

GOVERNANCE OF NONPROFIT ORGANIZATIONS: MISSING CHAIN OF ACCOUNTABILITY IN NONPROFIT CORPORATION LAW IN JAPAN AND ARGUMENTS FOR REFORM IN THE U.S.

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I. INTRODUCTION

The last several years have seen a remarkable development of the non-governmental, not-for-profit sector in Japan. Although private philanthropy and mutual help associations have long existed in various organizational forms,¹ it is only since 1998 that citizens' groups for public interest have been able to incorporate themselves with relative ease. This is courtesy of a major piece of legislation called the Law for the Promotion of Specified Nonprofit Activities (*tokutei hi'eiri katsudō sokushin hō*). Japan, as a civil law country, has a complex set of different acts for incorporation but has lacked a mechanism that private citizens could use to obtain legal personalities for their voluntary, not-for-profit activities.² Thus, the new Act of 1998 has been regarded as a major breakthrough for the development of a civil society in a country that has generally had extensive government regulation and limited space for voluntary activities undertaken by private citizens for public benefit. Both strong citizen demand for such legislation and the Awaji-Hanshin Earthquake of January 1994, where a large number of voluntary (unincorporated) groups did a remarkable job in helping the victims and rebuilding

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1. See Yoshinori Yamaoka, *On the History of the Nonprofit Sector in Japan*, in *THE NONPROFIT SECTOR IN JAPAN* 19 (Tadashi Yamamoto ed., 1998).

2. See *infra* notes 18-31 and accompanying text.

their communities, triggered legislative efforts to pass the law.³ By September 2005, more than 23,000 organizations have incorporated under this law, and the number has been steadily growing.⁴

Since 1998, much interest has been generated in the management of nonprofit organizations. There have been numerous seminars, workshops, and publications to help nonprofits with practical management issues such as organizational design, finance, and strategic relationships with government and businesses. Universities, as well as private training courses, have also cropped up to respond to the sector's needs.⁵ The development on this has been remarkable, but surprisingly little attention has been paid to governance as distinguished from management. There is no definitive explanation on the differences between governance and management, but if management refers to the organizational mechanism for performing certain tasks, governance is at a higher tier. It is to exert control over the organization as a whole and account for its conduct. It includes the definition and pursuit of organizational goals and mission, the oversight of basic principles and their implementation, the allocation of power and function within the organization, the ensuring of financial and legal compliance, and the support of the executive in implementing the strategic plans agreed upon by the governing body and the management. In the U.S. and most other common law jurisdictions, such a range of responsibilities are, by definition, assumed by governing bodies made up of unpaid directors whereas day-to-day management is the responsibility of the paid staff led by the Chief Executive Officer, who is appointed by the governing body. In the Anglo-American context, the distinction between governance and management of a formal nonprofit is, at least theoretically, made clear.

Today, for many Japanese working in the emerging nonprofit sector, governance defined in this way seems abstract and is not considered an important issue that they should worry about. Among public policy scholars, the recent use of the term

3. Makoto Imada, *The Voluntary Response to the Hanshin Awaji Earthquake: A Trigger for the Development of the Voluntary and Nonprofit Sector*, in *THE VOLUNTARY AND NONPROFIT SECTOR IN JAPAN* 40 (Stephen P. Osborne ed., 2004).

4. Naikakufu [The Cabinet Office] data as of Sept. 30, 2005. <http://www.npo-homepage.go.jp/data/bunnya.html> (last visited Nov. 9, 2005).

5. See a list of courses on the nonprofit sector taught at seventy-seven universities and fifty-nine seminars sponsored by local authorities or organized by nonprofit and for-profit institutions, compiled by the Japan Nonprofit Research Association in 2000, at <http://www.osipp.osaka-u.ac.jp/janpora/seminar/semi2000-1.htm>. Tôhoku Kôeki Bunka Daigaku [Tohoku University of Community Service and Science], established in 2001, is an example of a Japanese university with a department dedicated to the study of *kôeki* [public interest].

governance—referring to the arrangement by which the public, business, and not-for-profit sectors collaborate to tackle problems and issues in their localities—is often meant to distinguish itself from “government.”⁶ However, such usage is confusing in our context, and has had the effect of diverting the attention of nonprofit managers from their organizational issues to the style of public policy management. Governance within nonprofit organizations is particularly important as it relates to the accountability of the nonprofit as represented to the external world. In fact, governance and accountability in both the government and business sectors have only become issues in recent years in Japan (and elsewhere), whereas “management” is an established issue in the business and public sector. As the reorganization of the welfare state progresses in many advanced economies, reducing the role of the state to the planner and financier of public services, and the delivery of services is contracted out to private businesses and voluntary organizations, there is an increasing concern that public accountability is becoming unclear.⁷

Therefore, in the U.S. and other countries where the nonprofit sector is highly developed, governance occupies an important place in public debate. In the U.S. in particular, the passage of the Sarbanes-Oxley Act to reform corporate governance in the aftermath of the Enron and Arthur Andersen scandals has been received as a wake-up call by nonprofits for enhanced accountability and governance, although the Act is directly relevant only to publicly-held corporations. Indeed, governance is discussed in so many guidebooks for practitioners as well as in academic literature on nonprofits that it is impossible to review them in this limited space. There are numerous resources dedicated to governance and board development, including booklets written by the American Bar Association, nonprofit management consultants, and intermediary nonprofits such as BoardSource.

