Corporate Governance Without Shareholders: A Cautionary Lesson from Non-Profit Organizations

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CORPORATE GOVERNANCE WITHOUT SHAREHOLDERS: A CAUTIONARY LESSON FROM NON-PROFIT ORGANIZATIONS

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ABSTRACT

A debate about corporate governance has long raged over the allocation of power between shareholders and directors. Proponents of "shareholder primacy" believe that the corporate board should be chosen by and accountable to the stockholders rather than dominated by the CEO, as they believe is common now. Advocates of "director primacy" want to limit shareholder power because they believe that shareholders have conflicting objectives, are uninformed, and pressure the directors to sacrifice the long-term health of the company to short-term share price.

The governance of non-profit organizations ("NPOs") offers an example that illuminates the corporate governance debate. Directors of NPOs suffer no pressure from shareholders because NPOs have no shareholders; NPO boards are effectively self-perpetuating. If the director primacists are correct, the governance of NPOs should be a model of wise, long-term management effected by officers who are clearly subordinate to the board.

In fact, however, a remarkable consensus of experts on NPOs agrees that their governance is generally abysmal, considerably worse than that of for-profit corporations. NPO directors are mostly ill-informed, quarrelsome, clueless about their proper role, and dominated by the CEO—as proponents of shareholder primacy would predict. In sum, the experience of NPO governance refutes the claims of director primacy that the absence of strong shareholders facilitates effective corporate governance.

TABLE OF CONTENTS

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Electronic copy available at: http://ssrn.com/abstract=2481646

I. INTRODUCTION

For over eighty years, debate over corporate governance has centered on the balance of authority between boards and shareholders.[1] One side of this debate advocates "shareholder primacy" so that directors would actually be chosen by and would be accountable to the stockholders rather than bowing to the CEO as, they believe, often happens now.[2] The other side touts "director primacy" and keeping shareholders weak because shareholders are uninformed, have conflicting preferences, and focus obsessively on short-term results.[3] Further, this side claims that directors who are free of shareholder control would strive to maximize long-term firm value and have the wisdom and independence to pursue this goal intelligently and conscientiously.[4]

If this director primacy vision is accurate, non-profit organizations ("NPOs") should offer an attractive model for corporate governance.[5] Directors of NPOs are not answerable to shareholders because they have no shareholders; NPO boards are legally self-perpetuating.[6] Suffering no baleful shareholder pressure for short-term results, these boards are free to create and implement strategies for the prudent, long-term development of their organizations.[7] If the director primacists are right, NPO boards should function in the way that director primacists wish that corporate boards would function.[8]

The reality is quite the contrary. A remarkable number of commentators agree that boards of NPOs are generally even less effective than corporate boards.[9] Moreover, NPO boards tend to be dominated by the organization's executives, just as advocates of shareholder primacy claim happens when shareholders are too weak to hold corporate directors accountable.[10] The example of NPOs offers a cautionary tale that boards

[1] *See infra* Part IV.
[2] *See infra* Part I.
[3] *See infra* Part I.
[4] *See infra* Part I.
[5] *See infra* Part II.
[6] *See infra* Part III.
[7] *See infra* Part II.
[8] *See infra* Part III.
[9] *See infra* Part II.
[10] *Id.*; *see also* Paul L. Davies, *The Board of Directors: Composition, Structure, Duties and Powers*, OECD 6 (Dec. 7-8, 2000), http://www.oecd.org/corporate/ca/corporategovernanceprinc iples/1857291.pdf (pointing out that in the absence of strong shareholders, boards are likely to be "captured" by management, and become "expressions" of their unaccountability to shareholders).

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unconstrained by strong shareholders do not make for efficient organizations.[11]

Part I of this Article briefly describes the corporate governance debate between the director primacy and shareholder primacy factions.[12] Part II describes the functioning of boards of directors of NPOs.[13] Part III discusses the significance of this example for the corporate governance debate.[14]

II. THE CORPORATE GOVERNANCE DEBATE: DIRECTOR PRIMACY VS. SHAREHOLDER PRIMACY

Supporters of shareholder primacy see shareholders as entitled to the residual income of the corporation; they get all (and only) the income left after all other constituents (including employees, suppliers, creditors, and tax authorities) have been paid in full according to their legal claims.[15] Thus shareholders "have the greatest incentive to maximize the value of the firm."[16] Accordingly, the board of directors' objective should be to serve the interests of the shareholders by maximizing the value of the stock.[17] Corporate governance rules should be designed to serve this principle.[18]

Advocates of director primacy raise several objections to shareholder primacy.[19] They claim that different shareholders have different goals; shareholders are short-term oriented, ignoring the long-term welfare of the

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[11]*See infra* Part III.

[12]*See infra* Part I.

[13]*See infra* Part II.

[14]*See infra* Part III.

[15]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991) ("[S]hareholders are the residual claimants to the firm's income. Creditors have fixed claims, and employees generally negotiate compensations schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line.").

[16]Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267-68 (1999); *see also* EASTERBROOK & FISCHEL, *supra* note 15, at 68 ("As the residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions.").

[17]Macey, *supra* note 16, at 1267-68 ("[C]orporations [and their directors] should maximize value for shareholders and shareholders alone because shareholders, as residual claimants, have the greatest incentive to maximize the value of the firm.").

[18]*See* George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 51, 69-70, 76 (discussing how corporate governance rules should be designed to maximize the value of stock for shareholders).

[19]*See infra* text accompanying notes 20-22 (discussing the objections to shareholder primacy by advocates for director primacy).

corporation and even of the equity; and shareholders are ill informed.[20] They believe that shareholder power should not be enhanced and, indeed, that shareholders are already too powerful.[21] Shareholders should have little control over the board so that directors are free to act as "Platonic guardians."[22] Indeed, like Ulysses, shareholders of public corporations traditionally tied their own hands, ceding control to an independent board, in order to preclude the damage that shareholders would inflict on themselves if they exercised control.[23]

The governance of NPOs offers a lesson for the governance of for-profit corporations.[24] Boards of directors of NPOs are not accountable to shareholders because they have no shareholders;[25] they face no constraints to acting as "Platonic guardians."[26] If director primacy theorists are correct, this governance structure should result in intelligent, prudent, cooperative, far-sighted management.[27] If shareholder primacists are correct, the NPO boards' lack of accountability should result in laxity, confusion about goals, personality conflicts, and domination of boards by NPO executives, especially the CEO.[28] Who is right?

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[20]LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 69-70 (2012); George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 100-05 (2010); Lawrence Mitchell, *Protect Industry from Speculators*, FIN. TIMES, July 8, 2009, *available at* http://www.ft.com/cms/s/0/fac881b6-6be5-11de-9320-00144feabdc0.html.

[21]Dent, *supra* note 20, at 147 ("[S]ome commentators feel that shareholders have become too powerful and their rights should be curtailed. Delaware's Vice Chancellor Leo Strine, for example, wants to deny voting rights altogether to stockholders who have held their shares for less than a year or who seek control.").

[22]Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550-51 (2003). Similarly, Lynn Stout says (with nostalgia) that "for most of the twentieth century directors of public companies who did not breach their loyalty duties enjoyed virtually unfettered discretion to set corporate policy . . . ." STOUT, *supra* note 20, at 110; *see also* George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1216-40 (2008) (discussing in detail why shareholders should have little control over the board).

[23]*See* STOUT, *supra* note 20, at 74-83.

