclined to risk angering other directors or the ED by challenging the prevailing opinion.

As in the corporate context, ingroup bias may cause members to minimize the risk of self-dealing or conflict of interest transactions. But this danger is even more pronounced in the nonprofit context; because nonprofit directors are uncompensated, they may feel somewhat entitled to engage in transactions from which they receive tangible or intangible benefits.[93] The social ties that often bind members of the board may lead them to unconsciously minimize the dubious nature of the transaction. For example, the *Boston Globe* recently reported that Suffolk University has a $10,000 per month contract with lobbyist Robert Crowe's firm, Wolfblock Public Strategies.[94] Robert Crowe is also a Suffolk University trustee and a member of the compensation committee that made University President David Sargent the highest-paid university president in 2006.[95] When the *Boston Globe* questioned Crowe about the apparent conflict of interest, he replied, "To even

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92. The Urban Institute's recent study indicates that boards that focus board recruiting efforts on friends and acquaintances of current board members did less well with every aspect of governing except fundraising, where it had no impact. OSTROWER, *supra* note 9, at 16.

93. As Professor Deborah DeMott explains:

> [D]irectors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment. . . . Board members often join because they believe in an organization's mission and contribute to it with financial donations. They depend heavily on organization management to set the board's agenda and provide information to the board. Many large nonprofits also have relatively large boards. Some actors in this environment reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal. Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organization.

Deborah DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 140–41 (1993).

94. Frank Phillips & Peter Schworm, *Trustees' Fiscal Ties Roil Suffolk Conflict-of-Interest Policy Scrutinized*, BOSTON GLOBE, Nov. 26, 2008, at B1.

95. *Id.*

insinuate there is a conflict is wrong[.] . . . There is no conflict. . . . Whether or not my public strategy group is paid $10,000 is not relevant[.] . . . We don't make money on that. We are providing a service to Suffolk."[96] Another board member, who is also the beneficiary of a $360,000 contract with Suffolk University, agreed, calling the notion that there was a conflict of interest "ridiculous."[97]

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96. *Id.* (internal quotation marks omitted).

97. *Id.* According to Crowe, his firm's annual $120,000 rate is "half what other lobbying companies would charge." *Id.* Yet, Suffolk University failed to disclose the Wolfblock contract to the Massachusetts attorney general's office, in violation of Massachusetts law. *Id.*

These statements are consistent with a misconception—pronounced in the nonprofit world—that a transaction with a board member presents a conflict of interest only if it causes demonstrable harm to the organization. The misconception has given birth to the unfortunate term "potential conflict," used to describe actual conflicts that are perceived as beneficial. To this way of thinking, if the hypothetical director—Smith—offered to lease office space to the nonprofit on terms purported to be lower than market, Smith would not be operating under an actual conflict of interest, only a "potential" one. Only if Smith offered space "above market" would the "potential" conflict transform into an "actual" one. The increasing use of this terminology further minimizes the dangers of conflicts of interests and leads boards to exercise less vigilance in evaluating these transactions. A quick Google search of the phrase "potential conflict of interest" turns up several corporate conflict of interest policies that make the erroneous distinction between potential and actual conflicts. One example defines conflict of interest as "any activity that is inconsistent with or opposed to the Corporation's best interests, or that gives the appearance of impropriety or divided loyalty." *See, e.g.*, Apple Inc., *Guidelines Regarding Director Conflicts of Interest*, http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9OTg5MnxDaGlsZElEPS0xfFR5cGU9Mw==&t=1 (May 27, 2009). Another declares,

> A potential conflict of interest exists when a director, officer, employee, managing agent, or sales agent of the Society or a member of such person's immediate family has a financial or other relationship that might impair the independence of judgment or adversely influence the decisions or actions of such person regarding the business of the Society. This includes, but is not limited to, situations in which such person or their immediate family:
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> a. derives a material gain such as payment for services, consulting fees, equity interests, royalties, or other benefits from a relationship with another person or entity which has or is actively pursuing a relationship with the Society from which it may receive benefit, or
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> b. holds a position with a religious, charitable, educational, fraternal or other benevolent or non-profit organization (including directorships) which has or is actively pursuing a relationship with the Society from which it will receive benefit (see also Section 5 "Request for Charitable Grants"), or
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> c. engages in employment, consulting, directorship or any other professional relationship, with any competitor or entity that has or is actively pursuing a relationship with the Society.

Thrivent Financial for Lutherans, *Conflict of Interest Resolution*, https://www.thrivent.com/members/news/issues/2009/030109/BOD_Nom_conflict.pdf (last visited Oct. 10, 2010). Another policy instructs,

In fact, a conflict of interest exists whenever a fiduciary (or an entity or individual with whom the fiduciary is affiliated) is on both sides of a transaction—period.[98] Transactions involving conflicts of interest are not always harmful and may be beneficial (for instance, if a director leases to the nonprofit space that it actually needs on terms clearly below market rents), but they involve conflicts of interest nonetheless.

2. Greater Information Asymmetries

Information asymmetries can lead board members to defer unduly to the director who seems most informed (often the ED). In addition, information deficits are more pronounced in the nonprofit setting. Board members are volunteers who have careers, families, other professional commitments, hobbies, and social lives. Even the most well-intentioned board members may find that conflicting demands on their time result in inadequate preparation for, or sporadic attendance at, board meetings.[99] The need to prioritize among conflicting demands can also cause directors to adopt the least time-consuming approach to problem solving.[100] Because board members are generally volunteers, there may be less of a stigma attached to this behavior. This problem creates a fertile ground for groupthink and, in particular, for information cascades that can lead groups to approve conflict of interest transactions that are not in the nonprofit's best interests.

> Conflicts of interest occur when an individual, immediate family member, or business associate has a material interest in a company, product, or service that is affected by ASCPT activities in which the individual participates. A conflict of interest is "real" when an interest, whether economic or not, influences the individual's actions. "Perceived" conflicts may arise when others believe that the interest precludes unbiased behavior.

American Society for Clinical Pharmacology and Therapeutics, *ASCPT Conflict of Interest Policy*, 81 CLINICAL PHARMACOLOGY & THERAPEUTICS 788, 788 (2007).

98. *See* MELANIE B. LESLIE & STEWART E. STERK, TRUSTS AND ESTATES 216 (2006).

99. Brody writes, "Nonprofit directors devote even less time and attention to their positions. Such affirmative board duties as selecting the chief officer, preparing the budget, and reviewing operations are likely to be carried out haphazardly or by only a few of the board members." Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1445–46 (1998). One writer stresses that, "[U]nlike 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." David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 967 (1996); *see also* Harvey Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 J. CORP. L. 631, 633 (1998) (emphasizing that board members who fail to become involved are "corrosive" to nonprofit corporations).

100. Of those charities responding to the Urban Institute's study, fewer than half were able to state that their boards were "very active" at financial oversight and monitoring the boards' own behavior. OSTROWER, *supra* note 9, at 13.

The ED is often the individual who controls the agenda and flow of information to the board. Because the ED will tend to be someone with a high degree of expertise and often a magnetic personality, conditions are ripe for information cascades. When the ED is a voting member of the board, the problem is compounded.[101] In addition, most nonprofit boards are self-perpetuating, with directors or executives nominating new members. Appointed directors may feel loyal to those who appointed them and be less interested in challenging their positions.

