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Agents Without Principals: Regulating the Duty of Loyalty for Non Profit Corporations Through the Intermediate Sanctions Tax Regulations

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AGENTS WITHOUT PRINCIPALS: REGULATING THE DUTY OF LOYALTY FOR NONPROFIT CORPORATIONS THROUGH THE INTERMEDIATE SANCTIONS TAX REGULATIONS

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ABSTRACT

Delaware corporate law imposes a duty of loyalty on officers and directors as a mechanism to regulate and deter self-dealing transactions. In nonprofit corporations, however, there are generally no shareholders with direct financial incentives to monitor against self-dealing. In the absence of shareholders and other principals, Congress and the IRS have articulated duty of loyalty rules for nonprofits that reach far beyond those applied to the for-profit world—most prominently the § 4958 intermediate sanctions. This article identifies the persons who owe a duty of loyalty to a nonprofit corporation, the applicable fiduciary standards for violating the duty of loyalty, and the remedies, procedures, and exoneration provisions under these fiduciary rules. While § 4958 and Delaware corporate law cover similar territory, they take remarkably different paths. By comparing the Tax Code with Delaware corporate law, it is readily apparent that, in the absence of shareholders, tax rules police the duty of loyalty for nonprofits more strictly than Delaware corporate law.

I. INTRODUCTION

Delaware corporate law imposes a duty of loyalty on directors and officers as a mechanism to regulate and deter self-dealing transactions. One important method of monitoring for-profit companies for impermissible self-dealing transactions is through shareholders, who may sue for violations of fiduciary duties through derivative suits.[1] In public companies, shareholders can also exit through the public markets, which imposes a form of discipline through the threat of a hostile takeover.[2] Federal securities law also limits self-dealing, which includes insider trading and "say on pay" proxy rules governing executive compensation. In nonprofit corporations, however, there are generally no shareholders with direct financial incentives to monitor against self-dealing.[3] Because nonprofits do not have access to the shareholder mechanism to curtail unreasonable executive compensation and other forms of self-dealing,[4] they rely instead on other state and federal laws.

While state charitable trust law typically enforced by the state attorney general is one mechanism of protection,[5] the federal government is the primary enforcer of the duty of loyalty for tax-exempt corporations. Charitable organizations may qualify for tax-exempt status under § 501(c)(3) of the Internal

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[1] *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 615 (1999) ("In the corporate context, the shareholders are owners of the corporation and are protected by the fiduciary standards imposed on the directors. If the directors breach their fiduciary duties, shareholders can protect their interests by bringing a derivative action.") (citation omitted).

[2] Gary, *supra* note 1, at 615 ("If the shareholders do not approve of the way the directors run the corporation, the shareholders can sell their stock or, theoretically at least, vote the directors out of office.") (citation omitted).

[3] *Id.* at 596 n.23 ("One general rule is that members, unlike shareholders in business corporations, can have no ownership interest in their corporation.") (citation omitted). "If the nonprofit has voting members, the members may have a legal right to represent the nonprofit by taking directors who misbehave to court, but most nonprofits do not have voting members." *Id.*; *cf.* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); *see also* Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 227–72, 235 (1999) ("Neither principals nor agents have an ownership interest in a nonprofit; in a very real sense, nonprofits are unowned."); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 906 (2007) ("The market-driven regime breaks down for nonprofit organizations on two fronts: First, there is no market to keep the focus of individuals in control of nonprofits on a particular goal. Second, the goal of nonprofit stakeholders – including donors, beneficiaries, and the larger public – are likely to be more ephemeral and diverse than the common profit motive shared by the residual beneficiaries of businesses . . . . Nonprofit governance is not bolstered by either a market for corporate control or derivative litigation that focuses attention on the charitable mission.").

[4] Gary, *supra* note 1, at 615.

[5] *See* Manne, *supra* note 3, at 250 (citations omitted); *see also* Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 49, 11–13 (2010). It is difficult for state attorneys general to regulate nonprofits given limited staffing, underfunding and the highly political nature of the office. Manne, *supra* note 3, at 251; Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 946–47 (2004); Helge, *supra*, at 27–29.

Revenue Code (Tax Code).[6] One key requirement must be satisfied in order to qualify for this special tax status: private individuals cannot inappropriately benefit from transactions involving an exempt organization.[7] This issue often arises with respect to executive compensation and prohibitions against self-dealing.[8] Traditionally, the penalty for this private benefit was the revocation of an entity's tax-exempt status.[9] This penalty was sometimes seen as too severe because it not only punished the wrongdoer, but also penalized innocent parties that the charity was designed to serve.[10] Revoking the tax-exempt status of a charitable organization was seen as too severe of a penalty, so the Internal Revenue Service (IRS) asked for a less severe alternative, the "intermediate" sanction. Congress responded by enacting the Taxpayer Bill of Rights Act 2 in 1996, adding § 4958 to the Tax Code.[11] The transactions discussed during congressional hearings on this new section included inappropriately large salaries, transfers from nonprofit to for-profit subsidiaries, non-interest bearing loans, and personal perks including "luxury cars, servants, chauffeurs, country club memberships, and extremely lucrative severance packages."[12] A review of the tax returns of the 250 largest tax-exempt organizations revealed that, of the top 2,000 executives, fifteen percent were paid over $200,000 per year and thirty-eight individuals made over $400,000 per year.[13] Congress acknowledged that, "[a]t best, Federal and State enforcement officers have been limited," concluding that "[t]he Internal Revenue Service must have the tools to deter and punish inurement and private benefit . . . ."[14] Rather

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[6] 26 U.S.C.S. § 501(c)(3) (LexisNexis 2011).

[7] *Id.* §§ 501(c)(3)-(4); *see also* Helge, *supra* note 5, at 17.

[8] *See* Jack E. Karns, *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 WIDENER L.J. 383, 425–26 (2004) (citing Michael A. Shea, *New Intermediate Sanctions Regulations for Executive and Consultant Compensation,* 27 COLO. LAW. 51, 54 (1998)).

[9] *See id.* at 425–26 (citing Shea, *supra* note 8, at 51).

[10] *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 103rd Cong. 39 (1993); *see also* Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 736 (2007) ("[A]n intermediate sanction which allows the Internal Revenue Service (IRS) to discipline a charitable organization without revoking its tax-exempt status if the organization crosses over into an inurement situation but still generally operates for the benefit of the public.").

[11] Karns, *supra* note 8, at 425 (citation omitted); *see generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 569 (John Wiley & Sons 2007); Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575 (2000); Kertz, *infra* note 15; James R. King & David S. Boyce, *Revocation of Tax-Exempt Status, Excise Taxes, and Other Intermediate Sanctions Issues, Plus Income Taxes: How the Rules Have Changed After* Caracci v. Commissioner, 36 J. HEALTH L. 1 (Winder 2003); Manny, *supra* note 10; D. Alexander Ritchie, *Intermediate Sanctions: Controlling the Tax-Exempt Organization Manager*, 18 VA. TAX REV. 875 (1999); Allison M. Sawyer, *Intermediate Sanctions: Protection for Charitable Organizations and the Donations They Receive*, 15 LOY. CONSUMER L. REV. 125 (2003); Shea, *supra* note 8; Symposium, *The Push and Pull of Tax Exemption Law on the Organization and Delivery of Health Care Services: Executive Compensation in Nonprofit Health Care Organizations: Who's In Charge?*, 15 HEALTH MATRIX 67 (2005); J. Eric Taylor, *Intermediate Sanctions Under § 4958: An Overview of the Proposed Regulations*, 73 FLA. B.J. 73 (1999).

[12] *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearings before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 103rd Cong. 39 (1993).

[13] *Id.*

[14] Unofficial Transcript of Ways and Means Oversight Hearing on Activities of Public Charities at

than face the "uncomfortable choice: either to revoke an organization's exemption and cause untold havoc, or to walk away and do nothing," § 4958 provides a structure of intermediate sanctions.[15]

In the absence of shareholders or other principals to monitor and prevent self-dealing,[16] Congress and the IRS have articulated duty of loyalty rules for nonprofits far beyond those applied to the for-profit world.[17] Intermediate sanctions, in particular, know no real analogue in Delaware corporate law, as they seek to impose liability directly on the insiders, with few procedural hurdles. Intermediate sanctions are the hidden tiger of United States corporate fiduciary law, at least for the tax-exempt sector. When agents control assets without the watchful oversight of principals such as shareholders, perhaps an enhanced duty of loyalty regime is entirely appropriate.

This article first identifies the persons who owe a duty of loyalty to the corporation. In Delaware law, we focus on the directors. Under intermediate sanctions, the federal tax law widens the scope to include individuals with functional authority to make decisions, which include both the board as well as certain organizational managers. The third section articulates the applicable fiduciary standards for violations of the duty of loyalty. This time, Delaware takes the broader approach, sweeping in many additional categories beyond the narrowly prescribed categories under federal tax law. In the fourth section, we examine the remedies, procedural rules, and exoneration provisions under these two sets of fiduciary rules. As we will see, Delaware and the IRS cover similar territory with respect to the fiduciary duty of loyalty, but take remarkably different paths.