[24]*See supra* notes 15-23 and accompanying text.

[25]Seong J. Kim, *Hiding Behind the Corporate Veil: A Guide For Non-Profit Corporations With For-Profit Subsidiaries*, 5 HASTINGS BUS. L. J. 189, 205 (2009).

[26]*See* Bainbridge, *supra* note 22, at 605. This is in contrast to board of directors of for-profit corporations, according to the director primacy model. *See id.*

[27]*See supra* notes 19-23 and accompanying text.

[28]*See supra* Part I.

III. BOARDS OF DIRECTORS OF NON-PROFIT ORGANIZATIONS

Like business corporations, most NPOs are governed by a board of directors.[29] "Boards are charged with setting the organization's agenda and priorities . . . ."[30] Unlike business corporations, however, the boards of NPOs are not elected by shareholders because NPOs have no shareholders.[31] The charter may vest in the NPO's members or some other group authority to elect the board of directors periodically, but this is rarely done; most boards are self-perpetuating.[32]

In theory, then, NPO boards are accountable to no one so long as they obey the law.[33] Indeed, because they are fiduciaries, they cannot delegate or contract away their authority to anyone else.[34] NPO employees, including the CEO, are by law always subject to the superior power of the board; their authority can be reduced or completely withdrawn by the board at any time for any reason sufficient to the board.[35]

Clothed with authority not limited or accountable to anyone except to the law, NPO boards are free of the pressures that director primacists allege plague directors of business corporations; namely to produce short-term

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[29]Most NPOs are organized as non-profit corporations (NPCs) under state statutes that typically state that, unless otherwise provided, an NPC is to be managed by or under the direction of a board of directors. *See, e.g.*, OHIO REV. CODE ANN. §1702.30(A) (West 2012) ("Except where the law, the articles [of incorporation], or the regulations require that action be otherwise authorized or taken, all of the authority of a corporation shall be exercised by or under the direction of its directors."). Some NPOs are organized as trusts, the governance of which is similar except that the governing body is then a trustee or board of trustees. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 133, 138-47 (2004).

[30]RICHARD P. CHAIT, WILLIAM P. RYAN & BARBARA E. TAYLOR, GOVERNANCE AS LEADERSHIP: REFRAMING THE WORK OF NONPROFIT BOARDS 3 (2005).

[31]*See* Kim, *supra* note 25, at 205.

[32]A non-profit corporation may have members. *See, e.g.*, OHIO REV. CODE ANN. § 1702.26 (West 2004); FREMONT-SMITH, *supra* note 29, at 159. However, "[t]he majority of charitable corporations are governed by a self-perpetuating board of directors, often called trustees." *Id.*; *see* OHIO REV. CODE ANN. § 1702.14 (West 2004); BRUCE R. HOPKINS, STARTING AND MANAGING A NON-PROFIT ORGANIZATION: A LEGAL GUIDE 14-20 (5th ed. 2005) (stating that it is a common practice for an organization to have a self-perpetuating board that elects officers).

[33]NONPROFIT GOVERNANCE AND MANAGEMENT 3-4 (Cheryl Sorokin et al. eds., Am. Bar Ass'n 3d ed. 2011) [hereinafter NONPROFIT GOVERNANCE].

[34]*Id.* at 8-9.

[35]The board may commit to a contract to pay someone compensation for a term, but the board remains free to remove the person from office. *See, e.g.*, OHIO REV. CODE ANN. § 1702.34(B)(2) (West 2004) ("Any officer may be removed, with or without cause, by the persons authorized to elect or appoint the officer without prejudice to the contract rights of such officer."). Even if they wish to do so, boards "may not . . . abdicate their duty to direct . . . ." FREMONT-SMITH, *supra* note 29, at 162.

results at the expense of the long-term effectiveness of the organization.[36] An NPO board can choose the organization's objectives and set as distant a horizon as it wishes for the accomplishment of those objectives.[37] NPOs must report certain data annually to maintain their tax-exempt status, and these reports are available to the public.[38] However, NPOs need not, and typically do not, disclose quarterly results or project future short-term results.[39] Even informal public pressure for short-term results is extremely rare.[40] No one can threaten to oust NPO directors; so long as they obey the law, they need only satisfy themselves.[41]

Under the theory of director primacy that pressure from short-termist shareholders wreaks havoc with long-term corporate planning, NPO boards (which are free of that pressure) should be models of prudent, far-sighted leadership.[42] However, according to a virtually unanimous consensus of experts, this is not the case at all. NPO directors are generally uninformed and disengaged.[43] "[B]oard members . . . are faulted for not knowing what is going on in their organizations and for not demonstrating much desire to find

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[36] Bainbridge, *supra* note 22, at 550-51; *see supra* notes 22-23, 29.

[37] *See* NONPROFIT GOVERNANCE, *supra* note 33, at 5-6.

[38] JOHN TROPMAN & THOMAS J. HARVEY, NONPROFIT GOVERNANCE: THE WHY, WHAT, AND HOW OF NONPROFIT BOARDSHIP 241-42 (2009).

[39] *See* Debra Askanase, *The Non-Profit Quarterly Report = Transparency*, COMMUNITY ORGANIZER 2.0 (Dec. 30, 2008), http://communityorganizer20.com/2008/12/30/the-non-profit-quarterly-report-transparency/ (explaining the risks of releasing non-profit quarterly reports while indicating that such reports may help foster transparency).

[40] *See* Marc J. Epstein & F. Warren McFarlan, *Nonprofit vs. For-Profit Boards: Critical Differences*, STRATEGIC FIN. MAG., March 2011, at 28, 32-33 (explaining that the financial and performance metrics that create a strong focus on short-term performance in the for-profit world are not present in the non-profit world).

[41] Leslie Rosenthal, *Nonprofit Corporate Governance: The Board's Role*, THE HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Apr. 15, 2012), https://blogs.law.harvard.edu/corpgov/2012/04/15/nonprofit-corporate-governance-the-boards-role/ ("Unless board members are doing something illegal or are term-limited out of office, they may serve in perpetuity, giving them ultimate power over the organization. In this regard, nonprofit trusteeship is a unique and privileged role."); *see also* TROPMAN & HARVEY, *supra* note 38, at 31-32 (stating that non-profit boards have performed poorly because they are insulated from accountability and responsibility, and because no one fires a board member).

[42] *See* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1646 (2013) ("During the 1980s, prominent business school academics and business thought leaders argued that short-termism was an important driver of the United States' dismal performance during that period."); TROPMAN & HARVEY, *supra* note 38, at 26 (stating that stockholders are a dominant force in for-profits, whereas they are absent in the case of non-profits); SHARON M. OSTER, STRATEGIC MANAGEMENT FOR NONPROFIT ORGANIZATIONS: THEORY AND CASES 77 (1995) ("[T]here are no stockholders in the nonprofit . . . . Thus, the usual role of the board as a protector of stockholder rights over the interests of management is absent in the nonprofit.").

[43] CHAIT ET AL., *supra* note 30, at 20.

out. Attendance at board meetings is often spotty and participation perfunctory."[44]

The insignificance of the directors is even touted as a benefit of the job.[45] "[S]ome boards actually encourage the disengagement they later lament: They promise prospective board members that there will be little work to do, in the hope that low expectations will attract more prospective board members."[46] And:

> It is not uncommon to elect individuals to serve as directors because of certain unique contributions they are able to make. . . . In many instances it is understood that these individuals will not be expected to attend meetings or give the affairs of the charity the degree of attention expected of other board members.[47]

One reason for the directors' passivity is that "they do not know what their job is."[48] "[B]oard members often have no idea what they are to do individually and collectively."[49] "A central finding of the empirical literature on non-profit boards is that board members are uncertain both of their roles and those of their senior managers."[50] The NPO directors' lack of accountability leads not to wise governance but to confusion.

