Policy, Leaders, and Succession in Not-for-Profit Firms

by

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I. Introduction

The recent removal of the Board of Trustees of Adelphi University by the New York State Board of Regents (refs to NY times and CHE articles) highlights one of the more unusual and least-understood features of not for profit corporations -- the mechanisms for selection, replication, and removal of the ultimate leaders of such corporations. Not for profit (NFP) corporations as sanctioned by US tax code under Sec. 501(c)3 have important differences from standard for profit corporations. Only certain types of organizations (including educational institutions) receive automatic 501(c)3 exemption from taxation, while others (such as hospitals) must carry out certain "charitable" actions in return for their tax exempt status. The underlying logic for creating this class of firms rests on the belief that the activities they perform have some public-good aspect about them, or that the nature of their product or service (typically, service) carries with it some important element of trust that the for-profit motive may interfere with (Arrow, 1962). A little-understood aspect of NPF firms is their ability to earn profit. NFP firms may in fact earn profits, but they cannot distribute them externally to shareholders, and it is the lack of existence of shareholders (or any equivalent group of residual claimants) that most importantly distinguishes NFP firms from their for-profit analogs. Without formally designated residual claimants in the firm, the organization's leaders must select some other group or activity to receive any profits made by the firm. Often, but not invariably, such profits are dispersed through improvement in the quality of service provided, the scope of services, or the number of services rendered. In other occasions, the profits are dispersed to some affiliated group of individuals, such as the medical staff of a hospital (through provision of resources to the physicians at below-market costs) or employees of the organization (through higher than market equivalent wages). Occasionally, as in the Adelphi University case, allegations are
made (and in that case, sustained by Board of Regents ruling) that the profits had been directed to
the President (via compensation) and trustees (via transactions between the university and firms of
key Board members without competitive bidding).

NFP firms are usually characterized as having multiple goals, rather than the presumed single
goal of for profit firms of maximizing shareholder wealth.¹ The potential multiplicity of goals is
closely tied to the problem of identifying a presumptive residual claimant. Indeed, the question of
what a NFP firm "should" do as a corporate goal sits directly on the question of disperson of profits
and the question of the composition, succession, and potential replacement of boards of trustees of
such organizations. In other words, identifying the goals, the directors, and the proxy residual
claimants are essentially one and the same question (although the director and the proxy residual
claimants need not be the same groups).

These questions in turn focus on the incomplete nature of property rights in the NFP firm.
Without a legally designated residual claimant, the control of profits becomes a political quesiton
resolved with the structure set forth by the NFP firm's charter and bylaws, and the ability of
individuals from within and outside the firm to affect its behavior within the context of those
bylaws. The studies of agenda setting, principle-agent problems, coalition formation, and the like
are essential for understanding how such activities actually take place in specific NFP firms, but this
is not the focus of our study here. Rather, we will take as given that such a process exists, and at

¹ The presence of multiple goals for NFP firms also significantly affects the ability of the
firm to use incentive compensation for their executives, since, particularly with a complex and
incompletely defined set of goals. If executives are confronted with an incentive compensation
program that emphasizes only a subset of the multiple goals of the NFP firm, their behavior, and
hence the activities of the corporation can become distorted. This remains the topic for future
consideration.
least for temporary intervals, creates an organization that behaves as if it had a stable preference function embodying multiple goals. Just how this actually occurs is not important here, since we only wish to use these ideas to set the behavior of the NPF firm into the context of a market in which it often must operate, a task to which we turn in the next section.

After developing a simple model of market behavior for NFP firms, we turn to the fundamental issue for this paper, the question of how such firms specify their goals, how they replace their directors, and what alternatives exist to overturn such directors when the firm's behavior becomes sufficiently inappropriate. This last question, in turn, requires some sort of societal norm of behavior for the firm, and hence the identification of some group or groups of individuals whose preferences stand as the ultimate standard of behavior against which the NFP firm's behavior is judged.

II. A Model of Market Equilibrium with Not for Profit Organization

We begin with a model of market equilibrium in a monopolistic competition framework, posting an organization with the dual goal of increasing output (quantity) and improving quality. The goals serve as proxies for what might be a wider set of goals, but this approach captures many of the essential features of NFP firm behavior in a market context, and has a history of such analyses being used in previous work (Newhouse, 19xx, Phelps and Sened, 1989).