II. WHO OWES A DUTY OF LOYALTY TO THE CORPORATION?

Under federal tax law, the intermediate sanctions version of the duty of loyalty is owed by "disqualified persons" and "organizational managers."[18] Intermediate sanctions personally penalize individuals, in addition to the organization, for participating in "excess benefit transactions."[19] These categories are different from Delaware law, which generally focuses on the directors and

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3, 93 TNT 164-29 (June 21, 1993).

[15] Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 822.

[16] *See e.g.,* Manne, *supra* note 3, at 228 ("There is no market for corporate control; there are no proxy battles, no shareholder derivative suits, and there is very little market competition.") (citation omitted).

[17] *Id.* at 237 ("Because private monitoring is so costly in nonprofits, strong fiduciary rules provide a relatively inexpensive deterrence system, but one which, in theory accomplishes the same end as more expensive monitoring: '[b]y imposing personal liability on corporate officers and directors for breach of the duties of care (negligence) and loyalty (conflict of interest), litigation is thought to align managers' incentives with shareholder interests.'") (citing Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 55 (1991)); *see also* Ritchie, *supra* note 11, at 903 ("The modern trend is to apply corporate law standards on the rationale that the duties of exempt organization directors and managers are similar, if not identical, to those in for-profit corporations.").

[18] *See* I.R.S. Priv. Ltr. Rul. *200435019 (May 5, 2004);* see also Karns, *supra* note 8, at 425 (citation omitted).

[19] Karns, *supra* note 8, at 426 (citing 26 U.S.C. § 4958(c) (2000), 26 C.F.R. § 53.4958-4(a) (2011)).

officers of the corporation.

A. Disqualified Person

A "disqualified person," as defined under § 4958 is "any person . . . in a position to exercise substantial influence over the affairs of the organization [at issue]."[20] A person is disqualified as long as they possessed this authority "at any time during the 5-year period ending on the date of such transaction."[21] Even the family member of a person satisfying this definition may be considered a disqualified person.[22] Family members include spouses, siblings, spouses of siblings, ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren, and great grandchildren.[23] For example, the president and director of a nonprofit organization was found to be a disqualified person in a transaction involving his son, also a director, who was living rent free for six months in the organization's investment property.[24] His disqualified person status was a result of his familial relationship with his son, who was in a position that afforded the opportunity to "exercise substantial influence over the affairs of the organization."[25] The definition of a disqualified person also includes a "35-percent controlled entity."[26] The regulations explain that a 35-percent controlled entity results from a person owning voting power exceeding 35 percent in a corporation,[27] profit interests over 35 percent in a partnership,[28] or if a trust or estate owns a beneficial interest exceeding 35 percent.[29]

B. Substantial Influence

To satisfy the definition of a disqualified person, any of the aforementioned categories of individuals must be "in a position to exercise substantial influence over the affairs of the organization."[30] This requirement is automatically satisfied by (1) "voting members of the governing body,"[31] (2) "[p]residents, chief executive officers, or chief operating officers,"[32] (3) "[t]reasurers and chief

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[20] 26 U.S.C.S. § 4958(f)(1)(A) (LexisNexis 2011).

[21] *Id.*

[22] *Id.* § 4958(f)(1)(B).

[23] 26 C.F.R. § 53.4958-3(b)(1) (2011) (the relationship between the disinterested person and siblings or spouses of siblings may be "by whole or half blood").

[24] I.R.S. Priv. Ltr. Rul. 200435020 (May 5, 2004).

[25] *Id.*

[26] 26 U.S.C.S. § 4958(f)(1)(C) (LexisNexis 2011).

[27] 26 C.F.R. § 53.4958-3(b)(2)(i)(A)–(ii) (2011) (combined voting power includes voting power represented by holdings of voting stock, direct or indirect, but does not include voting rights held only as a director, trustee, or other fiduciary).

[28] *Id.* § 53.4958-3(b)(2)(i)(B).

[29] *Id.* § 53.4958-3(b)(2)(i)(C).

[30] 26 U.S.C.S. § 4958(f)(1)(A) (LexisNexis 2011).

[31] 26 C.F.R. § 53.4958-3(c)(1) (2011) ("This category includes any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority.").

[32] *Id.* § 53.4958-3(c)(2) ("This category includes any person who, regardless of title, has ultimate

financial officers,"[33] and (4) "[p]ersons with a material financial interest in a provider-sponsored organization."[34]

Under § 501(c)(3), tax-exempt organizations themselves are "deemed not to be in a position to exercise substantial influence over the affairs of an[other] applicable tax-exempt organization."[35] Furthermore, neither full nor part-time employees are considered to exercise substantial influence over an organization if they "receiv[e] economic benefits, directly or indirectly from the organization, of less than the amount referenced for a highly compensated employee" or are "not a substantial contributor to the organization."[36] The employee, however, still cannot be related to a disqualified person, have a 35 percent interest, or fall into any of the specifically articulated categories of individuals with substantial influence.[37] According to a private letter ruling, the IRS classified an individual as a disqualified person, not based on her consulting agreement with the nonprofit organization, but based on the fact that her husband was the organization's president and chief executive officer immediately prior to the execution of her consulting agreement.[38] Her duties under the consulting agreement included representing the company at meetings and events as well as participating in fundraising activities, and consulting with management and the organization's board of directors,[39] none of which alone would likely render her a disqualified person.

If an individual does not fall into one the aforementioned categories, his or her status is dependent on the "relevant facts and circumstances."[40] The regulations specify certain facts and circumstances that indicate when a person is likely to have substantial influence.[41] For example, substantial influence is indicated if an individual founded the organization, makes substantial contributions

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responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals (e.g., co-presidents), who may exercise such responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.").

[33] *Id.* § 53.4958-3(c)(3) ("This category includes any person who, regardless of title, has ultimate responsibility for managing the finances of the organization. A person who serves as treasurer or chief financial officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals who may exercise the responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.").

[34] *Id.* § 53.4958-3(c)(4) ("For purposes of section 4958, if a hospital that participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) is an applicable tax-exempt organization, then any person with a material financial interest (within the meaning of section 501(o)) in the provider-sponsored organization has substantial influence with respect to the hospital.").

[35] *Id.* § 53.4958-3(d).

[36] *Id.* § 53.4958-3(d)(3)(i), (iii).

[37] *Id.* § 53.4958-3(d)(3)(ii).

[38] I.R.S. Priv. Ltr. Rul 200244028 (June 21, 2002).

[39] *Id.*

[40] 26 C.F.R. § 53.4958-3(e)(1) (2011).

[41] *Id.* § 53.4958-3(e)(2).

to the organization, or owns a controlling interest in the organization at issue.[42] A person can also likely exert substantial influence over an organization if their "compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls" or if "[t]he person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees."[43] Substantial influence will also likely result if the person manages "a substantial portion of the activities, assets, income, or expenses of the organization" or "[t]he person is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons."[44] Individuals who commonly do not have substantial influence over an organization are contractors, such as attorneys, accountants, or investment managers, who only provide professional advice about transactions and receive no economic benefit except traditional service fees.[45] By the same logic, individuals that have no control over management decisions affecting a "substantial portion of the activities, assets, income, or expenses of the organization" are unlikely to have substantial influence.[46] Other factors that tend to disprove substantial influence include: a person who took a vow of poverty as a member of a religious organization; an individual whose supervisor is not a disqualified person; or if "[a]ny preferential treatment a person receives based on the size of that person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions."[47]

C. *Organizational Manager*

In addition to "disqualified persons," § 4958 also specifically targets "organizational managers."[48] Organizational managers are any "officer, director or trustee" of a tax-exempt organization.[49] According to the regulations, a person is deemed an officer of an organization for purposes of § 4958 if they are "specifically so designated under the certificate of incorporation, by-laws, or other constitutive documents of the organization" or "[r]egularly exercise general authority to make administrative or policy decisions on behalf of the organization."[50] The authority to recommend certain administrative or policy decisions without the power to implement them does not make an individual an officer.[51] Further, outside contractors acting as a tax-exempt organization's attorney, accountant, investment manager or advisor are not considered managerial

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[42] *Id.*
[43] *Id.* § 53.4958-3(e)(2)(iii)–(iv).
[44] *Id.* § 53.4958-3(e)(2)(v), (vii).
[45] *Id.* § 53.4958-3(e)(3).
[46] *Id.*
[47] *Id.*
[48] 26 U.S.C.S. § 4958(a)(2) (LexisNexis 2011).
[49] *Id.* § 4958(f)(2). This includes individuals with responsibilities similar to individuals acting as an "officer, director or trustee," irrespective of their actual job title. *Id.*
[50] 26 C.F.R. § 53.4958-1(d)(2)(i)(A)–(B) (2011).
[51] *Id.* § 53.4958-1(d)(2)(i)(B).

officers under the regulations.[52]

D. Delaware Corporate Law

Unlike federal tax law, the Delaware corporate duty of loyalty is focused almost exclusively on directors and officers.[53] The Delaware Supreme Court explained that a person is interested if they "appear on both sides of a transaction []or expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[54] In other words, corporate officers and directors are prohibited from using "their position of trust and confidence to further their private interests."[55] This prohibition is a result of their fiduciary relationship to both the stockholders of the corporation and the corporation itself.[56]

Delaware courts also explain what interests do and do not result in an "interested person." Board members are not automatically an interested person based on the receipt of a salary,[57] a large stockholding,[58] or if they are indemnified.[59] In *Cooke v. Oolie*, the court explained that if directors select a transaction that protects their personal interests as creditors over other proposals in the best interests of the company's shareholders, they are interested because they would be deriving a financial benefit.[60] Courts are also concerned about the motivations of directors when handling takeovers that threaten their control.[61]

When comparing the Tax Code with Delaware corporate law, it is clear

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[52] *Id.*

[53] DEL. CODE ANN. tit. 8, § 144(a) (2010) ("No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose . . . .").