Dysfunction is not limited to a minority of NPO boards: "Frustration with boards is so chronic and widespread that *board* and *troubled board* have become almost interchangeable."[51] Criticism of NPO boards is not limited to just a few gadflies; it seems to be shared by everyone

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[44] *Id*. at 13; *see also* TROPMAN & HARVEY, *supra* note 38, at 32 ("[Nonprofit] boards do not care about management in the largest, most positive sense . . . .").

[45] Rosenthal, *supra* note 41 (stating that a frequent error made by non-profit boards is inviting new members because of their wealth or marquee name without due consideration to the person's ability and availability to fulfill fiduciary duties).

[46] CHAIT ET AL., *supra* note 30, at 13.

[47] FREMONT-SMITH, *supra* note 29, at 433 (showing that it is often understood that directors will be disengaged).

[48] CHAIT ET AL., *supra* note 30, at 14.

[49] TROPMAN & HARVEY, *supra* note 38, at 32.

[50] THE GOVERNANCE OF PUBLIC AND NON-PROFIT ORGANISATIONS 151 (Chris Cornforth. ed., 2003) [hereinafter GOVERNANCE OF NPOS]; *see also* CHAIT ET AL., *supra* note 30, at 92 ("Most boards are on the outside looking in, as virtually everyone else in and around the organization participates in generative work.").

[51] CHAIT ET AL., *supra* note 30, at 11; *see also* Robert D. Herman & David O. Renz, *Board Practices of Especially Effective and Less Effective Local Nonprofit Organizations*, 30 AM. REV. PUB. ADMIN. 146, 148 (2000) ("experience and research suggest that many boards fail to meet fully their prescribed responsibilities").

knowledgeable about NPO governance. While conducting research, the authors of one volume on non-profit boards "came across one universally agreed upon point: Boards of directors are deeply flawed. They seriously underperform and malperform virtually everywhere."[52]

It is not surprising, then, that most non-profit boards do not actually govern.[53] CEOs actually run most NPOs; most boards merely rubber-stamp the CEO's plans.[54] "[M]any nonprofit executives are not only leading their organizations, but . . . they are actually governing them as well."[55] Rather than telling the CEO what to do, boards do what the CEO tells them: "Instead of identifying problems, framing issues, or making sense of the organization, most boards address the problems that managers present to them."[56] Indeed, although in theory the board is self-perpetuating and controls the CEO, in practice, the CEO picks the board as much as the board picks the CEO.[57]

CEOs are very happy with this state of affairs.[58] CEOs typically communicate with just a few key directors and leave the others ignorant.[59] "[W]hen a nonprofit executive says, 'I have a really good board,' savvy listeners know this often means 'I have a compliant board.'"[60]

Ironically, despite the passivity of non-profit boards and the widespread understanding that the job requires little effort, non-profit boards are often fractious.[61] "[T]he nonprofit board [has] more dissension on

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[52] TROPMAN & HARVEY, *supra* note 38, at 31; *see also* Herman & Renz, *supra* note 51, at 147 ("Some believe that "nonprofit boards are largely irrelevant anachronisms . . . .").

[53] Jan Masaoka & Mike Allison, *Why Boards Don't Govern*, COMPASSPOINT NONPROFIT SERVICES, http://www.maconsulting.org/wp-content/uploads/2008/07/why-boards-dont-govern.pdf (last visited Jan. 25, 2014).

[54] *See id*. (stating that CEOs normally possess much more knowledge about a specific field than board members).

[55] CHAIT ET AL., *supra* note 30, at 3; *see also* Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 FORDHAM L. REV. 521, 526 (2007) ("Board members sometimes feel beholden to the person or group that that recommended, nominated, or elected them to the board. Indeed, it is not uncommon . . . that the board as a whole defers excessively to the chief executive officer [] for this very reason.").

[56] CHAIT ET AL., *supra* note 30, at 92.

[57] *See* Robert D. Herman & F. Peter Tulipana, *Board-Staff Relations And Perceived Effectiveness in Nonprofit Organizations, in* NONPROFIT BOARDS OF DIRECTORS: ANALYSES AND APPLICATIONS 48, 58 (Robert D. Herman & Jon Van Til eds., 1989).

[58] CHAIT ET AL., *supra* note 30, at 11.

[59] Terry W. McAdam & David L. Gies, *Managing Expectations: What Effective Board Members Ought to Expect From Nonprofit Organizations, in* NONPROFIT BOARDS OF DIRECTORS: ANALYSES AND APPLICATIONS, *supra* note 57, at 79.

[60] CHAIT ET AL., *supra* note 30, at 11.

[61] *See id.* at 12-13.

average than the for-profit . . . ."[62] Since the directors do not really direct, they tend to descend into personal squabbling. "Their processes and meetings become a venue for expressing and implementing private agendas."[63] Thus, although NPO boards are self-perpetuating and not answerable to shareholders, they still are not unified, harmonious, or cooperative.[64]

Although in theory all directors have equal power, non-profit boards "are typically 'run' by the most socially 'powerful' person on the board."[65] Choosing the leader on the basis of social standing does not lead to effective governance. "Even the best ones fail in many areas and the worst ones are abysmal."[66]

In sum, "[t]here is a widespread view that nonprofit organizations are generally less well managed than businesses."[67] Even critics of directors of business corporations share this view. "While for-profit boards have much to answer for, and have been poor performers in many cases, nonprofit boards are, amazingly, worse."[68] I have found no one who claims that the governance of NPOs is generally superior to that of for-profit corporations.

IV. LESSONS FROM NON-PROFIT BOARDS

Director primacy theory posits that shareholder control is deleterious because shareholders are uninformed and short-term oriented, and different shareholders have different goals.[69] The experience of NPOs shows that director primacy produces no benefits in these respects.[70] Directors of NPOs are not well informed; they do not even know what they are supposed to do.[71] They are not far-sighted.[72] They lack a vision of the goals of the organization and tend to defer to the CEO in planning.[73] Neither are they

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[62] OSTER, *supra* note 42, at 76.

[63] TROPMAN & HARVEY, *supra* note 38, at 32.

[64] *See id.* at 31-32.

[65] *Id.* at 32; *see also id.* ("Status and hierarchy operating as they typically do, other members defer to the socially prominent.").

[66] *Id.* at 32.

[67] Robert D. Herman, *Board Functions and Board-Staff Relations in Nonprofit Organizations: An Introduction, in* NONPROFIT BOARDS OF DIRECTORS: ANALYSES AND APPLICATION, *supra* note 57, at 1.

[68] TROPMAN & HARVEY, *supra* note 38, at 31.

[69] *See* Dent, *supra* note 20, at 100-04 (illustrating the allegedly different goals of shareholders).

[70] *See supra* Part II.

[71] *See supra* notes 43-51 and accompanying text.

[72] *See supra* Part II.

