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LETTER FROM THE EDITOR

Dear Readers,

With best wishes to all of you for a peaceful 2009 and Year of the Ox, we at ICCSL send our greetings. This issue of IJCSL, which is the first in Volume 7, brings to your attention two articles about issues related to civil society law that are of great importance to modern conceptions of the regulation of civil society. We also feature a book review of a recently published volume that should provide readers with much food for thought.

The first article is **Patterns and Structures of NGO Self-Regulation in Africa** by **Mary Kay Gugerty**, Assistant Professor at the Evans School of Public Affairs, University of Washington. Prof. Gugerty has written several articles published in other journals about self-regulation of NGOs in Africa, an issue of prominence with regard to legal and regulatory frameworks. As she points out in her article, early initiatives to develop self-regulatory mechanisms were typically sponsored by NGO membership associations as standard-setting devices aimed at pre-empting government regulation. However, their effectiveness was hampered by “the low capacity and resource base of many sponsoring associations, the need to develop standards broad enough to apply to all NGOs, and the reluctance of many NGO associations to police their members.”

More recent attempts to develop voluntary self-regulation programs in Africa often focus on developing independently-sponsored certification initiatives, which Prof. Gugerty calls voluntary ‘clubs.’ Unlike the national programs, the certification requirement tends to create a barrier to entry that limits participation, meaning that these programs have a narrower regulatory scope but may be able to develop stronger standards and engage in more effective monitoring. In her article Prof. Gugerty draws on her own research and that of other scholars to demonstrate the ways in which each of the regimes develops and the extent to which they are effective.

The second article was written by **Giovanni Tamburrini**, a lawyer based in Rome, and is titled **The Agency Problem in Non-profit Corporations**. He deals with several of the most important issues of the day regarding NPOs. These include the right of beneficiaries to sue when there are director derelictions of duty, developing better internal controls for NPOs, expanding the concept of fiduciary duties, etc. He asserts that such an approach is needed because beneficiaries of “non-profit corporation will possess a very weak protection when faced with the opportunistic behavior of self-motivated directors. This is basically due to the fact that the *non-profit* sector has for long been overlooked by legal doctrines.” The development of Mr. Tamburrini’s thesis is quite strong, as he delved not only into recent scandals in the sector but also into the underlying legitimacy of legal theory as it applies to NPOs, which are logically different from for-profit corporations.

Our book review was written by **Debra Morris**, Assistant Director of Legal Studies at the Cayman Islands Law School. A known legal scholar with respect to law relating to charities and not-for-profit organizations, Ms Morris has reviewed the book **CHARITY LAW & SOCIAL POLICY. NATIONAL AND INTERNATIONAL PERSPECTIVES ON THE FUNCTIONS OF THE LAW RELATING TO CHARITIES**, by **Kerry O’Halloran, Myles McGregor-Lowndes and Karla W. Simon**, published by Springer in 2008, ISBN- 9781402084133. In her review Ms Morris emphasizes the breadth of the undertaking, and its scholarly importance. She looks, for example, at the development of the law of charities in Singapore, where the response of the law to social

policy issues is perhaps more limited than in some of the other jurisdictions studied by the authors.

We are very grateful to all of the authors for the submission of their original works for publication in this issue of IJCSL and we look forward to hearing from you about reactions to their pieces.

With best regards and wishes for an enjoyable read,

Karla W. Simon

Editor-in-Chief

Professor of Law

Co-Director, Center for International Social Development

Catholic University of America

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IJCSL EDITORIAL POLICY

January, 2009

Dear Reader,

CONTENT – The IJCSL publishes articles on a variety of topics, seeking to provide a venue for an international readership to learn about and express opinions on developments in law affecting civil society. These topics and the array of opinions on them are complex and sometimes controversial. The opinions expressed herein do not necessarily reflect the views of the IJCSL or its editorial staff.

STYLE – The IJCSL publishes articles by contributors from around the world. Therefore, the IJCSL uses a flexible editorial policy regarding questions of style. Articles submitted by persons for whom the English language is native are edited based on the author's original syntax and spelling. Articles submitted by persons for whom the English language is not native are edited according to American English style.

Occasionally, the IJCSL publishes articles in languages other than English. In those instances, articles are published as submitted and the IJCSL provides an English-language summary.

QUESTIONS & COMMENTS – The IJCSL welcomes readers' questions and comments on items it publishes. If you have a question or comment, please contact:

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Sincerely,

The IJCSL Editorial Staff and Editorial Board

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PATTERNS AND STRUCTURES OF NGO SELF-REGULATION IN AFRICA

BY MARY KAY GUGERTY¹

The growth in scale and scope of nongovernmental organizations (NGOs) around the world has been accompanied by growing governance and regulatory challenges for governments, NGOs and donors. Challenges to nonprofit and nongovernmental organization (NGO)² governance and accountability are particularly acute in sub-Saharan Africa (hereafter Africa), a region often characterized by illiberal democratic governance, weak mechanisms of regulatory oversight, and nascent civil societies. The combination of political liberalization and increased donor funding of nonprofits throughout the 1990s also sparked a dramatic increase in the number of NGOs operating in most countries in Africa. As an example in Kenya, the estimated number of NGOs registered with the government grew from less than 500 in 1990 (Ndegwa, 1990) to nearly 3200 in 2004 (NGO Council, 2004). As a result of these forces, governments in Africa found themselves increasingly dependent on NGOs for the provision of key public services, but with few regulatory or coordination mechanisms at their disposal to influence or oversee the activities of these organizations (Barr, Fafchamps and Owens, 2005). Donors also found it increasingly difficult to assess the capabilities and potential of the many newly emerging organizations. The need for standard-setting and oversight was underscored throughout this period by the periodic eruption of high profile nonprofit scandals that began to challenge the reputation and credibility of legitimate organizations (Kwesiga and Namisi, 2006; Gibbelman and Gelman 2004; Naidoo, 2004). These scandals emphasized to donors, governments and NGOs themselves the need for stronger standard-setting and credentialing mechanisms for the sector.

The NGO accountability context in Africa differs from industrialized country contexts in several respects, all of which suggest that accountability and oversight issues will be highly salient and particularly challenging throughout the continent. Unlike most charitable organizations in industrialized societies, African NGOs do not typically attract funds locally; rather, the bulk of NGO funding comes from international donors and NGOs. Concerns by governments about the legitimacy of NGOs operating within their borders are heightened by the reliance of many NGOs on foreign funds. International funding, combined with high levels of unemployment in many countries, give individual entrepreneurs, or ‘development brokers,’ the incentive to start NGOs as a means of employment, rather than as a means to serve the public good (Platteau and Gaspart, 2003). In addition, the legal status of NGOs in many African countries is precarious and the statutes governing the registration and operation of NGOs are often unclear or outdated (Armstrong, 2006).

The relationship between NGOs and government in Africa further complicates issues of NGO accountability and oversight. These relationships have often been characterized by a large amount of distrust, co-optation and outright repression, particularly where NGO were viewed as a form of political opposition (Fisher, 1990; Bratton, 1989). As many African countries experienced political liberalization throughout the 1990s, however, civil society organizations

¹ Research presented in this paper is drawn from Gugerty, 2008a and 2008b.

Mary Kay Gugerty is an Assistant Professor at the Evans School of Public Affairs, University of Washington.

² This chapter uses the terms nonprofit and NGO interchangeably, but NGO is used most frequently as it is the term most commonly employed in Africa.

proliferated, easily outstripping the ability of governments to regulate them (Batley, 2006). Governments, often in the midst of fundamental transformations themselves, struggled to manage their relationships with nonprofits, often operating with laws dating back to the colonial period. During the 1990s and early 2000s, a number of governments therefore sought to update the legislation governing the operation of nonprofits, often with the goal of consolidating government control over the sector. Such legislation has been enacted in Kenya, Malawi, Tanzania, Uganda, and Ethiopia among others. Not surprisingly, many of these attempts at increased regulation were highly contested by NGOs.

In the early years of political liberalization, donors tended to support NGOs in their attempts to counter interventionist regulation, viewing this issue as inextricably tied to issues of democratization and political liberalization. But by the end of the 1990s, the tenor of NGO relationships with governments and donors began to change. With the emergence of more democratic regimes, many nonprofit and civil society leaders were drawn from NGOs into the public sector. Donor funding began to shift back towards the public sector, and suddenly NGOs, like governments before them, faced the prospect of declining funding. As legitimate NGOs proliferated, so did ‘briefcase’ NGOs, and donors became increasingly concerned with finding ways to identify legitimate and effective organizations to fund (Edwards and Hulme, 1996). Increased competition for donor funding meant local NGOs now needed ways to distinguish themselves from their competitors, a sign of the ‘end of blind faith’ in NGOs (Naidoo, 2004).

This paper examines the emergence of NGO self-regulation initiatives in Africa in response to the accountability challenges outlined above. The first wave of self-regulatory efforts in Africa emerged in the early years of political liberalization, largely in response to regulatory reform initiatives by government. Many of the early initiatives were national in scope, intended to act as a self-regulatory mechanisms for all NGOs in the country. These initiatives were typically sponsored by NGO membership associations that attempted to set standards and develop self-regulatory mechanisms in order to pre-empt government regulation. Many of these initiatives involved collaborative efforts between governments and NGOs in which governments mandate participation and delegate authority to an NGO association charged with overseeing the system. As this paper argues, the effectiveness of these systems has been hampered by several challenges including the low capacity and resource base of many sponsoring associations, the need to develop standards broad enough to apply to all NGOs, and the reluctance of many NGO associations to police their members. More recent attempts to develop voluntary self-regulation programs in Africa have often focused on developing independently-sponsored certification initiatives, or what have been characterized as voluntary ‘clubs’ (Gugerty and Prakash, 2008). In contrast to national programs, the certification requirement creates a barrier to entry that limits participation, meaning that these programs have a narrower regulatory scope but may be able to develop stronger standards and engage in more effective monitoring.

The paper first provides an analytical framework for conceptualizing various forms self-regulation, and then documents the emergence of these forms across 22 countries in sub-Saharan Africa. The section that follows presents six brief case studies: three examples of national self-regulation from Kenya, Malawi, and Tanzania, and three voluntary certification initiatives from Ethiopia, Uganda and Ghana.

VOLUNTARY AND SELF-REGULATION: A CONCEPTUAL FRAMEWORK

This paper conceptualizes self-regulation as one regulatory form along a potential continuum of regulatory structures (Gugerty, Sidel and Bies, forthcoming). Self-regulation is defined as a set

of institutions or arrangements for affecting organizational behavior in which standards and rules of conduct are set by an industry-level organization, rather than a governmental or firm level apparatus (Gunningham and Rees, 1997). A framework for understanding the continuum of potential regulatory forms is shown in Table 1. The left-hand side of the table shows non-voluntary forms of regulation, which include traditional government regulation, as well as quasi-public systems of self-regulation in which participation is mandated by public authorities. Another form of third-party regulation, watchdog transparency initiatives, is also considered non-voluntary. In these programs private organizations provide public information on nonprofits, and these third parties make the decisions about who will participate and what information will be provided.

The remaining columns characterize the four forms of self-regulation that are both voluntary and private. These forms include donor-driven programs, accreditation clubs, collective forms of self-regulation, and voluntary codes of conduct. These forms are voluntary because participation is not publicly mandated (although there may be strong public or private inducements to participation). These forms are private because they rely largely on private funding and earned revenue mechanisms and operate without the force of law. In donor-led programs, funding agencies create standards for grantees and require compliance as a condition of funding. Accreditation or certification systems are voluntary programs in which nonprofit organizations provide information on their activities to third-parties in exchange for certification or accreditation. These third-parties could be NGO associations or other private entities. Collective self-regulation regimes involve the development of shared standards and peer monitoring mechanisms among a group of nonprofits, typically sponsored by a national nonprofit association; in some cases, participation in a national self-regulation scheme may be mandated by the government. Finally, voluntary standards or codes of conduct include standards for nonprofit behavior and governance that are developed across organizations in which participation is voluntary but neither participation nor compliance is monitored in any way. This distinguishes voluntary codes of conduct from the other three forms of private, voluntary self-regulation in which participation (and in some cases adherence) are monitored by peer or other organizations. The second row of the table lists the most common sponsors of each of the forms of regulation. The third row indicates the potential regulatory scope of each form of regulation. Public systems typically have the widest regulatory coverage, often national, while watchdog and donor-driven programs focus more narrowly on specific participants. Collective self-regulation, accreditation programs, and voluntary codes can be national in scope, or can be restricted to members of a particular association or sector. As we will see below, the particular form that self-regulation takes has implications for its regulatory coverage.

SELF-REGULATION ACROSS 22 COUNTRIES

The next section explores the context for the emergence of self-regulation initiatives in sub-Saharan Africa, and characterizes the main forms that are observed across a sample of 22 countries for which public data are available.³ Data were collected from a combination of key

³This method of data collection may have biased the sample towards countries with better information infrastructures and with English language documentation; the results should therefore be generalized with caution. Countries that experienced extensive periods of conflict or that lacked a functioning central government during this period were excluded. We began with the 47 countries in sub-Saharan Africa that are eligible for World Bank concessional lending. A primary criterion for selection of the countries was the existence of a functional governmental regime for the majority of the period 1990-2005, during which self-regulation efforts emerged on the continent. Countries that experienced prolonged governmental collapse or

informant interviews, public records, on-line archives of national NGO organizations, and secondary sources. The sample is presented in Table 2, which lists the countries in the sample, the main NGO associations involved in self-regulatory efforts and the year of initiation and type of self-regulatory systems, if any. Out of the 22 countries in the sample, regulatory reform or change was initiated in twelve countries during the period examined (column 3). Two countries, Kenya and Tanzania, established national self-regulation systems in which governments mandated NGO participation in the self-regulatory system. Malawi has also attempted such a system, but to date it has not been institutionalized. The most common form of self-regulation across the continent is the voluntary code of conduct, used in seven countries. The two newest initiatives, in Uganda and Ghana, both represent attempts to develop certification systems. As is discussed below, Ethiopia represents a kind of hybrid system.

What are the institutional challenges in establishing these self-regulatory systems and to what extent can they effectively address NGO accountability deficits? To examine these questions, the paper next presents brief case studies that describe the emergence of NGO self-regulation in six countries. Data collection for the case studies in Uganda, Kenya and Ethiopia incorporated fieldwork in all three countries that included interviews with 55 senior managers and program staff of nonprofits, donors, and governments. Data collection for Tanzania, Ghana and Malawi is based on review of publicly available government and nonprofit documents, secondary sources and ten telephone interviews with key informants. Documents reviewed for all cases include reviews of available government legislation and national policy frameworks, nonprofit association evaluations, strategic plans and annual reports; extensive secondary document review including donor assessments; and a comprehensive review of available media reports. The focus of this analysis is on the emergence and structure of these self-regulation systems, rather than on a detailed elaboration of the current situation in each country.

THE EMERGENCE OF NATIONAL-LEVEL SELF-REGULATION

The first wave of attempted voluntary NGO regulation in Africa began in Kenya, the first country in Africa to wrestle formally with issues of voluntary regulation. In the wake of rapid growth in the NGO sector and in response to growing attempts at policy advocacy on the part of some NGOs, the authoritarian Kenyan government introduced the NGO Coordination Act in late 1990 which was passed into law by parliament within two months. The act vested large amounts of power in a government-controlled NGO Board with the sole power to register NGOs and created a national NGO council with no independent powers outside the state (Adiin-Yaansah, 1997; Ndegwa, 1996). The interests of both domestic and international NGOs were threatened by the legislation (Ndegwa, 1996) and the NGO community, including both the larger domestic agencies as well as international NGOs, mobilized the support of the donor community and protested vociferously. A three-year process of contestation and consultation followed that ultimately resulted in the government increasing NGO representation on the NGO registration board and giving independent powers to the apex National NGO Council created by the legislation. Most importantly, the NGO Council was granted a legal mandate to develop its own governance structures and code of conduct (Adiin-Yaansah, 1997).

conflict during this period are excluded; this criterion excludes 6 of the 47 countries. Very small island nations are also excluded, which excludes 4 additional countries. There was insufficient public data available on the remaining sixteen countries to include them in the sample. In general, eastern and southern Anglophone countries are well represented in the sample, while central, west African and Francophone countries are under-represented.

The NGO Code of Conduct was subsequently developed by the NGO Council and established as Legal Notice no. 306 in 1995. All NGOs in Kenya are required by law to be members of the NGO Council and to abide by the provisions of the code upon registration with the government. The standards developed in the code of conduct itself are extremely broad, consisting of seven goals for NGO behavior: probity, self-regulation, justice, service, cooperation, prudence and respect. NGOs are not required to document compliance with these goals and no detailed management standards for the goals were developed. Monitoring and enforcement power is vested in a regulatory committee within the NGO Council with power to act as a quasi-judicial tribunal to hear complaints brought against NGOs. If an NGO is found to be violation of the code, the Regulatory Committee can verbally sanction the organization, recommend to the NGO Board that it be de-registered, or the general assembly can levy a fine or recommend suspension. Although the complaints review board does have strong powers that include the power to recommend de-registration, the detection of violations depends entirely on the public complaints process and it is not clear to what extent the public is aware of the code and their rights to bring a case against an NGO. In 2003, the last year for which data are available, the Council received 34 complaints; by the end of the year 27 of those cases had been at least partly heard by the Regulatory Committee. The Regulatory Committee has been hampered in its enforcement in several respects. The NGO Council as a whole has suffered from funding problems; member organizations do not always pay their annual dues and the council has limited mechanisms for enforcing the payment of dues. Estimates by NGO Council officials in 2004 suggested that only 400 of the approximately 3165 member organizations had paid dues for that year. As a result, the level of staffing and financial resources available to the regulatory committee has been low and hence enforcement of the code has been weak. With the advent of multiparty democracy in 2002, a number of key leaders in the NGO sector, including staff from the NGO Council, joined the new government and as a result the council has suffered from severe leadership and capacity problems in recent years. While the Kenyan experiment was initially hailed as a model for the continent, the weakness of the system in recent years draws into question the ability of an association-sponsored national self-regulation program to sustain itself over the long run.