[54] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[55] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); *see also* Valeant Pharmals. Int'l v. Jenery, 921 A.2d 732, 735 (Del. Ch. 2007) (involving a compensation committee comprised of interested members who were evaluating a transaction where they each would receive large cash bonuses).

[56] *Guth*, 5 A.2d at 510.

[57] Growbot v. Perot, 539 A.2d 180, 188 (Del. 1988) ("The only averment permitting such an inference is the allegation that all GM's directors are paid for their services as directors. However, such allegations, without more, do not establish any financial interest.").

[58] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985).

[59] Grover v. Simmons (In re Sea-Land Corp. S'holders Litig), 642 A.2d 792, 804 (Del. Ch. 1993) ("Normally, the receipt of indemnification is not deemed to taint related director actions with a presumption of self-interest . . . because indemnification has become commonplace in corporate affairs and because indemnification does not increase a director's wealth.") (citation omitted).

[60] Cooke v. Oolie, No. 11134, 2000 Del. Ch. LEXIS 89, at *40 (2000) (The court applied the rationale of section 144 even though the facts did not fall within the parameters of the statute. The court explained, "the defendants' creditor status provided motivation for them to pursue an acquisition proposal that best protected their personal loans to TNN . . . . Their fiduciary duties compelled them to seek the best deal possible for the shareholders, but their creditor status created the incentive to protect their personal loans despite the shareholders' interests.").

[61] Cheff v. Mathes, 199 A.2d 548, 554 (1964) (citing Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962); Yasik v. Wachtel, 17 A.2d 309 (Del. Ch. 1941)).

Delaware has a bright line rule that imposes the fiduciary duty of loyalty on directors and officers, while federal tax law extends beyond the scope of directors and officers through the application of flexible categories such as disqualified persons, persons with substantial influence, and organizational managers. Like the Tax Code, Delaware corporate law still takes into account the personal interests and level of control directors and officers exert, but generally during the subsequent step of determining whether fiduciary duties have been violated.[62]

III. HAS THE DUTY OF LOYALTY BEEN VIOLATED?

Disqualified individuals will be subject to § 4958 tax penalties if they engage in an "excess benefit transaction."[63] The Internal Revenue Code defines "excess benefit transaction" as:

> [A]ny transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.[64]

When evaluating whether an excess benefit transaction occurred, "all consideration and benefits . . . are taken into account."[65] The economic benefit can be direct or indirect.[66] For example, a benefit issued "indirectly through the use of one or more entities [the tax-exempt organization] controls" is still an excess benefit transaction.[67] Methods of control include "ownership of more than 50 percent of the stock[,] . . . profits[, capital] interest[, or] . . . beneficial interest" in a corporation, partnership or other entity as well as if "at least 50 percent of the directors or trustees of [a nonstock] organization are either representatives of, or directly or indirectly controlled by, an applicable tax-exempt organization."[68]

Essentially, this provision translates to mean that § 4958 tax penalties will be imposed when transactions would be considered private inurement or private benefit.[69] Excess-benefit transactions may include "excessive rental payments, purchase of assets for more than fair market value, and nonmarket rate loans."[70] This article will briefly explore a common transaction: executive compensation.

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[62] In US corporate law, any disloyal agent could be liable to the corporate principal for violation of fiduciary duties, but in the context of derivative litigation by shareholders, the targets are almost always limited to directors and officers, partially due to the demand requirements for derivative litigation: it is difficult to prove demand futility unless the board itself is amongst the accused.

[63] 26 U.S.C.S. § 4958(a)(1) (LexisNexis 2011).

[64] *Id* § 4958(c)(1)(A); 26 C.F.R. § 53.4958-4(a)(1) (2011).

[65] 26 C.F.R. § 53.4958-4(a)(1) (2011).

[66] *Id.* § 53.4958-4(a)(2)(i).

[67] *Id.* § 53.4958-4(a)(2)(ii)(A).

[68] *Id.* § 53.4958-4(a)(2)(ii)(B).

[69] Kertz, *supra* note 15, at 832.

[70] 26 U.S.C.S. § 501(c)(3)–(4) (LexisNexis 2011).

A. Benefits Involved in a Compensation Analysis

According to § 4958, compensation "includes all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services."[71] These benefits account for both cash and non-cash compensation, including salary, fees, bonuses and severance payments.[72] Benefits also include the payment of liability insurance premiums or the payment or reimbursement of "[a]ny penalty, tax, or expense of correction owed,"[73] unreasonable litigation expenses,[74] and any other welfare benefit plans.[75]

An economic benefit, however, is only deemed consideration if the provider of the benefit "clearly indicates its intent to treat the benefit as compensation when [it] . . . is paid."[76] This intent is only demonstrated if "the organization provides written substantiation that is contemporaneous with the transfer of the economic benefit at issue."[77] A transfer approved by an appropriate decision-making body or authorized officer for compensation consistent with the standard procedures of the organization can also be considered compensation for services.[78] This requirement makes it extremely difficult to claim *ex post* that an excess benefit transaction was actually compensation in an attempt to avoid tax penalties. It increases transparency, *ex ante* identification, and subsequently decreases the opportunity for fraud. Examples of written evidence include the nonprofit organization issuing a Form W-2 "Wage and Tax Statement," a Form 1099 "Miscellaneous Income" statement, or if the recipient of the benefit includes it as income on a federal tax return.[79] Another example of written evidence would be an approved written employment contract.[80] Lastly, a Form 990 could demonstrate whether or not a benefit received was compensation. Certain tax-exempt organizations are required to file a Form 990, which includes a list of expenses and the compensation paid to specific individuals within the organization.[81] In one private letter ruling, the son-in-law of the founder and President of a nonprofit organization was found to be a disqualified person engaging in an excess benefit transaction because he had exclusive use of the

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[71] 26 C.F.R. § 53.4958-4(b)(1)(ii)(B) (2011).

[72] *Id.* § 53.4958-4(b)(1)(ii)(B)(1).

[73] *Id.* § 53.4958-4(b)(1)(ii)(B)(2)(i).

[74] *Id.* § 53.4958-4(b)(1)(ii)(B)(2)(ii)–(iii).

[75] *Id.* § 53.4958-4(b)(1)(ii)(B)(3) (stating welfare benefit plans include "plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits . . . .").

[76] *Id.* § 53.4958-4(c)(1).

[77] *Id.* § 53.4958-4(c)(1)–(2) ("[A]n applicable tax-exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes . . . . Examples of these benefits include, but are not limited to, employer-provided health benefits and contributions to a qualified pension, profit-sharing, or stock bonus plan under section 401(a) . . . .").

[78] *Id.* § 53.4958-4(c)(3)(i)(B)(ii).

[79] *Id.* § 53.4958-4(c)(3)(i)(A)(1)–(2).

[80] *Id.* § 53.4958-4(c)(3)(i)(B)(ii)(A).

[81] *General Instructions: Overview of Form 990*, IRS, *available at* http://www.irs.gov/instructions/i990/ch01.html#d0e756 (last visited Jan. 3, 2012).

company's truck.[82] Though it was claimed that the son-in-law was managing a property owned by the organization, there was no documentation demonstrating when his employment began, what his responsibilities entailed, or any record of the business purposes the truck was used for.[83]

As this private letter ruling demonstrates, without the proper *ex ante* written evidence, any transaction that confers a benefit on a disqualified person will not be deemed consideration for services rendered.[84] Instead, it will be considered an automatic excess benefit transaction.[85] The reasonableness of the benefit is irrelevant.[86] This requirement penalizes people in order to increase compliance with the statute. Therefore, undocumented expenses will likely be treated as automatic excess benefit transactions under § 4958.[87] In one private letter ruling, payments for an officer's automobile, life insurance, consulting fee, and charges for travel and entertainment were all considered undocumented expenses and therefore, automatic excess benefit transactions.[88] In another private letter ruling, the tax-exempt status of an organization was revoked.[89] The organization's purpose was to "educate the public and policymakers about issues regarding hemp and motto and provide legal charitable services to certain medical patients."[90] One of the bases for this revocation was that the founder and President of the organization used the net earnings of the marijuana clinic for his own private inurement.[91] Although the board of directors, consisting of the president, the president's mother, and two other directors, approved the president's compensation package annually,[92] there was almost no documentation.[93] According to the minutes, which were identical every year, the president was expected to "raise and spend up to $*** in the next calendar year" and "pay his own expenses including rent, utilities and other costs."[94] The president used the organization's funds, over which he had complete control, to "pa[y] house rent and utilities . . . along with car payments, insurance, and personal living and travel expenses."[95] In other cases, examples of benefits deemed to be excess benefit transactions include the use of a

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[82] I.R.S. Priv. Ltr. Rul. *200435018 (May 5, 2004).*

[83] *Id.*

[84] 26 C.F.R. § 53.4958-4(c)(1) (2011).