[73] *See supra* notes 60, 63-65 and accompanying text.

unified nor even cooperative.[74] Many NPO boards are either riven by conflict or dominated by a couple of members who leave other directors in the dark and powerless.[75]

Why are NPO boards so passive, and is this a problem? To some extent board passivity and CEO dominance are inherent to and desirable for organizations, whether for-profit or non-profit.[76] No one believes that the board of either a corporation or a NPO should design the organization's strategy, much less manage its operations.[77] As a full-time manager with a full-time staff, the CEO (for-profit or non-profit) has much better information than the directors, who meet only a few times per year and who usually have no separate staff and, therefore, depend on the CEO for their information.[78] It is obviously difficult for directors to monitor the CEO's performance or to question her plans when they have only the information that the CEO deigns to give them.[79] The board hires the CEO to manage the organization; so long as it retains confidence in the CEO, it makes sense that the board would give heavy weight to the CEO's views.[80]

However, autocratic rule is undesirable because no one is omniscient and the personal interests of the CEO never coincide exactly with the interests of the organization.[81] Boards should provide the greater wisdom of group deliberation and curb the CEO's natural human tendency (often subconscious) to elevate her own interests over those of the organization. NPO boards could do this, but generally do not.

Director primacists charge that excessive shareholder influence trashes prudent long-term planning in favor of short-term gimmicks.[82] However, the

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[74] *See* CHAIT ET AL., *supra* note 30, at 12.

[75] *See supra* notes 65-66 and accompanying text.

[76] *See* CHAIT ET AL., *supra* note 30, at 92; Robert F. Hoel, *Boards and CEOs: Who's Really in Charge?*, FILENE RESEARCH INST. 1, 4 (2011), http://filene.org/assets/pdf-reports/254_Hoel_Board_CEO.pdf.

[77] *See* OSTER, *supra* note 42, at 76; *The Basics of Corporate Structure*, INVESTOPEDIA (Dec. 07, 2013), http://www.investopedia.com/articles/basics/03/022803.asp (stating that the board's role is to monitor a corporation's managers, including the CEO, who is responsible for company operations).

[78] *See* Robert F. Leduc & Stephen R. Block, *Conjoint Directorship: Clarifying Management Roles Between the Board of Directors and the Executive Director, in* NONPROFIT BOARDS OF DIRECTORS: ANALYSES AND APPLICATIONS, *supra* note 57, at 67, 71 (stating that non-profit boards get their information from the organization's "disseminator" who has large discretion to "tell the story" as he or she sees it).

[79] *Id.* at 72 ("Intentionally or unintentionally, the executive director can influence the policy decision capability of the board by either stressing or withholding certain information.").

[80] *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-69 (1974) (explaining the need for centralized decision-making in large organizations).

[81] *Id.* at 27.

[82] *See supra* note 20 and accompanying text.

record of NPOs demonstrates that the absence of shareholders makes matters worse, not better: "The planning horizon for an NPO is relatively short, while it is longer for a profit corporation."[83]

Experts advise measures that NPO boards could take in order to be more effective.[84] Many of these measures are also recommended for boards of businesses.[85] However, in NPOs, institution of reforms depends entirely on the volition of the directors; there is no external force to compel or even agitate for their adoption.[86] Perhaps more importantly, no model blueprint for a board (NPO or for-profit) will do much good unless the directors choose the right goals and work diligently to achieve them, and continue to do so forever.[87] Even when reforms are enthusiastically pursued for a while, the human tendency to take the easy path usually prevails eventually and the initial zeal dissipates unless there is some incentive to maintain discipline.[88]

Why, then, are NPO boards generally even less effective than for-profit boards? How do their incentives differ? One possibility is that directors of for-profit companies are compensated while directors of NPOs usually are not.[89] This explanation, too, seems unlikely. Most outside directors of businesses are highly-paid executives.[90] Their director compensation does not substantially alter their wealth. Boards of NPOs

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[83]ROBERT D. HAY, STRATEGIC MANAGEMENT IN NON-PROFIT ORGANIZATIONS: AN ADMINISTRATOR'S HANDBOOK 153 (1990).

[84]*See generally* CHAIT ET AL., *supra* note 30.

[85]*See, e.g.*, TROPMAN & HARVEY, *supra* note 38, at 7-9 (recommending promotion of the functioning of the board as a "group" and carefully planned divisions of authority); *see also* DENNIS D. POINTER & JAMES E. ORLIKOFF, THE HIGH-PERFORMANCE BOARD: PRINCIPLES OF NONPROFIT ORGANIZATION GOVERNANCE 23-79 (2002) (recommending, *inter alia*, a clear definition of organizational goals and standards for review of executive performance).

[86]*See* TROPMAN & HARVEY, *supra* note 38, at 55-56 (NPO boards are responsible for articulating the broad vision, long-term mission, and specific plans for their organizations).

[87]*See id.* at 39-54 (discussing responsibilities of boards, such as reassessment of strategic goals, annual audit of fiscal performance, closer oversight of the CEO, recruitment planning, and establishing a community representative system).

[88]An instructive example is the experience of monasteries in the Middle Ages. A monastery was always founded "to be a little oasis of sanctity." FRIEDRICH HEER, THE MEDIEVAL WORLD: EUROPE 1100-1350, at 41 (Janet Sondheimer trans., World Publ'g Co. 1962) (1961). However, "[w]ith monotonous regularity after two or three generations monastic discipline would start to decline. . . . There were thus any number of monastic reforms, all with the same object, to restore the monasteries to their proper functions, the performance of their specific duties." *Id.*

[89]*See* FREMONT-SMITH, *supra* note 29, at 168 (stating that members of boards of charitable corporations generally serve without compensation). Some commentators recommend that NPO directors be paid, but this recommendation is rarely followed. *Should Board Members of Nonprofit Organizations Be Compensated?*, AM. SOC'Y OF ASS'N EXECS. (Nov. 2006), http://www.asaecenter.org/Resources/whitepaperdetail.cfm?ItemNumber=22981.

[90]ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 260 (1995) ("[T]he most popular type of director is a top executive of another company.").

meet almost as often as for-profit boards, which suggests that the members of both devote similar amounts of time to their positions.[91]

More importantly, any explanation based on director compensation would require a showing of how compensation motivates for-profit directors and would motivate non-profit directors if they were paid.[92] It seems unlikely that gratitude for one's fee would by itself substantially change the behavior of NPO directors.[93] If anything, compensation with no strings attached would probably attract candidates for the board who have little interest in the mission of the organization and only wanted the money.[94] If for-profit boards are more effective, it presumably is because of some exogenous force that can continue or withdraw the benefits of the position.[95]

A second possibility is that under the law directors of businesses owe legally enforceable fiduciary duties to the corporation.[96] However, legal accountability of corporate boards (except for self-dealing) is almost non-existent, so fiduciary duties create very little incentive for corporate directors to strain to enhance share value.[97] The vulnerability of NPO directors to

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[91]The typical board of a major NPO holds a meeting about seven times per year. *See* Adrianne DuMond, *National Nonprofit Board Statistics*, MANAGING NONPROFITS, www.managingnonprofits.org/2013/02/12/national-nonprofit-board-statistics/; *see also* MONKS & MINOW, *supra* note 90, at 261 ("The typical [for-profit] board meets less than eight times annually.").

[92]*See* Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience Into Fidelity*, 76 FORDHAM L. REV. 893, 906 (2007) ("[M]arket mechanisms that encourage attention to profit making help [for-profit] directors . . . stay focused on the appropriate goals. . . . There is no market to keep the focus of [non-profit directors] on a particular goal.").