To develop this model, first, consider the willingness to pay (inverse demand curve) for individual \( j \) for quality of service \( i \), which we denote as \( p_{ij} \). This holds constant the prices and qualities of all other providers. Summing across all consumers in the market gives a family of demand curves, each representing a different quality \( i \), denoted \( P_i \). The height of these curves
systematically increases in quality, so for any quantity \( Q^* \), when \( QL_n > QL_m \), \( P_n(Q^*) > P_m(Q^*) \). We also assume a standard technology for producing the service with tradition U-shaped cost curves, also increasing in quality, so \( AC_n(Q^*) > AC_m(Q^*) \) similarly. Thus we can portray a family of inverse demand curves (generically, \( P_i \)) and average cost curves (generically, \( AC_i \)).

Not-for-profit legal rules prohibit distribution of profits to shareholders (there are none), so profits must be spent internally either enhancing quality or subsidizing output, or combinations thereof. (This ignores intertemporal transfer of profits through endowments, which only slightly complicates the discussion, but does not fundamentally alter the ideas we set forth below.) Thus for any quality \( QL_p \), the only legitimate operating points that simultaneously clear the market and satisfy the legal not for profit constraint are those where the demand curve intersects the average cost curve. If the organization prefers to produce more than less (see next section for further discussion) then if there are two intersection points, only the lower right of them will be observed. Entry (or changes in quality or price) by competing firms shifts the entire family of demand curves for the not for profit firm. Such entry can occur only until the inverse demand curves become tangent to the corresponding \( AC \) curves for all possible levels of quality, at which point entry is no longer supportable. We can trace out the set of all possible points of production that simultaneously satisfy the not for profit legal constraint and clear the market (so that quantity produced equals quantity purchased at the relevant price). Figure 2.1 shows a prototypical cost and demand curve in this situation, and the curve EE traces out all possible combinations of output that are possible. (Each point on this curve represents a similar tangency of an \( AC \) and \( P \) curve.) If quality can be adjusted continuously, then the EE curve is smooth and continuous. It also can be shown (see Phelps and Sened, 1989) that this curve is bowed as shown in Figure 2.1 (This relies only on the notion that
marginal value of quality increases at a decreasing rate and average cost of production eventually increases at an increasing rate with quality.). Further, as we show next, the only relevant portion of this curve is the backward bending portion where quality and quantity substitute one for another.

Figure 2.1 here -- Constructing the EE curve

The next question to ask is which of these qualities are chosen for the firm's actual output. To analyze this, we invoke an idea first introduced by Newhouse (1971), by presuming that the organization has, in effect, a stable utility function it wishes to maximize, which we denote U(QN, QL). For now, consider it as the utility function of the CEO; in the next section, we discuss how the preferences of others (including the members of the Board of Trustees) enter this discussion. Figure 2.2 shows such a preference function, and also maps the equilibrium production set EE from Figure 2.1 into a comparable opportunity possibility frontier FF in Figure 2.2. Thus, FF contains the same information as EE, but in a different "space." The utility maximizing output is readily found by the familiar tangency of the highest possible indifference curve with the opportunity possibility frontier FF. From this tangency the single optimum quality QL* can be chosen, and the intersection of the comparable demand curve and AC curve in Figure 2.1 will be the observed output and price. Since the indifference curves from the utility function are downward sloping, the optimizing tangency can only occur on the portion of the FF curve corresponding to the backward bending portion of EE in Figure 2.1. Thus, we should always expect to observe direct tradeoffs between quality and quantity of output in not for profit firms.

Figure 2.2 here -- Selecting the Optimal Quality

This framework is obviously static, omitting important dynamic considerations such as the effect of this period's quality on future demand, the ability to transfer resources intertemporally
through endowments (a feature allowed not for profit firms), and the possibility that the utility function of the not for profit organization may change through time. However, we set this model out primarily to motivate our subsequent discussion of how such a utility function might be formulated, which in turn leads to our discussion about the issues of ownership and leadership of such organizations that form the basic purpose for our analysis. For our purposes here, the key idea is that a not for profit organization can be expected to act as if it has such a utility function, that the function will contain factors in addition to profits of the firm, and that both the market and the legal not for profit constraint limit the choices of the leaders of the NFP organization in setting quality, price, and output.