[85] HOPKINS, *supra* note 11, at 616.

[86] *Id.*

[87] I.R.S. Priv. Ltr. Rul. 201013061 (Dec. 9, 2009).

[88] *Id.*

[89] I.R.S. Priv. Ltr. Rul. 201013062 (Jan. 6, 2010). The organization included on its Form 1023 that it intended:

> To provide a charitable service to medical patients who have medical cards permitting them to grow motto to alleviate their symptoms or condition. ORG will assist in the production of motto by those patients who are legally entitled to grow motto but are too poor or disabled to do so.

Id.

[90] *Id.*

[91] *Id.* We are tempted to label this activity "self-dealing."

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.*

company cellular phone, computer, no-interest loans, and payment for a spouse's travel.[96]

Alternatively, certain economic benefits are excluded from a compensation analysis. These include payment for reasonable expenses incurred by members of the organization's governing body to attend board meetings, and benefits conferred on a disqualified person "solely as a member of or volunteer of the organization" or "as a member of a charitable class."[97] The reasonableness component of compensation also excludes *de minimis* fringe benefits under § 132.[98] *De minimis* fringe benefits are "any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable."[99]

Further, a § 4958 compensation analysis does not include "fixed payments made pursuant to an initial contract."[100] A fixed payment is "an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services . . . ."[101] A fixed formula can incorporate a future event so long as the benefit is not subject to personal discretion.[102] An initial contract is "a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person . . . immediately prior to entering into the contract."[103] The person is not a disqualified person when an initial contract is executed because they do not yet work for the organization. If a contract contains both a fixed and non-fixed payment, the fixed payment portion of the initial contract will be excluded from the § 4958 compensation analysis and the non-fixed payment may be considered an excess benefit.[104]

B. *Reasonableness of Compensation*

Compensation will be considered reasonable if "the value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances."[105] The circumstances considered are usually those that "exist[ed] at the date when the contract for services was made."[106] This standard is distinct from the private inurement reasonableness standard which, according to the United States Tax Court, may consider "circumstances occurring after the transaction in

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[96] HOPKINS, *supra* note 11, at 616 (citing I.R.S. Priv. Ltr. Rul. *200435018 (*May 5, 2004*))*.

[97] *Id.* at 615 (citing 26 C.F.R. § 53.4958-4(a)(4) (2011)).

[98] I.R.S. Priv. Ltr. Rul. 200822039 (Feb. 21, 2008).

[99] 26 U.S.C.S. § 132(e)(1) (LexisNexis 2011).

[100] 26 C.F.R. § 53.4958-4(a)(3)(i) (2011).

[101] *Id.* § 53.4958-4(3)(ii)(A).

[102] *Id.* ("A specified event or contingency may include the amount of revenues generated by (or other objective measure of) one or more activities of the applicable tax-exempt organization. A fixed payment does not include any amount paid to a person under a reimbursement (or similar) arrangement where discretion is exercised by any person with respect to the amount of expenses incurred or reimbursed.").

[103] *Id.* § 53.4958-4(3)(iii).

[104] *Id.* § 53.4958-4(3)(vi).

[105] *Id.* § 53.4958-4 (b)(1)(ii).

[106] Hopkins, *supra* note 11, at 613.

question . . . ."[107] Factors such as a salary cap are one of several used to determine the reasonableness of a compensation package.[108]

C. Rebuttable Presumption of Reasonableness

A key feature of intermediate sanctions as described in § 4958 is the rebuttable presumption of reasonableness. According to the tax regulations, a compensation arrangement is presumed reasonable if three provisions are satisfied.[109] Nonprofits can rely on these provisions to avoid tax penalties and potential loss of their tax-exempt status. Failure to satisfy these provisions, however, does not result in an "inference that the transaction is an excess benefit transaction."[110] This provision is similar to the Delaware "safe harbor" statute discussed below.

First, a disinterested authorized body of the organization must approve the compensation arrangement.[111] An authorized body is simply a governing body of the tax-exempt organization, including a board of directors or board of trustees.[112] These individuals on the authorized body may not have a conflict of interest with respect to the proposed compensation arrangement.[113] This requires that they are not "a disqualified person participating in or economically benefiting from the compensation arrangement or . . . a member of the family of any such disqualified person."[114] The authorized body also may not have an employment relationship "subject to the direction or control" of the disqualified person benefiting from the compensation arrangement,[115] or receive their own compensation pending the approval from the disqualified person benefitting from the arrangement.[116] Members of the authorized body also may not have a material financial interest impacted by the arrangement,[117] nor can the benefiting party approve, in the past or future, "a transaction providing economic benefits to the member."[118] For example, in *In re InfoUSA, Inc. Shareholders Litigation* the Delaware court found that six members of the board of directors had self-interests that "would prevent them from considering objectively a demand upon the board."[119] One director was receiving more money as compensation for his board membership than he was at

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107 *Id.* at 613 n.35 (citation omitted).

108 I.R.S. Priv. Ltr. Rul. 200822039 (Feb. 21, 2008).

109 26 C.F.R. § 53.4958-6(a) (2011).

110 *Id.* § 53.4958-6.

111 *Id.* § 53.4958-6(a)(1).

112 *Id.* § 53.4958-6(c)(1)(i)(A). "[A]n individual is not included on the authorized body when it is reviewing a transaction if that individual meets with other members only to answer questions, and otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement or property transfer." *Id.* § 53.4958-6(c)(1)(ii).

113 *Id.* § 53.4958-6(a)(1).

114 *Id.* § 53.4958-6(c)(1)(iii)(A).

115 *Id.* § 53.4958-6(c)(1)(iii)(B).

116 *Id.* § 53.4958-6(c)(1)(iii)(C).

117 *Id.* § 53.4958-6(c)(1)(iii)(D).

118 *Id.* § 53.4958-6(c)(1)(iii)(E).

119 *In re* InfoUSA, Inc. S'holders Litig., 953 A.2d 963, 994 (Del. Ch. 2007).

his professorship at Creighton University.[120] InfoUSA was also paying sizeable legal fees to a firm in which another director was a named partner.[121] In addition, two other directors were using free office space for their own businesses in buildings owned by the director and CEO of InfoUSA, and later by InfoUSA directly.[122]

Second, similar to the Delaware standard, this authorized body must "obtain[] and rel[y] upon appropriate data as to comparability prior to making its determination."[123] This data includes "compensation levels paid by similarly situated organizations, . . . for functionally comparable positions," "the availability of similar services in the geographic area," "current compensation surveys compiled by independent firms," and "actual written offers from similar institutions competing for the services of the disqualified person."[124]

Third, the authorized body must "document[] the basis for its determination" *when* it makes the determination.[125] This contemporaneous documentation requirement demonstrates legislators' skeptical view of justifications provided in later litigation. It is not enough that a legislative body, agency, or court approved a specific compensation package.[126] The documentation requirement involves a written or electronic record that must include the terms of the agreement, the date approved, the members of the authorized body present during any discussions, the members who voted, the comparability data used, how the data was obtained, and any "actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction."[127]

It has been argued that if § 4958 had been in effect when the *United Cancer Council, Inc. v. Commissioner of Internal Affairs*[128] opinion was rendered, the tax-exempt organization could have relied on the "rebuttable presumption" doctrine.[129] In this case, a nonprofit organization conducting cancer research was in severe financial trouble as a result of a large termination of dues-paying memberships.[130]

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[120] *Id.* at 992.

[121] *Id.* at 991.

[122] *Id.* at 992–93.

[123] 26 C.F.R. § 53.4958-6(a)(2) (2011).

[124] *Id.* § 53.4958-6(c)(2)(i).

> For organizations with annual gross receipts (including contributions) of less than $ 1 million reviewing compensation arrangements, the authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. No inference is intended with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.

Id. § 53.4958-6(c)(2)(ii).

[125] *Id.* § 53.4958-6(a)(3).

[126] *Id.* § 53.4958-6(b)(1)(ii).

[127] *Id.* § 53.4958-6(c)(3)(i).

[128] United Cancer Council, Inc. v. Comm'r, 109 T.C. 326 (1997), *rev'd* 165 F.3d 1173 (7th Cir. 1999).

[129] Karns, *supra* note 8, at 440.

[130] *United Cancer Council*, 109 T.C. at 329–30.

United Cancer Council hired a professional fundraiser and executed a contract that compensated the fundraiser with a percentage of the net revenues they raised.[131] Under the agreement, if the proceeds did not cover the fundraising expenses, United Cancer Council would not reimburse the fundraising company.[132] Ultimately, over six years $26.5 million was raised and paid to the professional fundraiser for expenses and compensation.[133] Approximately $2.5 million was paid to the nonprofit.[134] The Tax Court concluded that "imposing an excise tax on 'excess benefit transactions' applies only to transactions occurring on or after September 14, 1995, and so does not apply to the instant case."[135] The case was later reversed and remanded by the Seventh Circuit to reevaluate the private inurement and private benefit issues.[136] Had the transaction occurred after September 14, 1995, it could have illustrated the benefit of § 4958 intermediate sanctions as compared to revocation of an organization's tax-exempt status based on private inurement.