Attempts to develop national self-regulation programs in Malawi and Tanzania also emerged in response to proposed changes in NGO regulatory frameworks and drew on the Kenyan experience. In Malawi, the process began in the late 1990s when the recently elected democratic government began to draft a new act defining a regulatory system for NGOs. The government's stated goal was to develop a regulatory system in which NGO policy was formulated and implemented with NGO participation, similar to the self-regulatory system in place in Kenya. Unlike in Kenya, however, the process of developing a national self-regulatory system was initially characterized by a more collaborative consultation between NGOs and the government.

As in Kenya, the intent was to have the main NGO umbrella association, the Council for Nongovernmental Organizations in Malawi (CONGOMA), act as the sponsor for the initiative. During the consultative phase of legislative design, CONGOMA facilitated a series of meetings between nonprofits and government officials over the content of legislation. When the provisions of the proposed NGO Act were made public in late 2000, however, the contents were a surprise to many NGOs. The Act designated CONGOMA as the official coordinating body for NGOs, required all NGOs to join the association, and charged CONGOMA with developing and maintaining a code of conduct for the sector. Some NGOs felt the Act gave the government and CONGOMA excessive powers and fifteen prominent NGOs issued a public appeal against the bill (Meinhardt and Patel, 2003).

When the Act was quickly passed by parliament in 2001, CONGOMA found itself in an awkward position, since some of its members had supported the act while others were vocal opponents (Mkamanga and Fanwell, 2001). The short period between the tabling and enactment of the bill precluded a process for generating consensus among NGOs and the conflict ultimately led to the breakdown of the process. While CONGOMA remains the official umbrella body for nonprofits in Malawi its authority over the sector remains weak and is not universally recognized; the association claims to have developed a code of ethics for NGOs but this code does not appear to be publicly available. The Malawi case illustrates another challenging feature of NGO association-sponsored self-regulation: sponsoring associations must retain legitimacy and credibility with member NGOs. When the association is perceived as being in the government's 'pocket', NGOs may be unwilling to participate and the association may not have the capacity for enforcement.

The process of NGO self-regulation in Tanzania has unfolded over nearly a decade. Attempts to agree on a national-style system, similar to Kenya, have floundered and to date self-regulation has not been fully institutionalized. Beginning in 1996, the Tanzanian government embarked on a process designed to produce a new NGO policy framework and regulatory system. The three major umbrella organizations, the Tanzanian Association of NGOs (TANGO), the Tanzanian Council for Social Development (TACOSODE) and the Association of NGOs of Zanzibar (ANGOZA) were lead actors and organized workshops for NGO input on the content of a national NGO policy. As in Malawi, the issue of sponsorship proved contentious. The process nearly broke down when the idea of creating a single umbrella body for nonprofits was proposed in 1999 by the head of the donor-supported Aid Management and Accountability Program (AMAP) (Mogella, 1999). The existing associations and their members threatened to pull out of the policy process altogether. The fifth draft of the policy was ultimately adopted in 2000 and a revised NGO Act was enacted in 2002, but without consultation with NGOs (Irish and Simon, 2003). The 2002 Act mandated the creation of a national umbrella association that would develop an NGO code of conduct; the National Council on NGOs (NACONGO) was subsequently formed in 2003. After passage of the act, a behind-the-scenes consultative process continued, ultimately resulting in amendments to the act in 2005 that reduced some of the more restrictive components of the original legislation (Iheme, 2005). But the experience left many NGOs distrustful of the process and the idea of a national apex body with self-regulating powers (Makaramba, 2007). While the existence of NACONGO was legally mandated, no provisions were made for its funding. Donors also were unwilling to support the effort, many preferring instead to support smaller thematic networks (Foundation for Civil Society, 2006). Moreover, had the government initially proposed more restrictive legislation, as in Kenya, NGO divisions might have been overcome in the quest to oppose the legislation. But the consultative process did nothing to assuage the fears of existing associations that they might be left out of the final institutional arrangements. NACONGO recently unveiled a National NGO Code of Ethics, which appears to be a passive code of conduct that does not spell out specific requirements for adherence or actions to be taken in the case of noncompliance. Again in Tanzania, as in Kenya and Malawi, the issue of sponsorship appeared to complicate national self-regulation. In the Tanzanian case, competition among pre-existing NGO associations for sponsorship presented an obstacle that was difficult to overcome.

These three cases highlight the difficulty of developing national-level self-regulatory systems, which have often foundered over the issue of sponsorship. A national system requires a sponsoring organization that has wide legitimacy and credibility. In the Kenyan case, such an organization was created in the face of severe threats to the NGO sector that gave NGOs the incentive to cooperate and to work under a single umbrella organization. In Malawi and Tanzania, initial state-NGO collaborations were ultimately perceived by NGOs to favor particular NGO

associations that did not have widespread legitimacy and this fractured NGO cooperation and trust. These challenges may explain why no strong national self-regulation initiatives have emerged subsequent to the Kenya case. The national systems that have emerged in the subsequent period are all voluntary codes of conduct sponsored by a national NGO association. These codes have relatively weak regulatory power, since they seldom require NGOs to make public commitments to adherence and they rarely develop mechanisms through which violations of the code might be heard and adjudicated. This relatively weak self-regulatory structure is common to programs in South Africa, Namibia, Lesotho, Nigeria, Senegal and Zimbabwe.⁴

THE EMERGENCE OF VOLUNTARY CERTIFICATION PROGRAMS

The difficulty of establishing national self-regulation programs and the resulting weakness of existing systems may have prompted efforts in some countries to develop self-regulation initiatives with more limited membership that could incorporate stronger standards and enforcement mechanisms. Unlike national systems that are mandated to include all NGOs, certification and accreditation systems operate on a principal of exclusion. Only those organizations that can demonstrate that they meet specific standards for participation are admitted to the regulatory 'club' (Gugerty and Prakash, 2008). The design of certification institutions therefore requires the establishment of criteria for participation and a mechanism for determining whether organizations are in compliance. The Ethiopian case illustrates a hybrid form somewhere between a national self-regulation system and a certification program.

The main self-regulatory initiative in Ethiopia is a code of conduct sponsored by the largest NGO association in the country, the Christian Relief and Development Agency (CRDA). The impetus for the Ethiopian code was similar to many other African countries. As the number of NGOs in Ethiopia proliferated throughout the 1990s, government concerns with NGO oversight increased and the government instituted increasingly restrictive administrative requirements for NGO registration and operation.⁵ As concern over these provisions mounted among NGOs, CRDA spearheaded the development of a code of conduct that was ratified by a national consultative meeting of over 200 international and domestic NGOs (at that time a majority of registered NGOs in Ethiopia) in 1998. The original intent of the code was to establish a nation-wide general assembly of NGOs that would elect a Code Observance Committee charged with monitoring adherence to the code and hearing complaints. In practice, setting up such a separate body appeared to be a strong barrier to implementation, and so the code observance committee was housed at CRDA, at that time the largest, most representative NGO agency (CRDA Interview, 2004). CRDA sponsorship, however, had important differences from the association sponsorship that emerged in Malawi and Tanzania. At the time of the code development, CRDA was a relatively strong association that boasted a waiting list for membership. And unlike in Tanzania, where multiple associations competed for membership and authority, CRDA at the time was the only national umbrella association in existence in Ethiopia.

The standards developed in the code of conduct are also relatively strong in comparison with the Kenya case and other African national voluntary codes. The code lays out 40 standards of conduct including a requirement for a written constitution defining a mission, objectives and

⁴ Zimbabwe does not have a self-regulation system per se, but the National Association of NGOs (NANGO) did produce in 2006 a detailed manual on NGO corporate governance that also contains a national NGO code of conduct intended to be maintained by NANGO.

⁵ The information presented here on Ethiopia largely pre-dates recently passed legislation, the "Proclamation for the Registration and Regulation of Charities and Societies," that severely curtails the activities of NGOs in Ethiopia.

organizational structure, and the requirement of an annual financial audit performed by an independent auditing firm and made public. Interviews with CRDA managers, however, suggested that the organization is not able to monitor compliance with this final requirement on an on-going basis. Although CRDA has not been able to develop an on-going monitoring capacity, the code of conduct may retain some ability to affect NGO behavior due to the relatively significant screening process CRDA uses to admit new members. Membership in CRDA is highly sought after because of important benefits associated with membership, including access to training programs, donor funding, and technical assistance. All members must pledge adherence to the code upon joining the organization, and the screening process for new entrants is relatively strict by African standards: NGOs must show proof of government registration, by-laws and memoranda of association, audited financial reports, and letters of support from three current CRDA members. NGOs may be willing to bear these costs however, because membership in CRDA provides a number of benefits, including access to donor funding. Since a number of donors channel project funds through CRDA, the threat of loss of membership or investigation into fraudulent behavior carries the potential for significant financial losses. CRDA has incentives to monitor its membership, since its own funding stream depends on its ability to recruit effective organizations to carry out donor-funded programs. Once NGOs have been admitted, the on-going process of applying for funding provides a reasonably steady exchange of information between the organization and its members, even in the absence of well-implemented reporting mechanisms. Because CRDA is highly reliant on donor funding, it has every incentive to address quality problems among its membership once identified. This model, however, involves one important tradeoff: rather than having national coverage, the code applies only to association members. In the Ethiopian case, this is about 60% of the total population of NGOs in the country, and membership is likely oriented towards larger, national NGOs and international NGOs. The code has also not been sufficient to forestall additional government regulation; in 2008 the Ethiopian government introduced the Charities and Societies Proclamation, which has been widely condemned by a number of human rights organizations as severely restricting freedom of association and voice (Human Right Watch, 2008; Amnesty International, 2008). This law was passed by parliament in early 2009.

The Ugandan case also illustrates the trend towards the development of self-regulatory systems employing stronger enforcement mechanisms and more restrictive membership. Self-regulation in Uganda has had two phases. In the first phase, voluntary codes of conduct were sponsored by the country's two main umbrella associations. The first association, DENIVA, was founded in 1988 as a support organization for indigenous NGOs. DENIVA had developed a code of conduct for members, but the code had no monitoring or enforcement mechanisms associated with it. The second association, the NGO Forum, was founded in 1997 to represent both national and international NGOs operating in Uganda and to provide a platform for NGOs to contribute to policy processes in the country. The NGO Forum launched a code of conduct for members in 2001. Like the DENIVA code, however, the NGO Forum code of conduct had no provisions for reporting, monitoring or enforcement. In addition, competition between the two associations for membership and influence weakened the incentives of each association for developing compliance and oversight mechanisms that might exclude some potential members.

The need for a system to promote stronger NGO governance in Uganda was subsequently underscored by the government's decision in 2004 to re-introduce into parliament a long-dormant bill to amend the Non-governmental Organizations Registration Act. The provisions of this act gave the government more control over the activities of NGOs and narrowly defined the scope of allowable policy and advocacy activities. The bill was quickly passed by parliament and forwarded to the president for signature. The reaction among NGOs was swift. Rivalries among networks and associations were laid aside as NGOs formed the Coalition on the NGO Bill

(CONOB). The coalition held sector-wide meetings and conducted a media campaign against the bill. Although President Museveni ultimately did not sign the bill, the threat of the legislation had helped to galvanize coordinated action and helped to mobilize the support of international donors and NGOs. Ultimately, a new version of the Act was passed in 2006 and signed into law. The NGO Registration Amendments Act of 2006 created a government-appointed committee with the power to issue and revoke registration NGO permits, which many NGOs claimed could be used to suppress politically active organizations. These amendments go into effect in 2008. Alongside these events, several scandals tarnished the reputation of the NGO sector, including the 2005 suspension of funds from the Global Fund on AIDS, Tuberculosis and on the grounds of corruption and misuse of funds. Subsequent investigations revealed that Global Fund resources administered by the government had been channeled through bogus NGOs linked to MPs, government ministers and other government officials. The resulting scandal provided legitimate NGOs with a strong rationale for developing screening mechanisms that could separate legitimate from illegitimate organizations.

This combination of government threat, public scandals and a new willingness of previously competitive NGO membership associations to work together gave additional support to on-going efforts to develop a new system for NGO certification. With donor support, the two major umbrella organizations collaborated on the development of the Quality Assurance Mechanism (QuAM) in 2006. The QuAM is a certification system that includes detailed and specific standards for NGO behavior and a clear monitoring and enforcement system. To receive certification, NGOs must complete a detailed application and documentation process which is audited by district 'quality assurance committees' that act as certification bodies. QuAM developers were able to draw explicitly on the experiences of other countries in developing self-regulation mechanisms unavailable in earlier periods (DENIVA, 2006). Because the QuAM is quite new, it has not yet begun accepting applications for certification. But it may signal the advent of a new set of self-regulation initiatives in Africa that draw on similar certification programs under way in other countries. A key feature of these programs is that they are likely to remain relatively narrow in scope and coverage. Thus in the U.S., two major charity certification efforts, the BBB/Wise Giving Alliance and the National Standards for Excellent Program, each have less than 200 charities certified.

A similar certification initiative is underway in Ghana, where NGO-government negotiations over nonprofit regulatory frameworks have been ongoing since 1995, when a bill was unilaterally framed by government and placed before the Congress. The bill met with protest and strong dissent from NGOs and was withdrawn. Subsequent draft policies on the nonprofit sector were revised in consultation with NGOs each year from 2002-2005. These drafts proposed the development of a national commission for NGOs that would register NGOs, oversee NGO policy, and develop and implement a code of conduct for NGOs. To date, the national commission has not been established.

In a parallel process, NGOs, with donor support, have been developing a standards-based accreditation system, the Ghana NGO/CSO Standards for Excellence. The Standards program is a joint effort of two of the largest nonprofit associations in Ghana, supported by the Ghana office of CARE International and USAID-Ghana. The initiative is developing a set of standards for nonprofit governance and management that draw explicitly on global standard-setting initiatives. The certification process will be overseen by a Standards Commission that will vet applications and award certification to nonprofits in compliance. The Commission is a peer review board composed of nonprofit managers from international and local NGOs. Applicant organizations will complete a self-certification process in which they document their adherence to detailed program standards for governance and management. Applications will be peer reviewed by a team of three

reviewers drawn from previously certified organizations. The team makes a recommendation on certification to the Commission and re-certification will take place after three years. The sponsors of the Ghana Standards have been explicit about their desire to move away from a code of conduct and toward the development of specific, measurable standards that include mechanisms for monitoring and compliance. The Ghana Standards program is also quite new, so it remains to be seen whether the program can be implemented as planned.

The Ethiopia, Uganda and Ghana cases suggest a move towards the development of more restrictive self-regulation programs in a number of African countries and may indicate a realization on the part of NGOs that demonstrating NGO accountability may require stronger standards and monitoring mechanisms, which will restrict the scope of the program. The willingness of some donors to invest substantial resources in supporting the development of these systems suggests that donors, the key financial principals of African NGOs, also recognize the value of accreditation. It is not clear how these initiatives will evolve in light of continuing attempts by some governments to impose additional controls on the NGO sector. These new certification systems would need to come to scale quite quickly to demonstrate to governments that the NGOs can adequately engage in self-regulation. Given the resource and capacity constraints that characterize most NGOs, however, this would seem to be an optimistic scenario at best.

CONCLUSIONS

This paper has briefly reviewed the emergence of self-regulation in sub-Saharan Africa, focusing in particular on the experiences of six countries. While NGO self-regulation has the potential to address concerns about NGO accountability by establishing stronger standards for NGO operations, the cases presented here illustrate that such institutional arrangements are not easily developed. Effective national self-regulation requires diverse organizations to agree on sponsorship arrangements as well as on common standards. To develop effective regulatory systems, NGO associations also need to develop administrative capacity that can be used to screen or monitor NGO adherence to standards. As the first three cases illustrate, such capacity is a challenge to develop in the absence of strong financial support. The national self-regulation systems in both Kenya and Tanzania were essentially unfunded mandates and resource scarcity, along with competition from other NGO associations, made it difficult to maintain these efforts. In Ethiopia, where the sponsoring NGO already had significant donor support, the self-regulation system provided a stronger assurance of NGO quality – not because the association monitored code adherence, but because it screened members prior to entry. Thus the Ethiopian system contains many elements of a certification program. Given the difficulties of developing effective national self-regulation systems, NGOs in many countries are experimenting with efforts at voluntary certification programs. It remains to be seen, however, whether these initiatives can be scaled up to any significant size. Although the perspective on NGO self-regulation presented in this paper is relatively pessimistic about the effectiveness of such programs, the process of developing and promulgating self-regulation standards may have potential to improve NGO operations and governance, even in the absence of strong regulatory mechanisms. The widespread dissemination of standards for governance, fundraising and financial management are likely to contribute over time to the professionalization of the sector, since these standards can help to increase public knowledge about what constitutes an effective and accountable organization.