3. Lack of Accountability

A significant body of psychological research suggests that a decision maker's knowledge that a legitimate authority will hold him accountable can help correct for many of the cognitive biases that an individual brings to decision-making.[102] There is evidence, however, that knowledge of an accountability mechanism can actually exacerbate the confirmation bias—fear of accountability may motivate an individual to stack the record with evidence supporting his decision.[103] If, however, the individual knows that the evaluation of his performance will focus on the process he used to make a decision rather than the outcome and if the individual is expressly instructed to consider other alternatives, confirmation bias can be alleviated.[104]

In many instances, however, the nonprofit board makes decisions that will escape scrutiny. In addition, no authority requires the board to engage in sound decision-making procedures. These facts contribute to the development of groupthink.

a. Absence of Market Pressures

Finally, few market pressures exist to counter groupthink in the nonprofit setting. There are no shareholders or beneficiaries with financial incentive and legal standing to police director behavior. The directors are not accountable to anyone for the bottom line, nor are they called upon to defend declining share price or the lack of success of the nonprofit's programs. Directorships are generally unpaid, and thus, there is no job market pressure. Directors need not fear corporate takeovers.

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101. Having the CEO/ED serve as a voting member of the board of directors is negatively associated with a charity's adoption of an outside audit, a conflict of interest policy, a document retention policy, or a whistleblower policy. *Id.* at 5. It is also negatively associated with the board's activity level that is devoted to financial oversight, and positively related to a lack of good governance factors. *Id.* at 16.

102. *See* Mark Seidenfeld, *supra* note 23 (explaining, in detail, the psychological literature on the effect of accountability mechanisms on decision-making).

103. *Id.* at 524.

104. *Id.* at 517–18, 524.

In the for-profit context, fiduciaries may also be shareholders, and that situation may create additional incentives to maximize corporate value.[105] This financial self-interest is absent in the nonprofit context, where directors are prohibited from being equity holders. As a result, those directors are unlikely to experience any negative financial consequences because of the negligent management or conflict of interest transactions.

The only significant market pressure that a charity may face (and it can be quite significant) comes from the need to attract capital. Sources of capital include donations from members of the public, corporate and foundation grants, and government support. In a few settings, the market for grants may discipline not-for-profit fiduciaries. Competition for corporate and private foundation grants is significant, and these entities often require significant financial disclosure as a condition for repeat giving. These funders often pay close attention to the charity's effectiveness in accomplishing its mission. In New York City, for example, there are scores of small charities that receive almost all of their funding from the city government. The greater the percentage of government and large foundation grants, the more effective the monitoring.[106]

But that pressure is insufficient to discipline most charities, who rely on a diverse array of sources for funding. Donors are generally ineffective monitors, exerting practically no pressure on board performance, for several reasons. First, many individuals donate based on the attractiveness of the cause and the public perception of the charity's effectiveness, which can be based largely on marketing efforts. Second, there is a small, but inadequate, information market at work. Prospective donors can find the charity's 990 Form online with little effort,[107] and recent enhancements to the 990 Form require charities to disclose all transactions that involve a conflict of interest. But prospective donors cannot determine the effectiveness of board performance, the charity's effectiveness in achieving its mission, or whether conflict of interest transactions are good for the corporation or are skimming resources away from the charity and into the pockets of board members.

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105. EASTERBROOK & FISCHEL, *supra* note 90, at 8–10, 91 (noting that in the for profit context, "The smaller the managers' share in the enterprise, the more the managers' interests diverge from the interests of those who contributed capital.").

106. The Urban Institute's study shows that the level of a nonprofit's reliance on government funding is positively associated with having an outside audit, a separate audit committee, a conflict of interest policy, and a whistleblower policy. OSTROWER, *supra* note 9, at 6.

107. GuideStar Home Page, http://www2.guidestar.org/Home.aspx (last visited Oct. 9, 2010).

b. Absence of Legal Pressures

The law does not significantly constrain agency costs in the nonprofit context because there is little chance that board members will incur legal liability for authorizing a conflict of interest transaction.[108] Boards are not directly monitored by a self-interested principal (such as a shareholder or beneficiary) with standing to sue for breach of fiduciary duty. Even if donors detect a breach of fiduciary duty, they have no standing to sue to enforce those duties but must contact the attorney general's office. Even if a donor structures a restricted gift in a way that gives him standing, he will only be able to enforce the terms of the restriction, not sue for breach of fiduciary duties more generally.[109]

The entities that do have standing to enforce the board's fiduciary duties (principally state attorneys general and the Internal Revenue Service) have extraordinarily low rates of enforcement.[110] From a political perspective, an attorney general would prefer to do something other than pursue a legitimate charity. It takes a major breach to get the attorney general's attention. For activity falling short of this, attorneys general do not sue but often work with the charity to pursue reform.[111]

In response to this reality, case law has evolved to allow board members, and occasionally other plaintiffs with a "special interest" in the charity, to sue for breach of fiduciary duty. Yet, special interest standing is rarely sought and unpredictably granted.[112] Finally, although board members have standing to sue, endemic institutional bias ensures that board members sue one another only when collegiality has completely eroded and directors are openly fighting.

The Internal Revenue Code also contains fiduciary requirements as a

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108. EASTERBROOK & FISCHEL, *supra* note 90, at 7 ("[I]f the anticipated penalty (the sanction multiplied by the probability of its application) is selected well, there will not be much wrongdoing.").

109. Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1, 44–45 ("The modern trend to grant donors standing to enforce the specific terms of their gifts, however, has not expanded to permit donors to bring suit to redress alleged breaches of fiduciary duty, fraud, and other misappropriation of charitable funds that do not relate to the donor's gift.").

110. State attorneys general, representing the public, are the principal monitors of nonprofits, and in most states, the pressure they bring to bear is minimal. Only a small minority of states has charitable enforcement bureaus; for those attorneys general, charitable monitoring competes for resources with all the other things the attorney general must do. In the states that do have separate bureaus, funding is limited. When determining how to apply limited resources, attorneys general face competing demands. *See* Dana Brakman Reiser, *There Ought to be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT. L. REV. 559, 598–99 (2005).

111. *See* Brody, *supra* note 33, at 948 ("Reform rather than punishment is generally the goal of the charity regulator.").

112. *See* FREMONT-SMITH, *supra* note 38, at 328–36 (discussing "special interest" standing).

condition for receiving and maintaining 501(c)(3) status. The Code is chiefly concerned with ensuring that the charity is providing public, not private, benefits and so seeks to curb the same types of transactions that the state law fiduciary duty of loyalty addresses.[113] But because the IRS audits 1% of all charitable returns, the threat of legal action creates minimal pressure to conform to fiduciary duties.[114] As a result, nonprofit board members, who have relatively little time to devote to governance issues, have little incentive—and even fewer resources—to devote to determining what exactly the law requires of them.

B. *Groupthink in Action: How Groupthink Leads to Self-Dealing*

Suppose a charity's lease has expired, and it needs to find new space. Smith, who sits on the charity's board of directors, owns a commercial building and offers to lease space to the charity for $12,000 per month. Smith believes that this is a "good deal" for the nonprofit because the building has a variety of amenities that allow him to command rents at the top of the market, and he estimates that market rents for comparably-sized office space in the area range from $8,000 to $12,500 per month. Suppose further that the charity could obtain office space that would suffice for its purposes for $10,000 per month. The proposed lease is not in the corporation's best interest because the charity does not need all of the amenities that Smith's building offers and it could find satisfactory office space for less money. If the charity agrees to the lease, the additional $2,000 per month that the charity will spend on rent represents a diversion of charitable assets from the charitable mission to Smith.

Defects in the charity's decision-making process, however, may lead the charity to agree to the lease. First, Smith may simply approach the ED, or some other executive with power to bind the charity, with his offer, and the executive may fail to bring the proposal to the board's attention (this may be less likely to happen with a major transaction like a lease agreement but more likely to occur when the goods and services are less central to the corporation's functioning). If the ED and the self-dealing board member have a relationship, that bond may induce the executive to take Smith's representations about the market at face value and to believe the transaction is a good one for the charity. She may also, consciously or unconsciously, wish to reward Smith for board

113. In the past few years, the IRS has strengthened the annual 990 Form to require corporations to report self-dealing transactions, which sends a clear message to those corporations that certain transactions are suspect. This may have a desirable effect on boards and may assist prospective donors in identifying whether the charitable fiduciaries are abusing their positions. Yet, it is unclear if this will increase legal pressure to conform to fiduciary standards.