Intermediate sanctions under § 4958 were applied in *Caracci v. Commissioner*, decided by the Tax Court in 2002,[137] and reversed by the Fifth Circuit in 2006.[138] The case involved three privately owned home health care agencies whose shareholders, directors, and officers were all employees and members of the Carracci family.[139] The three agencies were all tax-exempt under § 501(c)(3) in order to comply with Medicare regulations at that time.[140] The regulations were revised in the 1980s to permit taxable entities to participate in the Medicare program.[141] In 1995, Medicare also changed its reimbursement policy for home health care providers, paying "the lesser of the actual reasonable cost or the customary charge, up to a maximum per-visit 'cost cap.'"[142] This resulted in Medicare reimbursing only expenses "deemed allowable," rendering Medicare home health care agencies whose business relied primarily on Medicare much less profitable.[143] At this time, the Carracci's agencies were providing over ninety-five percent of their services to Medicare beneficiaries.[144] As a result of this difficult reimbursement environment, by the end of 1995 the three agencies had assets and liabilities equaling negative $1.4 million.[145] Under the advice of their attorney and outside counsel, they considered turning their agencies into for-profit entities in

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[131] *Id.* at 330–31.
[132] *Id.* at 331.
[133] *Id.* at 331–32.
[134] *Id.*
[135] *Id.* at 399–400.
[136] United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1179–80 (7th Cir. 1999).
[137] Caracci v. Comm'r, 118 T.C. 379 (2002).
[138] Caracci v. Comm'r, 456 F.3d 444 (5th Cir. 2006).
[139] *Id.* at 447.
[140] *Id.* at 448.
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] *Id.*

order to become eligible for loans unavailable to tax-exempt entities.[146] The agencies were converted from tax-exempt entities to taxable subchapter-S corporations.[147] The Tax Court concluded that the assets transferred surpassed the value of the liabilities and debts assumed by the subchapter-S corporations, resulting in an "excess benefit."[148] The Fifth Circuit overturned the Tax Courts decision, insisting that improper valuation methods were used and that "the Tax Court should have found in the taxpayers' favor."[149]

Though § 4958 case law is quite limited, there are a few private letter rulings on the subject. In one ruling, the chief executive officer of a nonprofit healthcare organization and his wife were paid executive compensation as part of a post-employment consulting agreement.[150] The IRS determined that they were both disqualified persons pursuant to § 4958.[151] The ruling addressed the application of the rebuttable presumption doctrine concluding that: (1) the contract was approved by a disinterested authorized body; (2) the contract had the proper supporting documents; (3) the documents were provided by an outside executive compensation consultant; and (4) the data was relied on to determine the reasonableness of the agreement.[152] The private letter ruling, however, indicated that the comparison did not occur "concurrent[ly] with the approval of the consulting contract."[153] By failing to satisfy this contemporaneous documentation requirement the executive compensation agreement was subject to § 4958.[154]

In summary, federal tax law exhibits a strong preference for *ex ante* evidence of loyalty and a willingness for the courts to carefully examine the reasonableness of potentially self-dealing transactions with insiders.

D. Delaware Corporate Law

Under Delaware law, it is more difficult to prove that a director or officer is receiving excess pay because they provide "unique executive talent," making it difficult to calculate a "market price."[155] In order to curtail risk-averse management behavior, especially given the instability of current executive management positions, compensation packages are increased in value to offset the decreased job security in for-profit corporations today.[156]

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[146] *Id.* at 449 ("The primary form of conversion used was a transfer of assets from the old exempt corporations to the newly formed nonexempt subchapter-S corporations, in exchange for assuming the debts and liabilities of the exempt corporations.").

[147] *Id.* at 449–50.

[148] Caracci v. Comm'r, 118 T.C. 379, 414 (2002).

[149] *Caracci,* 456 F.3d at 457–58.

[150] I.R.S. Tech. Adv. Mem. 200244028 (Jun. 21, 2002).

[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] WILLIAM T. ALLEN, REINIER KRAAKMAN, & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 332 (3rd ed. 2009).

[156] *Id.*; *see also* Denise Ping Lee, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 945–46 (2003).

Executive compensation packages are further complicated by the fact that compensation is determined by the board of directors, making it a "necessary form of self-interested transaction."[157] The board of directors is specifically given the power to determine board member compensation.[158] Of course, directors cannot participate in the vote to determine their own compensation. Boards typically have compensation committees, with independent members, who make these decisions for the inside directors. Corporations also have the power, under Delaware law, to provide compensation for officers and agents of the corporation.[159] The general rule is that directors, on behalf of the corporation, "have the sole authority to determine compensation levels."[160] Compensation packages may include a fixed salary,[161] pensions, profit sharing agreements, stock options, stock bonuses, retirement plans or benefit plans.[162] Executive compensation may also include golden parachute payments to departing executives.[163]

Though shareholders are often concerned with the level of executive compensation as well as its procedures and form, it is difficult to object to these packages because they are generally "protected by the presumption of the business judgment rule."[164] The concept behind the business judgment rule is that "courts should not second-guess good-faith decisions made by independent and disinterested directors."[165] As glossed by the American Bar Association's Corporate Director's Guidebook, "a decision constitutes a valid business judgment (and gives no rise to liability for ensuing loss) when it (1) is made by financially disinterested directors or officers (2) who have become duly informed before exercising judgment and (3) who exercise judgment in a good-faith effort to advance corporate interests."[166] Federal tax law does not provide an equivalent protection to interested persons under § 4958.

Delaware corporate law also affords the opportunity for executives to make *ex post* arguments to justify their actions. In *Broz v. Cellular Information Systems, Inc.*, the Delaware Supreme Court explained that "the determination of whether or not a director has appropriated for himself something that in fairness should belong to the corporation is a factual question to be decided by reasonable inference from objective facts."[167] As a result of this approach, the director Robert Broz was able to defend his decision not to present a corporate opportunity to the board of Cellular Information Systems, Inc. on the grounds that the company was not in a

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157 ALLEN, *supra* note 155, at 330.

158 DEL. CODE ANN. tit. 8, § 141(h) (2010) (this default provision may be restricted in the certificate of incorporation or bylaws).

159 DEL. CODE ANN. tit. 8, § 122(5) (2003).

160 Haber v. Bell, 465 A.2d 353, 359 (Del. Ch. 1983).

161 ALLEN, *supra* note 155, at 330–32.

162 DEL. CODE ANN. tit. 8, § 122(15) (2003).

163 ALLEN, *supra* note 155, at 330–32 ("[G]olden parachutes . . . reward executives for standing aside gracefully in the sale of their companies.").

164 *Haber*, 465 A.2d at 359.

165 ALLEN, *supra* note 155, at 250.

166 *Id.* (citing AMERICAN BAR ASSN., CORPORATE DIRECTOR'S GUIDEBOOK (2d ed. 1994)).

167 Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 155 (Del. 1996) (internal quotation marks omitted).

position to undertake new acquisitions or debts.[168] The courts willingness to accept post-hoc arguments allowed the director the opportunity to escape liability, despite his failure to request formal board approval at the time.[169] When comparing the IRS rule with Delaware's business judgment rule it is clear that the IRS rule is far more proscriptive.

The Sarbanes-Oxley Act also governs exchange-listed companies, adding another federal layer of legal rules for executive compensation.[170] Similar to the Internal Revenue Code, the Sarbanes-Oxley Act requires exchange-listed companies to implement compensation committees, which must disclose the specific reasons behind the compensation awarded as well as the parallel between the compensation paid and the financial performance of the company.[171]

Under Delaware law, shareholders dissatisfied with executive compensation packages may attack them on the grounds of a waste of corporate assets and an impermissible self-dealing transaction subject to the fairness standard.[172] Corporate waste "entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[173] These transfers are impermissible because they are technically a gift.[174] If the corporation receives "*any substantial* consideration" and there "is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude a post that the transaction was unreasonably risky."[175] According to Chancellor Allen, this standard is almost impossible to satisfy.[176] The Delaware Chancery Court is "ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, *ex post,* to judge appropriate degrees of business risk."[177]

Executive compensation may also be attacked in Delaware on the grounds that it is an impermissible self-dealing transaction. As mentioned earlier, executive compensation is a necessary self-interested transaction.[178] Therefore,

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[168] *Id.*

[169] *Id.*

[170] Sarbanes-Oxley Act, 107 P.L. 204; 116 Stat. 745 (2002).

[171] Martin D. Mobley, *Compensation Committee Reports Post-Sarbanes-Oxley: Unimproved Disclosure of Executive Compensation Policies and Practices,* 2005 COLUM. BUS. L. REV. 111, 115 (2005).

[172] In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

[173] *Lewis*, 699 A.2d at 336.

[174] *See id.* This is one of the reasons why shareholders must unanimously agree to ratify a transaction that amounts to a waste of corporate assets. *See* Saxe v. Brady, *184 A.2d 602, 605 (Del. Ch. 1962) ("[A]* waste of corporate assets is incapable of ratification without unanimous stockholder consent.*").*

[175] *Vogelstein*, 699 A.2d at 336 (referencing Gagliardi v. Trifoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996)).