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Table 1 – A Typology of Nonprofit Regulatory Forms

	Non-voluntary approaches			Voluntary Approaches			
	Public and quasi-public systems		Private Systems				
Regulatory System	Legal regulation	Government mandated association	Watch-dog	Donor-led programs	Accreditation and Certification Programs or 'Clubs'	Collective self-regulation	Voluntary Standards/ Code of conduct
Typical Sponsor	Government	Government (quasi-public)	Third party agency	Donor	Third party agency or Nonprofit/ NGO association	Nonprofit/ NGO association (may be mandated by government)	Nonprofit/ NGO association
Scope & Regulatory Coverage	National	National	Limited to reviewed agencies	Limited to participants	Limited to participants	National or sectoral	National or sectoral

Source: Gugerty, Sidel and Bies, forthcoming

Table 2 – Self-Regulation in 22 Countries in Africa

Country	Club Sponsor or Initiating Organization	Year NGO Umbrella Association Established (1)	Type of Self-Regulation (2)	Year established (3)
Benin	<i>Centre de Promotion des Associations et ONGs (CPA-ONG)</i>	2000	--	--
Botswana	The Botswana Council of NGOs, BOCONGO	1995	Voluntary code of conduct	2001
Burkina Faso	Civil Society Organization Network for Development (RESOCIDE)	2002	--	--
Ethiopia	Christian Relief and Development Association (CRDA)	1973		1999
Gambia	The Association of NGOs (TANGO)	1983	--	---
Ghana	Ghana Association of Private Voluntary Organizations in Development (GAPVOD)	1980	Voluntary certification program	In process
Kenya	The National Council of NGOs	1963	National self-regulation	1993
Lesotho	Lesotho Council of NGOs (LCN or Lecongo)	1990	Voluntary code of conduct	in process
Mali	Comite De Coordination Des Actions Des ONG Au Mali (Cca-Ong)	1983		--
Malawi	Council for Nongovernmental Organizations (CONGOMA)	1985		--
Mozambique	--	--		--
Namibia	Namibia Non-Governmental Organizations Forum (NANGOF)	1991	Voluntary code of conduct	2003
Nigeria	Nigeria Network of NGOs (NNNGO)	1992	Voluntary code of conduct	date unclear
Rwanda	Conseil de Consertacion des Organizations d'appui des initiatives de base (CCOAIB)	1987		--
Senegal	Conseil des Organisations d'Appui au Développement (CONGAD)	1982	Voluntary code of conduct	date unclear
South Africa	South African National NGO Coalition (SANGOCO)	1995	Voluntary code of conduct	1997
Swaziland	Coordinating Assembly of NGOs (CANGO)	1983		--

Country	Club Sponsor or Initiating Organization	Year NGO Umbrella Association Established (1)	Type of Self-Regulation (2)	Year established (3)
Tanzania	Tanzania Association of NGOs (TANGO) Tanzanian Council on Social Development (TACOSODE) Assoc of NGOs of Zanzibar (ANGOZA) National Association of NGOs (NaCONGO)	1988-TANGO 1987-TACOSODE 1992-ANGOZA 2003-NACONGO	National self-regulation	2008
Togo	National Congress of the Civil Society in Togo (CNSC)	2002		--
Uganda	The National NGO Forum DENIVA	1997-NGO Forum 1988-DENIVA	Voluntary code of conduct, Certification	2001, 2006
Zambia	National Council for Social Development (NCSD) NGO Coordinating Committee (NGOCC)	1985- NGOCC 1974-NCSD		--
Zimbabwe	National Association of NGOs (NANGO)	1962	Voluntary code of conduct	2006

BOOK REVIEW

KERRY O'HALLORAN , MYLES MCGREGOR-LOWNDES AND KARLA W. SIMON
**CHARITY LAW & SOCIAL POLICY. NATIONAL AND INTERNATIONAL
PERSPECTIVES ON THE FUNCTIONS OF THE LAW RELATING TO CHARITIES**

REVIEWED BY DEBRA MORRIS*

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Number of pages – 614 + xxviii

Undertaking an ambitious project, the authors of the book, *Charity Law & Social Policy*, explore contemporary law, policy and practice in a range of modern common law nations. The book undertakes this exploration in four Parts and from the perspective of how charity law and policy has evolved in England and Wales. The book is clearly a work of considerable scholarship with the authors making a comprehensive study of national and international perspectives on the functions of the law relating to charities in the countries under study, against the background of each country's respective evolving social policy concerns.

This is a necessarily dense book, packing much information into its 597 pages of text. It is however, made easier to read by the fact that it is split up into four Parts. As progenitor of a system bequeathed to its colonies and after centuries of leadership in developing the core principles, policies and precedents that subsequently shaped its development, the contribution of England and Wales, the originating jurisdiction, is first described and analyzed in detail in the first half of the book. Part I, consisting of two chapters, is concerned with *Charity, the Law and Social Policy in the UK* (although there are many references only to England and Wales) and it considers the concepts, the relationship between the parties and the politics of charity. This lays the groundwork for Part II, which follows with *A Functional Approach to the Law as it Relates to Charity in the UK* (although again, much of the material relates only to England and Wales). These two Parts broadly sketch the parameters and role of charity as seen as a mix of public and private interests, then address the law's role as it relates to charity and charitable activity in four areas: protection; policing; mediation and adjustment; and, finally supporting charity. Whilst some of the principles discussed in these two Parts appear somewhat disjointed at first, they do start to come together towards the end and they then provide the critical dimensions for the comparative analysis of experience in the selected common law nations that constitutes Part III of the book, *International Perspectives*, which has Chapters considering five common law countries: Australia, USA, Singapore, New Zealand and Canada. Part IV, *Re-configuring the Social Policy Context for Charity and the Law*, considers the findings of Part III and concludes with three chapters that appraise political influence as a factor in aligning charity law with social policy to create a facilitative environment for appropriate charitable activity. Attention is given to the central role of definitional boundaries, contemporary charity law frameworks and the regulator. Putting changing social policy objectives at the forefront, the authors recognise that future developments in charity law will need to have as a background these objectives so as to achieve a modern enabling framework for philanthropic activity throughout the common law world.

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The book and each Part can be read either as a whole (a lengthy task) or can be read in bite-sized chunks. For example, the five Chapters on five separate jurisdictions in Part III are both free-standing and inter-locking. Each of these Chapters outlines and contrasts the exercise of the main legal functions relating to charity and charitable activity (identified earlier in relation to England and Wales) in five common law countries. Each Chapter traces when, why and how these functions evolved as they did in each jurisdiction and identifies, weighs and evaluates their distinctive characteristics. The common law jurisdictions selected represent very different political contexts, allowing Part III of the book to highlight the relative significance of the roles played by particular functions, for example, policing, in contrast to support. This exercise was facilitated by uniformly applying an especially designed template of legal functions (set out at the back of the book) which permitted the systematic gathering of information and the profiling of functions and policy in respect of each of the countries examined. This Part of the book will be particularly useful to those who seek to learn about the examined jurisdictions, with which they may not be familiar.

To take one example, the Chapter on Singapore examines how the common law legacy, a remnant of its colonial past, has survived in Singapore and how the charity law aspect of that legacy now fits with the contemporary social policy challenges that are particular to this jurisdiction. It reveals that, following a scandal with a large prominent Singaporean charity, reforms of charity law have been introduced, which may well change the direction of charity law in Singapore. For this reviewer, with little knowledge of this particular jurisdiction, the brief socio-economic profile, detailing its population and multi-ethnic composition, its national economy, and some facts and figures on the charitable sector, provided a useful introduction. Readers will learn that, since independence, the authoritarian regime of the ruling People's Action Party (PAP) government has exercised tight control to manage any risk to social stability. As in the Eastern European countries of old, this has inhibited the growth of civil society in Singapore. The common law legal system, based primarily on English law, provides the regulatory framework for charities, with 'charity' being defined largely by reference to the *Pemsel* four heads of charity, with very little creative development. Whilst there is a Commissioner of Charities, the central regulatory authority rests with the Inland Revenue Authority of Singapore. Readers will also learn about the relevant legislation governing charity law in Singapore, including a Charities Act of 1982, as amended, modelled on the English Charities Act 1960 and the House to House and Street Collections Act 1947, as amended, regulating public collections. Consistent with the themes of the book, the rest of the chapter examines charity law's role in protecting, policing, mediating and adjusting and finally supporting charity. It is noted at the outset that the recent reforms introduced in Singapore will impact significantly on charity law's role in relation to these specific functions. For example, a new government emphasis on cultivating a more supportive environment for charity is becoming evident, with a corresponding transfer in emphasis away from the traditional policing function. Unlike charity law reform in other common law jurisdictions, the Singaporean process has so far avoided any consideration of legislative change to definitional matters and to the forum designated to determine charitable status. The authors note that Singapore, in its typically conservative fashion, does not seem ready to follow the example set in England and Wales, New Zealand and Canada where the mediation and adjustment function of charity law has been strengthened by legislative provisions identifying a new range of charitable purposes. By the end of the chapter, the reader will understand why the recent review process undertaken has led to this outcome which is different to that in the other jurisdictions just mentioned.

It is interesting to note that each of the jurisdictions examined (including England and Wales) has either recently completed or is in the process of undertaking a review of some aspects of charity law and regulation. It is only in Australia that the review referred to in the Chapter failed

to lead to significant legislative reform. Even there, however, there is a hint in the final footnote in the Australia Chapter that a new government voted in, in November 2007, may lead to future changes in the relationship between the state and the charity sector. The subject matter of this book is clearly an ever moving target.

The reviewer found each Part and then the Chapters within each Part well constructed, providing overviews initially before moving on to the detailed analysis. This allows the authors to lead the readers through what is sometimes complex and unfamiliar territory. The referencing in each Chapter will prove to be a researcher's delight with plenty of materials to be followed up by the interested reader. One slight niggle is that the headings within the Chapters could have been clearer, particularly where the same sub-headings fall within the chapter under different main headings, but both sub-headings and main-headings appear in the same size and font. Once the reviewer had overcome this confusion, each Chapter was easy to follow and to compare. In many of the jurisdictions considered, the impression is gained that there may well have been further developments since the writing of the book, but with the signposts provided by the authors, it is imagined that it will not be difficult to locate any new materials. So, for example, when it comes to an examination of legal structures in England and Wales, there are plenty of references to the long-awaited Charitable Incorporated Organisation, the final form of which is yet to appear on the statute books.

The book is a work of considerable scholarship, with the authors making a comprehensive study of charity law and policy in the common law countries under examination. The arrival of this book is both timely, with reforms having been discussed and recently implemented in many of the jurisdictions examined, and welcome. Whilst the initial focus is on England and Wales, the other countries chosen for comparative analysis are dealt with in a consistent and informative manner. In conclusion, this is a scholarly and extremely well researched book, containing much useful information. It will provide plenty food for thought for scholars and practitioners of charity law and social policy in many jurisdictions for many years to come.

THE AGENCY PROBLEM IN NON-PROFIT CORPORATIONS

BY GIOVANNI TAMBURRINI

ABSTRACT

Recent data concerning financial scandals in the *non-profit* sector demonstrates that whoever is considered the ultimate resource of the non-profit corporation will possess a very weak protection when faced with the opportunistic behavior of self-motivated directors. This is basically due to the fact that the *non-profit* sector has for long been overlooked by legal doctrines.

As the economic importance of *non-profit* corporations has steadily and drastically increased since the '60s, this article urges a revision of the relationship existing between *patrons* and directors, in order to elaborate possible legal solutions aimed at reducing the risk of exploitation. The study assumes the two parties are linked by an agency contract, which gives agents the opportunity to take advantage of information asymmetry in order to pursue personal interests in detriment of those of principals. Taking on the assumptions brought forward by rational choice and new-institutionalism theories, the analysis assesses the relationship on the basis of the features which characterize the *non-profit* sector.

In particular, the diverse roles *non-profit* organizations have been playing are taken into consideration, in order to understand when exactly the relationships began to be more exposed to agency problems.

The research reveals that a crucial shift occurred when specialized managers began to be added to boards of directors. This circumstance not only rendered *non-profit* corporations more business-like, but also introduced a strong conflict of cultures and interests among the various constituencies.

To defend the traditional role of *non-profit* organizations, this article suggests a legal reform which rethinks the relationship between patrons and directors as an incomplete contract to be completed according to relevant institutional rules. This would imply an extension of the right to sue directors, an intervention on corporate governance systems and a novel definition of *non-profit* fiduciary duties.

INTRODUCTION

A) THE ECONOMIC ROLE OF NON-PROFIT ORGANIZATIONS IN THE MODERN ECONOMY

Scientific research is normally required to shed light on real-world problems. In law and economic literature, scholars are attracted by questions concerning resource allocation, above all where the latter is of interest to a significant part of a specific economy. This paper will focus on the *non-profit* sector that, while on one hand has dramatically developed since 1960; on the other, has raised concerns related to numerous cases of mismanagement. The discussion will take into account the state of affairs in the United States of America, although the economic phenomenon has developed nearly at the same level on both the sides of the Atlantic. The paper intends to find the causes of such wrongdoings and to evaluate possible legal solutions.

To begin, it is necessary to provide a general overview directed to a better understanding of what *non-profit* organizations [NPOs] are and what their role is. In some respects, NPOs share important features with ordinary business firms. Both, through the cooperation of a group of individuals:

“use inputs – labor and capital – to produce outputs – goods and services. Viewed this way, it is apparent that non-profit are firms and whether a firm is for-profit or non-profit does not determine the output it is capable of producing”. (Easley, 1983: pp. 531-532)

The fundamental distinguishing characteristic between the two is represented by the limit on the distribution of the *surplus* on behalf of whoever exerts control over the entity [directors, managers, employees]. This means that for *non-profits* any surplus must be reinvested for the organization’s targets or somehow towards its interest.

The role NPOs have been playing in the economy has changed greatly. Originally, they were established by religious fraternities to pursue charitable purposes, that is to assist needy people. They depended on voluntary efforts of churchmen and did not involve any meaningful quantity of money.

This small, traditional role persists only in part in the modern economy. In the course of history, for the reasons we will see throughout the dissertation, *non-profit organizations* have progressively extended their activities to the point of becoming true competitors of business firms. Today, though their economic importance is acknowledged by scholars, the task of describing their role is more difficult.

Terms like *charitable organization* or *charity*, though currently adopted to refer to all kinds of *non-profits*, are conventional¹, but do not encompass the full range of services provided by *non-profits*. Literature, in fact, shows *non-profit* organizations are no longer homogeneous in the forms they present themselves and in the services they provide.

The complexity is such that attempts at categorization are admittedly incomplete and offered only for simplification purposes. Shaped in terms of finance and control, the most popular categorization is the one suggested by professor Hansmann (1980) including: (1) donative mutual, (2) donative entrepreneurial, (3) commercial mutual, (4) commercial entrepreneurial. The latter would represent the form that has boosted the *non-profit* sector in the modern economy.

Despite the recognition of diversity, Hansmann (1980) has elaborated a theory that assigns the same economic role for all types of *non-profit* organizations. These are thought to function as “devices to protect consumers from exploitation in circumstances in which ordinary for-profit producers would have excessive market power” (Hansmann, 1980: p. 889). The American scholar (1980), introduces the concept of *contract failure*, that expresses a situation in which consumers are not able to directly evaluate the performance of the organization.

Accuracy is required when underlining that donative organizations do not truly involve consumers, but donors. Therefore, to avoid terminology confusions, Hansmann (1980) defines whoever constitutes the ultimate resource of *non-profit* income as *patrons*. Given the *protective* role assigned by the author, it follows that the proliferation of *non-profit* organizations will principally occur in the forms where *contract failure* is more pronounced: namely donative and commercial entrepreneurial. Mutual *non-profit* organizations, in fact, normally consist in country

[commercial] or political [donative] clubs where *patrons* realize their social exclusivity rather than in a mere commercial purchasing of the services provided (Hansmann, 1980).

There is no doubt that *contract failure* theory has offered a logical rationale that helps to identify the role charitable organizations play in the modern economy. Nevertheless, such rationale loses part of its value when financial scandals involving the *non-profit* sector take place. These types of events may be considered as signals disproving *consumers' protective* role since they imply a misuse of financial resources.

Our aim is to go beyond the *contract failure theory* and its assumptions, and not to challenge them. In other words, we look to understand why charitable organizations are sometimes found untrustworthy and who is accountable for this. Accordingly, we assume that causes of wrongdoing are associated with the presence of the agency problem, the latter having effectively moved into NPOs since they started to be run by business oriented directorsⁱⁱ.

B) AGENCY RELATIONSHIPS AND THEORY OF THE FIRM

For a complete understanding of the agency relationships occurring in *non-profit* organizations – both in their traditional and in their business-like versions – we think it is suitable to proceed by taking on the neo-classical notion of the firm, conceived as a *nexus of contracts*. Such approach is justified by the fact that most *non-profit* organizations are structured as corporations and, as such, benefit from the insight offered by business corporation literature.

Economists state that all members of a corporation agree to contracts with corporate management, establishing an agency relationship. The latter, indeed, occurs when “one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (Jensen & Meckling, 1976: p.309).

The study of such relationships is based on the assumptions (Asimov, 1988)ⁱⁱⁱ that these scholars have expressed through the rational choice theory. They basically claim that:

- a) *homo economicus* has stable preferences;
- b) *homo economicus* acts rationally to pursue those preferences.

Point (a) demonstrates that economists like to make things simpler. In their opinion, regardless of the type of contract (James, 1979)^{iv}, actors “are not assumed to be governed by causal factors operating behind their backs” (Hedstrom & Stern, forthcoming). When they negotiate contractual clauses, actors aim at increasing/maximizing their wealth.

As regards point (b), it is asserted that “actors... are seen as conscious decision makers” (Hedstrom & Stern, forthcoming) because before they conclude a contract they calculate, they seek information, they assess all the effects that might take place, and so on. The latter is thought to be *optimal* by definition, as it satisfies parties' preferences.

This implies that parties to contracts must bear costs when they transact^v (Hisiung, 1999). We can, for example, imagine a simple contract^{vi} in a hypothetical situation where a bicycle must be sold. While negotiating the price, the purchaser may be willing to spend some money for an expert's opinion on the condition of the bike [information costs^{vii}] (North, 1990). Actors, therefore, reasoning in terms of costs and benefits, shall supposedly agree just in case the latter are higher than the former.

Mainstream economic ideas blossomed around the '70s-'80s, but the *transactions cost* theory was introduced fifty years earlier by Ronald Coase (1937) to justify the existence of the firm and, simultaneously, to disprove price system theory^{viii}. In other words, Coase had already claimed that market was not costless.

In particular, Coase's argument was that firm would have replaced market since it would have reduced the amount of transactions and therefore the relevant costs. To understand this concept, one may think about how entrepreneurs may better organize their economic activities. Supposing they need to contract a certain number of persons out in order to carry on with their enterprise, they would likely incur in the costs referred to above. The latter may still be lower than the benefits, so that the entrepreneur may choose to continue to seek for agents within the market. However, contracting persons out for every single operation would mean to iterate the transactions, increasing the relevant expenditures.

Hence, we come across Ronald Coase's (1937) theory. In Coase's opinion, entrepreneurs would better hire their agents on the basis of long-term contracts so that the series of contracts are substituted only by a special one which "corresponds closely to the legal concept of the relationship of employer and employee" (Coase, 1988: p. 29). The aggregate of the long-term contracts that entrepreneurs reach with their agents, constitutes the firm. More accurately, "firm is characterized by the existence of a central contracting agent and a contract whereby the factor, for certain remuneration, agrees to obey the directions of the entrepreneur within certain limits" (Coase, 1988: p. 29).

From a cost-benefit analysis one may underscore that on one side, it is true that the entrepreneur dramatically reduces the quantity of transactions, saving the relevant costs; but, on the other, it is correct to notice that he/she will incur in diverse expenditures "associated with the administrative cost of determining what, when, and how to produce, the cost of resource misallocation (since planning will never be perfect), and the cost of demotivation (since motivation is lower in large organizations)" (Canbäck, 1988: p.23). The latter are denominated management costs^{ix} (Canbäck, 1988). Accordingly, to explain the existence of the firm, the question is not whether management cost is more or less than transaction cost, but whether the sum of management and transaction cost incurred through in-house production is more or less than the sum of management and transaction cost incurred through purchase across markets, since either option entails expenditures on both cost categories (Demsetz, 1988: p. 145).