III. Establishing Organizational Policy and Behavior

Setting Board Policy. We are now in a position to understand where the utility function for the organization comes from. Consider a Board of Trustees with 3 members, whom (for convenience) we shall call Bob, John, and Hugo. Each has preferences for operating the university that differ in both the quality and quantity dimension. These trustees are considered sufficiently sophisticated to understand that the university must operate along the market-determined FF curve (from Figure 2.2), and in this simple two dimensional world, with the market constraint added, there is only one relevant policy dimension, and standard voting theory says that with a majority rule vote in the Board, the median voter will prevail. As portrayed in Figure 3.1, Bob is the median voter, and the point * will be the chosen policy point, the tangency of the median preferences with the FF curve.

Enforcing Board Policy. Although not wholly germane to our discussion here, it should be obvious that the President's preferences enter this discussion as well, so long as there is some slack
in the review system of the institution. For example, there might be a significant transactions costs to firing the president and replacing him, with no certainty that the new president will do better than the current one. That slack gives the President the opportunity to shift back to his most preferred point along the FF curve (his bliss point is shown as **), the degree of shift depending on the magnitude of slack. Some intermediate point, e.g., *** may be chosen, although it is obvious that with sufficient enforcement slack, the President may be able to operate at point **.

There may also be uncertainty about the actual market opportunities, giving the President further operating slack. Finally, as has been discussed in some studies of political behavior (e.g., Hill, 1986) the Board may not be able to specify policy on all relevant dimensions. (here, the world is sufficiently constrained so that the Board can except for enforcement problems). In such a setting, the sequence of voting on various dimensions of policy (or whatever mechanisms are used) can also lead to managerial prerogative that shifts operation away from formal Board policy. All of these provide reasons why the actual operation of the institution may deviate from the formal policy, yet the President retain his job.

**Board Succession.** Now consider what happens when the term of office for one of the Board members expires. Depending on how the succession policies work, the newly constituted Board could either proceed with the same outcomes or change to a different policy. How this happens depends on the established mechanisms of replacement as specified in the Bylaws of the organization. And, as we shall see in a moment, we may also have to consider the issue of an endogenous budget constraint confronting the Board.

Consider first a "constituency-based" board composition policy, for example, that John's Board seat is determined in the bylaws to represent a particular group (e.g. alumni, who favor a
successful athletic program). Their interests are to have a larger institution (presumably more successful in athletics) and they are willing to accept lower quality. If they replace John as their representative with any other board member who's preferences lead to a tangency with the FF curve to the southeast of point *, the new member will also find himself marginalized, ineffective, and frustrated. Like John, the new member will have no effect on policy or behavior.

However, if John's board seat does not come from a predetermined group, then when his term of office expires, then coalitions of the current Board, along with the President, can work together to find an alternative board member who helps support their own goals.

We are now in a position to consider how the selection of new members of the Board occurs. Potential candidates emerge who are willing to contribute both the time involved in Board participation and to bring new financial resources, either through their own gifts or through influence to cause others to give. At any point in time, we can enumerate the set of potential new board members, who can be characterized by their preferences and the endowment they bring. This can be characterized here as a triplet of (QL, QN, $). The current board (including John) votes on new members, and coalitions will form around the candidates who succeed in improving the utility most of some majority of the current trustees through their effect on policy, operational choices of the president, and the location of the FF curve.