[93]*See id.* at 906-07 ("Performance-based compensation, while familiar in the charitable sector, is not directly related to anything as concrete as financial-statement profitability or stock price, so its incentive effect is less direct than for business executives.").

[94]*See id.* at 907 ("There is no clear force that drives nonprofit directors . . . to achieve the good results for which their organizations exist; they must be self-motivated to an extent not expected of individuals in business organizations who are impelled by both fear and greed from external forces.").

[95]*See id.* ("Even individuals who feel a strong personal commitment may not be as motivated by that commitment as individuals stimulated by the external forces that encourage for-profit managers.").

[96]*See* Sugin, *supra* note 92, at 897 ("The directors of all corporations owe fiduciary duties of care and loyalty to those corporations.").

[97]*See* ROBERT CHARLES CLARK, CORPORATE LAW 126 (Francis A. Allen *et al.* eds., 2nd prtg. 1986) ("[T]he total number of reported cases in which derivative actions against directors of nonfinancial corporations were actually won on the merits on the basis of simple negligence uncomplicated by any fraud or self-dealing is small. . . . [T]he case law experience must still lead us to wonder whether the courts are serious when they say directors may be held liable for negligence."); *see also* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 242 (2002) ("[T]he duty of care tells directors to exercise reasonable care in making corporate decisions . . . [but] the business judgment rule says that courts must defer to the board of directors' judgment absent highly unusual expectations.").

individual liability is minimal,[98] too, but it is probably no weaker than the legal accountability of for-profit boards.[99] Although directors of NPOs are not subject to suit by shareholders, they can be sued by state attorneys general.[100]

A third possibility is that directors of a business corporation are usually also stockholders of the corporation and therefore have a personal monetary interest in its performance that directors of NPOs (which have no stockholders) do not have.[101] Most outside corporate directors (who are the majority of the board of most public companies) hold few shares in the company, so this financial interest creates little incentive for them to work hard to increase the share price.[102] This situation could be changed by giving outside directors a larger equity stake.[103] However, this would make their positions so valuable that they, like the officers, would want to retain those positions, even at the expense of share value.[104] Rather than overseeing

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[98] *See* HOPKINS, *supra* note 32, at 315-19 (listing grounds on which NPO directors can avoid personally liable).

[99] *See* FREMONT-SMITH, *supra* note 29, at 200 (stating that most courts have imposed the same standards of care and loyalty on NPO directors as on for-profit directors); *see also* Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries, 381 F. Supp. 1003, 1014 (D.D.C. 1974) ("A director [of a non-profit corporation] whose failure to supervise permits negligent mismanagement by other to go unchecked has committed an independent wrong against the corporation . . . ." (citations omitted)).

[100] *See* FREMONT-SMITH, *supra* note 29, at 305-09 (describing the powers of state attorney general with respect to NPOs).

[101] Consistent with statutes authorizing bylaws that require share ownership as a qualification to serve as a director, many public corporations have adopted share ownership guidelines for their directors. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(b) (2010) ("Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws."); *see also In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 366 (Del. Ch. 2008) ("[A] director who is also a shareholder of his corporation is more likely to have interests that are aligned with the other shareholders of that corporation as it is in his best interest, as a shareholder, to negotiate a transaction that will result in the largest return for all shareholders." (quoting Orman v. Cullman, 794 A.2d 5, 26 n.56 (Del. Ch. 2002))).

[102] "[A]ll too often, outside directors hold [in company stock], at best, only small proportions of their net worth, and merely token holdings at worst." MONKS & MINOW, *supra* note 90, at 262. Director compensation has tended to be "management largesse," which compromised director independence from management. *See* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 132 (1996).

[103] *See* Elson, *supra* note 102, at 133-34 (emphasizing the benefits of paying outside directors in large amounts of company stock, thus making the directors substantial shareholders who now have a personal interest in the company's profitability and productivity).

[104] *See* Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 792 (2011) ("If the board is supposed to be a truly independent, distant monitor, then giving directors personal ties to the firm's finances might make them too much like the managers they are supposed to monitor.").

management for the benefit of the shareholders, then, the board would align with management to entrench both.[105]

Nonetheless, even a small equity stake does give outside directors of business corporations an incentive that directors of NPOs lack.[106] However, this incentive is possible only because the for-profit corporation *has* stockholders and most of them are not directors.[107] If the directors own a majority of the stock, they will serve their own interests rather than those of the outside, minority owners.[108]

Thus, the main reason for the differences in the performance of for-profit and non-profit boards is that shareholders elect the former while the latter are self-perpetuating.[109] The importance of shareholder election of corporate boards should not be exaggerated. Proxy fights in board elections are extremely rare.[110] Absent a proxy fight, the board's self-selected slate of nominees runs unopposed.[111]

As an alternative to a proxy fight, stockholders can sell a majority of a company's shares in a tender offer by a bidder who can then elect its own nominees to replace the incumbent directors.[112] If the incumbent board has allowed the company's stock price to fall below what it would be under competent management, a tender offer becomes economically appealing

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[105] *Cf.* Elson, *supra* note 102, at 133 (explaining the need for outside directors to align their interests with those of the shareholder in order to "stimulate real oversight").

[106] *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 691 (1995) ("By becoming equity holders, the outside directors would assume a personal stake in the success or failure of the enterprise.").

[107] *See id.* at 690 n.87 ("[Y]ou can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' . . . ." (quoting A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932)).

[108] *See* Elson, *supra* note 106, at 691 (analogizing outside directors becoming substantial shareholders with an individual being responsible for looking over the individual's own property to demonstrate that, in both situations, the individual has a personal interest that will lead to more vigilant care).

[109] *See* Joshua B. Nix, *The Things People Do When No One Is Looking: An Argument for the Expansion of Standing in the Charitable Sector*, 14 U. MIAMI BUS. L. REV. 147, 158-59 (2005) (discussing some differences between for-profit boards of directors and non-profit boards of directors).

[110] *See* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 559 (2005).

[111] *See id.* at 560 (describing the possibility that proxy fights may not be initiated because the shareholders are satisfied with the board or, even if the shareholders are *not* satisfied, because of the consequent "cost and impediments").

[112] *See* WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 13-14 (2nd ed. 2007) (stating that tender offers were historically used in place of proxy contests as a quicker means to replace inefficient management and that the Securities Exchange Commission has since regulated the practice).

since the bidder can pay the existing shareholders more than the current price of the stock but less than its optimal value; both sides win.[113] However, there are many obstacles to takeovers by tender offer so that most underperforming boards avoid them.[114]

Many public companies have now adopted majority voting so that a director might be ousted if holders of a majority of the shares simply decline to vote for her.[115] However, to date, the prospects of removal from the board in such cases have been more theoretical than actual; most directors who have failed to obtain a majority vote remain in their positions.[116]

Nonetheless, shareholder rights create at least some incentive for corporate boards.[117] Although proxy fights in board elections and hostile

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[113]This phenomenon was first described by Henry Manne. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 120 (1965) (explaining that empirical evidence may not capture a company's true take-over motivation—to cure a poorly-run company of its inefficient management). There is considerable (though not unanimous) empirical support for the theory that hostile takeovers tend to displace underperforming managements. *See, e.g.*, Eugene P.H. Furtado & Vijay Karan, *Causes, Consequences, and Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence*, 19 FIN. MGMT. 60, 61, 65 (1990) (stating that weak firm performance increases the probability of a change in top management and that other researchers have found poor firm performance to be associated with turnover); *see also* Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671, 683 (1991) (finding hostile takeover targets are poor performers within their industries); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Characteristics of Targets of Hostile and Friendly Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101, 115, 117, 120-23, 124 (Alan J. Auerbach, ed., 1988) (finding hostile targets have fewer assets, lower market values, heavier debts, and incompetent management, which make them prime targets for takeover). *But cf.* Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721, 743-44 (2003) (finding insignificant to no evidence to support the hypothesis that takeover targets were previously poor performers).

