Saving Us From Ourselves: Reforming the Fiduciary Duty of Loyalty

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Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, Cardozo Legal Studies Research Paper No. 276 (2009). Available at SSRN.

In the wake of disaster, we as a species invariably reach out with untold generosity, donating vast amounts of cash and supplies to assist the victims. And, just as invariably, at least some of the charitable organizations through which most of us funnel our compassion will drop the ball through some form of mismanagement. In the past twenty years, the relief efforts following almost every major disaster – spring flooding in the Midwest, mudslides and wildfires on the West Coast, hurricanes throughout the Gulf of Mexico, tsunamis in the South Pacific, and, most famously, Katrina – have been plagued by reports of mismanagement ranging from lack of meaningful oversight to outright embezzlement.

Which should mean that right now, as the world struggles to come to the aid of a ravaged and overwhelmed Haiti, would be a prime time to consider meaningful reform of the standards by which such charities conduct their critical business. For several years, Prof. Melanie B. Leslie of Cardozo School of Law has offered a clarion call for reform of the rules governing fiduciary conflicts of interest, especially within the nonprofit sector. In the wake of the catastrophic earthquake January 12, the arguments and suggestions in her article *The Wisdom of Crowds? Groupthink and Nonprofit Governance* deserve serious attention.

Leslie's article, currently available as a working paper on SSRN, succinctly and clearly lays out the dilemma that lies at the heart of nonprofit management: With no principal readily available to monitor, and no market to correct, nonprofit boards of directors are uniquely vulnerable to the phenomenon of "groupthink," a process by which the desired advantages of information exchange are subverted by interpersonal group dynamics. When a board of directors lacks clear external standards or monitoring, Leslie argues, information asymmetries among the members of the group are more likely to be resolved, not by forthright questioning and discussion, but by confirmation bias and ingroup bias, both of which are further fueled by the desire for group cohesion which is arguably more powerful in the nonprofit sector than in a business setting. Current law governing fiduciary duties – both state law and the federal law governing tax exempt organizations – not only fails to correct this inherent problem, it actually exacerbates it by setting forth "fuzzy" standards rather than clear rules. "Fuzzy" standards necessarily require interpretation, and in a setting already prone to cognitive errors, that process of interpretation itself actually increases the board's tendency to overestimate its own objectivity, to overestimate a proposed deal's fairness, to under-investigate the true market conditions, and to discourage confrontation among its members.

Leslie proposes two options for correcting the problem of "fuzzy" fiduciary standards, both of them based on her preference for rules. Rules, she argues, communicate more clearly what the norms of behavior are in a given context and thereby reduce parties' overestimation of their own compliance, and she offers empirical evidence to support her contention that clearly demarcated rules do more strongly determine parties' behaviors. Her first suggestion – and clearly her own personal preference – is to prohibit all self-dealing, period. She argues that a blanket prohibition on self-dealing would not have to have the dire consequences often predicted, especially for smaller or rural nonprofits, but she also concedes that popular opinion tends to strongly oppose such a bright-line rule. Her second proposal relies on a set of lower-order rules that, taken together, would not absolutely prohibit self-dealing, but would, I think, get us nearly there anyway, simply by making the process of approving such a transaction more trouble than it would usually be worth to most nonprofit boards. That is, after all, exactly what Leslie is trying to suggest: So long as the standards governing self-dealing transactions make engaging in such transactions no more onerous than engaging in non-self-dealing transactions, those standards quietly convey a message to nonprofit managers that such transactions are legally and morally equivalent. Leslie's goal is to upend this applecart and, instead, to make clear to nonprofit directors that self-dealing transactions should be *presumed* impermissible, whether rebuttably or irrebuttably.

It is hard to see how Leslie's suggestions could be taken amiss. This "hard" version of the fiduciary duty of loyalty is, at the least, the starting point for learning the concept (or, at least, it is when I teach it), with such ideas as the business judgment rule coming later as particular exceptions to the general duty, exceptions justified in the business world by the availability of shareholder monitoring and self-correcting markets. Granted, any nonprofit director more accustomed to the rules for business decision-making will likely feel that such strictures hobble their efforts to get things done quickly and thereby provide more benefit to those in need. But recent history and my own personal experience serving on nonprofit boards tell me that Leslie is right: Those things we do in the name of beneficence are not always most beneficial for those we serve. In one of the numbers in the Broadway musical "Avenue Q," the characters encourage the audience that "When you help others, you can't help helping yourself," but that's precisely the problem. In the wake of disaster, we as a species *do* invariably reach out with untold generosity – but we also invariably overestimate our ability to do so in the impartial and objective way required of fiduciaries. Leslie's suggested rules would "build a fence" around our benevolence and thereby help us protect our generous impulses from our own short-sighted selves.

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