To see how this can work, consider figure 3.2, which posits a world where Hugo succeeds in finding a foundation that will contribute new resources to the University of sufficient magnitude to shift the opportunity frontier outward to FF'. If the foundation were independently to give the money, then everybody's well being would improve (to H' from H, to B' from B, and to J' from J), and that would be the end of the story. However, Hugo can cause the institutional policy to shift
along the new $F'F'$ curve in exchange for the work to get the new endowment resources. The pivotal participant here, to no surprise, is the median board member (Bob). Policy can shift upward along the new $F'F'$ curve up to the point where Bob is indifferent between the new point $**$ and the previous policy point $*$. So long as he is made slightly better than indifferent, he and Hugo can create a majority vote to accept the new gift, even if it entails a formal policy switch as well. John, who would support an unrestricted gift, will vote against accepting the gift given the restrictions that Hugo can impose (and get Bob to agree to), since John is worse off (lower utility) at the point $**$ than he would be at the original operating point $*$. 

Obviously, the same exercise takes place in the selection of new board members. Coalitions of current board members can band together to favor or disfavor various nominees among the eligible set using analysis that closely resembles the discussion about Hugo's gift-getting abilities. The existing trustees will enumerate the potential new board members (remember: they give up something to become board members, so the list will not necessarily be extensive), evaluating their preferences and potential additions to the endowment, and the majority will select the candidate who most improves their current position.

Is there any way that the athletics-loving alumni can succeed in capturing control of the organization? Yes; they can offer up a candidate who comes not only with appropriate preferences (from their point of view) but also with sufficient financial backing of alumni donations to cause Bob to form a new coalition with them, supporting a new replacement for John. As they do so, institutional policy will shift, away from Hugo's preferences towards Johns. Figure 3.3 shows such a shift in institutional policy, conditional on a successful gift-raising activity by the athletics-loving alumni group.
IV. Monitoring the NFP Firm's Behavior

The process of self-replication described in Section III (albeit in very abstract terms) models the process that most Boards follow for most of their existence. It is worth remembering that this process differs from that found in for-profit boards of directors in at least three important ways: (1) the NFP firm has multidimensioned goals, vs. the single-dimensioned goal of profit maximization in the for-profit firm. (2) Shareholders can contest and reverse a board not meeting those objectives. (3) Membership on a NFP board also can bring with it a shift in the budget and opportunity constraint of the organization, so that the opportunity set must be viewed as jointly determined with the selection of board members.

Given these differences, if the behavior of the NFP organization begins to deviate markedly from the interests of a more broadly defined society (which has an interest in the matter because of the subsidy arising through the Sec. 501(c)3 tax exemption), the mechanisms to oust the Board are weaker, and the transactions costs of assembling relevant constituencies to resolve the problem may be immense. For example, a group of irate alumni might generate a class-action suit to remove a current board of trustees, but the transactions costs of such a move are very high indeed, and the rewards to those trying to assemble the class may be quite small.

From a public policy point of view, what we might deem as the "right" group as the ultimate oversight group (akin to the legal concept of "standing") must ultimately be tempered by the economic concept of transactions and informational costs. Thus, we seek to determine if there is a relevant group in society that could serve in lieu of shareholders and perform the same policing function of boards of trustees as such shareholders do in policing the behavior of the NFP board of trustees, and to consider how such a group might be brought in as a final check on board behavior.
In concept, a number of groups could serve such an interest. In colleges and universities, the potential groups include current students, former students (alumni), current faculty (including or excluding those with tenure), former faculty (many possible sets here, including retirees, those who had moved to a different institution, etc.) donors (a group that will heavily overlap alumni), and in more locally oriented schools, residents of the surrounding community. In the case of colleges and universities, there are also available various accreditation bodies, who have been suggested as the relevant group to perform this policing function by at least one quasi-serious person (Atwood, 1997). Finally, we can consider the role of the state as a potential final monitor of NFP board behavior, in a manner akin to that exercised by the NY Board of Regents in ousting the Adelphi University trustees as described in our introductory (and motivating) comments.

In other settings, the relevant constituencies are also easy to identify. Most churches have leadership directly voted by the current membership, with oversight commonly by some national group with which the local church is affiliated (or, in some cases such as Roman Catholic, an international organization has ultimate authority). Local neighbors may be an affected constituency as well, as they might be from any commercial establishment, and will have the same recourse to limit obnoxious behavior (e.g., zoning law enforcement) as they would with commercial establishments. Hospitals have several obvious constituencies, the most prominent being the medical staff who perform the medical care within the hospital, and indeed, these groups often exert strong (some would say dominant -- see Pauly, 19xx) control. Current and former patients offer another possible constituency, although it may be difficult to contact those who have died, which raises the question of whether "standing" passes to relatives in such cases. Every NFP organization has one common constituency group that we can identify -- donors -- and as we shall argue below,
this group forms a logical basis for seeking a proxy shareholder group in many, if not all NFP organizations.