Ronald Coase's (1937) theorem, though providing a logical explanation of the existence of the firm, is nevertheless not sufficient to motivate the survival of the firm itself. It fails to accurately focus on the problems that employment relationships entail and on how they may be resolved. In particular, we have to bear in mind that the presence of widely held corporations implies that the entrepreneur is not a single *homo economicus* but, instead, is represented by thousands and thousands of shareholders. In economics, the latter are thought of as the owners of the firm and as such, they are the employers. Through the *central contracting agent* (Demsetz, 1988) they proceed in hiring specialized managers put in charge of running the business. Normally, all employees who deal with third parties are considered agents (LegalMatch, website). The separation of ownership and control identified by Berle and Means (1932) suggests that there is a very significant information asymmetry between the principals and the agents. The expenditures that the principals incur for monitoring purposes represent what Ronald Coase (1937) overlooked (Demsetz, 1988)^x. Entrepreneurs may choose to organize their activities under a firm since they have assessed that managerial costs are lower than the ones to be born if they had to contract an agent at every instant. The organizational form is thus justified, but its survival is not. The strategy opted for by the entrepreneur may well work just because he/she has

direct contact with managers. The situation dramatically changes when huge corporations are involved. It is the case where the *agency problem* naturally occurs and calls for neo-classical economists to study relevant solutions^{xi} (Hansmann, 2003).

C) THE CONCEPT OF EFFICIENCY IN THE *NON-PROFIT* SECTOR

The foregoing discussion can offer us two main insights. The first is that all the constituencies of a corporation necessarily agree on contracts with the management, establishing an agency relationship. The second one is that, according to rational choice theory assumptions, such liaison is characterised by a conflict of interests.

We argue that the different kind of conflicts of interest occurring in *non-profit* and business corporations affects the respective concepts of efficiency. As regards *for-profit* corporations, the idea that shareholders are the owners of the organization implies they boast rights to the assets. In particular their *stable* interest is to get the highest return from their investment. Shareholders, therefore, measure the efficiency of the firm on the sole basis of their profit maximization.

Incumbent management is interested in the efficiency of the firm only in the cases it will positively affect their payoffs or more in general the continuation of their employment. Since they may well take advantage of their decision making discretion and of their better informed position to the detriment of firm's efficiency, shareholders are keen on contractually eliminating incentives for opportunistic behaviours.

As mentioned above, the nature of the interest conflict within *non-profit* corporations presents substantial differences. First of all, the fact that there are no owners/shareholders implies that theoretically no one could have any claim to the assets^{xii}. That explains why US state law prescribes that only the attorney general is allowed to sue directors of *non-profits* for breach of duties^{xiii}.

That does not mean *patrons* have no interest in the performance of the organization but, rather, they consider different parameters to measure the efficiency of the firm. Our argument is that the patrons of *non-profits* are not truly interested in the economic performance of the corporation, but instead in the quality of the services/goods provided and in the way such quality is obtained, that is respecting the social values promoted by the firm itself.

This view reflects an institutional model which actually assigns more emphasis on the means [processes] than on the ends [final outcomes], leading literature to deem *non-profit* directors accountable primarily for *their intentions*; that is the motivations that led to take a specific decision^{xiv} (Goodin, 2003).

For *patrons*, therefore, any management conduct, even when significantly rewarding the corporation from a financial point of view, is considered a conflict of interest and, consequently, as a wrongdoing every time "it compromises the non-profit model which stresses the values of community participation, due process and stewardship" (Eikenberry & Kluver, 2004: p. 136).

D) THE AGENCY PROBLEM AND THE EFFICIENCY OF NPOS

Data related to public scandals reveal that agents may represent a serious danger for the efficiency of the *non-profit* firm. In such context, we established that this is basically due to two specific problems related to agency relationship:

- a) directors' opportunistic behaviours;
- b) directors' incompetence.

The problems that lie in the first category recall the conflict of interests described above, as all agents- whatever the context within which they operate [corporate or not corporate, *for-profit* or *non-profit*] – are expected to act towards maximising their wealth.

As for the second category, we argue that in *non-profit* agency relationship the risk that agents do not possess the proper skills to run the firm [to pursue the interests of principals] is far higher than in any other context.

Furthermore, our opinion is that both problems present a close connection with the particular configuration of *non-profit* board of directors. In order to shed light on this point, we now bring forward a comparison between *non-profit* and *for-profit* boards.

D.1) Board Configuration in Business Corporations

When called to deal with the agency problem, literature usually refers to the relationship occurring between shareholders and managers. Being those responsible for day to day activities, the latter represent the strong part of the information asymmetry problem and, as such, are feared to misbehave.

The very fundamental tools thought to reduce the risk that *agents will cheat you*^{xv} (Williamson, 1985) are represented by the market for corporate control, the free transferability of shares, and the board of directors (Fama & Jensen, 1983). Their functioning presents factors which are strictly correlated to each other.

As regards managers, these may feel the pressure of losing their jobs when the firm performs poorly. Takeovers, in fact, take place when a bidder succeeds to acquire sufficient stock to allow him to elect a new board of directors. Accordingly, the principle of free transferability of shares guarantees shareholders the right to exit whenever they do not feel comfortable with the incumbent management.

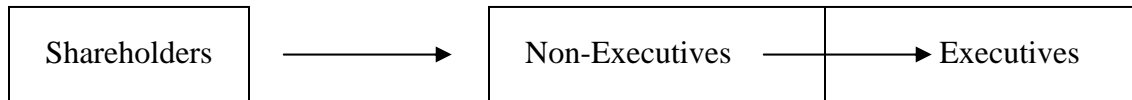
Finally, the board of directors is considered the most typical tool used to reduce the costs of the agency problem^{xvi} (Hansmann & Kraakmann, 2003). The board is meant to oversee the activities of the managers and to make its best effort to align their interests to the ones of shareholders. The power to appoint the relevant members is the result of a shareholder meeting. To ensure the highest level of neutrality, the law requires that the nomination, audit and remuneration committees must be constituted by non-executive directors, that is directors not directly employed by the firm^{xvii} (Mace, 1971).

It can not be denied that, if, on one side, agency theorists state that an effective board should be composed only of *nonmanagement* directors (Dalton, Daisy, Ellstrand and Johnson, 1998), on the other, it must be considered that the latter may not have all the indispensable

information to control effectively. This implies that independent directors must include top managers in the board as well, in particular the chief executive officer (CEO). Therefore, once appointed after the general meeting, directors are expected to select, evaluate and, if necessary, remove the management (Mizruch, 1983: p. 429).

This brief discussion helps to better frame agency relationship in a business corporation, that consequently may be represented as follows:

Fig. 1



D.2) Board Configuration in Non-profit Corporations

The market for corporate control and the free transferability of shares are tools that do not apply to the *non-profit* sector. This is due to the fact that *non-profit* corporations are *unowned* so that there are no shares and, consequently, no rights to control or to be taken over^{xviii}.

In monitoring terms, the role of the board of *non-profit* corporations reflects much the same the one of business corporations; that is to say, members must oversee the activities of the management. However, very fundamental differences regarding the election, the culture and the competence of the board may interfere with the level of director performance.

The first difference is that non-executive directors of business corporations are elected directly by shareholders. Since non-executives in turn appoint top-management, in some way shareholders, at least indirectly, participate in the selection of executives themselves. In modern NPOs, non-executive members of the board are normally the constituents of the firms themselves. In those cases where *non-profit organizations* are so old that the founders are no longer living, the composition of the board is continued on the basis of self-perpetuation. Unlike shareholders, therefore, *patrons* are generally not involved in matters related to the control of the firm, unless they are the founders of the organization or self-perpetuated members that continue to contribute.

The second difference concerns the culture of the board. As we will see throughout the next paragraph, in business corporations executives and non-executives share the same education, and they are expected to measure the efficiency of the firm according to the same parameter: profit maximization. In charitable corporations, on the other hand, we see a conflict of cultures which reflects a more delicate conflict of interests and which mirrors different concepts of efficiency. Unlike executives, in fact, non-executives are normally not educated in economics. This implies that the latter, other than monitoring managers for possible expropriation of money, are expected to intervene every time the actions of their agents, though economically beneficial, do not meet the social purposes of the organization. In other words, those actions that may well be appreciated by business directors, may not be accepted by *non-profit* directors.

The differences in the the way members are appointed and in the internal cultures are closely connected to the competence of the members. Indeed, in business corporations non-executive directors are elected by shareholders on the basis of their education. Accordingly, through the same criteria, non-executives choose executives. In *non-profit* corporations, instead, members of the board are community-based people who have founded the firm itself or have been

chosen because of their ideological motivations. They therefore do not necessarily present some economic education which allows them to exert an effective control over executive directors.

E) THE TWOFOLD DIMENSION OF THE AGENCY PROBLEM IN NON-PROFIT CORPORATIONS

As referred in the last part of paragraph A of the Introduction, we strongly believe that the agency problem in *non-profit* corporations has been interfering with the efficiency of firms ever since business-like directors began to be engaged in *non-profits*. In the US, this apparently happened when charities had to face federal cutbacks established by Reagan policy throughout the '80s so that they needed expertise to raise funds.

The reason why we sustain that the agency problem has not properly concerned the *non-profit* sector since its origins, is related to an absence of a true conflict of interests. Before the shift towards trained and specialized directors we have proof that charitable organizations were controlled by *patrons* themselves. This was done by sitting personally on the boards or, indirectly, by appointing trustworthy volunteers [*trustees*]. As financiers [principals] and controllers [agents] were basically the same person, in such cases any premises for conflict of interests were absent.

With the ingress of executives coming from the *for-profit* sector, we are convinced that in some respects Joseph Mwaura was correct about what he suggested in his article about Kenyan parastatals (Mwaura, 2007). In particular, we refer to the fact that while previous *non-profit* organizations and ordinary business corporations have a single principal (shareholders) and agent (managers), new business-like *non-profits* are governed by multiple agents, namely non-business and business based trustees (Mwaura, 2007)^{xix}. This has not only moved into NPOs the agency problem encountered by charitable organizations, but it also has conferred to it a more complex dimension than the one characterising the *for-profit* sector.

On one side, in fact, business trained executives have attracted diverse financial contributions. The state of affairs by which boards of directors were at the same time managers and *patrons* of the organizations no longer characterizes modern *non-profit organizations*. Ultimate resources, instead, embrace more and more people who, as donors or customers, are definitely not in control of the organization and lack any kind of tool to know how their money is being utilized. To put it differently, the ingress of professionals into the board has entailed a revolution in management composition, whose members are now “strangers” asked to boost the economic performance of *non-profit* firms. Truly, the scheme envisaging the separation of *patrons* and control recalls that of the separation of ownership and control (Berle and Means, 1932) and, as such, confers charitable organizations a first dimension of the agency problem, rendering them more business-like. On the other side, the cohabitation of multiple agents may entail an internal conflict of interests due to the mix of cultures described earlier, conferring on it the second dimension of the agency problem.

Indeed, in relation to the instance of Kenyan parastatals, we can see that inefficiency “arises because the agents (public officials) who have the powers to appoint board members and issue managerial directives do not always act in the best interest of parastatals, but in the interest of voters who can vote them out” (Mwaura, 2007: p. 4). Similarly, for what concerns *non-profit organizations* in a strict definition^{xx}, directors will not succeed in acting in the interest of the organization if they demonstrate incompetence in appointing and controlling executives.

F) THE STRUCTURE OF THE DISSERTATION

The dissertation will be divided into three parts. Part I is a background meant to offer a deeper analysis of the economic role that *non-profit* organizations play in the modern economy. In section I we will discuss more accurately the *contract failure* theory referring also to the critiques that part of literature has made to it. In order to follow such goal, we will also consider other economic theories that have attempted to justify the development of charities. An historical overview of the different roles *non-profit* organizations have been playing since the beginning of their existence will prove itself necessary. The observation of the evolution of the agency problem, indeed, will allow us to identify firstly the moment at which it reached a dimension such to seriously affect the efficiency of NPOs and, secondly, the variables determining this dimension. In particular, this article will analyse the agency problem occurring in mutual-benefit NPOs.

Part II offers a theoretical framework about the contractual dimension of the *nonprofit* corporation, obviously making an extensive use of business literature to the extent it is applicable to the *nonprofit* context. The “law and economic” analysis present in it will be fundamental to set the basis for the discussion and elaboration of legal solutions concerning the agency problem.

Finally, Part III is divided into four sections (I-IV). Sections I and II will deal with opportunistic behaviours and director incompetence. In fact, these factors are thought to present very peculiar aspects in *nonprofit* corporations, rendering the relevant agency relationships more problematic and costly. Section III and IV will concern legal solutions. The former will take into account the state of affairs while the latter, through a discussion of the current solutions themselves, will attempt to suggest certain improvements.

I. BACKGROUND

SECTION 1: BURGEONING AND ROLE OF THE NON-PROFIT SECTOR

1.1) Aims of the Section

This section is aimed at providing a general overview of theories that have tried to explain the burgeoning of NPOs. First, the attention will be particularly focused on Hansmann’s (1980) contract failure theory, as its rationale takes into account topics related to the agency problem occurring between *patrons* and directors. Although it is one of the most qualified in literature, we believe it is necessary to set forth some of its weaknesses, also with the support of other scholars. Secondly, there will be a brief reference to theories that have given importance to secondary economic factors.

1.2) Contract Failure Theory

As observed in the introduction, the arguments provided by Professor Hansmann (1980) to justify the development of *non-profit* corporations have been essentially underpinned on the basis of an economic analysis. The scholar sustains that, for certain entrepreneurial initiatives, NPOs may perform better than ordinary business firms.

The *contract failure* theory, indeed, relies on the fact that sometimes *patrons*^{xxi} are not technically able to evaluate the goods or services they are purchasing or financing.

For instance, one may imagine consumers shopping in a supermarket. In that case, buyers may personally and directly check what they are buying. Among the stock of products, they easily choose the one which satisfies their preferences the most.

In other situations, though, such advantages may not be available. The clearest example is represented by the Red Cross. If one of its commitments is to distribute food for African children, contributors will barely know if their money has been fairly employed. They are not in a position to countercheck for what purposes for which their aid has been actually utilized.

Similar circumstances can be found when someone engages a company for flower delivery. Nonetheless, though consumers are not able to personally evaluate the performance they've required, they still can make sure by phone-calling the recipient. This evidently does not occur in the aforementioned instance concerning the Red Cross.

It is true that, in situations where *patrons* would hardly realize a possible misuse of their money, the market alone *fails* to provide any tool for the problem. In other words, the market itself can not guarantee a fair allocation of the resources.

When this happens, the authority of the state is expected to come into play. Through commercial law, it historically has been aiming at:

- a) preventing unfair distribution of risks – above all when it is delegated to a weaker part, as for example the donor to the Red Cross – or;
- b) reaching greater efficiency.
- c)

Accordingly, *non-profit* corporations have been penetrated via legal provisions directed to “help” the market satisfy the conditions for working efficiently. Undoubtedly, the most significant among them is the *nondistribution constraint* which, as quoted in the introduction, disallows to distribute any income generated by an entity's activities.

Such mandatory by-law clause would ensure *patrons* that the money they have given will be employed for organizational purposes. This explains why the American scholar claims that *non-profit* organizations play a protective role^{xxii}.

1.3) Observations on Contract Failure Theory

Hansmann (1980) basically justifies the existence and the survival of NPOs on the basis of the *NDC*, seen as an excellent device to reduce the agency problem occurring between *patrons* and directors. First of all, we argue that the rationale offered by the American scholar is complete only if one assumes that many “if not most, not-for-profit firms are started by entrepreneurs”^{xxiii} (Glaeser & Shleifer, 2001: p. 99). In fact, before bringing to life any activity, the latter are expected to make cost-benefit evaluations. Consequently, once they realize their enterprise might present problems related to market failure, they would find the *non-profit* option to be more trustworthy because of the *NDC*, that would attract more consumers than a business organization would.

Yet, as we shall see in section II, many *non-profit* organizations are joined by entrepreneurs only after they have already been constituted. This would lead us to sustain that the “protective role” would justify the survival, rather than the mere existence of NPOs.

Moreover, we argue that the stream of thought based on Hansmann's (1980) findings relies too much on the effectiveness of the above mentioned legal provision. The disallowance, indeed, implies penalties for whoever is found responsible, but this does not actually mean mismanagement may not occur^{xxiv}. We consider *patrons* aware that the *nondistribution constrain* alone does not ensure fairness unless an effective oversight is established. This leads us to suppose that the reasons that drive them to choose the *non-profit* route must be found in other factors.

Ortman and Schlesinger (2002), for instance, sustain that the monitoring mechanism of a *non-profit* corporation has historically been weaker than the business counterpart so that the *NDC* alone would not guarantee that expected management's fairness. The legal provision would appear fragile even where one assumed it to be supported by other elements such as the altruistic and ideological motivations supposedly driving NPO directors (Ortman and Schlesinger, 2002). *Patrons* know directors change, situations change, and behaviors change. The authors define Hansmann's (1980) theory as "trust hypothesis", underscoring its extremeness. Rather than upon the trust element, they instead prefer to explain the market share of *non-profit* organizations upon the concept of reputation supposed to best ensure a proper usage of financial resources (Ortman and Schlesinger, 2002) for *patrons*. At the same time, however, they acknowledge that reputation takes time to be formed and, moreover, would play its protective role just in cases where information flow among customers is good.

Hansmann's (2000) counter-response has insisted on the misinterpretation of his article. He claims that the *trust hypothesis* should not to be considered so strong. He outlines that if *NDC* were sufficient to guarantee interest alignment, then the agency problem would have been solved and the whole economy would have functioned thorough *non-profit* organizations. Accordingly, he has been keen to acknowledge the limitations of his findings, clarifying that he simply wanted to underscore the asymmetric information element, and quote one of the possible legal solutions to challenge mismanagement.

1.4) Tax Exemption Theory

The *Contract failure* theory is definitely the most popular in literature (Brody, 1996). Yet, some scholars attempt to explain *non-profit* sector success underpinning the statutory tax advantages which are granted to *non-profit* entities but not to their business competitors (Schoenfeld, 1970 and Fama & Jensen, 1983). If we took on this justification then we could ascribe a completely different role to NPOs. Rather than structures aimed to protect *patrons* in cases of *contract failure*, such entities would represent an ideal device for astute entrepreneurs to hide business activities, taking advantage of the fiscal benefits.