[176] Steiner v. Meyerson, 1995 Del. Ch. LEXIS 95, at *3 (Jul. 18, 1995) ("[Corporate waste] is obviously an extreme test, very rarely satisfied by a shareholder plaintiff.").

[177] *Vogelstein*, 699 A.2d at 336.

[178] ALLEN, *supra* note 155, at 330.

self-dealing transactions are not necessarily void or voidable on this basis alone.[179]

Delaware corporate law carves out a safe-harbor provision reminiscent of the first element of the § 4958 rebuttable presumption of reasonableness standard in the Internal Revenue Code. Under Delaware law, assuming the interested party disclosed the material facts, a self-dealing transaction is protected if it is approved in good faith by either disinterested directors, shareholders, or "[t]he contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders."[180]

The independence of a director is based "on whether a director is, *for any substantial reason,* incapable of making a decision with only the best interests of the corporation in mind."[181] Although a director may not have a financial or obvious personal interest in a transaction, courts also express concern about their susceptibility to alternative influences.[182] For example, some "independent" directors may still be controlled by the board.[183] A controlled director "is one who is dominated by another party . . . ."[184] There is also a concern regarding "structural bias" and that disinterested or independent directors "will . . . identify with those of their fellow directors who have such a stake that their ostensibly independent judgment will be tainted in favor of their fellows."[185] Bias may also be external, coming from "relatives, corporate employees, vendors, lawyers, long-standing business associates or friends, or even college or foundation officers whose institutions have benefited."[186] In the *In re Oracle* case, the court incorporated in its independence analysis the "social nature of humans" as well as the fact that "corporate directors are generally the sort of people deeply enmeshed in social institutions [with] norms [and] expectations that, explicitly and implicitly, influence and channel the behavior of those who participate . . . ."[187]

Advisors hired by the board of directors must also be disinterested and independent.[188] In *Kahn v. Tremont Corp.*, the Supreme Court expressed a concern about the financial advisor utilized by a special committee.[189] The advisor

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[179] DEL. CODE ANN. tit. 8, § 144(a) (2010).

[180] *Id*.

[181] In re Oracle Corp. Derivative Litig., 824 A.2d 917, 920 (Del. Ch. 2003) (quoting Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001)); s*ee id.* at 941 n.62 ("'Independent director' means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.") (citing 68 Fed. Reg. 14,451, 14,452 (Mar. 25, 2003)).

[182] *See, e.g.,* Telxon Corp. v. Meyerson, 802 A.2d 257 (Del. 2002); *In re Oracle*, 824 A.2d at 920; Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002).

[183] *Telxon*, 802 A.2d at 264.

[184] *Id.* (citing *Orman*, 794 A.2d at 25 n.50).

[185] 1-15 Delaware Corporation Law and Practice § 15.05 (2009).

[186] *Id.* (citations omitted).

[187] *In re Oracle*, 824 A.2d at 938 (citations omitted) (concluding that the special litigation committee was unable to meet its burden to demonstrate independence, partially as a result of the board's ties to Stanford University and the involvement of a prominent figure in the Silicon Valley community) (citations omitted).

[188] Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997).

[189] *Id.*

selected "had a long and personally beneficial relationship" with two of the interested directors, worked for a bank that had a profitable business relationship with one of the director's related companies, and was associated with one of the three outside directors through a connected bank.[190] The Court concluded that the special committee failed to act independently.[191]

Satisfying the Delaware safe harbor provision, however, does not always "foreclose[] judicial review for fairness."[192] For example in *In re Wheelabrator*, despite the fact that the defendant obtained approval from disinterested directors, the whole board, disinterested shareholders, and all shareholders, the court was not willing to deny the plaintiff the right to make his case.[193] Rather, it shifted the burden of proof of fairness to the plaintiffs.[194]

Authorization, approval, or ratification by the board of directors is usually achieved through an independent negotiating committee of outside directors.[195] This special committee "must be properly charged by the full board, comprised of independent members, and vested with the resources to accomplish its task."[196] A special committee is responsible for negotiating the best available deal.[197] This enables the board of directors to maintain arm's length independence during the transaction.[198] Though less severe, the independence requirement of this committee is similar to the restriction in the tax regulations that members of the authorized body approving compensation are prohibited from serving if the benefiting party will, in the past or future, approve "a transaction providing economic benefits to the member."[199]

The Delaware standard is not as narrow as the tax regulations with respect to who can approve compensation, but "when directors approve in round-robin fashion each other's compensation while abstaining with respect to their own under circumstances which have the aura of quid pro quo," courts will usually consider them self-dealing transactions.[200] Though not required by law, and despite the apparent flaw in true independence, the use of outside directors to approve compensation packages is widespread.[201]

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[190] *Id.*

[191] *Id.*

[192] *See* ALLEN, *supra* note 155, at 320.

[193] In re Wheelabrator Techn's, Inc. S'holder Litig., 663 A.2d 1194 (Del. Ch. 1995); *but c.f.* In re CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010); Krieger v. Wesco Fin. Corp., 2011 WL 4840686 (Del. Ch. Oct. 13, 2011).

[194] Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1116 (Del. 1994) (citing Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985)).

[195] *See* Weinberger v. UOP, 457 A.2d 701, 709 n.7 (Del. 1983) ("Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length.").

[196] ALLEN, *supra* note 155, at 325.

[197] *Id.*

[198] *Weinberger*, 457 A.2d at 709 n.7.

[199] 26 C.F.R. § 53.4958-6(c)(1)(iii)(E) (2011).

[200] 1-15 Delaware Corporation Law and Practice § 15.05 n.20 (2009); *see also* In re InfoUSA, Inc. S'holders Litig., 953 A.2d 963 (Del. Ch. 2007).

[201] 1-15 Delaware Corporation Law and Practice § 15.09.

Shareholder authorization, approval, or ratification of executive compensation is far less common than authorization, approval, or ratification by the board of directors.[202] If shareholders approve or ratify a compensation package after it was approved in good faith by disinterested directors, the review standard on appeal would be the almost insurmountable, corporate waste standard.[203] In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act became law, allowing shareholders of publicly traded companies to cast non-binding "say-on-pay" votes on the compensation of executives.[204] The Act also requires disclosure of golden parachute packages to shareholders when voting on certain merger transactions.[205] While the Act is not designed to modify the fiduciary duties of directors and officers, several "shareholder derivative actions . . . have been filed based on negative shareholder say-on-pay votes in 2011."[206] Regardless of the outcome of these suits, it is clear that this legislation significantly increases the involvement of shareholder approval and ratification of executive compensation.

Lastly, the fairness component of Delaware § 144's safe harbor provision requires that interested directors "demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[207] According to this standard, a fairness analysis focuses on "fair dealing" and "fair price."[208] Although this fairness language is absent from the Internal Revenue Code and the tax regulations, it is reminiscent of the Code's overall requirement of reasonableness.

The second and third elements of the rebuttable presumption of reasonableness standard under § 4958 have specific parallels in Delaware corporate law. The Internal Revenue Code requires that the authorized body approving the compensation rely on appropriate data,[209] and "document the basis for its determination."[210] Similarly, § 144's safe harbor provisions are conditioned on the disclosure of all material information.[211] In addition, Delaware courts place

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[202] *See* 1-14 Delaware Corporation Law and Practice § 14.03 (shareholder involvement is most prominent when a compensation plan involves an issuance of stock options).

[203] Lewis v. Vogelstein, 699 A.2d 327, 338 (Del. Ch. 1997).

[204] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 STAT. 1376 (2010).

[205] *Id.*; *see also SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act*, U.S. SECURITIES AND EXCHANGE COMMISSION, www.sec.gov/news/press/2011/2011-25.htm (last visited Jan. 3, 2012).

[206] *Say-on-Pay Under Dodd-Frank*, N.Y. L.J., Aug. 25, 2011 (citations omitted).

[207] Weinberger v. UOP, 457 A.2d 701, 710 (Del. 1983).

[208] *Id.* at 711.

> The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

Id.

[209] 26 C.F.R. § 53.4958-6(a)(2) (2011).

[210] *Id.* § 53.4958-6(a)(3).

[211] DEL. CODE ANN. tit. 8, § 144(a) (2010); *see also* In re Pure Res. S'Holders Litig., 808 A.2d 421

emphasis on the use of outside experts and the overall process boards use when determining compensation packages. It is necessary to "probe and consider alternative[s]" when making decisions on behalf of a company.[212] Specifically, in certain circumstances the Delaware courts will impose additional obligations on directors overseeing the sale of control of a corporation.[213] When a company has been put up for sale at auction, "the Board's fiduciary obligations shift to obtaining the best value reasonably available to the target's stockholders."[214] Delaware courts do not impose such a stringent standard on other transactions, such as calculating executive compensation packages, but afford a great deal of deference to decisions based on proper process.[215]

A prime example of deference is the *In re Walt Disney Co. Derivative Litigation,* where the court determined that the board did not breach its fiduciary duty of care regarding the compensation committee's actions.[216] This was the court's decision despite the fact that Michael Ovitz, the short-term president and board member of Walt Disney, ultimately received approximately $140 million from the company for working for approximately one year before his employment was terminated. Disney's board delegated the power to create and approve compensation packages for the company's CEO and President to the compensation committee.[217] Defendant/appellants claimed "the record establishes that the compensation committee members did not properly inform themselves of the material facts and, hence, were grossly negligent in approving the [Non-Fault Termination] provisions of [Ovitz's employment agreement]."[218] They argued that the process of approval was flawed because: all of the committee members did not review a draft of the employment agreement; the minutes did not reflect a discussion of the non-fault termination provision; the committee did not consider alternative similar agreements; two committee members did not receive or review certain spreadsheets; and one board member was absent from the committee meeting.[219] The Chancellor concluded that while these failures in process were less than what "best practices" would have entailed, the process was not so insufficient as to warrant a breach of due care.[220] The Delaware Supreme Court affirmed this determination.[221]

The court concluded that based on the documentation in the compensation committees possession, the committee understood that the non-fault termination

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(2002) (holding that material information relevant to the decision-making process had not been fairly disclosed to the minority shareholders).