In contrast to the above situation in the U.S., there is surprisingly little support available for Japanese nonprofits on the issue of governance. Exceptions include a Japanese translation of a BoardSource publication made by an intermediary nonprofit,⁸ a book by a consultant who refers to the roles of the Ex-

6. See, e.g., ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD), *CITIES FOR CITIZENS: IMPROVING METROPOLITAN GOVERNANCE* (2001).

7. Chris Cornforth, *Introduction*, in *THE GOVERNANCE OF PUBLIC AND NON-PROFIT ORGANISATIONS* (Chris Cornforth ed., 2003).

8. RICHARD T. INGRAM, *NPO RIJI NO. 10 NO KIHONTEKI SEKININ* [Ten Responsibilities of Nonprofit Boards] (Hideto Kawakita trans., 1999).

ecutive and the Board,⁹ and a report published by a government-appointed committee on the reform of the broadly-defined nonprofit sector that mentions governance as an issue.¹⁰ But these resources are scarce, illustrating the wide gap between Japan and the U.S. in the importance assigned to governance as opposed to management of nonprofits. Admittedly, the degree to which nonprofits and public policy for the nonprofit sector may be concerned with governance is a reflection of the sector's developmental stage, the nature of civil society, and the accumulated knowledge and scholarship in nonprofit research of each country. Japanese nonprofits are still in their infancy and many remain organizationally immature.¹¹

Nonetheless, the negligence of nonprofit governance in law and public discourse should not continue any longer. The Japanese welfare state is increasingly dependent on contracting between the public and private sectors, in which nonprofits are expected to be a major player. Those nonprofits must not only be effectively managed, but also have a proper line of internal and external accountabilities, which is ensured by effective governance. To have better governance in place would also help nonprofits with organizational growth and in their aspiration to attain higher social recognition. Based on this belief, the paper will investigate the way in which nonprofit governance is construed in the Law for the Promotion of Specified Nonprofit Activities. It will be contrasted to that in the U.S., using U.S. state laws for nonprofit corporations as a reference point. The paper will argue that the Japanese law is flawed in its definition of nonprofit governance and accountability, which needs to be amended if nonprofits are going to play a more important role in Japanese civil society. While the law seems to regard members meetings as a key institution in governance, members do not have the voting right to elect directors. This leads to the lack of clarity in the final point of internal accountability. In contrast, in the U.S., the governance of nonprofits seems relatively clearly defined and well established. A major problem in the U.S., however, is that the theory on governance does not easily match its application therefore resulting in a number of proposals for reforming the law and regulation for the nonprofit sector, some of which have interesting implications for the Japanese nonprofit sector.

9. FUMITAKE SAKAMOTO, NPO NO KEIEI [Management of Nonprofit Organizations] 30-41 (2004).

10. Kōeki hōjin seido kaikaku ni kansuru yūshikisha kaigi [The Expert Committee on the Reform of the Institution Governing Public Interest Corporations], Hōkokusho [A Report] Nov. 19, 2004, at 7, 9.

11. See *infra* notes 43-48 and accompanying text.

To make such arguments, the paper is structured as follows. Section One provides background about the enactment of the law of 1998 for the purpose of explaining its significance. Section Two examines the provisions of the law in relation to governance. In Section Three, the paper turns to the law in the U.S. and investigates the extent to which the legally structured model of nonprofit governance is put into practice. The Conclusion sums up the discussion and suggests policy recommendations for Japan.

The definition of the terms “nonprofit organizations” or “nonprofits” in this paper is narrow, only referring to those organizations incorporated under the Law for the Promotion of Specified Nonprofit Activities for Japan. Those nonprofits have popularly been called in Japanese, after the English acronym for Nonprofit Organizations, NPO or NPO *hōjins* (corporations). In contrast, a very wide *de jure* definition of nonprofits imagines the nonprofit as a corporate entity involves Educational Corporations, Social Welfare Corporations, Medical Corporations, and Public Interest Corporations, as discussed in more detail in Section One. They tend to possess the following attributes typical of nonprofits, as identified by an international research project organized by the Johns Hopkins University:

1. independence from government,
2. formality or continuity,
3. established chiefly by citizens voluntarily,
4. profits not divided among members, and
5. self-governance.¹²

Because a major purpose of the Johns Hopkins project was to document and compare the scope, structure, financial base, and background of the nonprofit sectors of the participating countries, uniform definition suggested by the above list was necessary.¹³ Although the definition may have worked in a relatively straightforward way in the U.S. to match the legal definition of the sector, it was contentious that the uniform definitions could be over-broad or too narrow as to miss something important when applied to different countries. In particular, the problem of adopting this definition for the team of Japanese researchers was that the aforementioned corporations include too many quasi-governmental organizations and those that are institutionalized and hardly voluntary (i.e. with no volunteers and no

12. LESTER M. SALAMON & HELMUT K. ANHEIER, *THE EMERGING NONPROFIT SECTOR: AN OVERVIEW* 1-22 (1996).

13. For more detailed discussion on the conceptual challenges in defining the nonprofit sector and applying the employed definition to national data, see *DEFINING THE NONPROFIT SECTOR: A CROSS-NATIONAL ANALYSIS* 1-102 (Lester M. Salamon & Helmut K. Anheier eds., 1997).