To illuminate our thinking on this matter, let us explore in more detail the various groups within colleges and universities that might serve as proxy shareholders for the purpose of monitoring Board behavior. In these discussions, we will consider in particular how to measure the strength of interest of the individual (the "degree" of standing), possible conflicts of interest in resource allocation within the college or university, both across function within a single time period and intergenerationally.

Let us begin with the question of current students. This is a natural group to consider, since they are easy to identify and communicate with, and are presumably at least modestly well informed about the activities of the institution (albeit from a limited perspective). This group brings with it, however, several problems in turning to them as proxy shareholder. First, their extent of affiliation with the organization is as yet unproven, since they may transfer to another institution to complete their training. Once they have received a degree, they acquire a capitalized interest in the reputation of the institution. Second, and perhaps most important, they have important incentives to tip the resource allocation decisions intergenerationally towards themselves, away from future students.

Current faculty (and to a lesser extent, staff) bring similar strengths and weaknesses to the table. Particularly tenured faculty have a presumptively strong long term affiliation with the institution (unlike current students), and are (like current students) presumptively modestly well informed about the institution's activities (again, from a limited perspective, differing from that of the students). However, current faculty have the same considerable defect as current students -- they
face important incentives to tip the resource allocation mechanism in their favor, not only across activity (as is also true of current students) but also intertemporally. Cross-function distortions that can occur in any time period include increased compensation, larger faculty or increased staff assistance (to reduce work loads), offices with more amenities, etc. But the most important distortions are intertemporal. These incentives have been explored in depth in studies of worker-owned firms (citations). All of the resource-consuming activities just listed require a source of support, and in NFP organizations, three distinct mechanisms exist to shift resources from the future into the present that current faculty will have strong desires to use -- excess use of the endowment, commitment now to post-retirement benefits that must be funded from future operations, and finally, deferral of capital maintenance and replacement. (The latter issue looms large on many campuses, perhaps nowhere larger than the widely publicized accumulation of $1 billion in deferred maintenance expenses at Yale University, including a $.1 billion expense for a single building -- the university library.) Thus, although current faculty bring both a long term time commitment and a relatively good body of information about the institution's functioning, their resource allocation incentives stand as an important obstacle to using them as a monitor for Board behavior.

Alumni of the college or university form a natural body to consider as a proxy shareholder group. They are easily identified with virtually no ambiguity, and they have an incentive to maximize the reputational value of the degree they received from the institution. But this statement alone emphasizes one difficulty with this group: the importance of that reputational value differs by age of the alumni. Those who have just graduated have the greatest present-value concern with the reputation, and those near death the least. Should they each count equally in serving as proxy shareholders, or should they count on some actuarial life expectancy basis? There is a separate but
also age-related issue; previous alumni may seek to make the institution more like they one they knew than the one they currently see, and many conditions will have changed through the many decades since some alumni have graduated, making both their knowledge base about the institution and their preferences less relevant. Obviously, underlying economic conditions may have changed dramatically through time (in our parlance, shifting the EE and FF curves described in section II) in a way that makes the entire preference set of far-distant alumni irrelevant. Social customs and mores also change, and hence attitudes about what is appropriate and acceptable behavior. This is not to say that past attitudes and preferences should not count automatically, but to note that they may come into jarring conflict with current social custom and economic reality.

Donors to the institution stand as another potential proxy-shareholder group. This group overlaps in part with almost all of the previously-discussed groups to some degree, since donations come from current faculty and staff, alumni, current students (and their parents), neighboring residents, and trustees themselves. In addition, donors can include corporations, foundations, and otherwise-unrelated individuals. The advantages of using donors as a proxy shareholder group include most obviously that we have a direct measure of the intensity of interest they have in the college or university, a basis upon which "proxy shareholder" votes could be established.