We do not deem the tax exemption theory convincing enough to motivate the impressive increasing number of NPOs. Along with that, we can refer to the fact that non-profit entities existed long before the introduction of the income tax in the United States, and hence are unlikely to be a byproduct of income taxation (Glaeser & Shleifer, 2001).

Moreover, the rationale behind fiscal exemption in actuality has never been very clear. Hansmann (1981) himself has provided a very significant article in which he has firstly analyzed the relevant existing legal and economic theories and, secondly, offered a novel, perhaps more satisfying, justification for the benefits recognized to NPOs.

In particular, he argues that “the best justification for the exemption is that it helps to compensate for the constraints on capital formation that non-profit organizations commonly face, and that such compensation can serve a useful purpose, at least for those classes of non-profit organizations that operate in industries in which, for various reasons, non-profit firms are likely to serve consumers better than would profit-seeking firms” (Hansmann, 1981: p. 55). Such argumentations demonstrate that Hansmann (1981) still relies on the *nondistribution constraint* element, considering it as a prerequisite for granting tax benefits and, therefore, confirming his idea that NPOs play a protective role on behalf of *patrons*.

A more general observation referring to legal aspects, however, would explain tax exemption based on the fact that *non-profit* incomes do not match with the terms used in the Internal Revenue Code.

1.5) General Economic Observations

As Hansmann himself claims, *contract failure* and tax exemption are not necessarily competing theories (Hansmann, no year specified). The author, indeed, acknowledges the benefits of fiscal advantages to strengthen the protective role of the *non-profit* sector. However, literature suggests that other key-factors are also involved in the development of NPOs. Two in particular are to be referred.

The first one is related to the general observation that, since 1960, “as Americans became wealthier they bought more services of all kinds” (Hammack, 2001: p. 158). The second, instead, is more specific and it is associated to the “world-wide quest to find alternatives to government in the provisions of human services, a quest largely borne out of disillusionment with government’s handling of the welfare state” (Gibelman & Gelman, 2000: p. 7). In Hansmann terms, this actually means that the cases of market failure have increased and, accordingly, NPOs have found more room to pursue their objectives.

SECTION 2: EVOLUTION OF THE AGENCY PROBLEM IN NPOS

2.1) Aims of the Section

The aim of this section is to study how the agency problem relies on the different roles *non-profit* organizations have been playing in the economy. Such analysis is meant to support our hypothesis according to which the agency problem has moved into *non-profit* corporations only after the ingress of business trained managers into the boards of directors.

The structure of the discussion thus reflects three historical stages throughout each of which a determinate role performed by *non-profit* organizations corresponds to a certain level of complication of the agency problem. In particular, it will be explained that the process that has led the agency problem towards a twofold dimension marked by the cultural diversity of board members, and how such board configuration has facilitated the occurrence of opportunistic behaviors.

2.2) Origins of NPOs

2.2.1) First Stage: Absence of Agency Problem

Non-profit entities have been in existence for a very long time, almost a millennium. Thus, their roots are dated far behind the seventeenth century, when the first examples of business corporations were constituted (Hansmann, 1989). In the beginning, most of these organizations were very small in size and in number. Traditionally, they were structures created to pursue charitable purposes such as religious or hospital services, teaching, and looking after people in need. Their finance relied upon tax funds until the American revolution [1775-1783] disestablished the state connection and forced NPOs to seek for private donations (Hammack, 2001).

During this period it is evident that the role played by charities was far from being economic. As charitable entities, their existence could be better explained through sociological motivations. Daniel Webster claimed that charities were “founded by the piety of our ancestors to alleviate human misery and scatter blessings along the pathway of life” (Hammack, 2001: p. 160). Organizations without profit purposes were likely constituted by elitist people that, “fearing the political power of the general populace, endowed universities, hospitals and other charities in order to build up the learned professions (such as law, medicine, science and business) for their sons” (Brody, 1996: p.438)^{xxv}.

Moreover, another kind of NPO was very popular. These were the “grassroots organizations to be considered as the mutual-benefit, single/issue interest, based in the goals of ethnic, neighborhood, denominational, political, aesthetic (and some times athletic) interests” (Hall, 2002: p. 140). As one can easily note, the American territory was characterized by a heterogeneousness of *non-profit* organizations that depended on the particular local culture.

Despite such diversity, we are ready to sustain that, whatever the specific structure of charity, we do not yet detect any significant agency problem. They fundamentally were voluntary organizations controlled directly by their founder-donors, with little money involved (Hammack, 1989)^{xxvi}.

2.2.2) Second Stage: Agency Problem Between Public Power and Private Founders

The situation experienced a first shift around 1873, when the liberal capitalist-based American state was threatened by worker riots against the industrial class. Indeed, the most thoughtful men of affairs understood that their economic system would have resisted only in the case institutions would have guaranteed equal opportunities for every citizen. Such condition would have allowed the “*Social Darwinism*” to select the most skilled people for high locations in the business hierarchy. The latter, therefore, was not conceived by these leaders as a birthright (Hammack, 1989).

Such “*scientific philanthropism*” assigned a new dimension to the role of *non-profit* organizations, although this was still far more political and sociological than economic. In particular, these organizations were expected to provide those services theoretically of public

competence, but which the state was not in the condition to perform. Wealthy people, in fact, used to give out large amounts of money in order to constitute charities. The diffusion of these, however, did not reach sufficient percentages to be of concern to the American economy. This was due to two basic reasons.

The first one is related to the fact that corporations, whether *for-profit* or *non-profit*, were not free to be founded. A grant from the state was necessary, which was not very easy to obtain.

The second reason is also associated with the involvement of public power into these structures which, actually, were private in nature. The state, indeed, other than the concession, also once affected the operation of NPOs through a direct financial participation.

Through our research we have found that the public-private cooperation has not always entailed satisfactory results. We believe that this happened because the conflict of interests between these gave rise to an agency problem. In fact, although the founders were private individuals, state law prescribed that directors had to be appointed by the superior court. A perfect example of such was presented by Miami University [State of Florida] which was shut down in 1873 for being unable to face the enormous debts that it incurred [the university reopened its doors ten years later]. Our hypothesis, according to which such lack of financial resources was a consequence of an agency problem, is supported by the words of a contemporary scholar:

“There are advantages and disadvantages in this method. It ensures a conservative management and expenditure of funds. This is important to state institutions of all kinds. Inasmuch as all appropriation must be provided by the legislature the university is held to a careful regard for the intelligent public opinion of the state, There being no corporate rights to be forfeited the legislature might, at any time, change the character, alter the methods, or entirely abolish the institution. On the other hand, the limitations of the State University are such as to hinder it from meeting emergencies as they arise, or devising plans looking into the future. There is a limit to the resources available from the state, and this limits as well what may be undertaken” (Burns, 1982: pp. 326-327).

The truth is, the agency problem that characterized those *non-profit organizations* run by a combination of public and private, did not imply any financial scandal. The inefficiency of the firm was not due to self-dealing behaviors or whatever shameful managerial operation. The reasons were rather rooted from the incompetence of public directors to raise funds or to manage them in order to lead to an increase.

The private/public conflict of interests has not concerned all the states of the Federation since they historically have been autonomous as far as corporation law is concerned. This means that some of them, acknowledging the private nature of *non-profit organizations*, did not boast any economic claim on the firms themselves. An example may be represented by Harvard University [State of Massachusetts] whose board was composed by members of the state senate only until 1865 when, indeed, the corporation began to be considered as a private non-profit organization in the modern sense (Hall, 2002)^{xxvii}.

Where public power did not penetrate into *non-profit* affairs, agency problems barely arose. As was true for charitable organizations before the revolution, *the boards were the organizations*^{xxviii} (Wood, 1992). The sole difference with early charities was essentially the

presence of an increased value of the assets, due to the donations made in accordance to the *Scientific Philanthropism* ideas.

We sustain that if mismanagement situations had occurred, they hardly would have caused public scandals. The press as well as academic literature became interested in wrongdoing issues just when two conditions were satisfied. The first one concerns the involvement of significant amounts of money, while the second one concerns the unfair expropriation of such.

Non-profit organizations of the late nineteenth and third fifth of the twentieth century were not actually concerned with the above referred situations. Cases of inefficiency, just like the Miami University instance, were essentially due to the lack of economic skills of managers.

2.2.3) *Modern Stage: Business-Like Non-profit organizations, Agency Problem and Public Scandals*

Here we come across the agency problem presented in the introduction. As already mentioned, in 1960 charitable organizations began to increase in number and in their assets. There are approximately 1.4 million *non-profit organizations* in the US at present, holding \$ 2 trillion in assets and accepting annual donations totaling \$ 241 billion (Fremont-Smith, 2004).

We have already seen the economic theories – contract failure and tax exemption – that have attempted to justify such phenomenon. Also, it is fair to remind that literature more concerned with political or sociological motivations also exists. The point is not to assess which among these is more plausible, since today they “do not reflect any longer completely different views of how the world of organizations works, but rather more nuanced differences concerning the relative importance of contextual factors” (Ben-Ner & Gui, 2003: p.1). Instead, our task is to borrow the assumptions made in them in order to develop our analysis of the agency problem.

To begin with, we will discuss the role played by charitable organizations. It is obvious that the contextual factors referred to above would provide important hints to identify the role of a determinate charity. For example, if we had to assess the reasons that have driven founders to constitute a political party, we would probably claim that the charity’s role was to broadcast the relevant biased ideas. On the contrary, we would concentrate more on economic motivations – such as *consumer protective* role or tax exemption – if we had to explain why an entrepreneur had founded a *non-profit* hospital.

Considering its peculiarity, it appears very hard to offer a general definition of the role of *non-profit* enterprise. Each of these plays a specific role according to the *contextual factors* involved. Yet, despite such recognized, evident diversity, all thinkers, whether economists, sociologists or politicists, share a fundamental assumption. They agree that all *non-profit organizations*, hence considered as a whole, play a cumbersome role within the national economy^{xxix}. In other words, the key-question is not which role NPOs play, but to what extent it truly affects modern economy.

Another fundamental assumption agreed on by scholars, which is more a mere observation, is associated with the specialization of *non-profit* management. As mentioned in the introduction, business trained directors started to enter charitable organizations in 1960. However, changes in *non-profit* governance had already occurred by 1920, above all for what concerns hospitals and medical services. For our purposes, such shift does not account for very much, as it only concerns the ingress of nationally mobilizing professionals replacing local upper classes (DiMaggio & Anheier, 1990). In fact, one may take as an example the management of a hospital.

On one hand, if professionals [physicians] join the boards, there is no doubt that they bring prestige and clients to the firm. On the other, it is also true that they are not educated to face competitive pressure and to operate supply factors (DiMaggio & Anheier, 1990). To put it differently, while in the beginning doctors enjoyed high level of credibility for having entailed improvements to hospital efficiency, they later experienced a dramatic decline as they proved to be unable to operate the firm in economic terms. Evidently, the complexity of the agency problem occurring with them and *patrons* was much the same of when upper class seated on the boards. Physicians, in fact, were not feared to behave immorally as a hospital would be considered the last place for someone with such professional ideologies to work in. Hence, there was still no room for public scandals.

The most significant shift in the history of the *third sector* took place during the 60's when *non-profit* organization directors began to feel the pressure of the market. This was basically due to President Reagan's policy which envisaged federal cutbacks concerning NPO funds. Such provisions forced directors to intensify their efforts to seek for private donations or any profiting activity^{xxx}.

As previously observed, the lack of economic expertise did not allow *patrons* to raise sufficient resources to guarantee the survival of the organizations they operated. Rather than dissolving their charities, they opted to strengthen their links with business corporation management reflecting the assumptions of resource-dependency theory, according to which "organizations require resources to survive, and so must interact with others who control these resources" (Eikenberry, 2004: p. 132).

For-profit directors saw in the *non-profit* sector a formidable key to extend and increase their businesses. They felt very happy to join and finance charities, frequently requesting the chair of the boards and the engagement of a certain number of executives with whom they had strict ties in return^{xxxi}. Not necessarily, however, were these dangerously greedy agents. In fact, literature underlines that some of them, the most thoughtful, aimed at a ROI (return on investment), a SROI (Social Return on Investment), a FROI (Financial Return on Investment) or a EROI (Emotional Return on Investment) (Gingold, 2000).

Corporate financial intervention into *charitable* organizations was basically executed for restructuring purposes. Once the firm had restored its financial assets it would have been far more trustworthy for attracting private donations^{xxxii}. Furthermore, business executives, unlike their *non-profit* colleagues, were able to raise funds through "commercial income such as fees for services, product sales, and other profit-making ventures" (Eikenberry, 2004: p. 134).

Charitable organizations were getting more and more similar to their business counterparts. *For-profit* directors dramatically increased their financial resources, yet at the same time moved a new and more problematic dimension of the agency problem into the charities. This was new because, as seen in the introductory part of this dissertation, it involved the question of a multiple agent and the related conflict of cultures. Managers coming from the business sector, in fact, were educated to take into account only profit maximization rather than also the social values and ideas for which the charity had been constituted. In general, "marketization may be beneficial for the short-term survival needs of non-profit organizations, but it may have negative long-term consequences" (Eikenberry, 2004: p.132).

Fundamentally, *non-profit* organizations were about to experience what Berle and Means (1932), analysing business corporations, defined as "separation of ownership and control." Given the absence of owners, we attempt to edit that expression into "separation of supply and

control^{xxxiii}.” No longer was the organization the board, but to a certain extent the board tried to control the organization. This underscores the greater presence of problematic aspects of the agency problem in modern *non-profit organizations* rather than in business corporations.

Boards of directors in the *for-profit* sector are normally composed of experts that, where honest and efficient, may ensure a proper monitoring function to shareholders. In the case of charitable entities, instead, the self-perpetuated boards members, although well intentioned, are not supported by sufficient knowledge to tackle possible misbehaviours of business executives. We associate such intrinsic deficiency to the monitoring mechanism – due to director incompetence – with the accomplishment of opportunistic behaviours that have attracted the attention of press and literature. Among such incidents, which certainly mirror the ones having occurred in Enron and Worldcom in the business sector, notable ones may be the misuse of charitable funds committed by William Aramony as president of United Way (Salmon & Whoriskey, 2003), and the embezzlement done by Jacques Crozemarie, president and leading fund-raiser of the Association for Cancer Research (Gibelman & Gelman, 2000).

II. THEORETICAL FRAMEWORK

SECTION 1: THEORETICAL FRAMEWORK

1.1) Aims of the Section

This section has the aim of providing a theoretical understanding of the contractual dimension of *non-profit* corporations through a law and economic analysis, focusing specific attention on the relationship existing between *patrons* and directors. The discussion will include the findings of *for-profit* literature, as these can be applied to the non-profit sector.

The following analysis will describe how director accountability is conceived by legal doctrine and how it is conceived by economists. First of all, it should be made clear to whom directors are accountable. On one hand, the former school of thought does not recognize the donation to a *non-profit* organization as a contract, with *patrons* not having the right to sue directors. On the other, the latter school, characterising the corporation as private affair, gives *patron*-director relationship a contractual dimension, justifying the need to recognize the right to also sue *patrons* and other stakeholders such as the beneficiaries.

Through such comparison of points of view of the two schools, moreover, it should be assessed which the level of accountability is, that is the standards to which directors must comply. In particular, neo-classical economists claim that the business judgement rule – according to which *non-profit* directors are equalized to business corporation ones – is too loose for a sector in which market forces do not exert enough pressure to keep directors’ interests equally aligned. Accordingly, those scholars would suggest to apply the standards envisaged by the law of trust, restoring an ordinary negligence regime.

1.2) Law and Economic Analysis

Defining the concept of corporation is as hard as defining the concept of love or the concept of money. So many theories have been overlapping and overruling each other that nowadays

students may easily get puzzled. In this dissertation we choose to set out from the very elementary notion that sees the corporation as an aggregate of persons with the aim of pursuing a determinate target. If *for-profit*, the activities of the organization should maximize income in order for it to be distributed amongst the associates. If *non-profit*, instead, the income derived from the various activities should be redeployed to perpetuate the existence of the organization, without being distributed amongst the controllers. That is the fundamental difference between business and *non-profit* corporation.

The truth is that, in *for-profit* corporations, the ultimate resource is necessarily also a member of the organization. By contributing to corporate assets, the investor becomes a shareholder of that corporation and, as such, part of it. On the other hand, in *non-profit* corporations, unless mutual-benefit structures are involved, the ultimate resource is *not* necessarily a member of the organization. In fact, *most* of the time he is not. Once donors or customers accomplish the contribution to corporate assets, they do not enter the corporation but simply maintain an interest in their contributions, utilized for the organization's missions or any other particular service requested.

1.2.1) *The Legal Point of View*

From a strictly legal point of view, neither shareholders nor donors or customers of a *non-profit* organization, are bound by a mere contractual relationship with the management of the organization. This is due to the fact that contractual theory in common law jurisdiction has always based the whole system of analysis of contractual relations on the *parole evidence rule*, which imposes on the interpreter to draw the terms of an agreement by using only the written document and its literal meaning (Peratoner, 2003). In reality, the terms of the agreement existing between *patrons*/shareholders and management are contained in the charters of the organizations they deal with. Although *patrons* do not participate in the negotiation of by-law clauses, they still may link specific requests to their donations.

Applying the classic contractual theory to this setting, it would be quite hard to frame the aforementioned agreements in the notion of a contract. In fact, shareholders and *patrons* entrusting specialized professionals for the management of resources they provide could not be able to envisage what could happen in the relatively long term. Furthermore they might lack the sufficient expertise or information that could lead them to conclude an optimal contract, resulting in a mix of *bounded rationality* and *uncertainty* (Brosseau and Fares, 2000). In other words, managers may take advantage of their discretionary authority and of the information asymmetry to accomplish day-to-day operations, the outcomes of which would not reflect the terms of the agreement. Evidently, it would be impossible to imagine shareholders and *patrons* having to negotiate every single management operation.

Such rationale would lead to suppose that shareholders and *patrons* would not have any contractual action against managers at hand, because the operations of the latter would not be covered by any agreement.