voluntary roots) in their views, although there were also many “genuine” nonprofits in these categories as well.¹⁴ Thus, the project leaders characterized the nonprofit sector in Japan as having no clear boundaries to set it apart from government, for-profit, and household sectors.¹⁵

At the same time, the project definition leaves out a very large number of unincorporated groups and associations that have the aim of serving public interests in Japan. They are unincorporated and informal but, to the extent that their existence and activities are often known to their local authorities, more active on a regular basis than temporary projects. Thus, the Cabinet Office has been conducting surveys every four years since 1996 on “groups of civic activities” (*shimin katsudô dantai*) (and NPO *hōjins* since 2000), drawing on the lists of those groups held by local authorities nationwide. Each survey found more than three-quarters of the respondents were unincorporated while the rest were incorporated organizations under the Law for the Promotion of Specified Nonprofit Activities (henceforth the NPO Law).¹⁶ In writing of the Japanese nonprofit sector, Professor Deguchi thus calls both incorporated organizations under the law of 1998 and unincorporated associations as a whole “N/NPOs”, meaning non-institutionalized nonprofits, as opposed to “I/NPOs” for institutionalized nonprofit organizations that have legal status under laws other than that of the new law of 1998.¹⁷

The attention which the Cabinet Office and Deguchi pay to unincorporated associations is important and interesting, but the focus of this paper is exclusively on the incorporated organizations. However, the type of organization included in what Deguchi calls I/NPOs and the complexity of this sector still needs to be explained, a task undertaken in the next section. The “non-profits” in the U.S. discussed in this paper will refer to public interest, nonprofit corporations formed under state corporation laws, which often have tax privileged status under the Internal Revenue Code and can receive tax-deductible donations under the federal tax law.

14. Takayoshi Amenomori & Tadashi Yamamoto, *Introduction*, in *THE NON-PROFIT SECTOR IN JAPAN*, *supra* note 1, at 1.

15. SALAMON & ANHEIER, *supra* note 12, at 22-23.

16. Heisei 16 nendo shimin katsudô dantai kihonchōsa hōkokusho [Report on the Survey on Groups of Civic Activities, 2004] (2005), from the latest version by Naikakufu [Cabinet Office].

17. Masayuki Deguchi, *The Distinction between Institutionalized and Noninstitutionalized NPOs—New Policy Initiatives and Nonprofit Organizations in Japan*, in *THIRD SECTOR POLICY AT THE CROSSROADS—AN INTERNATIONAL NONPROFIT ANALYSIS* 153 (Helmut K. Anheier & Jeremy Kendall eds., 2001).

II. LAWS GOVERNING THE NONPROFIT SECTOR IN JAPAN

To understand the significance of the new act of 1998, it is necessary to understand the pre-1998 corporation law regime for voluntary groups. Put briefly, there was virtually no appropriate legal entities into which citizens' voluntary activities for public benefit could choose to incorporate themselves.¹⁸ Japan has a civil law system, formed during the modernization efforts of the late nineteenth century and with much influence from German and French systems.¹⁹ As in Germany, there is a clear distinction between public and private laws: public law defines the areas where government acts in public, or common good, while private law governs contracts and transactions between private parties. The distinction is meant to prevent the state's intervention into private affairs. Thus, civil law systems tend to have "public corporations,"²⁰ defined by specific public laws and private organizations such as business corporations defined by private law. Such systems tend to both correlate the public-private division with the nonprofit-commercial division and struggle to accommodate the private, not-for-profit organization as a concept.

The researchers of the Johns Hopkins University project found Japan a typical example of a country that strictly defines private, not-for-profit organizations.²¹ On the one hand, public law in Japan defines over a hundred of *kôkyô hôjins* (Public Corporations) and *tokushu hôjins* (Special Legal Entities), each of which is created by specific legislation. NHK, Japan's national public broadcaster, thus is established and governed by the Broadcasting Law. In fact, many of the organizations in this category are for commercial and industrial purposes, and are heavily subsidized and staffed by government. In addition, there are private institutions defined by specific legal provisions. Exam-

18. For more details on the discussion of this section, see, e.g., Takako Amemiya, *The Nonprofit Sector: Legal Background*, in *THE NONPROFIT SECTOR IN JAPAN*, *supra* note 1, at 29; Robert Pekkanen & Karla Simon, *The Legal Framework for Voluntary and Nonprofit Activity*, in *THE VOLUNTARY AND NONPROFIT SECTOR IN JAPAN*, *supra* note 3, at 76.

19. HIROSHI ODA, *JAPANESE LAW* 7 (2d ed. 1999) (discussing the various introductions of foreign law into the Japanese system). According to Oda, the second stage of introduction from German and French legal systems is more significant than the first from China in the 7th and 8th centuries or the third after the second World War, where the American legal system influenced the amendment of Japan's Civil Law.

20. For an analysis of "public policy companies" – a wider concept referring to corporations, created to serve public policy goals, in which government holds ownership – see CHALMERS JOHNSON, *JAPAN'S PUBLIC POLICY COMPANIES* (1978). For a more recent account, see SUSAN CARPENTER, *Special Corporations and the Bureaucracy* (2003).