[114]*See* FRANKLIN A. GEVURTZ, CORPORATION LAW § 7.3.1, at 704-10 (2d ed. 2010) (describing a variety of takeover defenses that a board can adopt to prevent hostile takeovers, some of which include amending the articles and bylaws, communicating with shareholders, repurchasing the company's stock, issuing more stock, suing the hostile buyer, and seeking out a "white knight").

[115]*See* Denise F. Brown, *Updated Study Shows Majority Voting Being Adopted at "Breathtaking Speed,"* 5 CARE 190 (2007) (stating that many boards have adopted majority voting policies that directly affect mandatory, board-member resignations).

[116]*See* James B. Stewart, *Why Bad Directors Aren't Thrown Out*, N.Y. TIMES (Mar. 29, 2013), http://www.nytimes.com/2013/03/30/business/why-bad-directors-arent-thrown-out.html?hp&_r=0 ("Last year, there were elections for 17,081 director nominees at United States corporations, according to [Institutional Shareholder Services]. Only 61 of those nominees, or 0.36 percent, failed to get majority support. More than 86 percent of directors received 90 percent or more of the votes. Of the 61 directors who failed to get majority approval, only six actually stepped down or were asked to resign. Fifty-one are still in place, as of the most recent proxy filings.").

[117]*See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1300 (2008) (stating three general ways shareholders exert their influence on corporations).

tender offers are both rare, they do happen occasionally.[118] Partial proxy fights are becoming more common.[119] An activist investor that acquires a substantial block of stock and suggests changes that other investors are likely to support can make a credible threat to mount a proxy fight for board seats or to attract a takeover bidder.[120] Facing a serious effort to oust them because they have allegedly disregarded shareholder interests is embarrassing to directors even if they ultimately prevail; to lose would be even more ignominious.[121]

Short of a proxy fight or a tender offer, an investor can threaten to submit a policy resolution for a shareholder vote.[122] Such resolutions often fail, and even when approved they are usually not binding on the board.[123] Nonetheless, even an unsuccessful insurgency generates publicity that criticizes management.[124] High-paid full-time executives may accept this criticism and the effort of resisting the campaign as the price of maintaining their authority and perquisites, but the outside directors (the majority of most boards) often respond differently.[125] Even for shareholder resolutions addressing the powers of the board the real target is usually management.[126]

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[118]*See* Bebchuk, *supra* note 110, at 559 (finding only 215 proxy fights occurred in the six year period studied).

[119] *See* Steven M. Davidoff, *Revisiting the Proxy Contest*, N.Y. TIMES (Mar. 2, 2009), http://dealbook.nytimes.com/2009/03/02/revisiting-the-proxy-contest/?_r=0& pagewanted=print.

[120]*See* Morgan N. Neuwirth, *Shareholder Franchise—No Compromise: Why the Delaware Courts Must Proscribe All Managerial Interference with Corporate Voting*, 145 U. PA. L. REV. 423, 432-35 (1996) (describing the role that institutional investors play in board challenges).

[121]*See* Anabtawi & Stout, *supra* note 117, at 1300.

[122]*See* 17 C.F.R. § 240.14a-8 (2013) (describing the process a shareholder must follow to have a proposal included on the company's proxy card).

[123]In Delaware, where most large public companies are incorporated, the shareholders cannot amend the corporate charter without the board's cooperation. *See* DEL. CODE ANN. tit. 8, § 242(b) (2011) (requiring a board resolution before shareholder approval to amend the charter). The Model Business Corporation Act, which is followed in many other states, is the same. *See* MODEL BUS. CORP. ACT § 10.03(a) (2010). In most states, shareholders alone can amend bylaws, but the charters of many public companies require a supermajority vote for this purpose, and a shareholder-adopted provision may not bind the board. George W. Dent, Jr., *Corporate Governance: The Swedish Solution*, 64 FLA. L. REV. 1633, 1665-66 (2012).

[124]*See* Andrew R. Brownstein & Igor Kirman, *Can A Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 46-47 (2004) (discussing the implications of shareholders withholding votes in a board election).

[125]*See* Dent, *supra* note 18, at 40 (observing that corporate executives are determined to maintain their privileges in the face of corporate governance reform).

[126]For example, resolutions concerning antitakeover provisions or executive compensation usually deal with board powers, but their ultimate purpose is to loosen the entrenchment of the managers or to curb their compensation. *See Adjusting to Shareholder Activism*, SULLIVAN & CROMWELL LLP 1-2 (Aug. 22, 2013), http://www.sullcrom.com/files/Publication/533e7c3d-bd93-46b6-af66-7f61424f962f/Presentation/PublicationAttachment/9df56a6e-6e36-4d4b-8856-81a5c95

The outside directors may not feel much of a personal stake in these battles; they may be unwilling to wage a public campaign against the shareholders just to preserve the privileges of the managers.[127] As a result, shareholders often do exert some influence over corporate boards.[128]

Non-profit organizations, however, have no shareholders who can wage a proxy fight to oust directors, to adopt policy resolutions, or to publicly criticize the board.[129] As a result, "there is no set of standards" for non-profit boards.[130] Most directors do not even know what they are supposed to do.[131]

Apart from suits by the state for illegal acts, the only possible challengers to the dominance of the NPO board are the organization's executives, especially the CEO.[132] As in the business corporation, the officers can legitimately claim to know more than the outside directors.[133] And as in the business corporation, the full-time executives of non-profits are much more affected by the organization's policies than are the part-time, outside directors, so the executives are more likely to fight for the policies

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80067/SC_Publication_Adjusting_to_Shareholder_Activism.pdf (noting successful shareholder proposals on dismantling classified boards, takeover projections, say-on-pay votes, proxy access, and other governance measures).

[127] *See* Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance* 29 (The Ohio State Univ. Moritz Coll. of Law Pub. Law and Legal Theory Working Paper Series, Paper No. 225, 2013), *available at* http://papers.ssrn.c om/sol3/papers.cfm?abstract_id=2324151 ("[I]nformation provided [to] the market place . . . by offensive shareholder activism is in general perceived to be valuable to shareholders and is being integrated into corporate strategy in a statistically significant way.").

[128] *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *Tackling the Managerial Power Problem*, PATHWAYS, Summer 2010, at 10 ("Executives have less power over directors when shareholders are larger or more sophisticated and thus can more easily exert influence over the board.").

[129] *See* TROPMAN & HARVEY, *supra* note 38, at 31 ("[Non-profit boards] are worse [than for-profit boards] because, in effect, they have no oversight.").

[130] *Id.* at 32 (estimating there could be 28 million board members managing a trillion dollars while operating with no practical or ethical guidance).

[131] *Id.*; *see supra* notes 43-51 and accompanying text; *see also* CHAIT ET AL., *supra* note 30, at 14 (offering an unambiguous official job description as the best solution for board members who do not know what their job is).