114. *See* Siske & Baker, *supra* note 36.

service. Moreover, self-interest may lead her to accept the lease; transacting with Smith eliminates the need to devote time to researching the market, evaluating other possibilities, or engaging in the formal process of obtaining board approval.

If there is a culture of board disengagement or deferral to the ED, the board may fail to react when it discovers that the ED has acted unilaterally. Or, the board may ratify the contract after the fact. Given what we know about how boards operate, the board would be unlikely to rescind the transaction unless it is an egregious example of self-dealing (and sometimes, not even then). The pull of ingroup bias will lead the group to view the contract as beneficial to the nonprofit, and the tendency to engage in groupthink will prevent board members from rocking the boat by objecting to the deal after the fact. Thus, a rational ED may determine that it is cheaper and easier to contract without advance approval.

Second, the ED may seek approval of the contract from a committee of the board charged with overseeing financial or business issues, instead of bringing it to the full governing board. This group will be smaller, and probably more cohesive, than the board as a whole, which renders it more vulnerable to groupthink.[115] If committee members have close personal or business ties with Smith, or simply want to curry favor with him, they are likely to approve the deal. Under the law in most states, committee approval is sufficient to create a presumption of fairness.

But even if the ED presents the contract to the full board for approval, board members may be inclined to authorize it regardless of whether it represents the best deal for the nonprofit. Board members may be uninformed about the details of the deal and the market alternatives, even if those details have been disclosed to the board in advance of the meeting. Because information deficits set the stage for groupthink, and information cascades in particular, uninformed directors may approve this deal if the ED, or other board members, are in favor of it.

But even when directors have received full disclosure about the proposed transaction, groupthink may undermine the decision-making process. Smith and the other board members are likely to characterize this opportunity as an altruistically motivated gesture on Smith's part, and if Smith is a respected or well-liked member of the group, other directors may hesitate to disrupt the cooperative group spirit by raising questions or objections to the deal.[116] Smith will attend the meeting and

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115. *See, e.g.*, Strom, *supra* note 83 (noting that a majority of groups that lost about a third of their assets in the Madoff scandal had no more than four board members).

116. As Professor Susan Gary has pointed out, "Given the structure of many charitable

may even vote in favor of the transaction, greatly increasing the potential for groupthink.

If groupthink occurs, directors will fail to seek out information from alternative sources, challenge the representations made by the interested board member, consider alternatives, consult experts, or generally engage in an independent evaluation of the transaction. They will also convince themselves that the deal is a good one; the price may not be wildly out of line with the directors' sense of the market, and they will not be inclined to believe that Smith, whom they like and admire, would use his fiduciary position to obtain a personal benefit. This attitude may induce directors to forego market research and other forms of due diligence and may cause them to edit out information that does not support their initial inclination. Some directors may feel that Smith is entitled to the deal since he receives no compensation for serving on the board. If the ED is in favor of the arrangement, directors may be reluctant to challenge that viewpoint. In addition, no one with standing to object to the transaction is likely to find out about it, and on the off chance a whistle-blower brings it to the attorney general's attention, there will likely be no personal liability in most states because the deal was approved in advance.[117] In short, groupthink's corruption of the

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boards and the lack of attentiveness of the directors, disinterested directors may be unlikely to challenge the interested director's characterization that the transaction is fair." Gary, *supra* note 31, at 614. She argues that, standing alone, "A reasonable belief in fairness does not require a particular level of scrutiny and does not require that the transaction be the best approach for the charity." *Id.*

117. *See, e.g.*, Revised Model Nonprofit Corp. Act § 8.31(1987). It provides:

Director Conflict of Interest

> (a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. *A conflict of interest transaction is not voidable or the basis for imposing liability on the director if the transaction was fair at the time it was entered into or is approved as provided in subsections (b) or (c).*
>
> (b) A transaction in which a director of a public benefit or religious corporation has a conflict of interest may be approved:
>
> > (1) in advance by the vote of the board of directors or a committee of the board if:
> >
> > > (i) the material facts of the transaction and the director's interest are disclosed or known to the board or committee of the board; and
> > >
> > > (ii) the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation; or
> >
> > (2) before or after it is consummated by obtaining approval of the:

group decision-making process can push directors to extremes, leading them to approve deals in which they would not have engaged if acting on their own behalf.

Evidence strongly supports the hypothesis that the toxic combination of groupthink and impotent fiduciary duty laws has created nonprofit subcultures, where self-dealing and conflict of interest transactions are routine. In addition, there is reason to believe that a significant number of these transactions are not in nonprofits' best interests. In 2007, the Urban Institute's Center on Nonprofits and Philanthropy completed the most comprehensive study to date on board governance issues, with more than 5,100 nonprofits across the nation participating.[118] Overall, more than 20% of public charities reported engaging in financial transactions with board members in the two years preceding the study.[119] If the self-reported figures are accurate, larger charities, which one might assume would have more professional boards and better legal counsel, self-deal more frequently than smaller charities. Among those nonprofits with at least $10 million in annual expenses, 41% reported transacting with board members in the past two years.[120] These figures underreport the frequency of conflict of interest transactions because only 50% of respondents had adopted any type of conflict of interest policy, and 75% stated that they do not require board members to disclose their financial relationships with entities with which the nonprofit transacts business.[121] Charities may engage in self-dealing transactions far more frequently than they realize or admit.

Of course, if all of these conflict of interest transactions were for goods and services at well below market rates, then self-dealing would not result in diversion of nonprofit assets and there would be no reason for concern. But 74% of charities that admit to engaging in conflicted transactions state that they engage in transactions at "market value," while only 51% reported that they obtained some goods and services at below market costs.[122] Oddly, nonprofit size is correlated to the frequency of self-dealing at market transactions but not in the direction one might expect: 58% of the smallest nonprofits (those with operating expenses less than $100,000 per year) report that they received goods

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> (i) attorney general; or
>
> (ii) [describe or name] court in an action in which the attorney general is joined as a party; . . . .

Id. (emphasis added).

118. OSTROWER, *supra* note 9, at 1.

119. *Id.* at 8.

120. *Id.*

121. *Id.*

122. *Id.*

and services at below-market prices, but 85% of charities with more than $40 million in annual expenses reported engaging in conflict of interest transactions for market value while only 24% of these charities also reported engaging in below-market deals.[123]

Given what we know about group dynamics, there is reason to question whether the nonprofits were able to assess objectively whether these deals were really necessary to advance the nonprofit's agenda and whether the deals truly are "at market value." This is especially true of larger charities, which are less likely to obtain board approval prior to engaging in self-dealing—only 66% of the largest nonprofits reported that they obtained board approval for conflict of interest transactions, which means that significantly fewer individuals are involved in the decision to make the transactions.[124] As the author of the study cautions, "[I]f anything, the figures are likely to underreport transactions resulting in obtaining goods at above market value or at market value and overreport transactions resulting in obtaining goods below market cost."[125] Because the law does not require directors to establish that a conflict of interest transaction is the best deal that the nonprofit can obtain and because groupthink causes directors to edit out information that does support the group's initial inclination, it is reasonable to believe that many of these deals represent transfers of wealth from nonprofits to directors, ranging from marginal to egregious.

IV. Creating Accountability: Fiduciary Duties As Social Norms

Because fiduciary duty law is both unclear and underenforced, it often fails to influence board behavior. One cure might be to devote more resources to legal enforcement to increase deterrence and clarify legal standards. But the political will to redirect limited public dollars to monitoring nonprofits is lacking. Moreover, state attorneys general, more interested in strengthening charities than destroying them, often prefer to direct limited government resources toward reforming rather than prosecuting troubled nonprofits. As a consequence, harnessing the expressive power of the law to strengthen social norms against shirking, self-dealing, and conflict of interest transactions[126] may be the most

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123. *Id.*

124. *Id.* at 10. If self-reports are accurate, smaller charities are much more likely than large ones to obtain advance approval for self-dealing from the board. Ninety percent of the smallest nonprofits (expenses of $100,000 or less) claimed that they regularly obtained advance approval for transactions with board members while only 66% of the largest nonprofits (expenses of $40 million annually or more) routinely did so. *Id.*

125. *Id.* at 8.