21. SALAMON & ANHEIER, *supra* note 12, at 92.

ples in this category include *gakkō hōjins* (Educational Corporations such as private schools, colleges, and universities), *shakaifukushi hōjins* (Social Welfare Corporations), and *iryō hōjins* (Medical Corporations). They are all privately organized and in theory self-governing, but often are under heavy regulation and supervision of relevant government departments. For example, private universities (i.e. Educational Corporations) are not particularly well funded by public money, but must obtain permission from the Ministry of Education when they set up new departments by providing detailed curriculum plans and the CVs of teaching faculty members. For a long time, many organizations in this category have been under bureaucratic influence and are often institutionalized.

Meanwhile, private law, the *Minpō* [Civil Code] more specifically, defines private legal personalities, including for-profit businesses. An important provision in the Civil Code for non-profits has been Art. 34, which defines *kōeki hōjin*, or Public Interest Corporations. Art. 34 specifies three elements that are required for a corporation to be qualified for the status of either a *zaidan hōjin* (Incorporated Foundation) or a *shadan hōjin* (Incorporated Association) whose legal personalities subsist in the assets held in trust for specified purposes or in the aggregate of natural and/or corporate persons gathered for specified purposes. Thus, a *zaidan hōjin* is similar to a charitable trust whereas a *shadan hōjin* is reminiscent of a membership club. To obtain the legal personality under this provision, an organization must (1) be “not-for-profit,” (2) be “concerned” with religious or charitable purposes or other public benefits, and (3) have the license granted by a “competent authority.” Once the status is granted, the organization automatically becomes entitled to tax concessions and exemptions under the Taxation Act. There were 25,825 of such corporations as of October 2003, just above half of which were Foundations and the rest Associations.²²

However, this provision, due to its ambiguous and over-broad nature, has been highly problematic as a vehicle for incorporating a citizens’ voluntary activities; the ambiguity allows for a high degree of bureaucratic discretion. Japanese bureaucracy is generally infamous for being intrusive and over-powerful. This area is no exception. To start with, unlike business companies that only need to meet the requirements set out by the Commercial Code for registration purposes, a process which is largely clear and easy to follow, becoming a *kōeki hōjin* is a matter of a

22. Sōmushō [Ministry of Internal Affairs and Communications], Heisei 16 nendo kōeki hōjin ni kansuru nenji hōkoku [Annual Report on Public Interest Corporations, FY2004] 27 (2005).

permit to be granted by the relevant authority. Because the authority grants the license at its discretion, no applicant has the general right to it. There are different ways in which the government grants administrative licenses to private parties, which is varied in terms of governmental control and discretion. The one relevant to the Public Interest Corporations, called *kyoka* (permission), is the most discretionary, whereas *tôroku* (registration) is at the other end, meaning automatic approval, with *ninshô* (certification) used for the NPO Law somewhere in the middle.²³

It would be straightforward to apply to one of the ten Ministries of the central government which has jurisdiction over the area of the activity in which the group is engaged. Thus, for example, if the activity is to provide care to the elderly, the relevant authority would be the Ministry of Health, Labour and Welfare. However, then, the activity would also be tied up with the competence of the Ministry and not allowed to include services related to other Ministries. It is possible to have more than one authority (the arrangement called *kyôkan* [co-supervision]), but this would only complicate the matter and increase the administrative burden for the nonprofits. An alternative is to apply to local authorities, but then the geographical boundary of the activity would be limited to their jurisdictions.

Because some central government Ministries are particularly infamous for being intrusive and power-abusive, a nonprofit group should avoid those Ministries if it wants to retain autonomy and self-governance. An interesting example of this is the Toyota Foundation—one of the largest grant-making foundations in Japan set up by the Toyota Motor Corporation in 1974, whose supervisory authority was the former Office of General Affairs (*Sôrifu*, reorganized as the Cabinet Office, or *Naikakkufu* in 2001). This was a wise choice, as the Office had, unlike the Ministry of Health, Labour and Welfare, for instance, no competence in public service delivery, causing no conflict of interest or reason for interference. Relatively free from disciplinary limitations and governmental interference, the Foundation now funds projects and research to tackle environmental social welfare, and educational problems, especially in developing countries.

Principles and rules in the application process and thereafter vary considerably from one authority to another. Although large companies such as Toyota may have resources to research the differences and choose the right ones for them, such resources are beyond the capacity of smaller groups. The application process is known to be very complicated and time-consuming, unnecessarily and excessively so, even for those who know little of

23. PEKKANEN AND SIMON, *supra* note 18, at 83.

the *modus operandi* of bureaucracy. Mission statements, corporate objectives, and business plans are scrutinized by the granting authority. Anecdotes indicate that in this process the authority concerned tends to "suggest" alterations to the policies of the applicant so as to make them fit in with the authority's own objectives and agenda. As a result, the application process becomes lengthy, often lasting between twelve and eighteen months to complete.