[132] *See* TROPMAN & HARVEY, *supra* note 38, at 31-32 (remarking that boards are insulated from accountability and responsibility and that no board members are ever fired).

[133] *See* CHAIT ET AL., *supra* note 30, at 180 (calling for board members to bridge the knowledge gap by working diligently as a group and answering complex and important questions).

they favor.[134] The outside directors are more likely to consider a fight not worth the effort and cave in to the executives.[135]

Such a result is particularly likely when the directors are not sure what the organization's goals are.[136] Shareholder primacists (but not director primacists) consider the goal of the for-profit corporation to be maximizing shareholder value. Directors of NPOs, however, are uncertain of their goals.[137] The CEO will pursue an agenda of her choosing and present the board with information of her choosing about the organization's performance.[138] There are no shareholders to contest this agenda.[139] Even a director who prefers a different agenda will hesitate to undertake a lonely battle against the better informed CEO.[140] A director who is uncertain about what the NPO's goals should be and knows nothing more about its performance than what the CEO deigns to divulge is unlikely even to ask pointed questions, much less to challenge the CEO.[141]

Critics of shareholder primacy in for-profit corporate governance object to the use of shareholder value as the ultimate corporate goal.[142] They argue for letting the board pursue a variety of goals, including "mak[ing] commitments that attract the loyalty of customers and employees" and "sacrific[ing] at least some profits to allow the company to act in an ethical and socially responsible fashion."[143]

However lofty these goals may sound, the inevitable result of fragmenting the organization's goals is to shift power from the board to the

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[134]Leduc & Block, *supra* note 78, at 67 (emphasizing that the tension between executives and board members arises because while the executives are responsible for the daily operations and meeting the goals of the organization, they have to share the power in determining what those goals are with board members).

[135]*See* Evelyn Brody, *Agents Without Principles: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 499-501 (1996) (discussing the differences between non-profit and for-profit boards).

[136]*See* GOVERNANCE OF NPOS, *supra* note 50, at 151; *supra* Part II.

[137]*See* GOVERNANCE OF NPOS, *supra* note 50, at 151; *supra* Part II.

[138]*See supra* Part II.

[139]Nolo, *Running Your Nonprofit Corporation*, BPLANS.COM, http://articles.bplans.com /small-business-legal-issues/running-your-nonprofit-corporation/192 (last visited Mar. 16, 2014).

[140]*See* Lumen N. Mulligan, *What's Good for the Goose is not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981, 1987-88 (2007) (discussing factors that affect non-profit board governance).

[141]*See id.*

[142]*See* Gordon Pearson, *The Truth About Shareholder Primacy*, GUARDIAN (Apr. 27, 2012), http://www.theguardian.com/sustainable-business/short-termism-shareholder-long-term-leadership/print.

[143]STOUT, *supra* note 20, at 9. Not all director primacists share this view. *See* Bainbridge, *supra* note 22, at 563-64 (supporting shareholder wealth maximization as the proper corporate goal).

CEO.[144] It is hard enough for part-time directors to determine how effectively management is maximizing shareholder value.[145] When several diverse, vague, and immeasurable goals, like those just listed, are thrown into the equation, it becomes much more difficult for directors to gauge how well management is performing.[146] As Michael Jensen puts it, "[a]ny organization must have a single-valued objective as a precursor to purposeful or rational behavior."[147]

As the highest authority in an NPO, its board has not only the power, but also the obligation to determine the organization's goals;[148] it would be a breach of its duties to delegate this function to anyone else.[149] However, most NPO boards fail to set goals or even to play a meaningful role in the entity's governance.[150] NPO boards do not use their freedom from accountability to shareholders (or anyone else) to create and implement wise, far-sighted plans as director primacy theory would predict.[151] Rather, that freedom has left them drifting aimlessly while the crucial decisions are made by the NPO's officers, who, in theory, should merely execute the strategy instituted by the board.[152]

Is this for the best? Despite its legal status as the ultimate authority in the organization, perhaps the board is not well positioned to gather information, map out options, and identify the ideal strategy for the NPO.[153] A wise board might instead defer to the more knowledgeable executives but carefully scrutinize plans drafted by the executives and revise them where appropriate; monitor the officers' implementation of the plan ultimately chosen;[154] and intervene if the executives were ineffective, inefficient,

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[144] *See* Dent, *supra* note 18, at 43 (describing pressures by management that fractured boards face).

[145] *See* Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 546-48 (2006) (defining agency costs).

[146] *See supra* notes 136-41 and accompanying text.

[147] Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 237 (2002).

[148] *See generally* Thomas Lee Hazen & Lisa Love Hazen, *Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors' Fiduciary Duties*, 14 U. PA. J. BUS. L. 327 (2012) (examining the current state of non-profit directors' fiduciary duties).

[149] *See supra* notes 33-35 and accompanying text.

[150] *See supra* notes 69-75 and accompanying text.

[151] *See* Dent, *supra* note 20, at 104-05.

[152] Francie Ostrower & Melissa M. Stone, *Governance: Research Trends, Gaps, and Future Prospects*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 612, 617 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

[153] *Id.* at 619 (discussing the different perceptions that board members have about their roles).

[154] *See id.* at 621.

moving the NPO in the wrong direction, or placing their own interests above those of the organization.[155]

Unfortunately, experience shows that the freedom of NPOs from shareholders rarely leads to such effective governance.[156] Like any insular group, an executive management team tends to develop tunnel vision and to ward off anyone who disputes their vision.[157] Managements can (and do)[158] present the board only with information that supports management's strategy, withholding any information that might suggest any alternative approach.[159] The full-time, experienced managers are experts; by comparison, the directors who meet five times per year are rank amateurs.[160] Given this imbalance of information and expertise, it takes great determination and effort for any outsider to mount a serious challenge to the executives.[161] In both non-profit and for-profit corporations the outside directors have little to gain or lose from the corporation's performance, so their personal interest alone will not induce them to undertake a battle with management.[162]

In the business corporation, large shareholders have enough at stake to motivate them if they believe that management's policies seriously impair the value of their stock.[163] They then put pressure on the board to change those policies.[164] In doing so, shareholders face many obstacles, but in many cases they can exert some influence.[165] In non-profits, however, there are no shareholders (or any other constituency) that can put such pressure on the board, which therefore usually takes the path of least resistance by deferring to the executives.[166] To the extent that NPO directors assert themselves at

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[155]*See id.* at 619 ("Staff members wanted trustees to play more of a leadership role in initiating projects").

[156]*See* CHAIT ET AL., *supra* note 30, at 13.

[157]*See* McAdam & Gies, *supra* note 59, at 79.

[158]*See supra* notes 57-59 and accompanying text.

[159]*See* Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 612 (discussing CEO dominance and the "manipulat[ion] of the governance process."); *see also* Alces, *supra* note 104, at 783 (cautioning over the asymmetry of information over the affairs of the corporation between the board and the CEO).

[160]*See* Ostrower & Stone, *supra* note 152, at 619.

[161]*See id.*

[162]*See* Steven M. Haas, *Loyalty Claims Against Outside Directors*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Feb. 10, 2012, 9:52 AM), http://blogs.law.harvard.edu/corpgov/2012/02/10/loyalty-claims-against-outside-directors/.

[163]*See* Neil Kokemuller, *How Shareholders Affect a Business*, SMALL BUS., http://smallbusiness.chron.com/shareholders-affect-business-65880.html (last visited Jan. 29, 2013).