126. Fiduciary duties of care and loyalty are more than legal concepts; they are expressions of social norms. *See* Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the*

promising path to controlling agency costs.[127]

Self-interest is a powerful force. When a fiduciary has not internalized fiduciary norms, she will (consciously or unconsciously) weigh the benefits of shirking or self-dealing against the risks of exposure and the severity of the penalty.[128] When nonprofit boards function effectively, as many do, it is often because the most influential fiduciaries have internalized fiduciary norms that require them to subordinate self-interest in favor of the nonprofit's best interests.[129] A fiduciary who has "internalized" a norm complies with it because she instinctively feels it is the "right thing to do,"[130] not because she wants to avoid adverse legal, financial, or social consequences.[131] When dominant directors (or a majority of the board) have internalized fiduciary norms, other directors, fearing adverse reputational sanctions, will fall in line.[132] If groupthink occurs at all, it will produce decisions

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Limits of Doctrine, 22 CARDOZO L. REV. 51, 71–72 (2000); Eisenberg, *supra* note 37, at 1265–79.

127. *See supra* note 29.

128. Sociologists explain that "although norms initially elicit compliance through external reinforcement, they often are subsequently internalized by individuals: 'Without internalization, one obeys the norm to avoid external sanctions made possible by the desire for esteem, though the sanctions may in fact include material punishments.'" Amitai Etzioni, *Social Norms: Internalization, Persuasion, and History*, 34 LAW & SOCIETY REV. 157, 167 (2000) (quoting Richard H. McAdams, *The Origin, Develoment, and Regulation of Norms*, 96 MICH. L. REV. 338, 381 (1997)).

129. For example, in addition to being a member of Yeshiva University's board, Ezra Merkin was also a member of the investment committee of the UJA Federation. But the UJA never authorized Merkin to invest any of its funds, for two reasons: first, directors adopted a policy that prohibited the hiring of board members; second, the investment committee would not engage any financial services professional without first conducting due diligence, which included obtaining an understanding of the professional's investment strategy. Asher Meir, *Charities, Financial Institutions and the Public Trust*, THE BUSINESS ETHICS CENTER OF JERUSALEM, Dec. 18, 2008, http://www.besr.org/Article.aspx?ArticleID=590. No law required the Federation to adopt these policies; by all appearances, the board adopted them because they felt it was the right thing to do.

130. Etzioni, *supra* note 128 (explaining that norm "[i]nternalization is an element of socialization whereby the actor learns to follow rules of behavior in situations that arouse impulses to transgress and there is no external surveillance or sanctions").

131. Internalized norms are norms so embedded that they prevent an actor from violating them regardless of the possible benefit that might result from violation. Kaushik Basu, *Social Norms and the Law*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 476, 477 (Peter Newman ed., 1998). Professor and economist Kaushik Basu offers this example:

> [M]ost individuals would not consider picking another person's wallet in a crowded bus. This they would do not by speculating about the amount the wallet is likely to contain, the chances of getting caught, the severity of the law and so on, but because they consider stealing wallets as something that is *simply not done*.

Id. at 477; *see also* TYLER, *supra* note 29, at 24.

132. *See* Christine Horne, *Collective Benefits, Exchange Interests, and Norm Enforcement*,

that are in the nonprofit's best interests.

But when dominant fiduciaries have not internalized fiduciary norms, the stage is set for harmful groupthink. Norms of reciprocation, cooperation, and group loyalty compete with fiduciary norms, and reputational sanctions may attach, not for deviating from fiduciary norms but for objecting to deviation.[133] In this situation, self-interest triumphs over the best interests of the organization.

Groupthink may also cause group members who have internalized fiduciary norms to discard them. Research shows that if sufficient numbers of people depart from a norm, a "tipping point" is reached, and the norm loses its "obligational" force; actors who had internalized the norm now feel like "chumps" for continuing to abide by it when most others have ceased to.[134] A study released in 2009 by economists Robert Innes and Arnab Mitra establishes that dishonesty, in particular, is contagious.[135] That is, even someone inclined to be honest will behave dishonestly if he believes that his peers are dishonest.[136] This response is situational.[137] In other words, individuals who are inclined to act honestly and do so in most situations will act dishonestly if placed in an environment where they believe most others are acting dishonestly.[138] Scholars have advanced various theories to explain the slide from honest to dishonest behavior. Some argue that the reduced threat of reputational sanctions in a dishonest environment perpetuates dishonesty;[139] others state that the need for approval creates it[140] while

82 SOCIAL FORCES 1037, 1039 (2004). As Sunstein explains, "Norms solve . . . problems by imposing social sanctions on defectors. When defection violates norms, defectors will probably feel *shame*, an important motivational force." Sunstein, *Expressive Function*, *supra* note 37, at 2029–30; *see also* Eisenberg, *supra* note 37, at 1265–79; Hillman, *supra* note 126, at 72–73.

133. Fiduciary norms cannot operate if there is no social enforcement of them. *See* Horne, *supra* note 132.

134. *See* Eisenberg, *supra* note 37, at 1264 (explaining that if a sufficient number of people believe that others have ceased to follow a particular social norm, there is a "tipping point," and the norm loses its obligational character); SUNSTEIN, GOING TO EXTREMES, *supra* note 14, at 85–90 (exploring how group dynamics can change social norms).

135. Robert Innes & Arnab Mitra, Is Dishonesty Contagious? An Experiment 2 (June 26, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426002 (click "One-Click Download" link; then select "Open" in the pop-up window).

136. *Id.* at 17.

137. *Id.* at 29.

138. *Id. See generally* Jonathon R. B. Halbesleben et al., *Everybody Else Is Doing It, So Why Can't We? Pluralistic Ignorance and Business Ethics Education*, 56 J. BUS. ETHICS 385, 385 (2005) (discussing the implications of pluralistic ignorance in training business ethics and ethics education).

139. *E.g.*, George A. Akerlof, *A Theory of Social Custom, of Which Unemployment May Be One Consequence*, 94 Q.J. ECON. 749, 751 (1980).

140. *E.g.*, B. Douglas Bernheim, *A Theory of Conformity*, 102 J. POL. ECON. 841, 844 (1994).

others argue that it might be a hardwired response to social cues.[141]

This research has implications for board behavior. If board members consistently authorize conflict of interest transactions without investigation, those directors who had internalized fiduciary norms might gradually abandon their allegiance to those norms and conform to group behavior. The result is that fiduciary norms will be supplanted by norms that favor self-interest at the expense of the corporation.

V. RESTRUCTURING FIDUCIARY DUTY LAW TO SUPPORT FIDUCIARY NORMS

A. *The Advantage of Rules*

When critical members of a board have internalized fiduciary norms, the best interests of the corporation are not in tension with the desire for consensus and cooperation. In such a case, either groupthink will not occur or it will lead to results that are in the nonprofit's best interests. But how can we ensure that directors will embrace fiduciary norms? The law can be refashioned to facilitate this objective.[142] To harness the law's expressive function and facilitate internalization of fiduciary norms, the law governing board behavior must be simple and transparent.

Rules are superior to standards for generating and supporting social norms that counter the pull of self-interest.[143] Because standards do not prescribe clear limits of legal behavior, people who are self-serving will interpret fuzzy information in ways that benefit them.[144] In other words, they will determine that their behavior fits within the standards of allowed behavior even if an objective observer might disagree. A standard requiring drivers to drive at a "reasonable" speed may lead a driver to conclude that driving 90 miles per hour on a highway meets the legal standard given his driving prowess and his assessment of road and traffic conditions. Rules, on the other hand, tend to minimize the effect of self-serving bias because they communicate more direct information about the limits of allowed behavior and leave less to the

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141. Innes & Mitra, *supra* note 135, at 29.