There is also a financial hurdle. Ministries and the central government would require the applicant to have a substantial endowment from the beginning, anecdotally hundreds of million yen in recent years.²⁴ This requirement has been introduced arbitrarily and no specific stipulation has ever existed in official documents on this matter, but it is a well-known fact that no penniless applicant would succeed. The logic behind this endowment requirement is that Incorporated Foundations or Associations cannot, and should not, rely on their activities for basic overheads and for annual operating expenses. According to this logic, the endowment should not be liquidized, and the interest earned by the investment of assets should be sufficient to keep an office space and a secretary per year. It is unrealistic for citizens' voluntary groups to raise the amount of money implied in this scenario at the outset. Such a requirement comes from an idea long held by government that "public interest" must be pursued through some kind of operational activities, thus eliminating the possible existence of corporations to raise money from the public to distribute to other public interest corporations.²⁵ Although the Civil Code itself does not define public interest in such a way (or in any way, for that matter), such an interpretation has been developed since the early twentieth century by government, and has shaped the Public Interest Corporation not only as a legal personality but also as an entity to operate businesses.²⁶ This interpretation seems to explain the limited existence of private, grant-making foundations in Japan.²⁷

The above discussion may lead the reader to wonder then what constitutes the sector of over 25,000 Public Interest Corporations. Available statistics show that the average value of assets

24. See the discussion of Yamamoto based on his insight into the works of the Ministry of Foreign Affairs, in Tadashi Yamamoto, *The State and the Nonprofit Sector in Japan*, in *THE NONPROFIT SECTOR IN JAPAN*, *supra* note 1, at 119-20.

25. MINORU TANAKA, *KŌEKI HŌJIN TO KŌEKI SHINTAKU* [PUBLIC INTEREST CORPORATIONS AND PUBLIC INTEREST TRUSTS] 9-10 (1986).

26. *Id.* at 9.

27. *Id.* at 10. According to the Japan Foundation Center, the total assets of the top twenty grant-making foundations in the US is twenty-eight times as much that of their Japanese counterparts. <http://www.jfc.or.jp/eibun/index.html> (last visited Dec. 14, 2005).

for a Foundation supervised by a central government Ministry is over twenty-five billion yen,²⁸ while the average income for all Public Interest Corporations is 736 million yen (with the median income at 59 million).²⁹ When it comes to the nature of this sector, however, it is very difficult to generalize because of its diversity, which has evolved in the course of its history. Professor Mori'izumi suggests that the "ideal" public interest corporations are in fact rather small in number, outnumbered by mutual benefit corporations and trade associations.³⁰ However, by far the largest are quasi-governmental corporations. The term "public interest corporations supplementary to government agencies" (*gyôsei hokangata kôeki hôjin*) is an established and accepted one in Japanese.³¹ They are executive agencies of central or local government set up for specific purposes such as urban development, similar to *tokushu hôjins*, and are often staffed by seconded civil servants. They are created by the government for the purpose of efficiency, political neutrality and commercial flexibility (at least in theory). Organizations of this type, sometimes called Quangos (quasi-autonomous, non-governmental organizations) in English, are ubiquitous worldwide and normally recognized as executive agencies of government rather than private nonprofits. Apparently, Japanese administrative law has long confused "public interest" with the interest of the state, placing Quangos as part of Public Interest Corporations governed by private law.

Furthermore, in addition to Quangos, there are Public Interest Corporations for mutual benefit of relatively small, well-defined groups as well as those for industry interests, but neither of these types of organizations should theoretically easily pass as organizations for public interest. Thus, for example, local groups of medical doctors and automobile manufacturers are labeled as Public Interest Corporations and incorporated as associations (*shadan hôjins*). The problem with these organizations is that while they may be not-for-profit they do not explicitly serve a public interest. To resolve this inadequacy of allowing mutual benefit organizations to incorporate as a Public Interest Corporation under Art. 34 of the Civil Code, a new law has been enacted in 2002 (*chûkan hôjin hô*, the Law for Intermediate Organiza-

28. Sô mushô, *supra* note 22, at 60.

29. *Id.* at 53.

30. AKIRA MORI'IZUMI, KÔEKI HÔJIN NO GENJÔ TO RIRON [PUBLIC INTEREST CORPORATIONS: THEIR CURRENT STATE AND THEORY] 7-17 (1982).

31. Naosumi Atoda, Takayoshi Amenomori, and Mio Ohta, *The Scale of the Japanese Nonprofit Sector*, in THE NONPROFIT SECTOR IN JAPAN, *supra* note 1, at 117.

tions), which has had more than three hundred corporations incorporated under it.

The other major issue of this legal structure and its application has been the lack of recognition for voluntary activities undertaken by groups of citizens and their contribution towards creating a civil society. The private, Educational and Social Welfare Corporations have largely been institutionalized and are under governmental control. Meanwhile the Public Interest Corporation sector, narrowly defined by Art. 34 of the Civil Code, is restrictive for incorporation purposes yet confusingly over-broad in its nature. The laws related to public and private corporations for non-commercial purposes have mostly been used by the government itself for its administrative purposes, leaving little room for incorporation of voluntary groups. Voluntary groups used to be resigned to remain unincorporated, possibly leaving executive directors and staff personally liable for actions that the groups take. It used to be difficult to make even basic administrative arrangements such as renting office space and opening bank accounts. Moreover, unincorporated organizations are mostly ineligible for public and private grants because they lack the capacity to conclude contracts. It was against such a background that the new legislation was eagerly anticipated with the hope that it could provide a legal structure for the voluntary groups and aid in promoting the recognition that voluntary organizations play an important role in the emerging Japanese civil society. To understand the new legislation's significance, it is useful to refer to some of its provisions, the aggregate of which suggests the meaning of a nonprofit organization as embodied in the NPO Law. To incorporate under this law, a "nonprofit" organization must be engaged in one of the areas of activities listed in the law for the purpose of public benefit (Art.2[1]). Religious and political organizations and organizations that specifically purport to advance interests of particular individuals, corporations, or political parties do not satisfy the law (Arts. 2[2][2] and 3). In this light, advantages of the new law of 1998 are identified as follows:

1. It does not require a supervisory authority to grant a permit (*ninka*). It is a matter of meeting the minimum standards and obtaining certification (*ninshô*). The procedure (i.e. the standards used for recognition) and supervision by the relevant authority is clearly spelt out in the statute (Arts. 10, 12, 41-43 of the NPO Law).
2. There is a significantly decreased possibility that the "competent authority" (*shokatsuchô*) of government,

mostly local authorities,³² can interfere in the management of corporations.