[212] In re Ft. Howard Corp. S'holders Litigation, 1988 Del. Ch. LEXIS 110, at *5 (Aug. 8, 1988).

[213] In re Smurfit-Stone Container Corp. S'holder Litig., 2011 Del. Ch. LEXIS 79, at *43 (May 20, 2011).

[214] *Id.* (citing Revlon v. Maandrews and Forbes Holdings, 506 A.2d 173,182–84 (Del. 1986)).

[215] *See e.g.* Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006).

[216] *Id.* at 59. Note that "no duty of loyalty claim was asserted against the Disney defendants . . . ." *Id.* at 52.

[217] *Id.* at 53.

[218] *Id.* at 55.

[219] *Id.*

[220] *Id.* at 56.

[221] *Id.* at 60.

payout coupled with Ovitz's accelerated options could have such a high value after only one year.[222] Although the minutes do not clearly reflect this understanding, the Delaware Supreme Court determined that the Court of Chancery had enough alternative evidence demonstrating the requisite process.[223] Other evidence included trial testimony of witnesses regarding the spreadsheets prepared as part of the compensation evaluation process, in addition to the valuation opinions of the former President's and Chief Operating Officer's and the current Chief Executive Officer's compensation packages, and the valuation of the potential Ovitz options conducted by an executive pay consultant.[224] The exempt organization tax regulations suggest similar comparisons when approving compensation schemes.[225]

It is important to note that Delaware does not always defer to the compensation committee, even after *Disney.* In *Valeant Pharmaceuticals Int'l v. Jerney*, the process used by the special committee responsible for calculating bonuses was tainted and the court concluded the "fair process" was entirely superficial.[226] Before the evaluation process even began it was clear that "there would be a bonus pool in the $50+ million value range."[227] The compensation committee was created after investors strongly criticized the proposed bonus pool.[228] The members of the committee evaluating the transaction were all interested parties.[229] They hired an advisor, who later told the court that he "understood that the proposal was . . . predetermined, and that [his firm's] job was to find a rationale to support it."[230] The final report omitted his initial suggestions to decrease the value of the options awarded in the transaction.[231] This case demonstrates that even if you have process, the presence of interested parties and their participation in evaluating a transaction can negate any deference the courts might otherwise afford under Delaware corporate law. Even if the parties were disinterested, the review process undergone here would still fall short of the § 4958 requirement regarding contemporaneous documentation.

IV. REMEDIES UNDER INTERMEDIATE SANCTIONS AND DELAWARE LAW

While the application of Delaware law would seldom result in recovery from the personal assets of a director, § 4958 not only targets these personal assets, but

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[222] *Id.* at 57.

[223] *Id.* at 58.

[224] *Id.* at 57.

[225] 26 C.F.R. § 53.4958-6(a)(2) (2011). Examples include "compensation levels paid by similarly situated organizations, . . . for functionally comparable positions," "the availability of similar services in the geographic area," "current compensation surveys compiled by independent firms," and "actual written offers from similar institutions competing for the services of the disqualified person." *Id.* § 53.4958-6(c)(2)(i)–(ii).

[226] Valeant Pharmals. Int'l v. Jenery, 921 A.2d 732, 746 (Del. Ch. 2007).

[227] *Id.* at 747.

[228] *Id.*

[229] *Id.* at 746.

[230] *Id.* at 747.

[231] *Id.*

actually forbids some forms of corporate indemnification and insurance.

Section 4958 imposes an initial tax equal to "25 percent of the excess benefit."[232] An additional tax of ten percent of the excess benefit will also be imposed on any involved organizational manager, if he or she knowingly was involved in the excess benefit transaction.[233] Knowingly participating requires the organizational manager have actual knowledge that the transaction would confer excess benefit and possibly violate federal tax law.[234] The manager must also negligently fail to determine whether an actual excess benefit will result, or he or she must actually be aware that the arrangement is an excess benefit transaction.[235] If the organizational manager's participation was not willful and was the result of reasonable cause, the tax will not be imposed.[236] If multiple organizational managers were involved in the excess benefit transaction, they are all held jointly and severally liable for the tax.[237] All of this would be radical territory for a Delaware corporation.

Further, if the excess benefit transaction is not rectified within the taxable period, a 200% tax is imposed on the excess benefit and must be paid by the disqualified person.[238] The taxable period begins on the earlier of "the date of mailing a notice of deficiency [regarding the initial tax]"[239] or "the date on which the tax imposed . . . is assessed."[240] In order to correct the excess benefit transaction, it must be "undo[ne] . . . to the extent possible" and "any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."[241]

To satisfy this standard, the disqualified person must make a payment in cash or cash equivalents to the tax-exempt organization.[242] It is also possible to correct an excess benefit transaction by returning assets to the tax-exempt organization.[243] If the excess benefit, however, was in the form of unpaid deferred compensation the disqualified person will correct the excess benefit by "relinquishing any right to receive the excess portion of the undistributed deferred compensation."[244] If the contract resulting in the excess benefit is not yet completed, the parties must

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[232] 26 U.S.C.S. § 4958(a)(1) (LexisNexis 2011).

[233] *Id.* § 4958(a)(2).

[234] 26 C.F.R. § 53.4958-1(d)(4)(i) (2011).

[235] *Id.*

[236] 26 U.S.C.S. § 4958(a)(2) (LexisNexis 2011); *see also* Hopkins, *supra* note 11, at 629 ("Participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act.").

[237] 26 U.S.C.S. § 4958(d)(1) (LexisNexis 2011).

[238] *Id.* § 4958(b).

[239] *Id.* § 4958(f)(5)(A).

[240] *Id.* § 4958(f)(5)(B).

[241] *Id.* § 4958(f)(6).

[242] 26 C.F.R. § 53.4958-7(b)(1) (2011) (a disqualified person may not correct an excess benefit with a payment by a promissory note).

[243] *See* Caracci v. Comm'r, 118 T.C. 379 (2002).

[244] 26 C.F.R. § 53.4958-7(b)(3) (2011).

amend its terms to prevent any excess benefit transactions in the future.[245] The correction amount is not only the excess benefit, but interest on the excess benefit as well.[246] The interest charge "is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the excess benefit transaction occurred to the date of correction."[247]

It is impossible to even imagine a comparable remedy under the Delaware corporate law framework. Not only do directors have the opportunity to retain control of funds that are the subject of litigation, but directors may be indemnified without security for activities which are later determined to have violated the duty of loyalty.

As discussed above, intermediate sanctions under § 4958 were applied in *Caracci v. Commissioner*.[248] The Commissioner of the IRS concluded that the assets transferred surpassed the value of the liabilities and debts assumed by the subchapter-S corporations by $18.5 million, resulting in an "excess benefit,"[249] and the Commissioner imposed an excise tax on the various defendants totaling $250 million.[250] The Tax Court concluded that there was excess benefit, but reduced amount of benefit conferred because the tax and penalties imposed were based on inaccurate deficiency notices that the Commissioner's own expert conceded were "excessive, incorrect and erroneous."[251] The Fifth Circuit overturned the Tax Courts decision, citing improper valuation methods.[252] Both the Tax Court and the appeal in the Fifth Circuit focused on the fair market value of the assets and liabilities transferred to determine how much economic benefit was conferred, rather than the punitive application of excise taxes under § 4958 itself.[253] Ultimately, practitioners were disappointed with the *Carracci* case because the § 4958 issues were not clearly presented.[254]

While the judicial application of § 4958 intermediate sanctions has been limited, several private letter rulings are available. In one private letter ruling, the IRS did not find an excess benefit despite the opportunity for some indirect private benefit.[255] In this ruling, a nonprofit organization (F), operated a short-term acute care hospital.[256] F purchased a 10-passenger bus to be used for F's inpatient rehabilitation program to transport and enable patients to transition back into the

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245 *Id.* § 53.4958-7(d).

246 *Id.* § 53.4958-7(c).

247 *Id.*

248 Caracci v. Comm'r, 456 F.3d 444, 450 (5th Cir. 2006).

249 *Id.*

250 *Id.* (this extremely high excise tax suggests that the IRS was doubtful that Caracci's motivations for converting the tax-exempt entities into for-profit corporations were solely to qualify for loans that were not eligible to tax-exempt entities).