142. As Professor Harvey Goldschmid has noted, "[I]n contrast to the for-profit world, the law plays little role, other than aspirational, in assuring accountability in the nonprofit sector." Goldschmid, *supra* note 99, at 632.

143. *See, e.g.*, Korobkin, *supra* note 37, at 55; Sunstein, *Expressive Function*, *supra* note 37, at 2025–26 (arguing that the way in which a legal rule is framed can influence social norms).

144. *See* Korobkin, *supra* note 37, at 46 (citing Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2101–02 (1979); George Lowenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 150–51 (1993); Linda Babcock et al., *Biased Judgments of Fairness in Bargaining*, 85 AM. ECON. REV. 1337, 1340 (1995)).

discretion of the individual actor.[145] If faced with a rule limiting the speed to 70 miles per hour, the same driver would be unlikely to convince himself that driving 90 miles per hour was within the law.

Some recent empirical scholarship provides evidence that institutions change behavior in response to the implementation of clear legal rules. For example, Professors Robert Sitkoff and Max Schanzenbach have established that institutional trustees significantly increased the percentage of trust assets invested in equities after trust law's traditional "prudent man" rule, which discouraged investments in equities, was replaced with the "prudent investor rule," which permitted trustees to adopt modern portfolio theory.[146] Because the prudent man rule was a default rule, it never prohibited trust investments in stocks—with the settlor's consent, the trustee could have created a risk-preferring portfolio.[147] For that reason, one might not have expected to see a dramatic change in trust investment portfolios after the change in the default rule. Yet, the prudent investor rule's express embrace of modern portfolio theory appears to have encouraged trustees to change their investment practices.[148]

In another example, a recent experiment by Professors Aleksandra Gregoric, Katrina Zajc, and Marko Simoneti indicates that even in countries with poor legal enforcement mechanisms, the promulgation of clear corporate rules can trigger the social norm of "obeying the law."[149] The authors suggest that "transition" countries' development of a corporate code could therefore have an important impact on corporate behavior, even if the law is unlikely to be efficiently enforced.[150]

Most importantly, evidence indicates that nonprofit corporations themselves often change behavior in response to clear directives. Although states allow self-dealing and conflict of interest transactions that are "fair," most flatly bar nonprofits from giving or lending money to directors.[151] In a recent comprehensive national study, fewer than 1% of the 50,000 nonprofits surveyed admitted loaning money to directors.[152] Clearly, the law has effectively communicated the prohibition. In addition, a significant number of large nonprofits have

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145. Korobkin, *supra* note 37, at 46.

146. Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J. LAW & ECON. 681, 681–82 (2007).

147. *Id.* at 687.

148. *Id.* at 707.

149. Aleksandra Gregoric et al., Agent's Response to Inefficient Judiciary: Social Norms and the Law in Transition 14–15 (May 12, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1403816 (click "One-Click Download" link; then select "Open" in the pop-up window).

150. *Id.*

151. *See, e.g.*, REVISED MODEL NONPROFIT CORP. ACT § 8.32 (1987). The majority of states have substantially similar or identical statutes. FREMONT-SMITH, *supra* note 38, at 226.

152. OSTROWER, *supra* note 9, at 3.

voluntarily adopted many of Sarbanes-Oxley Act's requirements, such as implementing a yearly independent audit and enacting whistle-blower policies, which may be a result of the Act's relatively clear rule-like articulation of good governance practices.[153]

In addition, rules are superior tools for combating the groupthink and ingroup bias that cause directors to subordinate the best interests of the corporation to the self-interest of board members.[154] Besides clarifying the limits of permissible behavior and making more clear when contemplated action is a violation,[155] rules can provide "cover" for directors who wish to fulfill their fiduciary obligations but are afraid of sanctions that might attach as a result of confrontation. In other words, invigorating fiduciary norms by prescribing clear expectations about how directors ought to behave reduces the negative reputational sanction that might attach by behaving that way. Rules that prescribe a particular procedure also benefit the corporation in a second important way: questioning by directors is less likely to disrupt group cohesion—rather than a sign of uncooperative behavior, questioning becomes part of the decision-making process. Thus, by reducing the "costs of confrontation,"[156] clear procedural rules can replace norms of self-interest with norms of questioning and debating.

In addition, clear procedural rules can compensate for ingroup bias by *requiring* the group to ensure that decisions are not infected by bias. In other words, rules that require boards to gather sufficient evidence to support a particular decision can help make directors aware of conflict of interest situations and compensate for selective editing tendencies.

Of course, legal rules can impact behavior only if actors are informed of the rules' content. Thus, rules should be crafted to ensure that they are easily understood by their intended audience. Complexity tends to muddy transmissibility. When actors regularly receive expert legal advice, complexity may be less of a concern. When they do not, complexity tends to make the law more difficult to understand and, thus, less effective at norm building. For this reason, rules in the nonprofit context, where fiduciaries have few material resources and even less time to devote to mastering applicable law, should be simple to

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153. *Id.*

154. *See, e.g.*, Brudney, *supra* note 89, at 612 (citing MARVIN E. SHAW, GROUP DYNAMICS 267–79 (1971); JAMES T. TEDESCHI & SVENN LINDSKOLD, SOCIAL PSYCHOLOGY 561–73 (1976); Stanley Foster Reed, *On the Dynamics of Group Decisionmaking in High Places*, DIRECTORS & BOARDS, Winter 1978, at 40, 51–53).

155. As Professor James Fishman states, "If nothing else, explicit standards of care will provide a clearer guide for conduct and will sensitize board members not only to their responsibilities but to potential liabilities as well." James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 413 (1987).

156. Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 688–89 (2002).

facilitate the transparency so necessary for effective norm building.

Finally, to compensate for the relative lack of legal enforcement of fiduciary duties, the consequences of failure to follow legal rules should be sufficiently serious so as to affect the cost-benefit analysis in which a director who has failed to internalize fiduciary norms might engage prior to taking action that hurts the nonprofit. Currently, a fiduciary who is tempted to place self-interest ahead of the nonprofit's best interest might be encouraged to do so by the knowledge that no one is likely to sue her.

Of course, there are ways to change that calculus; we might direct additional resources to state attorneys general and the IRS or expand the standing rules to allow various third parties to sue charities. But political considerations make it unlikely that states will increase funding, and broadening standing may not have much impact since litigants would not be motivated by the possibility of monetary recovery.[157] The next best step is to make the consequences of violating fiduciary rules quite clear and unpleasant. This approach would have two advantages: one, it would support fiduciary norms by communicating the idea that they are important to take seriously; two, it would bolster the law's deterrent effect.

B. *Restructuring the Duty of Loyalty*

When fiduciaries enter into contracts on behalf of the nonprofit corporation, the goal should be to obtain the best value for the corporation. To accomplish this, fiduciary duty law addressing self-dealing and conflicts of interest must be reformed to generate and support a norm that requires directors to subordinate self-interest in favor of the best interests of the nonprofit. It should correct for the tendency of groups to ignore or minimize the impact of conflicts of interest and correct for information asymmetries that exist in the decision-making process, including information deficits about the relative value of the conflict of interest transaction. It should seek to eliminate the negative reaction that active questioning generates and replace it with a culture where open discussion and airing of differing perspectives are viewed as desirable. Finally, the law should be

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157. Brody argues that broadening standing rules to allow members of the public to sue charities is a bad idea because members of the public are unlikely to be effective monitors:

> The public appears uneducated about the fiscal needs of charities, as many people express surprise that nonprofit managers are paid at all and reveal ignorance of charities' productive demands. . . . A public that does not understand constraints cannot perform effective oversight. A public whose oversight focuses on the wrong considerations induces charities to adopt inefficient and ineffective behaviors.

Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 502 (1996).

refashioned to perform its deterrent function more effectively by making it clear what behavior will constitute a violation, and penalties should be designed to deter behavior that places self-interest ahead of the nonprofit's best interest.

1. Option One: Prohibiting Self-Dealing

The most effective way to accomplish all of these objectives would be a simple rule flatly prohibiting self-dealing and transactions involving a conflict of interest. The rule has the advantage of simplicity, which increases the chance that it will be communicated to nonprofit fiduciaries, even those who lack the benefit of legal counsel. Because it gives clear guidance as to what acts will invite legal trouble, it reduces the "costs of confrontation"—directors do not need to worry about undermining group cohesiveness because they will not have to debate the merits of a self-dealing transaction.[158] Combined with a conflict of interest policy that requires board members to reveal other business interests, the rule would drastically reduce or eliminate information asymmetries; board members would need only to know of the conflict; difficult issues, such as whether the transaction is really the best one for the corporation or whether the transaction is truly below market, would no longer be a problem.

Almost thirty years ago, Professor Henry Hansmann suggested that the best way to protect the donors' and charities' intended beneficiaries' interests was to flatly prohibit business transactions between the nonprofit and members of boards of directors.[159] Hansmann argued that the absence of legal and market monitoring in the nonprofit context warranted imposing a rule that would be clear and easy to police, and he noted that private foundations manage to function with such a ban.[160] The wealth of understanding generated during the past thirty years about group dynamics and how those dynamics play out in the boardroom bolsters the case for a flat prohibition on self-dealing and conflict of interest transactions.

But one thing has remained constant: nonprofit advocacy groups, and many academics,[161] strongly object to such a ban. In 2004, the Senate Finance Committee, citing Hansmann, proposed banning

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158. *See* Stout, *supra* note 156, at 689.

159. Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 567–73 (1981).

160. *Id.* at 569–70.

161. *See* Brody, *supra* note 157, at 500 ("[P]eople often make desirable directors because of their ties to certain businesses and their ability to obtain certain goods or services for the nonprofit on terms favorable to the nonprofit. Barring such insider transactions would cost the nonprofit sector dearly."); Gary, *supra* note 31, at 635 ("Obtaining help from directors may enable some nonprofits, in particular small, local nonprofits, to survive. An absolute prohibition on such transactions seems too drastic.").

nonprofits from transacting with board members, among other reforms.[162]

Although nonprofit groups praised many of the proposed Act's provisions, they were unanimous in their objection to the proposed ban.[163] For example, the CEO of Independent Sector warned that prohibiting transactions with board members "'could be extremely detrimental to a number of charities. . . . Public charities, particularly smaller charities, frequently receive from board members and other disqualified parties goods, services, or the use of property at substantially below market rates.'"[164] This objection was echoed by the National Council of Nonprofit Associations, made up of smaller and mid-sized nonprofits. Because board members may have a deeper understanding and ability to value a small or fledgling nonprofit's performance, they may offer business deals that are better than those available to the nonprofit on the wider market.[165] For this reason, the Nonprofit Coordinating Committee of New York warned that the cost of banning transactions with board members would "vastly exceed the benefits."[166]

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162. *See* STAFF OF S. FIN. COMM., 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT 13 (2004), *available at* http://finance.senate.gov/imo/media/doc/0622 04stfdis.pdf [hereinafter STAFF DISCUSSION DRAFT] (citing Hansmann, *supra* note 159, at 569–73).

163. OSTROWER, *supra* note 9, at 7.

164. *Id.* (quoting Letter from Diana Aviv, President and CEO, Indep. Sector, to S. Fin. Comm., Comments on Discussion Draft on Reforms to Oversight of Charitable Organizations 5 (July 16, 2004), http://finance.senate.gov/newsroom/chairman/download/?id=406b10f9-a85c-44fd-a554-01bfaad147d7 (referring to STAFF DISCUSSION DRAFT, *supra* note 162)).

165. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 215 (3d ed. 2006).

166. The following is an excerpt from the Nonprofit Coordinating Committee's written testimony:

> We strongly urge you not to apply the private foundation self-dealing rules to public charities. Applying to public charities the flat prohibitions of the private foundation self-dealing rules would be very costly in many circumstances. Here is a case in which we would expect the costs to vastly exceed the benefits. Many acts of self-dealing between a public charity and its disqualifying persons involve transactions that are very favorable to the public charity—such as a board member renting space to the public charity at a rent well below market. These transactions should be documented as to their fairness to the nonprofit and should be prohibited where they are not fair, as is generally the case under state law. In addition, the "intermediate sanctions" excise tax provisions under Section 4958 of the Internal Revenue Code already impose serious penalties on unfair and abusive transactions between public charities and their disqualified persons, while allowing beneficial transactions to go forward. A simple prohibition on transactions between public charities and disqualified persons is too blunt an instrument to wield in this context and would deprive a great many nonprofits of opportunities to obtain needed goods and services on very favorable terms.

Letter from Jonathan A. Small, Executive Dir., Nonprofit Coordinating Comm. of N.Y., to S.

Opponents of a ban on conflict of interest transactions also argue that engaging in conflict of interest transactions, presumably even at-market ones, reduces transaction costs for nonprofits and that such a ban would harm nonprofits operating in small, rural areas, where members of boards of directors might also be the only professionals to offer goods and services that the nonprofit needs.[167] All of these arguments lack force.

To begin with, 80% of respondents to the Urban Institute's study stated they did not engage in transactions with directors.[168] Although there is reason to question this number,[169] it may be safe to say that a significant number—perhaps a majority—of nonprofits function well without engaging in insider transactions and would thus not be harmed by a ban on self-dealing.

Second, banning conflict of interest transactions would not be detrimental to nonprofits that tend to engage in market value transactions with board members. As I have established, groupthink often blinds directors to the real costs of these transactions and discourages them from doing the leg-work that might reveal that the transactions are not quite the good deal that they may at first appear to be. The argument that market value conflict of interest transactions are beneficial because they save transaction costs is a nonstarter. The transaction costs saved—pricing the market, finding the best deal for the nonprofit, sanctioning the deal in advance—are the very costs that we want the board to incur. Eliminating these costs is what leads a board to engage—sometimes quite innocently and with the best of intentions—in deals that waste money or, worse, lead to egregious acts of self-dealing.

The most appealing argument for allowing conflict of interest transactions is that nonprofits—especially smaller ones—rely on being able to obtain below-market deals with board members. If the Urban Institute's study is accurate and representative, then the claim that the smallest nonprofits receive significant benefits from transactions involving board members is a valid one.[170] Moreover, 17% of those nonprofits that report engaging in below-market deals with directors state that functioning without these transactions would be "very difficult."[171]

Fin. Comm., Comments on Senate Finance Committee Staff Discussion Draft Concerning Tax-Exempt Organizations (July 14, 2004), http://www.npccny.org/info/gov_rel_071404.htm (referring to STAFF DISCUSSION DRAFT, *supra* note 162).

167. OSTROWER, *supra* note 9, at 7.

168. *Id.* at 8.

169. *Id.* (establishing that 75% of the nonprofit organizations surveyed did not require board members to reveal their ties to companies doing business with the nonprofit).

170. *Id.*

171. *Id*.