Having said that, however, we must immediately note some major complications in moving in such a direction, particularly revolving around the timing and purpose of the donation. As to

\[2\] An true, albeit anecdotal example: The University of Rochester was founded as a Baptist school, but became non-sectarian relatively early in its history. During the 1993 search for a new president of the University, one of us (Phelps, obviously) chaired the faculty advisory committee to the Board of Trustees' Presidential Search Committee. The search committee received a letter from an elderly alumna who wrote, "Please, make the new President a good Baptist. No more Catholics! [The previous president was a Roman Catholic.] And NO Jews!" Not only do tastes differ, but mores change!
timing, one must consider (in both directions) the present real value of the gift vs. its nominal amount at the time given. Older gifts have created intererst income that has either previously benefitted the institution or accumulated for future benefit. Some gifts are also future pledges, including many estate gifts with an uncertain time of conversion to actual cash. Making all such gifts commensurate would be an important step in using the degree of giving as a basis for proxy shareholder voting. A second important consideration -- more complex in complicated universities with professional schools than in simpler college structures -- is the treatment of restricted gifts. Does a gift to the Dept. of Neurosurgery in a medical school "count" the same as an unrestricted gift to the undergraduate college? Similarly, do gifts restricted to certain programmatic uses "count" equally to unrestricted gifts, even within the College environment? Many corporate gifts, particularly in recent years, are really quasi-contracts for the performance of specific research. How should these count? Even the simple classification of "restricted" vs. "not restricted" does not necessarily suffice, since some restricted gifts are infra-marginal to the the otherwise-intended patterns of resource allocation within the university or college, and hence serve realistically as equivalent to unrestricted gifts.

[Tom: I am prone to working this section up more, and positing that this group, if any, serve as an external check on the Board. But the complications are very real.]

What of other more external groups, i.e., those with no direct current or previous affiliation with the institution? Two such groups come to mind, and yet they are not unrelated -- private accreditation bodies and the government. They are related in the following way: in many important settings, private accreditation acquires its importance not from the quality or importance of its work per se, but because the accreditation becomes a de facto government accreditation process. This
occurs on every occasion when government disperal of funds hinges on private accreditation approval. Such a link is commonplace, arising in hospitals (the Joint Commision on Accreditation of Health Care Facilities, sponsored by the American Medical Assn. and the American Hospital Association), higher education (the various regional accreditation authorities on who's approval hinges the ability of the students to use federal aid to education at the school), and other similar settings.

The college and university accreditation process, with which we are most familiar, offers a good point of discussion about the more general issues. The most important of these, because government rules only allow students to use federal aid and loan monies at accredited schools, are the regional accreditation bodies. These groups accredit every institution of higher education (2 year colleges, 4 year colleges, limited-range universities, and major research universities together) within their defined geographic region. Accreditation visits, which occur every 10 years, require a wide range of data gathering from within the institution for the site visit, plus a fairly intense self-study. The current emphasis of regional accreditation bodies is the development of "outcomes" measures, a task for which there is little precedent or guidance within higher education. The array of organizations studied makes it unlikely that the accrediting bodies will have expertise in all areas of their perview equally. Perhaps most importantly for our purposes here, regional accreditation visits have little if anything to do with the leadership of a college or university at the trustee level. Neither the professional staff of the accrediting bodies nor the site visit teams (a combination of staff and visiting faculty and academic leaders from other institutions) are likely to understand the nature of trustee leadership within an institution, and virtually no relevant data on these issues are collected in the data gathering process. Site visits do not routinely include even discussions with trustees, let
alone probing analysis of such matters as trustee succession policy. Thus, accreditation bodies are unlikely to serve a useful function here. Further, we would argue that it is unlikely that such bodies could meaningfully probe trustee relationships, since many of the pertinent matters can only be understood either from within the workings of the Board itself or by observing a long period of behavior and change within the academic institution.

[comment here about the last accreditation visit at Adelphi? Note that there is a risk in all of this that our article precipitates a more intense review of trustee matters, making the whole accreditation process even more onerous. I also need details of what the process actually does; the above para. is a guess.]