[164]*See id.*

[165]*See id.*

[166]*See* Greg McRay, *Who Really Owns a Nonprofit*, FOUND. GRP. (July 22, 2009), http://501c3.org/blog/who-really-owns-a-nonprofit/.

all, it is primarily to squabble with each other rather than to provide oversight of management.[167]

Some experts on non-profit boards acknowledge that this difference explains why they perform worse than for-profit boards: "They are worse because, in effect, they have no oversight. They are, in effect, like public servants. Insulated as both groups are from the 'political' process, they are insulated, as well, from accountability and responsibility. No one 'fires' a nonprofit director (board member)."[168] This results in diversion of the NPO from its supposed goals. "The absence of owners . . . means that managers are largely free of outside discipline, which creates the risk of managerialism (or, in economic terms, agency costs)."[169] With no discipline and no personal stake in the NPO's performance, the directors tend to abdicate to the insiders. "In the case of nonprofits, some observers believe that the absence of shareholders emphasizes an inappropriate reversal of the power relationship between the board and the officers."[170]

The same phenomenon has been noted in Europe: "The main difference from [for-profit] corporate boards in terms of control is that adequate control is often underdeveloped. This is obvious for nonprofit organizations without members who could hold the board accountable. State supervisory bodies . . . cannot replace the control wielded by shareholders."[171] I have found no one who claims that the absence of shareholders, on balance, results in better governance of NPOs than of for-profits.

One critique of shareholder primacy in for-profit corporations is that, if shareholders dominate, they may exploit other corporate constituents, especially employees.[172] In particular, critics charge that shareholders may make "opportunistic attempts to increase 'shareholder value' by changing the corporate rules in the middle of the game."[173] The shareholders' insistence on

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[167] *See supra* notes 31-35 and accompanying text.

[168] TROPMAN & HARVEY, *supra* note 38, at 31-32.

[169] Henry Hansmann, *The Economics of Nonprofit Organizations*, *in* COMPARATIVE CORPORATE GOVERNANCE OF NON-PROFIT ORGANIZATIONS 60, 64 (Klaus J. Hopt & Thomas Von Hippel eds., 2010).

[170] Brody, *supra* note 55, at 534.

[171] Klaus J. Hopt, *The Board of Nonprofit Organizations: Some Corporate Governance Thoughts from Europe* 6 (Eur. Corp. Gov't Inst., Working Paper No. 125, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1425670.

[172] *See* Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 796 (2007).

[173] *Id.* at 805; *see also* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 79 (2003) (claiming "the

short-term profits also allegedly results in conduct that alienates customers.[174] On the other side, advocates of shareholder primacy claim that freeing boards from shareholder control results not in the directors' governing as wise Solons, but in CEO domination, and does not even generate benefits for employees.[175]

The experience of NPOs clearly confirms that, in the absence of board accountability to shareholders, control gravitates away from the board and to the executives, especially the CEO.[176] Moreover, amid all the critiques of NPO boards there are no claims that this state of affairs leads to better treatment of employees (or any other constituency) in NPOs than in for-profits.[177] Again, the evidence refutes director primacy theory; the treatment of employees and other constituencies is no silver lining to the cloud of dysfunctional NPO boards.[178]

V. CONCLUSION

The governance of business corporations is debated between advocates of shareholder primacy, who want corporate boards to be accountable to shareholders, and supporters of director primacy, who want directors to be relatively free of shareholder control so that they can act as "Platonic guardians."[179]

This debate is hardly new. Eighty years ago Merrick Dodd decried "the view that business corporations exist for the sole purpose of making profits for their stockholders."[180] Adolph Berle countered that to abandon this principle would result in corporate control being "simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all. . . . This is an invitation not to law or orderly government, but to a process of economic civil war."[181]

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need to have a body that balances a wide array of competing interests, both among the shareholders themselves and between shareholders and other constituencies.").

[174] *See* STOUT, *supra* note 20, at 80 (discussing the importance of commitments from customers).

[175] *See* Dent, *supra* note 22, at 1240-49.

[176] *See supra* notes 53-57 and accompanying text.

[177] Indeed, the general practice is to "pay[] lower wages in the nonprofit sector than can be earned elsewhere . . . ." Vladislav Valentinov, *Internal Organization and Governance*, *in* HANDBOOK OF RESEARCH ON NONPROFIT ECONOMICS AND MANAGEMENT 208, 210 (Bruce A. Seamon & Dennis R. Young eds., 2010).

[178] *See id.*

[179] *See supra* Part I.

[180] E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

[181] Berle, *supra* note 107, at 1368-69.

Non-profit corporations have no shareholders; their boards of directors are mostly self-perpetuating, an ideal condition for "Platonic guardians."[182] Accordingly, NPO boards offer an opportunity to test the competing claims of shareholder primacy and director primacy.[183] The experience of NPO boards confirms shareholder primacy theory and belies director primacy claims.[184] Free of accountability to shareholders, NPO boards do not provide intelligent, prudent, cooperative, and far-sighted governance.[185] Instead, they are lax, uninformed, conflict-ridden, and confused about institutional goals.[186] Rather than overseeing their organizations, as is their legal duty, they tend to defer to the control of the executives, especially the CEO.[187] All of this conforms to what shareholder primacists would predict.[188] It is not quite the "economic civil war" predicted long ago by Adolph Berle, but it is often chaos and confusion.[189]

The director primacists' critique of shareholder power has a political counterpart in the critiques of democracy that have been and still are often voiced from both the left and the right.[190] In these critiques the public is presented as ill-informed and fragmented into warring interest groups.[191] Therefore, prudent government can be achieved only by vesting control in a self-perpetuating elite (either of some sort of aristocracy or of Marxist politburo) that is insulated from *hoi polloi*.[192] Of course, the critiques of shareholder and political democracy both have some validity; shareholders and the public are not always well-informed, dispassionate, and fair.[193] However, self-perpetuating elites never govern in the interest of their supposed constituents, and their lack of accountability typically results in their not even being very efficient in achieving whatever goals they do pursue.[194] It is true of shareholder democracy, as Winston Churchill said of

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[182] *See supra* notes 22-26 and accompanying text.
[183] *See supra* Part III.
[184] *See supra* notes 174-76 and accompanying text.
[185] *See supra* Part II.
[186] *See supra* notes 69-73 and accompanying text.
[187] *See supra* notes 69-73 and accompanying text.
[188] *See supra* Part I.
[189] *See supra* note 181 and accompanying text.
[190] *See* Jennifer L. Hochschild, *If Democracies Need Informed Voters, How Can They Thrive While Expanding Enfranchisement?*, 9 ELECTION L.J. 111, 111-12 (2010).
[191] *Id.* at 117-18.
[192] *Id.* at 118.
[193] *Id.* at 117.
[194] Hochschild, *supra* note 190, at 117.

political democracy, that it "is the worst form of Government except all those other forms that have been tried from time to time."[195]

The example of NPO governance does not tell us exactly how to implement shareholder primacy in for-profit corporations. It does show, however, that freeing directors from shareholder control leads not to optimal governance, but to dysfunction.[196]

[195] Winston Churchill, Speech to Parliament (Nov. 11, 1947), *in* THE OXFORD DICTIONARY OF QUOTATIONS 202 (Angela Partington ed., 4th ed. 1996).

[196] *See supra* text accompanying notes 163-70.