But, as Hansmann pointed out, nonprofits need not suffer harm if self-dealing is prohibited because transactions with board members can be structured to eliminate conflict and ensure that all transactions advance the nonprofit's best interests.[172] The example he offered was of the board member willing to extend furnishings on credit to a nonprofit on more favorable terms than the market because his inside knowledge of the nonprofit gave him justification for doing so.[173] Instead of self-dealing, the board member could act as a guarantor on a transaction with an independent furniture provider.[174] Consider my hypothetical involving director Smith, who is willing to lease office space to the nonprofit on favorable terms. Suppose the nonprofit was a very small one, with annual expenses of less than $100,000, and Smith wanted to lease office space for the demonstrably below-market price of $2,000 per month. If self-dealing was prohibited, Smith would have two options for accomplishing that goal without self-dealing. First, he could donate the space to the nonprofit and take the tax write-off. In the alternative, Smith could lease the space to a third party at the market rate, say $4,000 per month, and pledge to deliver $2,000 of the monthly income to the nonprofit. The nonprofit could then use the money to offset the $4,000 rent on a comparable space. This arrangement would eliminate all the valuation problems inherent in allowing self-dealing transactions and would leave the nonprofit in the same position as it would have been if it had contracted with Smith directly.

Finally, the Urban Institute's study indicates concerns that rural nonprofits would be unable to obtain necessary goods and services if the law prohibited director transactions are not supported by the facts. The institute's author reports, "There was no significant difference between nonprofits inside and outside metropolitan statistical areas either in the percentage engaged in financial transactions or in their perceptions of how difficult it would be for them were such transactions prohibited."[175]

It is far from clear that a flat ban on transactions with board members would create more costs than it would eliminate, and it is hard to see why larger nonprofits ought to be able to engage in such transactions. Perhaps nonprofits believe inside deals are important because transacting with a board member has intangible benefits that make the transaction more valuable to the nonprofit than a market-based transaction would be. For example, it may be helpful to have a landlord who believes in the nonprofit's mission and is willing to stick with the organization during unexpected bumps that occur. Perhaps an accountant or investment advisor who is emotionally committed to the

172. Hansmann, *supra* note 159, at 571–72.

173. *Id.*

174. *Id.* at 572.

175. OSTROWER, *supra* note 9, at 8.

nonprofit's mission will work harder and give more thought to planning and advising—for the same price—than an unrelated third party might. These concerns seem most relevant to small to mid-sized nonprofits, and may justify creating different duty of loyalty rules for differently sized nonprofits. Nonprofits with annual expenses below some arbitrary cut-off point, say $500,000 per year, might be allowed to engage in demonstrably below-market transactions with directors on the terms developed in the next section. Nonprofits that grow beyond that size, which have less need for inside deals and have a greater ability to structure transactions to avoid conflicts, would be subject to the bright-line prohibition.

2. Option Two: Rules that Create Better Procedures

In light of the political opposition to a ban on director transactions, alternative reforms deserve consideration. In particular, fiduciary duty law might be reformed to ensure that nonprofits contract with directors only when the transactions are demonstrably in the nonprofit's best interests and clearly superior to the terms the nonprofit could obtain transacting in the broader market. At the very least, law should change the incentive structure facing those nonprofits that have not internalized the loyalty norm. To that end, optional mushy standards should be replaced with clear, mandatory rules that focus on procedure. The goal is to correct for directors' tendencies to minimize conflicts, to counter groupthink, and to encourage healthy group decision-making processes. The following sections suggest some key reforms.

a. Require Disclosure of Conflicts of Interest

The psychological literature shows that group members generally, and boards of directors in particular, are often blind to conflicts of interest that occur within the group or that they tend to minimize the costs of conflict of interest transactions. Exacerbating this problem is the fact that significant numbers of nonprofits do not have conflict of interest policies and even fewer require directors to disclose their financial interests, even though IRS and other best practices guidelines strongly suggest that nonprofits adopt both practices.[176] Thus, it is entirely possible that a significant amount of self-dealing occurs under the radar—boards may be approving transactions with no knowledge that they involve a conflict with a board member.

Disclosure of conflicts of interest should be a norm of behavior. Any revision of fiduciary duty law should include a duty to disclose the fact

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176. Only half of the charities that responded to the Urban Institute's study had adopted conflict of interest policies, and only 29% of those surveyed required directors to disclose their financial interests in other entities. *Id.* at 9.

that a director has a conflict of interest. A conflicted director's failure to disclose a conflict of interest transaction could be grounds for imposing liability. In addition, following the lead of the better "best practices" guides, the law could require directors to disclose to the board all businesses and corporations with which they are affiliated and to reaffirm and update the form once a year.

b. Advance Approval Requirement

Second, borrowing from trust law, advance approval of a majority of disinterested directors should be required, not optional as it us under current law.[177] Currently, state and federal law allow nonprofits to engage in conflict of interest transactions without advance approval by a majority of independent directors.[178] Although both state law and the

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177. As I noted in a prior article, trust law has historically required the trustee to obtain advance approval for conflict of interest transactions:

> Almost none of the market forces that pressure corporate fiduciaries to forgo opportunistic behavior are at play in the trust context. There is no "share price" or secondary information market that informs other potential customers of a trust term that reduces fiduciary duties or communicates trustees' opportunistic behavior to potential customers. Even if a particular beneficiary discovers that her trustee is performing poorly, she will be unlikely to communicate this to the trustee's other clients, of whom she is unaware. Moreover, that beneficiary cannot exit if she is dissatisfied.

Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 82–83 (2005).

> [Professor Robert] Sitkoff notes that aftermarkets for beneficiaries' interests are weak; moreover, in many trusts, spendthrift clauses prevent beneficiaries from alienating their interest even involuntarily. Beneficiaries' only recourse is to mount a suit for breach of fiduciary duty. Because lawsuits are expensive, beneficiaries are likely to bring them only in those relatively rare instances where opportunism can be clearly proven and recovery is likely to be large. This knowledge of the beneficiaries' relative lack of options may cause less than honorable trustees to push the envelope toward opportunistic behavior.

Id. at 83 n.83 (citing Robert Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 570 (2003)).

> In addition, trustees need not worry about raising money, maintaining or increasing stock prices, or responding to the threat of hostile takeovers. Although employees of trust companies may be concerned about the labor market, it pressures them less than it does their corporate counterparts. Because there is no information market that reveals their poor performance, employees of trust companies may be less concerned about finding a new job if they are terminated. . . . When the trustee is an individual professional, the problem is compounded.

Id. at 83.

178. *See* FREMONT-SMITH, *supra* note 38, at 215, 270.

Code create incentives to obtain advance approval, failure to do so generates no negative consequences as long as the deal is "fair" (state law) or does not exceed market value (the Code).[179] Here, we can learn from trust law, which generally imposes liability on the trustee who fails to obtain advance approval from a court or the trust beneficiaries prior to self-dealing.[180] The rule forces early disclosure of the conflict, and it places the burden on the trustee to justify the need for the transaction, which compensates for the trust beneficiary's poor ability to detect self-dealing and to assess whether a proposed transaction is in his or her best interests.[181] The detection and evaluation problems that trust law seeks to remedy are even more pronounced in the nonprofit context. A nonprofit's "beneficiaries" are represented by the attorney general, who lacks the resources to detect the transaction, and directors have less incentive than trust beneficiaries to detect the transaction since self-dealing will cause them no personal financial harm. In recognition of this, California's nonprofit law has eliminated the corporate law "fairness" defense, which indicates that the scheme is workable.[182]

Finally, requiring advance approval allows the law to work on an expressive level; it sends a clear message that conflict of interest transactions are problematic and should not easily be entered into, which helps counter the tendency to engage in groupthink. To allow the loyalty norm to take root, failure to obtain advance approval should expose the parties to the transaction to personal liability and such other relief as the court deems appropriate, such as disgorgement of profits or removal of directors. The lack of a "fairness" defense and the threat of court-imposed penalties will compensate for infrequency of legal enforcement, creating a true incentive to abide by the law's requirements.[183]

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179. *Id.*

180. *See* Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 543 (2005).

181. *Id.* at 564.

182. California's statutory scheme creates, in a sense, strict liability for self-dealing transactions with some limited exceptions, such as the board's prior approval of a transaction under specific circumstances that include the following:

> Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction.