The very strict application of the classical contractual theory would have as greater consequence the very weak protection of shareholders and *patrons*. Concerning *for-profit* corporations, Anglo-Saxon jurisdictions have solved such problem by using a very common device of their legal culture: *fictio juris*. With the *fictio juris*, interpreters have been allowed to conceive the relationship between shareholders and directors as a contractual one. Yet, the same strategy has not been applied with regards to *non-profit* corporations. In fact, legal doctrine has

deemed that the acknowledgement of the right to sue *patrons* would involve an infinite number of suits, freezing the activity of the courts. As a contract is a promise or a set of promises for the breach of which the law gives a remedy (Bukspan, 2002), then the donations and customer contributions to *non-profit* entities do not set contractual relationships.

The right to sue, therefore, remains in the hands of the Attorney General, confirming the public and institutional dimension of the *non-profit* corporation.

1.2.2) *The Economic Point of View*

Neo-classical economists see the corporation as a *nexus of contracts*, conceived not as a real entity but as an aggregate of various inputs acting together to produce goods or services. The legal notion of contract would find its application on the basis that employees provide labour in exchange of wages, creditors provide debt capital in exchange of interests, shareholders provide equity capital in exchange of dividends, *patrons* provide finance in exchange of specific services which vary according to the type of *non-profit* corporation, and so on. All such contracts, in fact, are considered to be complete on the basis of rational choice theory assumptions according to which *homo economicus* acts rationally to maximize his interests. The capability to choose the most efficient solution among the ones that may arise in a certain economic situation renders the contracts cost-worthy by definition. The corporation is therefore simply legal fiction representing the complex set of contractual relationships between those inputs.

The consequences of the economic conception of the firm will be incumbent over business company law, demanding for provisions to be freely adopted by incorporators. It is argued for statutory rules to be as much as possible default rules which will be functioning to reduce transaction costs. In other words, instead of spending time and money in the efforts of framing, writing and discussing all the clauses of the by-law, members should be able to choose either the ones pre-elaborated by the legislator or the ones they deem more efficient themselves.

Nonetheless, for what concerns *non-profit* corporations, neo-classical arguments according to which economic actors would be able to set an efficient contract would lack essential premises. Differently from shareholders, in fact, *patrons* not being part of the corporation not only could not negotiate proper clauses of the by-laws, but they would also incur in the market failure described by Hansmann (1980). This would mean that the sole source of *patron* protection would be the law, since market forces such as the market for corporate control do not operate within the *non-profit* sector.

Paradoxically, courts and legislatures have chosen on one hand to not equalize *for-profit* and *non-profit* corporations in relation to their contractual dimension, while, on the other, have chosen to equalize them for what concerns fiduciary duties of the directors.

The conception of the latter dates back to 1720 when the Bubble Act strongly restrained the free constitution of corporations, *for-profit* as well as *non-profit*. This led investors and *patrons* to set up their organizations as *trusts*, involving the application of law of trust and charitable law of trust respectively. Fiduciary duties of trustees of both the laws were actually rather tight, attaching liability for ordinary negligence to them. The conception according to which the director was a *trustee* continued even when *for-profit* and *non-profit* entities started to be constituted as corporations again, that is after the cancellation of the Bubble Act in 1825.

Nonetheless, in the US, differently from England, their standards were lowered until they reflected the concept of business judgment rule which precluded courts to second-guessing director decisions as long as they were rational, not self-interested, and made in good faith on an informed basis (Lee, 2003).

We hold that equalizing the duties of *non-profit* and *for-profit* directors would be like going against the nature of *non-profit* organizations themselves, as it would render it very hard to uncover possible violations of the *non-distribution* constraint. This explains why neo-classical economists, in the light of recent public scandals, urge a drastic reform of *non-profit* corporate law aimed, at least, at restoring the standards of nineteenth century trustees' fiduciary role.

1.3) New-Institutionalism Theory

Courts and legislatures have strictly applied the classical contract theory to the relationship existing between *patrons* and directors, therefore not welcoming the arguments of neo-classical economists. Yet, a different stream of thought has been attempting to demonstrate the contractual dimension of the corporation. According to new-institutionalism, indeed, *patrons* and directors are tied to a particular contract which, although incomplete – and therefore not a contract in the classical theory sense –, is expected to be efficiently completed by managers where they respect the social rules promoted in determinate (*non-profit*) contexts.

With such understanding, new-institutionalism theory demands for a “mechanism that will complete the contractual incompleteness by monitoring the contractors” (Brousseau & Fares, 2000), that is an efficient and competent board of directors.

III. CAUSES OF AGENCY PROBLEMS

SECTION 1: OPPORTUNISTIC BEHAVIOUR

1.1) The Concept of Opportunism

In sub-section D of the introduction we have mentioned a quote by Williamson (1985) referring to opportunistic behaviors: the possibility that the person with whom you are transacting will cheat you. The scholar, moreover, also provides a more technical description aimed at defining the concept:

“by opportunism I mean self-interest seeking with guile...[O]pportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real contrived conditions of information asymmetry which vastly complicate problems at economic organization”. (Williamson, 1985: pp. 47-48).

For conventional purposes, within this general definition we will distinguish two categories of opportunistic behavior which refer to: expropriation of money; and self-dealing transactions.

1.1.1) Expropriation of Money

We associate such category with great wrongdoings, which other than involving corporate law rules – either *for-profit* or *non-profit* ones – are relevant to crime law, including theft and all the actions that may be recognized as such crimes.

In order to provide a very complete description of the phenomenon we will entirely reproduce a study realized by the American Association of Home and Services for the Aging (Herman, 2004):

“Most thieves' motivations fit into one of four categories:

- 1) *Greed* - some people steal simply because they need money to purchase basics or luxury items they want and can't afford.
- 2) *Personal financial loss or pressure* - others steal after suffering a personal financial loss or while under an unusual financial strain.
- 3) *Denial* - some employees steal without believing they are doing so. An example is the employee who regularly takes office supplies from the supply room for use at home. The employee may believe that she's entitled to the supplies, that the items won't be missed, or that they are of minimal value.
- 4) *Revenge or thrill seeking* - some thieves steal from their employers as a way of getting revenge for actions the employer has taken that the employee believes to be unjust, discriminatory or corrupt. And others steal to see if they can get away with it. Once they do, the desire to steal more frequently or larger quantities may become an uncontrollable impulse.

How - Some of the most common ways in which funds are misappropriated include the use of fictitious vendors, check forgery or theft, credit card fraud, theft of incoming receipts, and identity theft.

Fictitious vendors or consultants - A common embezzlement scheme is the use of fictitious vendors or consultants. This plot can be perpetrated by any employee with authority to approve the payment of invoices. In most the non-profit organizations the CEO is always in position to perpetrate this type of scheme, while in larger organizations a mid-level employee may be able to do it. The thief creates fraudulent vendors and deposits checks written to pay the false invoices in his personal bank account. In a recent case involving a large DC-based trade association, the CEO is alleged to have embezzled \$2.5 million from the association over a 13-year period through recurring payments to phony consultants. In this case, the consultants were real people (including one public figure), but no services were provided and the payments were received by the CEO. While any theft of resources is disturbing, this case extracted a particularly heavy price as the association had undergone a painful downsizing process-before the theft was discovered-due to its weak financial condition.

Check theft - In a recent case involving a chapter of a prominent national youth-serving group, an employee obtained one of the non-profit's blank checks, created counterfeited copies, forged the signature of an authorized signatory, and attempted to pass the checks. An observant bank employee recognized the phony checks and stopped the embezzlement scheme. Although no dollars were stolen, the non-profit has spent thousands of dollars on legal expenses and countless hours to investigate the theft and take steps to prevent its recurrence. According to one source, 500 million checks are forged annually in the United States generating losses in excess of \$10 billion. The odds are against you.

Credit Card Fraud - In another recent case, a non-profit's accountant was caught applying customer refunds to her own credit card account. Credit card fraud can also occur with respect to use of the non-profit's corporate credit card. A dishonest employee may believe that the non-profit won't notice the use of the card for a personal, unauthorized purchase. In some cases the employee may view the use as a loan, and intend to pay the non-profit back in the future.

Theft of Cash Receipts - Perhaps the simplest form of fraud committed by insiders is the pocketing of incoming cash receipts. Countless non-profit organizations have been victims of theft by staff who pocket cash receipts at the bake sale checkout or special event ticket booth.

Identity Theft - Although the principal victim of identity theft is an individual, non-profit organizations can also suffer when the workplace provides the setting for these schemes. The organization could be held liable for failing to adequately protect the personal information of its employees. Despite the widespread belief that identity thieves are principally computer hackers working out of dark basement offices in far-off locations, each year thousands of Americans are victimized by co-workers. According to the director of security at an international pharmaceutical company, a common scheme is for a support staff member to respond to a credit card offer addressed to his or her boss, simply changing the address to which the card is mailed. Other workplace-based identity theft schemes involve theft of human resource department reports that contain employee names, social security numbers, annual salaries, addresses and more-documents that were left lying around, such as on the desk of a management employee.

All of the schemes described above can be perpetrated on a larger scale, and by volunteers in addition to paid staff members. A larger-scale embezzlement might involve a wire transfer of funds from the non-profit's to the thief's bank account. Some thieves believe it's safer to drain their employer's bank account in small but regular amounts. Others make bolder attempts, stealing large sums in one or more transactions.” (Herman, 2004: *web page*)

1.1.2) Self-Dealing Transactions

As for our second category of opportunistic behaviors, we can refer to the definition provided by Professor Hansmann (1981) according to which a self-dealing behavior is a transaction between the corporation and one of its directors or officers, or between a corporation and another organization in which one of its directors or officers has an interest.

For-profit literature is replete of examples concerning such kind of transaction. Among these, we underline those that present aspects which may also be relevant to non-profit corporations: (a) misuse of corporate property for personal gain; (b) kickbacks; (c) individual tax violations related to self-dealing.

As for the first instance (point a), we refer specifically to receiving executive loans with no intention to ever pay back, and extraordinary personal expenses charged to the company. Instances of point (b), instead, are represented by the cases of awarding business contracts in return for personal compensation. Finally, point (c) may involve failure to report forgiven loans or reimbursed personal expenses as taxable income^{xxxiv}.

With a large margin of approximation, we might say that examples considered by point (a) and point (c) concern transactions between the corporation and one of its directors or officers, while those considered by point (b) concern transactions between a corporation and another organization in which one of its directors or officers has an interest. Evidently, the borders of such transactions are rather blurry.

Through the description, one can notice how amongst the categories of examples, we have left aside that of insider trading, presenting the latter aspects which are typical only to business corporations, notably the involvement of shares in the transactions.

1.1.2) Self-Dealing Transactions

The second category of opportunistic behaviors, self-dealing, is a transaction between the corporation and one of its directors or officers, or between a corporation and another organization in which one of its directors or officers has an interest. Professor Hansmann (1981).

For-profit literature is replete of examples concerning such transactions. Some of these transactions that present aspects which may also be relevant to non-profit corporations include: (a) misuse of corporate property for personal gain; (b) kickbacks; (c) individual tax violations related to self-dealing.

The first type of transaction, (a), refers specifically to receiving executive loans with no intention to pay back, and also to extraordinary personal expenses charged to the company. Instances of transaction (b) are represented by the award of business contracts in return for personal compensation. Finally, transaction (c) involves the failure to report forgiven loans or reimbursed personal expenses as taxable income^{xxxv}.

With a large margin of approximation, examples considered by point (a) and point (c) concern transactions between the corporation and one of its directors or officers, while those considered by point (b) concern transactions between a corporation and another organization in which one of its directors or officers has an interest. Evidently, the borders of such transactions are rather blurry.

Through these descriptions, one may notice among the categories of examples, that we have left aside the example of insider trading, presenting the latter aspects which are typical only to business corporations, notably the involvement of shares in the transactions.

1.2) The Influence Over Efficiency

The last proposition of a definition provided by Williamson (1985) suggests how opportunistic behaviors negatively interfere with the efficiency of a determinate organization. Accordingly, if one would need to assess to what extent they affect non-profit organizations, the relevant concept of efficiency must be established.

The presentation of the latter throughout the dissertation, in fact, has been rather general. We have assumed that a charity is efficient only if two conditions are satisfied: (1) when the services or goods provided are of reasonable quality, and (2) when that quality is obtained without breaking the social values promoted by the firm itself. This means that a mathematical computation that enables the measurement of such efficiency does not exist, as it would occur for business corporations. In this sector, shareholders simply and easily realize the efficiency of the

firm every time they receive their dividends. If these show a high amount of profit, then the firm is efficient, otherwise it is not.

In charitable organizations, assessing efficiency is far more complicated. Under the first condition, we can refer to one of the assumptions underpinning contract failure theory by Hansmann (1980) according to which patrons, not being the beneficiary, cannot judge the quality of services or goods. Even in the case of a non-profit hospital, where patrons are also beneficiaries, Hansmann sustains that it would still be difficult to evaluate the performance of a physician (Hansmann, 1980). In relation to the second condition, measuring the efficiency is even more difficult since one must take into account the intentions that have pushed the director to make a determinate decision. Such reality helps to explain why studies of non-profit organizations' effectiveness are characterized by varying theoretical perspectives and research objectives which make accumulation and integration impossible (Forbes, 1998).

For instance, some literature agrees that organizational efficiency can be measured by using three metrics: the ratio of administrative expenses to total expenses, the ratio of fundraising expenses to total expenses, and the ratio of program expenses to total expenses (Callen, Klein and Tinkelman, 2003). This current of thought acknowledges the presence of detractors, as sustained by Letts, Ryan and Grossman (Callen, Klein and Tinkelman, 2003). These scholars basically argue that if patrons rely too much on such ratios to assess the efficiency of the firm, then directors are induced to dysfunctional behaviors including underinvestment in the necessary organizational capacity to function effectively (Callen, Klein and Tinkelman, 2003).

Our opinion in this regard is that both the schools give an undue emphasis to the financial aspects of efficiency. In fact, we have already explained our conception that patrons are interested in the economic balance only to the extent it serves to reach reasonable quality through the respect of the values of the firm. In this sense we share the same ideas as D'Aunno (1991), who has criticized the tool of financial ratio to measure the efficiency of a non-profit organization. In particular, this scholar has presented an institutional theory model according to which charitable organizations are influenced by widely held beliefs and rules present in the environment. As non-profit outputs or outcomes are especially difficult to measure, such organizations face strong pressure to conform to expectations about how they should behave (Callen, Klein and Tinkelman, 2003).

In the light of our conceptions of opportunistic behaviors and non-profit efficiency we are prepared to present our hypotheses:

- a) expropriations of money are the greatest factor negatively affecting the efficiency of the non-profit firm. This kind of opportunistic behavior is inevitably in conflict with both the interests pursued by patrons because I) the quality becomes jeopardized by a lower employment of finances, and II) manager intentions do not reflect the spirit of the organization;
- (b) self-dealing transactions negatively affect the efficiency of non-profit organizations only when they tackle patrons' interests in the respect of social values promoted by the firm itself. A self-dealing transaction, moreover, may well be aligned with the second patron's interest, as it may entail a financial improvement of the organization and, consequently, of the quality of the services or goods provided.

1.3) Opportunism and Agency Problems

Hypothesis (a) in the previous sub-section demonstrates that, once proven, expropriations of money represent a “complete” conflict of interests, giving rise to an agency problem. This implies that directors will always be accountable for such actions.

Hypothesis (b), instead, suggests that self-dealing behaviors, once proven, do not always represent a conflict of interest, either “partial” or “complete”, and therefore do not necessarily arise an agency problem. However, we are of the opinion that, in non-profit corporations, the risk that a self-dealing behavior implies a conflict of interest is far more present than in the for-profit sector. Such a thesis can be easily demonstrated on the basis of few important observations.

To begin with, we must keep in mind that, on one hand, shareholders have a sole interest. This is represented by profit maximization, which is measured through the mathematical computation of the outcomes. On the other hand, in the non-profit sector, patrons pursue two interests. The first one concerns the quality of the services or goods provided. Yet, the satisfaction of such interest is not accomplished by the mere and rational evaluation of the outcomes. Instead, it involves the realization of the second interest. This is satisfied when the processes through which those outcomes have been reached do not infringe beliefs and rules supported by the firm.

It is true that, if we took into account only the interests concerned with the final outcomes – profit maximization and good quality – opportunistic behavior would likely cause agency problems every time resources were squandered [self-dealing] or captured [expropriation of money] by management (Callen, Klein and Tinkelman, 2003). In fact, either shareholders or patrons of a non-profit organization would see their interests – dividend maximization and quality – jeopardized by the actions of their agents. At present, the fact that patrons follow a further interest automatically increases the number of conflicts in NPOs and, consequently, increases the possibility of agency problems.

To clarify the point, let us refer to hypothetical real-life situations. Shareholders of business corporations in reality do not concern themselves with management decisions as long as they receive their dividends. In the neo-classical perspective, residual claims would have no interest to take account of the fact that their high dividends were obtained failing, for example, to respect minimal standards of worker or environment protection. In this case, there has been opportunism in the sense that the decisions to save money on worker and environment protection on account of the profit maximization of the shareholders have, at the same time, aimed at strengthening management entrenchment. [Such behavior, therefore, might represent a self-dealing behavior as it reflects a type of misuse of corporate property for personal compensation.]

The same sort of reasoning is applied if managers decide to conclude certain negotiations with parties in an agreement by which they keep an interest to their own. One may think, for instance, of a manager of a for-profit hospital that agrees to buy technical instruments from a corporation where he holds stock. If the price of the transaction is convenient and brings an economic reward to the hospital, shareholders would not have any logical motivation to argue, rather, they would feel quite satisfied. Certainly, they would be far more satisfied than if the manager had negotiated with a “neutral” corporation and had bought goods at a higher price.

[Such behavior, therefore, might represent a self-dealing behavior as it reflects a case of kickback].

In charitable organizations, as observed, the interest in the quality [outcome] is conditioned by the interests that *patrons* keep in the processes. A real-world case could demonstrate how a director's self-dealing behavior may result in a conflict of interests and cause agency problems. The scenario involves the Widget Museum, which was a grassroots non-profit organization that decided to engage business trained executives to boost its productivity. In the beginning, the new management actually brought prosperity and improved the quality of the services but, at a certain stage of their commitment, they began to take advantage of the Museum to advertise their own business corporations. Space limitations do not allow for examples of all of the self-dealing behavior which occurred, so we have selected the one we think to be most representative. The CEO made the decision to shift the Museums' accounts into a bank to which his firm was closely tied – although the museum's own bank offered the same services at the same costs – in order to encourage the new bank to make a large donation to the museum. On the one hand there is no doubt that such action was potentially highly rewarding, on the other, the financial benefit risked to be a short-term one, while the Museum aimed at long-term grants for historic preservation (Hall, 2002).