251 *Id.* at 450–51.

252 *Id.* at 457–58.

253 *Id.* at 456; *see also* Karns, *supra* note 8, at 448.

254 Karns, *supra* note 8, at 448 (citing 3 TAX MGMT. IRS PRAC. ADVISER REP. 61, Dec. 10, 1999, at 74).

255 *Caracci*, 456 F.3d at 450.

256 *Id.* at 457–58.

community.[257] The surrounding area did not provide a taxi service or public transportation.[258] When the bus is not being used by the rehabilitation program, F planned to provide free transportation "from any adult patient's home to the hospital, any of its outpatient services, or to a physician office within the service area's communities, regardless of whether the physician is a member of F's medical staff."[259] According to the facts "[n]one of the physicians benefiting from this transportation system have a direct business relationship with F . . . [or] a financial interest in the transportation system."[260] The facts also indicate that three of F's board members are physicians, whose patients will be able to use the transportation service.[261] The ruling reasoned that because the free transportation service will be accessible to the surrounding medical service area and not just the patients of F's medical staff, the service would not constitute excess benefit by a disqualified person under § 4958.[262] Intermediate sanctions were not warranted despite the fact that the board member physicians and their patients could use the bus service because it will "be equally available to all patients of all physicians in F's service area."[263] The IRS concluded that "the fact that disqualified persons may derive a benefit from the operation of the bus service to the same extent as similarly situated members of the general public is insufficient to support a conclusion that the operation of the bus service will confer an excess benefit on disqualified persons."[264] While this letter ruling provides some evidence of IRS reasonableness, the applicant felt sufficiently concerned to undertake the process. The willingness of individuals to pay to have a private letter ruling issued is indicative of the level of concern of the imposition of intermediate sanctions, whereas it is difficult to imagine that the Delaware courts would even take the time to address such a low level benefit.

Under Delaware law, interested directors and officers of for-profit entities are seldom found personally liable. In Delaware, corporate law affords directors four layers of protection that insulate them from liability for violations of their fiduciary duties. The first layer of protection is the business judgment rule, which excuses independent and disinterested directors from "liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty."[265] Contrast this with the provision in § 4958 that excuses an organizational manager from intermediate sanctions if his or her participation was not willful and was the result of reasonable cause.[266]

A second layer of protection is indemnification, permitted under § 145 of the

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[257] I.R.S. Tech. Adv. Mem. 200244028 (Jun. 21, 2002).
[258] *Id.*
[259] *Id.*
[260] *Id.*
[261] *Id.*
[262] ALLEN, *supra* note 155, at 332.
[263] *Id.*; *see also* Lee, *supra* note 156, at 945–46.
[264] *Id.* at 330.
[265] *Id.* at 1052–53 (citing Saxe v. Brady, *184 A.2d 602, 602 (Del. Ch. 1962)*).
[266] 26 U.S.C.S. § 4958(a)(2) (LexisNexis 2011).

Delaware Annotated Code.[267] The provision gives corporations the power to indemnify any director, officer, employee or agent of the corporation against expenses, judgments, fines and settlements if the person acted in "in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[268] This protects directors from liability for breaches of both the duty of care and duty of loyalty. Indemnification is not permitted if the person is found liable to the corporation, unless the Court of Chancery determines the director, officer, or employee deserves the indemnification.[269] If the person is successful on the merits or otherwise, the corporation has an affirmative obligation to indemnify them.[270] This indemnification would include the cost of attorneys' fees, regardless of whether the director acted in good faith.[271] Further, these attorneys' fees and any other expenses can be paid in advance by the corporation and later repaid if necessary.[272] As described above, indemnification is forbidden for penalties under § 4958.

Director and officer insurance is a third mechanism for limiting the personal liability of a Delaware director.[273] Delaware law permits a corporation to buy and maintain an insurance policy for any liability asserted against a director, officer, or other agent of the corporation, thus insulating directors from liability for a breach of duty of care or loyalty.[274] This insurance may be provided irrespective of "whether or not the corporation would have the power to indemnify such person against such liability."[275] The corporation may even pay the insurance premium.[276] Under intermediate sanctions, the tax-exempt corporation is forbidden from purchasing insurance to cover the excise taxes.

The final layer of protection is the liability waiver permitted under Delaware law. Delaware's § 102(b)(7) permits the corporate charter to limit or eliminate personal liability for monetary damages for a breach of the duty of care by a director.[277] This waiver, however, does not protect a director from liability for a breach of duty of loyalty or for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law . . . or for any transaction from which the director derived an improper personal benefit."[278] In addition, Delaware General Corporate Law § 122(17) gives corporations the power to

> Renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity

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267 DEL. CODE ANN. tit. 8, § 145(a) (2010).

268 *Id.*

269 *Id.* § 145(b).

270 *Id.* § 145(c); *see also* Waltuch v. Conticommodity Services, Inc., 88 F.3d 87 (2d Cir. 1996).

271 DEL. CODE ANN. tit. 8, § 145(c) (2010).

272 *Id.* § 145(e).

273 ALLEN, *supra* note 155, at 243.

274 DEL. CODE ANN. tit. 8, § 145(g) (2010).

275 *Id.*

276 ALLEN, *supra* note 155, at 249.

277 DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

278 *Id.*

> to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or [one] or more of its officers, directors or stockholders.[279]

Section 4958 is quite stark in the threat of personal liability, without the additional institutional insulation of a pro-corporate Delaware judiciary generally unwilling to punish executives. Unlike the four layers of protection insulating directors from liability under for-profit Delaware corporate law, the Internal Revenue Code offers no such protections. Nonprofit corporations cannot waive or limit personal liability, nor are they permitted to obtain insurance to protect individuals found personally liable under § 4958.

V. CONCLUSION

Before § 4958 was added to the Internal Revenue Code, tax-exempt organizations were harshly penalized for impermissible inurement and private benefit.[280] With the creation of intermediate sanctions, the IRS is given the option of imposing a penalty focused on the organization's directors and officers instead of the charity itself.[281] This penalty subjects individual actors committing the wrongdoing to personal tax penalties.[282]

While § 4958 and Delaware corporate law cover similar territory, they take remarkably different paths to accomplish the same objective. By comparing the Tax Code with Delaware corporate law it is readily apparent that, despite the similarities, § 4958 is far more restrictive.

It is arguable that, unlike the IRS and the Tax Court, Delaware common law is shaped by institutional bias. According to both scholars and practitioners, "corporate law . . . is created by a process of competition between the states, [with] [e]ach state ha[ving] an incentive to entice out-of-state corporations to incorporate under its law because it derives tax revenue from the corporation."[283] Delaware's small size, central location and limited countervailing interests create the necessary conditions to develop favorable corporate laws.[284] Over time, Delaware has become very dependent on the revenue derived from corporate taxation.[285] Authorities speculate, "should any other state find an attractive corporate law innovation, Delaware will match if not better it."[286] Alternatively, the grasp of the IRS spans across the country. Nonprofit entities have no choice of venue in which to escape the Internal Revenue Code. While it is arguable the harsh personal liabilities under § 4958 might deter individuals from working for nonprofits, there is no supporting empirical data. Therefore, the IRS has no incentive to create less

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279 DEL. CODE ANN. tit. 8, § 122(17) (2010).

280 I.R.S. PRIV. LTR. RUL. *200435019 (May 5, 2004).*

281 Karns, *supra* note 8, at 425 (citation omitted).

282 Id.

283 Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 384 (2005).

284 *Id.* at 387.

285 *Id.*

286 *Id.* (citations omitted).

restrictive laws governing unreasonable nonprofit executive compensation.

A more overt justification for the heightened tax regulations is that nonprofits lack the same external governance that Delaware law affords.[287] The actions of directors, officers, and employees of for-profit corporations are monitored by shareholders who have a financial interest in the corporation.[288] When corporate management engages in wrongdoing, shareholders may bring direct and derivative actions against them.[289] Specifically, a derivate claim for excess compensation requires a plaintiff demonstrate that "the board or relevant committee that awarded the compensation lacked independence" or that "the board, while independent, nevertheless lacked good faith in making the award."[290] Derivative actions are not available in the context of nonprofit entities because there are no shareholders. Further, the nonprofit counterpart to shareholders are donors who have no direct financial incentive to monitor against self-dealing. If a donor feels their charitable donation is not being used to further the charitable purpose of the organization, he or she simply can stop making contributions.[291] Though the IRS monitors nonprofits through audits and Form 990, there is arguably no greater motivator than one's own financial well-being. Monitoring by shareholders with vested interests in for-profit companies will likely be more successful than monitoring solely to prevent abuse or wrongdoing in nonprofit organizations. In the absence of shareholders, federal law imposes a much stricter liability regime policing the duty of loyalty. The deterrents must be stronger and the rules tougher when the agents lack principals.

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[287] *See* Gary, *supra* note 1, at 596 (citation omitted).

[288] *Id.* at 595 ("In a corporation, the shareholders keep an eye on the directors since director malfeasance will harm their interests.").

[289] ALLEN, *supra* note 155, at 363.

[290] Gagliardi v. Trifoods Int'l Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996).

[291] Jeremy Benjamin, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677–79 (2009); Gary, *supra* note 1, at 615.