Government oversight of private higher education is also fraught with potential difficulty. First and foremost, government bodies are inherently conflicted in this matter whenever they operate, either directly or indirectly, a state-owned college or university (or system thereof) that competes with the private institution. Since every state government in the US has some degree of state-owned higher education, this conflict cannot be avoided at the state level. Second, and perhaps equally important, state authorities (both executive and legislative) have a long and unhappy history of interfering with the operations of state schools, interfering in matters ranging from student admissions to curriculum to research activities carried out within the colleges and universities that they own. While one need not necessarily blame them for interfering in the operation of entities that they own, the degree and nature of interference raises the real risk that the same government authorities may well carry over the same type of interference into private institutions, particularly if given the legal authority as a final arbiter of private Board selection and behavior. (The threat of removal of a private Board would make the private university a de facto captive of the public sector
officials.)

For these and other reasons, we would opt, if forced to choose, that the current mechanisms of self-replication of private boards are superior to the problems raised either by government oversight or by more intensive use of private accreditation boards as a final monitor of private higher education boards.

Are there mechanisms that would likely improve on the current practices of self-replication? In our judgement, the best possible approach would be to mimic as closely as possible the tender offer (takeover) mechanism currently available in private for-profit corporations. To do so, of course, requires identifying a group of proxy shareholders and clarifying the number of votes that each might have. Of all possible candidates, for reasons elucidated previously, we would prefer the selection of donors, with votes weighted in some way according to the magnitude of donations, above alternative choices. The proper mechanism, we conjecture, would allow a "recall vote" of trustees by vote of donors, much in the way that shareholder votes can seek the recall of boards of directors. We presume that such voting processes could take place in much the same way as current shareholder votes take place in for profit corporations, and that proxy fights for control of a board would emerge, as in for profit firms, only when key institutional policies grew so far out of accord with the preferences of donors that they felt compelled to seek a recall or to contest a particular election. Indeed, the complex nature of colleges and universities (with their multi-dimensional preference functions, in contrast to the single-valued preference function of profit maximization in for profit firms) makes it less likely that donor interest would often rise to a sufficient degree to make a serious Board contest very frequent.

Institutionalizing a systematic donor-approval of Board elections would have several
advantages over current legal mechanisms available for overturn of a private NFP board under current law. The major legal strategy currently available to any interested party would probably be a class action suit, wherein interested parties (alumni, donors, students, faculty, etc.) could attempt to mount a challenge to a sitting Board under normal legal processes. To succeed in such a process, some individual or group must first assemble and have certified the relevant class. The transactions costs of such an activity can be considerable, in part because universities and colleges systematically assemble only limited information about the identity and whereabouts of some potentially affected groups. (For example, files on past donors might be very difficult to retrieve if such donors had become inactive, a likely occurrence if they had become disaffected.) Building towards a systematic process of donor validation of Board selection would reduce considerably the transactions costs of carrying out such an activity, at least in the future if not the present.

We do not envision any specific mechanism for choosing which types of donors are granted which levels of voting. Several observations occur to us that might affect this process. First, regarding the distinction between restricted and unrestricted donations (ignoring the issue of inframarginal vs. marginal donations), donors making restricted donations by definition have a limited or single-purpose goal for the college or university, and hence may have a more limited perspective than donors making unrestricted donations. As every college and university president knows, unrestricted donations are the most precious, because they allow the greatest fungability in carrying out the activities of the institution. But this issue provides a striking example of why local rules should prevail in classifying donors for purposes such as ours -- some types of restricted donations (e.g. those for undergraduate student scholarships) serve almost identically to unrestricted gifts, and every institution should have the opportunity to classify such gifts appropriately.
The issue of intertemporal equivalence (or non equivalence) of gifts (and the ability to pass along voting power to heirs arising from such gifts) deserves special attention, and estate gifts are particularly interesting. Our own preferences would be to allow donors of estate gifts "voting rights" at the time the gift became completely irrevocable and fully funded (e.g., stock shares in an irrevocable trust), and revalued annually based upon the value of the assets in the trust and the actuarial value of the time at which the assets would revert to the institution's final control.

OBSERVATION: Restricted gifts change the slope of the FF curve by subsidizing internally the favored activity.