CAL. CORP. CODE § 5233(d) (West 2010). This last requirement represents a major departure from the Model Nonprofit Corporations Act and the law of other states. By eliminating the "fairness" defense but creating a safe harbor for directors who follow procedure and substantiate that the deal is below market, the statute invigorates social norms against self-dealing, creates strong disincentives to engage in it, reduces the likelihood that social sanctions will result if directors carefully evaluate the deal, and ensures that the nonprofit that complies with California law will be in compliance with relevant provisions of the Internal Revenue Code.

183. The new IRS Form 990, which requires disclosure of all conflicts between nonprofit

c. Clear Rule Stating When Boards May Authorize a Conflict of Interest Transaction

Requiring advance approval will do little to minimize the agency costs caused by self-dealing if groupthink causes directors to approve unworthy transactions. Because ingroup bias and groupthink problems are most pronounced when conflicts of interest arise, advance approval alone should be insufficient to insulate board members from liability.[184] Even in those jurisdictions where board approval must be accompanied by a reasonable belief in the fairness of the transaction, the law does little to counter the tsunami-like pull of groupthink.

What is needed is a clear, procedure-focused rule that gives boards guidance about what transactions are appropriate to approve and levels a penalty for failing to follow the procedure. A rule requiring a majority of disinterested directors of the board to establish that the transaction is in the corporation's best interest and that the nonprofit is obtaining goods and services at 20% below market would do much to combat groupthink.[185]

More specifically, to satisfy the "best interest" standard, the board would have to establish that obtaining the good or service was necessary to advance the nonprofit's mission. For example, a below-market contract for architectural services is not in the best interests of the corporation if the corporation's offices do not need to be remodeled. Second, the board should have to prove, with documentary evidence,[186] that the transaction was better than the corporation could have received by transacting in the market.[187] Because proving that a deal is "below

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and board members, will be helpful. It also sends a strong message to boards that conflict of interest transactions are problematic.

184. *See* DeMott, *supra* note 93, at 143. DeMott suggests that the duty of loyalty rules should create no safe harbor for approved transactions but that transactions tainted by self-interest should be voidable unless the transactions' proponents can establish that the transaction was fair to the corporation at the time it was entered into. *See also* Goldschmid, *supra* note 99, at 648.

185. Of course, the board must be given full disclosure of (1) the nature and extent of the conflict of interest and (2) the details of the transaction.

186. *See supra* note 26.

187. California law takes this approach. That statute provides that in addition to requiring that the board establish that the deal was in the nonprofit's best interests, the board must show that, prior to authorizing the transaction "the board considered and in good faith determined after reasonable investigation . . . that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances." CAL. CORP. CODE § 5233(d)(2)(D)(i) (West 2010). In the alternative, subsection (d)(3) provides the same safe harbor for transactions approved in compliance with subsection (d)(2)(D) by a committee or agent of the board if it was not reasonably practicable to obtain approval of the board prior to entering into the transaction and the board determines that the committee followed correct procedures and ratifies the transaction at the next meeting. *Id.* § 5233(d)(3). I would argue that this provision is not an adequate cure for groupthink and should not be adopted.

market" can be quite difficult at the margins, it might be beneficial to pick an arbitrary requirement, such as 20% below market, as the legal rule. A bright-line rule would send a clearer message that claims of below-market deals must be substantiated and could become a norm in the industry. The rule would force board members to conduct research and compile a record that substantiates the conclusion that the deal was in fact the requisite percentage below market. Perhaps most importantly, this requirement reduces the "costs of confrontation"; in other words, board members who want to probe and question can explain that the law gives them no choice. A board meeting this rule could also rest assured that it was in compliance with the various provisions of the tax code addressing self-dealing and conflicts of interest.

d. Bar Interested Director(s) from Participating in Debate or Voting to Approve a Conflicted Transaction

Of course, directors with an interest in the transaction should attend the meeting to present facts and take questions. But allowing an interested director or directors to be involved in the approval process practically guarantees that groupthink and information cascades will occur. Directors may fear that questions may be interpreted as challenges to the interested director's motives or integrity. Barring the director from participation would make it easier for group members to objectively analyze the transaction. It would also reinforce the loyalty norm by emphasizing the importance of engaging in independent discussion.

e. "Strict Liability" for Violating Conflict of Interest Rules to Compensate for Lack of Enforcement

Given political constraints, it is unlikely that the federal or state governments are going to increase funding for charitable enforcement any time soon. To compensate for the lack of enforcement, there should be no defense to violations of the above requirements. Instead, the court may impose remedies and penalties that it deems just and appropriate, including, but not limited to, voiding the transaction, requiring disgorgement of profits from the interested director, payment of damages by the interested director and/or other board members, or removal of directors. To ensure that the rules are perceived as mandatory, that a board member acted in good faith should not be an affirmative defense to liability (although there is nothing to stop a court from taking it into account in fashioning remedies). Again, this approach is similar to that taken by California, and thus, it is not a stretch to imagine that it is workable.[188]

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188. *See supra* note 182. Subsection (h) of § 5233 provides:

f. A Word About Diversity

By now it should be clear that nonprofits with diverse boards will be better equipped to resist the pull of groupthink and engage in healthy decision-making procedures. And in fact, diversity is positively associated with whether a nonprofit conducts an outside audit, has a separate audit committee, a conflict of interest policy, and a whistle blower policy.[189] Any legal rule requiring board diversity would be difficult to implement and enforce, and would suffer from the fuzziness problems that this Article criticizes. Nonetheless, any nonprofit serious about implementing good governance procedures would do well to keep diversity in mind when selecting board members.

CONCLUSION

When nonprofit directors consider whether to approve a transaction involving a conflict of interest, directors may—consciously or unconsciously—conclude that a detrimental transaction is good for the nonprofit. Decades of psychological research about group dynamics teach us that groupthink can cause directors to place allegiance to fellow board members ahead of the nonprofit's best interests. Groupthink may also induce directors to refrain from adequately monitoring ongoing business relationships with board members, which may end up costing nonprofits more in the long run. As a result, nonprofits' conflict of interest transactions often divert charitable assets away from the charities' intended beneficiaries and into directors' pockets.

> If a self-dealing transaction has taken place, the interested director or directors shall do such things and pay such damages as in the discretion of the court will provide an equitable and fair remedy to the corporation, taking into account any benefit received by the corporation and whether the interested director or directors acted in good faith and with intent to further the best interest of the corporation. Without limiting the generality of the foregoing, the court may order the director to do any or all of the following:
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>> (1) Account for any profits made from such transaction . . . ;
>> (2) Pay the corporation the value of the use of any of its property used in such transaction; and
>> (3) Return or replace any property lost to the corporation as a result of such transaction . . . or account for any proceeds of sale of such property, and pay the proceeds to the corporation together with interest at the legal rate. The court may award prejudgment interest to the extent allowed in Section 3287 or 3288 of the Civil Code. In addition, the Court may, in its discretion, grant exemplary damages for a fraudulent or malicious violation of this section.

Id. § 5233(h)(1)–(3).

189. OSTROWER, *supra* note 9, at 5–6.

Social norms that require directors to place the interests of the organization ahead of self-interest are the most effective weapons against groupthink. As currently structured, fiduciary duty law does nothing to plant or support those norms in environments where fiduciaries have failed to internalize them. Comprised of fuzzy standards that appear to sanction self-dealing that is "fair" or "not excessive," fiduciary duty law facilitates, rather than fights, groupthink that undermines the nonprofit's best interests.

The law should be restructured to support desirable social norms. Restructuring the state law fiduciary duty of loyalty as a set of clear rules would best accomplish this goal. A flat prohibition on self-dealing and conflict of interest transactions would be the most effective way to ensure that fiduciaries place the best interests of the nonprofit ahead of self-interest. The rule would be unlikely to hurt nonprofits because board members who wish to help can structure transactions to avoid conflict. Short of that, clear rules that require investigation of alternatives, deliberation, and proof that inside transactions are clearly below market would do much to counter the damaging impact of groupthink.