3. There are no formal or informal requirements for initial assets.
4. The corporation must be engaged in an activity that contributes to the public interest in one or more areas specified by the Law. The list of the areas includes, *inter alia*, social welfare, education, gender equality, community development, and arts and culture. Since 1998 the areas have been expanded from twelve to seventeen, and as a whole are reasonably comprehensive, broad, and flexible.

A major disadvantage relative to the Public Interest Corporations defined by Art. 34 of the Civil Code is that there is no automatic tax privilege given to the nonprofit corporations under the NPO Law.³³ To start with, income tax on “profit-making businesses” is levied at a rate the same as any business, even though the surplus may be used for “nonprofit-making activities,”³⁴ while a lower rate is applied to “profit-making businesses” of the Public Interest Corporations.³⁵ The definition of “profit-making businesses” provided in the Corporation Tax Law (Art.2[13]) is “the business activity that is continuously undertaken at particular premises,” irrespective of whether the activity is consistent with the objectives of the corporation for which the nonprofit status has been granted. The definition is accompanied by a list of thirty such activities in the regulations of corporation tax law (Art.5), including a number of activities that nonprofits tend to be engaged in such as selling goods and properties, catering, brokering, promoting performances of the arts and entertainment, publishing and so on. In addition, the limitations on tax-deductibility for charitable donations have been hailed as a more serious hurdle to encouraging private giving to nonprofits.³⁶ While individual and corporate donations to charitable

32. 23,323 out of 25,500 registered corporations are within the competence of prefectures, while the rest of 2,177 under the Cabinet Office as of Oct. 31, 2005. <http://www.npo-homepage.go.jp/data/pref.html> (last visited Dec. 5, 2005).

33. For a detailed discussion on the taxation on the nonprofit corporations before the NPO Law was enacted, see Amemiya, *supra* note 18.

34. Hojin zeihō [Corporation Tax Law] art. 66(1)(2). The definition of ‘domestic corporations’ to which these sections apply is provided in art. 2(3), which does not distinguish NPOs discussed in the present paper from commercial business corporations.

35. *Id.* art. 66(3). The definition of ‘kōeki hōjin’ to which this section applies is provided in art. 2(6). The full statute of Corporation Tax Law is available in Japanese at <http://law.e-gov.go.jp/htmldata/S40/S40HO034.html>.

36. A more detailed account is found in Amemiya, *supra* note 18, at 80-98.

causes is limited in volume and value in Japan,³⁷ the lack of access to tax-deductible donations for corporations formed under the NPO Law is hard to justify. To address this inequity, a new category was created in 2001 to allow certain nonprofits under the NPO Law to qualify for tax-deductible status. However, the hurdles for qualification are exceedingly high, including restrictions on expenditures and reporting duties,³⁸ and the qualification is valid only for a period of two years (renewable upon re-application).³⁹ The most demanding hurdles are the three “public benefit” tests, which (1) require the geographical spread in terms either of funding base or service provision, (2) prohibit more than half of service provisions to members or other specific groups of people (in terms of expenditure, time devoted, or any other reasonable measure),⁴⁰ and (3) require more than one-third of the total revenue of the nonprofit from charitable contributions.⁴¹ In response to the criticism that these requirements are too difficult to meet, the Fiscal Year 2003 Tax Reform has made provisions to relax some of them. Nonetheless, the number of those qualifying corporations remains very small, amounting only to thirty-eight as of November 30, 2005⁴² out of more than 25,000 registered.

37. Corporate donations were in the amount of 509.2 billion yen in FY 2002. <http://www.nta.go.jp/category/toukei/tokei/menu/kaisya/h14/06.htm#2> (last visited Jan. 8, 2006). It should be noted however that only 66.9 billion yen was donated to charitable, public-interest organizations (including semi-governmental corporations). For the difficulty of estimating the charitable donations made by corporations, see Nobuko Kawashima, *Businesses and the NPO Sector in Japan*, in *THE VOLUNTARY AND NONPROFIT SECTOR IN JAPAN*, *supra* note 3, at 107-08. Individual donations amounted to 25.2 billion yen in FY 2002. http://www.nta.go.jp/category/toukei/tokei/jikei/1594/01_01.htm (last visited Jan. 8, 2006). This relates only to those who claimed deductions from their taxable incomes.

38. Sozei tokubetsu sochi hō [Special Law on Taxation] arts. 66-11-2, 41-19, 70; Sozei tokubetsu sochi hō sekōrei [Enforcement Ordinance on the Special Law on Taxation] arts. 39-23. See Pekkanen and Simon *supra* note 18, at 93-95 for an explanation of the system.