For these reasons we consider it is necessary to keep an internal distinction of opportunistic managerial behaviors when involved with the elaboration of legal solutions.

SECTION 2: DIRECTOR PREFERENCES AND LEVEL OF COMPETENCE

2.1) Aims of the Section

Both categories of opportunistic behavior, in one way or another, represent a real danger to the efficiency of the firm. This explains why neo-classical economists have extensively studied the circumstances in which corporate agents tend to make determinate decisions. In particular, scholars have been interested in investigating the preferences of economic actors, attempting to find out which are the factors that shape them.

With this understanding, the scope of this section is to borrow literature's assumptions and to analyze how they play out in the very atypical world of non-profit organizations. Such theoretical conceptions will be taken into account in the light of two fundamental empirical data:

The first concerns the fact that most of the opportunistic behaviors are due to greed (Gibelman and Gelman, 2000), thus our study will keep points 2, 3, and 4 of the list concerning "theft motivations" aside^{xxxvi}.

The second is that public scandals basically involve top management incumbency in NPO boards of directors (Gibelman and Gelman, 2000). This means that our study will not consider opportunistic behaviors performed by simple employees, but only those performed by executives with significant authority and discretionary power.

2.2) Psychological Analysis of the Behaviour of NPO Agents

Arguing that various psychological factors characterize the economic behavior of non-profit agents somehow implies a revision of the original and extreme rational choice assumptions

according to which all economic actors act to maximize wealth. Indeed, the idea that individuals take a large number of reasons into account when making decisions, which extend well beyond the stereotypical self-interested motive, is now largely accepted among rational-minded students (Grimalda and Sacconi, 2002). This may lead one to think that directors of a non-profit organization do not necessarily act to maximize their wealth, but instead may reach levels of satisfaction for simply having accomplished the interest pursued by the organization^{xxxvii}.

In fact, some literature claims that, for what concerns the non-profit sector, agents might lean more towards presenting altruistic motivations rather than self-interested ones (Ackerman, 1987). One of the arguments presented in such literature is that managers attracted by charities are generally more interested in pursuing an ideological aim than an economic one. Another is related to the fact that the selective process of managers itself entails the choice of similar minded people to them (Young, 1983)^{xxxviii}. For instance, we can refer to a traditional non-profit corporation needing to hire business educated managers to face the financial difficulties that we have discussed above. Most likely, the board of directors will address only managers whose reputation does not conflict with the purposes of the organization. Accordingly, managers are expected to accept the engagement only if they share the same social values and ideas.

Although these arguments present a logical and coherent rationale, it still seems difficult to match them to the empirical data demonstrating the existence of public scandals due to opportunistic management behavior (Gibelman and Gelman, 2000). Consequently, the simplest solution to this discussion would be to accept that not all the economic actors behave to maximize their wealth and, at the same time, to neglect the fact that all the agents working in a non-profit organization are necessarily driven by ideological motivations. That is like saying: sometimes managers behave opportunistically and sometimes they do not.

The weakness and simplicity of this observation risks to remain as such until one does not investigate the specific circumstances which actually drive agents towards a determinate performance, opportunistic or ideological. Only through a deeper study we will be able to answer the question: what has shaped the preferences of directors involved in public scandals?

To begin with, we can take on the study developed by Sacconi and Grimalda (2002). These scholars start from the assumption that human behavior is affected by a stable preference represented by the self-interested motivation. Yet, they sustain that this stable preference is accompanied by a conditional one which depends on conforming to other people's decisions^{xxxix}. In particular, they conclude that the disposition to comply with moral principals is more likely when the other participants to social interactions are also doing so (Sacconi and Grimalda, 2002).

Therefore, we would guess that public scandals due to opportunistic behaviors would reveal that the first and stable preference of some members has not been influenced by other colleagues' performances. This may emphasize two aspects: the first one concerns the fact that the self-dealer has a personality so strong that the behaviors of the "others" do not truly interfere with his decisions; the second one regards the fact that the "others", instead, play a role so passive that the self-dealer feels free to pursue his own personal interests.

Along with our research purposes, the next step is to apply such findings to the governance systems of modern non-profit corporations, with particular focus on the board of directors. The latter, pursuant of the organizational need to hire professional managers, has experienced significant changes in its composition and functioning.

As for composition, we have earlier observed the conditions set by business trained managers according to which they would likely accept the office only in exchange of being appointed members of the board. That management penetration into the body would imply an increasing ratio of executive [inside] directors, among whom the CEO would stand out^{x1}.

Notably, the changes related to the functioning are tightly connected to the ones related to the composition. Indeed, the board's role is no longer limited to a monitoring function or, rather, there is no longer a separation between management and governance. Through the executive committees, the board of directors looks after the day-to-day operations.

On the basis of such description we can therefore develop both the arguments indicated above. First of all, they take into account a very important observation offered by for-profit literature which acknowledges that the strong personality of the CEO positively affects the financial performance of the firm (Unquoted author, 2005). Given this assumption, we would argue that if the business-like CEOs pay attention to market forces without losing sight of their organization's underlying missions, and seek to use the language and skills of the business world to advance material well-being of their members or clients (Gregory & Economy, 2001), then there would not be any reason to expect opportunistic actions from the other members of the board. The CEO's philanthropic behavior may be explained by the will to conform to other CEOs involved in other NPOs, at the same time improving and defending his reputation, thus satisfying his primary stable interest.

Our hypothesis would be further confirmed by the school of thought in literature which focuses the attention on the "leadership" question (Wallis & Dollery, 2005). Such school, in fact, highlights the role of the leader of the board and his/her charismatic aspects that frequently influence other peers. The study brings forward several factors, as for instance those related to emotions and to the ways the leader uses to express himself during his speeches.

On the other hand, when the professional CEO is meant to run the non-profit firm exclusively relying upon his business education, then the fear of self-dealing behaviors becomes more actual. This is basically due to three reasons. The first, most obvious one, regards the actions of the other members of the board who might follow their leader's example. The second, which is particularly true for non-profit organizations, involves the passive role of non-executives, who, expected to monitor top management activities, lack either the incentives or professional skills to do it. The third, which is directly correlated to the second, takes into account the incompetence of executives themselves, who, educated to run business corporations, are not able to vary from their self-dealing behaviors. The latter, indeed, may be efficient for a for-profit organization but not efficient for a charity.

The question related to the incompetence of both executives and non-executives, however, will deserve a deeper discussion through the next chapter. For now, referring to the public scandals data we are ready to point out our answers to the previously posed questions.

First of all, the fact they were public scandals already suggests that a large amount of money was involved and, therefore, that CEOs with strong personalities were in charge of the operation of such firms. This, in fact, is explained by the previously quoted theory according to which the strong personality of a CEO positively affects the economic performance of the firm. We would therefore justify the prevalence of the stable preference; setting foundation on the fact that: directors did not receive the proper influence to develop their conditional preference from the CEO; and directors, being aware of the scanty monitoring action on their operations, felt more free to pursue their first preference.

Of course, in the case – which is in actuality the most common – within which the self-dealer is represented by the CEO himself, we would sustain that his stable preference has dominated because of the passive role of the other members of the board.

SECTION 3: CURRENT SOLUTIONS

3.1) Aim of the Section

Before introducing our solutions related to the agency problem due to opportunistic behaviors, we deem it necessary to provide a general overview of the already existing solutions. For such purpose, we will keep following our conventional distinction between the category of expropriation of money and that of self-dealing transactions.

3.2) Expropriation of Money

From our point of view, the category of expropriation of money embraces cases involving criminal offences such as thefts, embezzlement, and fraud. Theoretically such crimes should be prosecuted regardless of a corporate context, implying that the competence to pursue and to punish wrongdoers relies on the state or federal government.

As data reveals that the majority of mismanagement cases represent crimes (Fremont-Smith, 2004) [although we have some doubts over the data collection's validity, see next § 3.3], one would expect the courts to represent a formidable tool to tackle corporate governance failures. Yet, the results so far disclosed would confirm the contrary. Literature on the subject of criminal law explains that such phenomenon is due to three reasons.

First of all, criminal law may deter future actions or punish past crimes, although it does nothing to limit or uncover ongoing offences. Secondly, the government is solely responsible for enforcing criminal laws, and state and federal governments realistically do not have the time or resources to pursue every instance of criminal activity. Finally, as they are subject to the principle of prosecutorial discretion, prosecutors are free to choose which offences will be pursued, and are typically expected to choose less challenging and less expensive categories of crime (Gilkeson, 2007).

3.3) Self-Dealing Transactions

As seen earlier, self-dealing transactions are not necessarily illegal or in conflict of interests unless they constitute a breach of duties. In realistic terms, sometimes it is not very easy to identify the border between self-dealing and the expropriation of money. In fact, if we look more accurately at the above mentioned study concerning non-profit wrongdoing, we will note that of the 152 incidents reported, 48 entailed breach of the duties of loyalty and prudence [which we refer to as self-dealing]...while 6 fell into both categories (Fremont-Smith, 2004). Such statistics, therefore, demonstrate that self-dealing transactions may imply expropriation of money and vice versa.

The fact that 98 cases involved criminal offences would mean that the majority of opportunistic behaviors, arising in the form of an agency problem, belong to the category defined as expropriation of money. Yet, we have some concerns about such a finding. In our opinion, the

quoted study fails to consider that breaches of duties due to self-dealing transactions are still harder to report. In other words, judge-made laws regarding activities of non-profit directors are almost non-existent, rendering the sample of 152 cases not completely valuable and fuelling suspicions of undetected self-dealings. According to certain literature, this occurs because of the lack of practical enforcement devices and the deterrent effect of costly litigation on those who have no direct economic interest (Leshner, 1967).

In fact, the sole authorities allowed to exert an external control over director duties are the Internal Revenue Service [IRS] and Attorney Generals. The first is competent on the basis of § 501 of the Internal Revenue Code, which prescribes what Hansmann (1980) has defined nondistribution constraint, meaning the organization is prohibited from distributing any profits to directors, officers or members. Should it occur that such disallowance is broken, the IRS may impose intermediate sanctions against those individuals receiving unfair benefits/compensations, or more drastic ones reaching even the cancellation of the entity's tax-exempt status. The IRC, moreover, requires that officers of non-profit organizations whose income is more than \$25,000 to sign Form 990, certifying that according to their best knowledge and belief the document is true, correct and complete.

Despite these measures, however, the IRS is limited in its ability to prevent non-profit fraud and mismanagement for various reasons (Gilkeson, 2007). First of all, because the primary function of the agency is to collect revenue for the federal government, it must employ all its resources for that purpose, not for pursuing self-dealing directors. Secondly, because Form 990 signed by an officer does not receive any external audit, the accuracy of information relies solely on the honesty and competence of the signer. Finally, the IRS is restrained in sharing information it collects for tax purposes with other branches of the government. Thus, if the IRS finds out a fraud, but the fraud is not appropriately or efficiently pursuable by the taxing authority, the IRS would likely be unable to refer the matter to state attorney generals or the Department of Justice (Gilkeson, 2007).

As regards to the fraud, we would like to re-state that we have earlier categorized it among cases labeled as expropriation of money. Actually, the definition of such illegal action is rather debated in literature (Unknown author), so that it would be possible to trace certain opinions which would view such fraud closer to a self-dealing transaction than a mere crime. In the former case, if it were to represent a breach of duties, it would fall within the competence of the Attorney General. Similar to the IRS, the intervention of such an authority is also rather limited by problems concerning resources and incentives.

As observed above, the common law has in fact not provided a valuable and consolidated number of decisions. However, in *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries* [381 F. Supp. 1003 (D.D.C. 1974)], the Court noted the history of director liability in the non-profit sector. This established a business corporation-like rule according to which self-dealing transactions are neither void nor voidable if either: (I) the conflict of interest is disclosed to the other members of the board of directors and the transaction is approved by a majority of the disinterested directors; (II) the conflict of interest is disclosed to the members [in the case of a mutual non-profit organization; in the way it is disclosed to shareholders in business corporations] and the transaction is approved by a majority of the disinterested members [shareholders]; or (III) the transaction is "fair" to the corporation.

That decision has been corroborated by its reproduction in most of the state non-profit statutes (Hansmann, 1981).

SECTION 4: PROPOSED SOLUTIONS

4.1) Aims of the Section

With the aim of proposing solutions to the agency problem in *non-profit* corporations, we set out our rationale from the very fundamental observation that *patrons* represent the very weak part of the contract which ties them to the management. For the reasons we have analyzed throughout the dissertation, the asymmetry of information seems to be even more dangerous than the one which characterizes the relationships in *for-profit* corporations, namely shareholder-management relationships.

The Enron and WorldCom incidents have disproved neo-classical argumentations according to which contractual parties are perfectly able to set complete and efficient agreements. As a consequence, they have set forth the need for public intervention to reduce the risk of unfair distribution of resources. The result has been the establishment of the SOX Act, passed in July 2002, containing significant provisions related to corporate governance systems.

Setting ground from such experience, we suggest a law reform aimed to strengthen the protection of *patron* interests. We first take on the neo-classical proposal which aims to a formal acknowledgment of the contractual dimension of the relationship, whatever the legal fiction to be adopted. That would, in fact, ensure to *patrons* the right to sue directors in case of breach of duties. Nevertheless, it is going to be explained how that right need not be intended in an absolute sense.

Secondly, we start from the too extreme neo-classical conception of complete and efficient contract, giving credit to new-institutionalism theory and, in particular, to its concept of incomplete contract. The latter is efficiently completed by managers only if the initiation and implementation (Fama and Jensen, 1983) of their decisions comply with the processes which characterize *non-profit* institutions, including “cognitive and moral structures, rules or norms which are regarded as socially or legally binding but which are not self-enforcing” (Black, 1997: p. 54). We propose, therefore, a reform of the corporate governance system that is able to guarantee an effective monitoring function over specific *non-profit* expectations.

Finally, we will attempt to provide a more proper definition of a director’s fiduciary duties, recalling the neo-classical argument intended to restore the ordinary negligence regime.

4.2) The Right to Sue

Neo-classical economists identify a contractual dimension in the relationship which ties *patrons* to directors. On one hand, we share such conception, but only to the extent a possible acknowledgement – regardless of the legal fiction – by the legislatures or courts may ensure *patrons* the right to sue directors. As we will see below, we do not deem such a contract complete and efficient. On the other hand, we understand the legal doctrine argument which, by acknowledging *patron*’s rights to sue directors, would involve a dangerous proliferation of suits.

Our proposal lies somewhere in between. In particular, we set out from the provisions contained in a Wisconsin statute of 1945 which acknowledged the right to sue to any ten or more *patrons* if the Attorney General, upon demand, refused to act in accordance with the special interest doctrine (Hansmann, 1981). The latter envisages the grant of standing up only for individuals who have a special interest in charities, which are to be intended in their strict

definition, as for example in the case of a charitable trust created for the benefit of the minister of a church. “In this context the current minister is considered to have a special interest sufficient to justify standing to sue for enforcement of the trust” (Hansmann; 1981 p. 607).

We deem that the legal definition of a minimum number of *patrons* granted of the right to pursue legal action may represent an ideal solution to the extent it succeeds to move away from the spectrum of “harassing” litigations. Yet, assuming for example that the minimum is 10, we would consider the fact that 9 *patrons* with heavy suspicions of mismanagement could not sue “their” unfair directors. A discrimination hinging on mathematical computations would seriously harm the principle of all citizens being equal.

For this reason, we would extend the special interest doctrine to *non-profit* corporations [so not only charitable trusts in a strict sense] establishing that, in cases where the number of *patrons* is less than the minimum required, they still are acknowledged the right to sue if they succeed to prove they have a special interest. As the concept of special interest has not yet been well defined, the judges will take advantage of the [expected] increased number of suits and of their rule-making powers to create principles universally applicable throughout the whole US territory. In the meantime, the Attorney General ‘s offices will maintain their external monitoring function along with the right to sue opportunistic directors, supporting the interests of *patrons* whose conditions do not allow to afford litigation expenses. As a big part of the suits is expected to be initiated directly by *patrons*, public offices will have the chance to employ their resources more efficiently.

The acknowledgement of the right to sue the general class of beneficiaries would, instead, be far more complicated. While for patrons or shareholders it is still possible to imagine a legal fiction which sees the by-laws as the terms of a contract between them and management, identifying a contractual dimension also involving beneficiaries would mean to start off a revolution within common law doctrines. After all, we are rather convinced that once *patrons* are granted the right to sue, the room for management misconduct would become fairly restrained.

4.3) Internal Controls

Even if acknowledged the right to sue, *patrons* rarely have sufficient information concerning managerial activities of the organization. In fact, we have already seen how, differently from shareholders, they are not in a good position to evaluate the firm’s efficiency. Theoretically, it would also be rather costly for Attorneys General and IRS agencies to carry out deep investigations. We believe, therefore, that the very first tool to face agency problems in *non-profit* corporations is represented by an effective mechanism of internal controls.

The majority of the United State’s *non-profit* corporate laws are still based on neo-classical arguments according to which the terms of the contract are complete and efficient as long as freely chosen by the parties. Just as it happens for business corporations the legislature, therefore, arranges a model of articles of association containing either opt-in or opt-out clauses. A wonderful and extreme example of such approach is represented by the State of Delaware which applies the general corporate law established for business corporations to *non-profit* corporations. This means that before Delaware general corporate law there is no distinction between *for-profit* and *non-profit* corporations. The distinction between corporations only requires a statement indicating the status of *non-profit*, however the Internal Revenue Services has additional requirements.

In the light of public scandals such as United Way and Association for Cancer Research, the need for a normative intervention over *non-profit* corporate governance has been felt as urgent as the one following Enron and WorldCom cases. Indeed, the initial reaction has been to extend SOX provisions to *non-profit* corporations. The state of ‘politics’ regarding discussions over this topic is actually very intense, considering moreover that the effectiveness of the Act has been argued even for what concerns *for-profit* corporations themselves.