39. Sozei tokubetsu sochi hō [Special Law on Taxation] art. 66-11-2-4.

40. Sozei tokubetsu sochi hō sekōrei [Enforcement Ordinance on the Special Law on Taxation] art. 39-23-2.

41. A survey by the Cabinet Office conducted in 2004 has shown, however, that the majority of the responding corporations (71.7%) had donations amounting only to zero to ten percent of their annual income. Naikakufu [The Cabinet Office], NPO Hōjin no Jittai oyobi Nintei NPO Hōjin Seido no Riyōjyōkyō ni kansuru Chōsa Hōkokusho [A Report on the Current State of Nonprofit Corporations and the Extent of Use of the System for Qualified Nonprofit Corporations] 28 (2004).

42. Kokuzeichō [The National Tax Agency]. <http://www.nta.go.jp/category/np0/04/01.htm> (last visited Dec. 19, 2005).

III. THE NEW LAW AND NONPROFIT GOVERNANCE IN JAPAN

Having provided the reason why the new law for nonprofits has been groundbreaking, the paper now proceeds to examine the law's provisions to examine how the governance of nonprofits is structured in the law. Before doing that, it is useful to give a profile of the sector. I have mentioned that there are seventeen specified areas of activities in which nonprofits can operate under the law. It is possible and common for a nonprofit to focus on more than one area. As a result, 56.8% of those incorporated under the NPO Law are active in health and social welfare, followed by 47.1% in the promotion of education and learning, the sum of which already exceeds 100%.⁴³ Also popular is the area of help and support to other nonprofits, chosen by 44.5% of the nonprofits.⁴⁴ A recent survey undertaken by *Naikakufu* (the Cabinet Office) in 2004 shows that most nonprofits are young, and very small in terms of financial base and employment.⁴⁵ Over 40% of the respondents to the survey were established in 2003 or later.⁴⁶ Although the survey shows the average income of the NPO Corporations as over 18 million yen, given the median as only 3.7 million yen, it can be said that the average is offset by those with very large income while the majority seems to have smaller incomes.⁴⁷ Another *Naikakufu* survey also conducted in 2004 has data on the size of the "administrative staff" (which seems to exclude those in service delivery, but include those working at the offices, who are paid, unpaid, full-time, and part-time workers). The survey shows that a little over 40% of the responding nonprofit corporations had less than five administrative staff members.⁴⁸

A. MEETING OF MEMBERS—WHO EXERCISES CONTROL OVER THE ORGANIZATION?

The Introduction of this paper may have suggested that, although boards of directors as governing bodies exist in Japanese nonprofits, their importance is under-estimated. In reading the NPO Law, however, one sees a different conception of governance emerge. To start with, it seems that the Meeting of Members is a major forum of governance with the decision-making

43. Naikakufu [The Cabinet Office]. <http://www.npo-homepage.go.jp/report/h16a-2-all.pdf>. (last visited Dec. 5, 2006).

44. *Id.*

45. Naikakufu, *supra* note 41, at 20-22, 29-39.

46. *Id.* at 20.

47. *Id.* at 25.

48. Naikakufu, *supra* note 16, at 33-34.

power on crucial matters for the corporation. Arts. 15 and 10(1)(3) provide that a nonprofit must have at least three directors (*rijis*, but not their board), one auditor (*kansayaku*), and ten members (*shains*). Because *shain* in everyday Japanese means an "employee" of a business corporation, to avoid the confusion with an employee, the Japanese word *kai'in* equivalent to the English word "member" is preferred by many nonprofits. Members (*shains*) have votes at the Meeting, which must be called at least once a year (Art. 30). The qualifications for a member can be defined by articles of incorporation, but, in principle, membership must be non-discriminatory, open to the public regardless of the candidate's age, sex, or any other attributes (Art. 2(2)(1)*i*).

Two matters crucial to the corporation's mission and survival, namely, the amendment of the charter and the corporate merger, are exclusive to voting at the Meeting of Members (Arts. 25 and 34).⁴⁹ The law for nonprofits in Japan has no statutory distinction between what are often called the Articles of Incorporation and bylaws in the U.S. context. The charter of a corporation thus starts with identifying information (i.e., the name of the corporation, its location, etc.), moves to define various organs and their functions and ends with the process of corporate dissolution. If minor provisions of the charter are amended, the relevant authority must be notified for those amendments to become effective (Art. 25[6]). The Meeting of Members can also vote on the entity dissolution, although there are other methods of dissolution such as the death or withdrawal of members without replacement by new members (and the failure to meet the minimum requirement of ten members, Art. 31[1]-[7]). Also, members can call for a Special Meeting (Art.30, applying Art. 63 of the Civil Code). As the NPO Law does not require a Board of Directors or Trustees (which is extraordinary and problematic as will be discussed later), it appears that the Meeting of Members is the primary body for nonprofit governance.

However, the law specifies that only three matters shall be decided by the Meeting of Members and leaves almost all of the other matters to directors. Art. 30 (applying Art. 63 of the Civil Code) provides that a nonprofit must subject decisions on any matters to the Meetings of Members except on those delegated to directors and other officers as set forth in charters. A proper reading of Art. 30 is that most corporate affairs can be delegated to directors. It is understood by nonprofit practitioners that Art. 30 gives founders a large degree of flexibility in designing gov-

49. NPO Law art. 25(2) requires attendance by a majority of voting membership and three-quarters of vote for the amendment of bylaws, unless otherwise specified in bylaws.