Interfering in the heart of such matter is beyond the scope of this article, yet some observations deserve to be made. In particular, we would like to remind that we support the new-institutionalism theory according to which by-laws of corporations, above all *non-profit* ones, are incomplete. This implies that we support state intervention in the regulation of those contractual relationships, setting out from the principle that legislative acts stand for the interests of all citizens, being equal *patrons* and managers. The truth is, we find that the Act is potentially an ideal device to improve corporate governance in *non-profit* organizations, but we would still propose to better shape its provisions when applied to the *non-profit* context.

First of all, let us take into account the rule establishing that the audit committee of the board must be composed only of independent directors, one of them being a financial expert. While we strongly agree with the status of independence, we would advance some concerns on the “kind” of expertise a *non-profit* board actually needs. As we have thoroughly discussed, one cannot measure the efficiency of a *non-profit* organization only by assessing its economic performance. Rather than financial expertise, therefore, we would propose the mandatory presence of a director qualified with a specific education based on *non-profit* issues. In the meantime, we urge a reform of academic courses, aimed to pay far more attention on this topic which seems to have been overlooked. In this way the problems related to the level of board’s competence which concerns non-executive or independent directors as much as top management would be solved.

According to Roberts, McNulty and Stiles (2005), the role of non-executives is not merely the monitoring function but also to support the insiders through being “engaged but non executive”, “challenging but supportive” and “independent but involved”. The envisaging of a specific *non-profit* education, therefore, would promote the shift from the independent-insider contrasting dichotomy to a more effective cooperation between these functions (Wei Shen, 2005).

As regards to the SOX provision requiring an independent external auditor (to be rotated every five years), we share with other commentaries the opinion that smaller *non-profit* organizations would be barely able to afford the expenses charged by auditing companies. Instead, we would propose to institute a public external agency. With the intervention of the IRS, it would be opportune to establish a special and soft taxation system which, taking into account the size of the organizations involved, would serve to provide the resources for the agency itself. It might be fair, for instance, to establish a tax exemption for the very small *non-profit* organizations with incomes of less than a pre-defined amount of dollars. Therefore, an agency would identify any malfeasance, and immediately pass the information to whoever has the interest and the right to sue.

It can be added that an audit of the auditors (directors), regardless of its public or private nature, is to be considered a very important tool directed to increase the accountability of the board which, feeling under pressure, is likely expected to function more efficiently.

Finally, the federal dimension of the SOX should be underscored, meaning that the interventions concerning *non-profit* corporate governance will apply over the whole US territory.

This would avoid a very dangerous “race to the bottom” considering the co-existence of states like Delaware which, equalizing *for-profit* to *non-profit* corporations, require very low standards; or California where, instead, the *Non-profit Integrity Act* passed in 2004 contains tight provisions strongly inspired by the SOX ones.

4.4) Fiduciary Duties

The extension of the right to sue and corporate governance improvement, either in quality (specific education on *non-profit*), or in quantity (external auditing), would be rather pointless if we did not offer an accurate definition of director duties. What do courts have to enforce when called to judge? Which top management [executive director] decisions are independent directors allowed to ratify? How will the external agency assess independent director ratifications?

To begin with, it must be observed that such questions address only one of the categories of opportunistic behaviours, that is self-dealing transactions. It is quite obvious that expropriation of money represents a crime rather than a breach of fiduciary duties, and it must be prosecuted as such. For example, if someone [that can be either a manager or a director] is found stealing, the criminal action will be brought before the court because it breaches criminal law and not only because it breaches corporate [*non-profit* or *for-profit*] fiduciary duties. With this understanding, although we agree with neo-classical economists on the cancellation of the business judgement rule, we propose a conception of fiduciary duties more relevant to our definition of *non-profit* efficiency.

Neo-classical thinkers, in fact, assume that the relationship between *patrons* and managers corresponds to a trust contract (Lee, 2003) and, as such, it must be regulated by the law of trust or law of charitable trust. The latter envisages that the duty of care of trustees has to be measured according to standards which take into account:

- a) the level of care exercised by the trustee in managing his own property;
- b) caution and conservation of capital (Lee, 2003).

Instead, since they do not acknowledge the contractual dimension, legal doctrines (legislatures and courts) deem director duty of care as simply based on the conception of the reasonable man, gross negligence being necessary to constitute a breach of duties. This is the standard also applied to *for-profit* corporations.

As regards to the business judgement rule, we argue that it would not be sufficient to guarantee *patrons*' expectations, as it would increase the risk of self-dealing transactions. Indeed, people involved in such operations might claim that they believed to act in the interest of the organization. This explains why we expect *non-profit* boards to be formed by competent directors, specifically educated in *non-profit* management. This solution would allow self-dealers to not take advantage of their low standard of knowledge to justify that their actions complied with their duties of care.

Yet, as long as the board composition lacks an adequate number of experts, we strongly suggest to repeal the business judgment rule and to elaborate far more strict standards. For what concerns the proposal of neo-classical economists, we maintain that trustee standards are too focused on financial aspects of the organization. According to our conception of *non-profit* efficiency, self-dealing actions do not only involve factors concerning property, caution (to be intended as risk taking), and conservation of capital. We have already seen how we give fundamental importance to the institutional environment to be considered as a set of norms,

values, beliefs and expectations that conform to social mores, even when these social pressures may get in the way of effective organizational performance. (D'Aunno, Sutton & Price, 1991)

Therefore, assuming that “organizations of the same type become increasingly isomorphic, or similar, to those in their environment” (Miller-Millesen, 2003 p. 536), it is possible to identify specific *non-profit* decision-making processes. We sustain that the duty of loyalty to the latter represents an essential standard whose breach may be enforced by *patrons* of a *non-profit* contractual action. This means that we do not see the *patron*-director relationship as a typical trust contract, but as an incomplete contract whose written terms are integrated by particular institutional [*non-profit*] clauses which are fundamental to define fiduciary duties of directors.

CONCLUSIONS

This article has been an attempt to investigate the causes associated with many public scandals involving *non-profit* corporations. On the basis of the experience concerning the *for-profit* sector (Enron and WorldCom), the analysis has immediately taken into consideration a crisis of the corporate governance system, compelling us to retrace all the stages which have marked the relationships among *non-profit* constituencies.

In particular, we have found that until roughly 1960 the “boards were the organizations” in the sense that they constituted, funded and managed their *non-profit* entities. Being the agents of themselves, donors did not incur problems related to agency relationship. Yet, by 1960, the need to provide resources in order to ensure survival of the organizations drove constitutors/donors to engage professional managers. This has represented a very revolutionary shift within the *non-profit* sector, which has become more and more business-like, involving both its advantages and its disadvantages. As for the advantages, *non-profit* corporations began to benefit from a greatly increased number of financial resources while, in terms of disadvantages, they began to experience problems related to managerial opportunistic behaviors. It has been proved that such danger has depended on the very peculiar composition of *non-profit* boards of directors, characterized by the presence of a strong conflict of culture. On one hand, business trained executives, headed by their CEO, have tended to run NPOs according to their education shaped on cash-flows parameters. On the other, non-executives have rarely exerted a proper monitoring function because of lack of incentives and, above all, lack of minimum expertise.

Setting foundation on new-institutionalism theories, this study has tried to elaborate solutions aimed at reducing the risks of managerial opportunism. Starting from the conception that *patrons* are tied to directors by means of an incomplete contract, legal doctrines might use a *fictio juris* to acknowledge the *patrons* right to sue. This first solution would exert major pressure on directors' discretion, increasing their fear to be prosecuted.

Moreover, the incomplete contract notion would suggest an integration stemming from legislative intervention. Accordingly, an extension of SOX corporate governance provisions, directed to improve the level of competence of boards would be necessary, considering, however, the singular aspects which characterize the *non-profit* sector. In particular, the mandatory presence of experts educated in *non-profit* disciplines would ensure a minor exploitation of the information asymmetry.

Finally, a diverse definition of fiduciary duties is urged. These have to be measured according to the social values and beliefs embedded in the *non-profit* institutional context.

ENDNOTES

¹ Along with [the] current literature, we also choose to use the expressions “charitable organizations” or “charities” indistinctively, to refer to *non-profit* entities in general.

² We would like to clarify that when we use the term “director” alone, is to be intended in a general sense, involving both non-executive and executive. For a more detailed description on difference between the two qualifications, see Peter, Forrester. “The Non-Executive Director”, available on line at www.jtes.co.uk/docs/The%20Non-Exec%20Director%20May2003.doc

³ According to this author an assumption is: “something accepted without proof, and it is incorrect to speak of an assumption as either true or false, since there is no way of proving it to be either (If there were, it would no longer be an assumption). It is better to consider assumptions as either useful or useless, depending on whether deductions made from them corresponded to reality. ... On the other hand, it seems obvious that assumptions are the weak points in any argument, as they have to be accepted on faith in a [philosophy](#) of science that prides itself on its rationalism. Since we must start somewhere, we must have assumptions, but at least let us have as few assumptions as possible.” See also Wikipedia, at: <http://en.wikipedia.org/wiki/Theory> accessed on 28 June 2008.

⁴ The expression “types of contract” is most commonly associated to civil law legal systems and it is used to indicate the different disciplines provided by the statutes. Common law literature prefers to refer to *particular contracts*.

⁵ *LITERATURE CONSIDERS SUCH COSTS TO BE GENERALLY RELATED TO SEARCH, BARGAINING AND ENFORCEMENT OF CONTRACTS.*

⁶ *Simple or parole contract* is considered “a bargain or voluntary agreement made, either orally or in writing not under seal, upon a good consideration, between two or more persons capable of contracting, to do a lawful act or to omit to do something, the performance whereof is not enjoined by law.” Definition provided by “The Lectric Law Library's Legal Lexicon”, available on line at: <http://www.lectlaw.com/def/c123.htm> accessed on June the 24th.

⁷ This scholar belongs to that stream of thought which insists on the fact that the costs of a transaction hinge on the incomplete information.

⁸ According to this theory transaction cost is zero.

⁹ It is very important to warn the reader of the fact that literature does not use an unambiguous terminology. Part of it, indeed, distinguishes between market transaction costs and internal transaction costs (Canbäck, 1988). Other scholars, instead, deal with transaction costs and management costs (Demsetz, 1988). As it can be noticed, in the present dissertation we have chosen to refer to Demsetz terminology.

¹⁰ In fact, according to Demsetz, the transaction costs theorem did not properly consider the information issue.

¹¹ Actually the agency problem does not involve only the relationship between managers and owners but it may also interest the:

- a) relationship major between and minor shareholders;
- b) relationship between creditors and shareholders.

¹² “*Economic theory fragments ownership into three characteristics: the right to profits, the right to control and to utilize assets, and the right alienate*” (Brody, 1996: p.466). The author advises to see Putterman (1993) and Alachian and Demsetz (1972).

¹³ “*Under law, the non-profit firm is not the agent of a particular donor or client or beneficiary. As a result, most state non-profit laws, perhaps without intending to, create agents without principals*”. See (Brody, 1996: p.465).

¹⁴ The scholar distinguishes *non-profit* accountability from the State and Market sectors. In particular directors of the former are accountable for their actions while the ones of the latter for their results.

¹⁵ The scholar actually says that opportunistic behavior is *the possibility that the person you are with whom you are transacting will cheat you* (pp.47-48)

¹⁶ Literature identifies agency costs in: monitoring costs by the principal, the bonding costs by the agent, and the residual loss. Bonding costs are the costs paid by the agent to induce the principal to hire the agent. The residual loss is the dollar equivalent of the reduction in the principal’s welfare resulting from the divergence between the agent’s decisions and those decisions which would maximize the welfare of the principal. (Jensen and Meckling in Brody Evelyn, 1996: p. 473).

¹⁷ Directors do not receive any salary from the corporation. They have been qualified as *non-management*, that means they are not officers of the company and as such they do not spend full time looking after the company.

The motivations which would induce them to accept the role are wonderfully indicated by Mace (1971):

- a) the opportunity to learn through exposure to other companies' operations something of value that might be useful in their own situations – they usually serve as managers in other companies;
- b) the intangible value of identification with well-known and prestigious companies, executives, and other directors .

¹⁸ That is not to be meant in an absolute sense. Indeed, Market for Corporate Control may take place in the case of mutual *non-profit organizations*. In such cases, indeed, members of the corporations boast the right to control. For a more accurate description of the market for corporate control in NPOs (Brakman, 2006).

¹⁹ The author actually assigns the multiple agents theory to Brumby & Hyndman (1998).

²⁰ We just want to make it clear that since parastatals are also not established to make profits, they still present specific characteristics that distinguish them from private *non-profit organizations*.

²¹ Accuracy requires to underscore the fact that the word “*patrons*” should indicate whoever is the ultimate resource of a corporation, whichever *for-profit* or *non-profit*. Yet, to distinguish them from shareholders, this Note will use the word *patrons* referring only to *non-profit* contributors.

²² *Contract failure* theory is agreed upon by other scholars as well (Nelson & Krashinsky, 1973 and Easley & O'Hara, 1983).

²³ The author reminds that the Red Cross was also founded by an entrepreneur.

²⁴ “[...]Because of the presumed information asymmetry between the non-profit and the patrons, the nondistribution constraint alone cannot assure the patron that his donation (or fee) will achieve his intent” (Brody, 1996: p. 466).

²⁵ “[...]in the small industrial cities such as Lynn and Fall River, those men who were the activists in the formative years of these charity organizations were the elites of the city, and their policy making role within the agencies reflected their social economic status”. (Cumbler, 1980: p. 99)

²⁶ “[...]for the first four-fifth of the nineteenth century most non-profit social service organizations were domestic in scale. (Hammack, 1989: p. 184)

²⁷ See his note n. 6 (p. 17) for a better overall account of Harvard's complex corporate evolution.

²⁸ “[...]Urban elites remain prominent in NPO governance, largely as members of boards of trustees and volunteer committees. Evidence suggests that such activities promote and maintain upper-class solidarity and permits elites to monitor and control NP policies.” (DiMaggio & Anheier, 1990: p. 141) On this topic the author quotes, Daniels (1987) and Domhoff & Salzman(1983).

²⁹ By 1984 charitable *non-profit organizations* (including foundations and churches) generated 5.6% of national income and 9.5% of employment. (DiMaggio Paul and Anheier Helmut, 1990)

³⁰ In the UK, differently from the USA, the shift was basically marked by the participation of the State into *non-profit organizations* affairs. This has also been a trend started around the '70s. In particular, the state began to contract them out to alleviate its expenses and to improve the efficiency of public services.

“[...] throughout the last three decades, a major shift in welfare state policies has taking place through the expanded use of private organizations to deliver public services.” (Middleton, 1996: p. 61)

However, we find it very important to underscore the fact that State involvement in charity represents a very specific field of research. For the case of Kenya see Mwaura Joseph *ibid* note 31.

³¹ “[...] Each of non-profit constituents has its own goals, which can be furthered either by exercising voice – imposing condition on the donation or contract – or exit rights – withdrawing future donations or dealings”...“[...] Non-profit organizations on occasion sell their name to the highest corporate bidder”. (Brody, 1996: pp. 461-469)

Concerning the participation of business corporations in *non-profit* sector the author suggests to see: Mallory, Matia. “The Cola Wars Go in College”. [1994]. *Bus. Wx*, p. 42 (discussing the \$10 million, 10 year contract giving the Coca-Cola Company exclusive rights to the soft-drink market on Rutgers University Campuses; a \$ 14 million, 10 years pact between the Pennsylvania State University and Pepsi-Co started the trend in 1992).

³² We find that there may be a substantial difference between the donation made by a corporate director for restructuring the firm and one made by ordinary people. We argue, in fact, that the first case may lack the philanthropic element.

³³ A similar statement has already been offered by Brody (1996) p. 471. The author speaks about “separation of supply and demand” where “*by demand we mean the beneficiary's demand rather than the*

donor's". Indeed, she refers to the situations in which *patrons* do not personally benefit from the activities of the charity they finance. We argue that this is not a new event. *Patrons* being beneficiaries of the organization was an issue related to the era when social elite funded charity in order to guarantee their sons a proper education. However, to be fair we must remind that even nowadays there exist *non-profit* organizations which provide services for the contributors themselves. These are defined as mutual *non-profit organizations* [see supra note n. 2]. Although *donors* may not be personally involved in the management, agency problems are, at least theoretically, not very costly to resolve. Indeed, in mutual *non-profit organizations* the *patrons*, as members, exercise direct control over the affairs of the organization through the election of the board. This additional means may assure them to not be exploited by the organization.

³⁴ The proposed categorization takes into account the one offered by the *American Institute of Certified Public Accountants*. The study has been realized by Slotter Keith, see its PowerPoint presentation at www.bus.lsu.edu/academics/accounting/events/downloads/2007/SlotterPresentation.ppt accessed on August 2008 the 25th. For a more detailed analysis of corporate frauds, see FBI document at: http://www.fbi.gov/publications/financial/fcs_report052005/fcs_report052005.htm accessed on August 2008 the 25th.

³⁵ See supra section 1, § A. Expropriation of Money

³⁶ "[...] the correspondent choices need to satisfy requirements of internal consistency in order to be called rational"; [...] individual rationality is not assessed on the grounds of the agent's effectiveness in pursuing some notion of self-interest, but rather on the logical internal coherence of her choices with respect to her ends". (Grimalda and Sacconi, 2002: p. 4)

³⁷ Quotation offered by Brody (1996). Brody, reproducing Young's words, continues: "Screening or self-selection occurs on the basis of differences in structural variables among sectors..., such as income potential and intrinsic character or the work to be performed. The differential filtering of motivation into sectors that allow room for managerial discretion determinate the ultimate behavior of firms. Thus, for *non-profit organizations*, according to Hansmann's and Weisbord's analyses, the screening process may be expected to produce organizational activity that is less aimed to pecuniary aggrandizement than that of firms in the profit making part of the economy."

³⁸ The authors, Sacconi and Grimalda (2002), refer to the theoretical underpinning provided by Ben Nér and Puttermann (1998). Such model of individual choice distinguishes between self-regarding, other regarding and process regarding motivations. In particular, in the case of other-regarding motivations, "*the agent uses a perspective to that of her own self. In this case, she may adopt the standpoint of a single agent different from her, which may lead to altruism, or that of the team she is part of, or the point of view of an impartial observer sympathetic to each member of the group of agents.*" (p.4)

³⁹ For data related to the configuration of the boards of directors of *non-profit organizations* and to their changes (Jeffrey and Weiner, 1998).

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