ernance and management structures. Two types of governance have been identified by them: one with decision-making power mostly assigned to the Meeting of Members and the other to directors.⁵⁰ Reflecting the practical inefficiency involved in membership-led governance, C's, an intermediary nonprofit to support the development of the sector, recommends that many nonprofits choose to assign only the ratification of annual reports and accounts to the Meeting of Members. In case the members are geographically spread or large in number, it is even difficult to satisfy the quorum required for each matter. Also when the organization's activity is highly specialized or technical, it is inefficient and ineffective to involve the members at the meeting and ask for their approval for complex issues. Most founders of nonprofits thus tend to find the directors-led type of management more efficient and realistic, and design the charters to place the board of directors at the center of major decision-making.⁵¹ Many organizations have at least two classes of members, one with votes and the other without,⁵² while minimizing the size of the class with votes by requesting higher amounts of membership fees. In practice, it is thought that relatively few people are particularly interested in participating in management (which may well be the case), and that the leaflets for recruiting new members may skilfully draw attention to the category without discussing who receives voting rights. The following comment by Tsutomu Hotta, a well-known lawyer and practitioner in the nonprofit sector, made in a panel discussion on the NPO Law, is interesting in this respect:

It is difficult to define what a member is at a nonprofit. *Shain* is basically a concept for mainstream, established organizations for commercial purposes. But a distinctive feature of nonprofits is related to the fact that they do not know exactly who the members are and what they really are doing. The NPO Law however defines that a nonprofit corporation must have at least ten members. Then, it becomes necessary for it to decide which of the founders must be registered as members and so on. This is ridiculous and inefficient. Also, the nonprofit would minimize the number of members, because it is time-consuming to run meetings. The law is ineffective and

50. See SHINPAN NPO HÖJIN HANDOBUKKU [A HANDBOOK ON NPO CORPORATIONS] 59 (new ed. 2003).

51. NPO HO KONMENTÄRU [THE NPO LAW: A COMMENTARY] 204 (Hotta Tsutomu & Amemiya Takako eds., 1998).

52. The Naikakufu survey mentioned earlier shows that more than half of the respondent nonprofit corporations have members without votes. Naikakufu, *supra* note 41, at 21.

does not take the reality [of nonprofit operation] into account.⁵³

The above comment may overemphasize the chaotic nature of nonprofits, but it suggests a gap between the *de jure* definition of the Meeting of Members as the primary vehicle of organizational decision-making and the general understanding in the sector that the decision-making should *de facto* be in the hands of directors. However, it must be added that the default rule for the quorum and the minimum votes required for the amendment of the charter (a majority and the three-quarters of votes respectively) can be determined otherwise in charters (Art. 25[2]). It is possible to overrule the default rule and lower the minimum votes of members for merger (Art. 34[2]) as well as for dissolution (Art.40, applying Art. 69 of the Civil Code), where the quorum is not even specified in the NPO Law. The members' right to call for a Special Meeting is realized when one-fifth of the members agree, but this proportion can also be made higher by the charter (Art. 30, applying Art. 63 of the Civil Code). It follows, then, that the significance of the Meeting of Members, which at first looked large, is in fact limited and vague; it can be deliberately weakened in the designing of the charter to determine the relevant provisions and the qualifications for voting members.

Considering that the nonprofits are by definition for public interest, it becomes even less clear why they must have a certain number of members in the first place as a condition for incorporation. One reason for this requirement may be that the NPO Law has been created as a special addition to the general Civil Code, analogizing nonprofits to Incorporated Associations (*shadan hōjins*, part of the Public Interest Corporations sector) explained earlier, whose legal personalities subsist in the membership.⁵⁴ Another possible reason is a public policy concern to prevent the existence of dormant nonprofits, for which the requirement of ten living persons was considered to be effective.⁵⁵ There is some evidence, however, that the Japanese legislators found this statutory requirement somewhat problematic, as illustrated by a query made at the Lower House of the Diet as to whether membership-based corporations could be congruent with the concept of public benefit.⁵⁶

53. Transcript in NPO HO KONMENTĀRU, *supra* note 51, at 39 (translation by the author).

54. As a Special Law of the Civil Code, however, the NPO Law should not overlap the Civil Code, as long as "specified areas" are in existence.

55. Yukinobu Tachibana, *Tokudei Hieiri Katsudo Sokushin Hō: NPO Hō no Seitei* [The Legislation of the Law for the Promotion of Specified Nonprofit Activities], *Toki no hōrei* [Current Legislation], Aug. 30, 1998, at 6, 25.

56. *See id.*, at 20.

The students of U.S. nonprofit corporations, most of whom would understand nonprofits as corporations held in trust to contribute to the benefit of society at large, might find it odd that Japanese law places such an emphasis on membership. As will be discussed later in this paper, the general lack of respect for members and the failure to recognize them as “owners” of nonprofit corporations may well be a source of problem in the U.S. . However, the theoretical model of governance in the U.S., when matters related to membership are disregarded, has a certain degree of elegance, whereas the Japanese law fails to present a logical model of nonprofit governance. It is possible for us to interpret that, in the Japanese NPO Law, the members are presumed to be the people who are sympathetic to the purposes to which the nonprofit corporation makes public commitment and agree to join the organization as members to help realize the organizational goals; through such a body of people the pursuit of public interest would be ensured. In fact, most membership applications have such statements as “I agree with the mission of this corporation and would like to become a member to support it,” thereby creating a contractual relationship between the nonprofit and its members. Nonetheless, as will be detailed in the following subsection of this paper, the problem is that the NPO Law does not provide for the right to members to elect or appoint directors. Thus it is not evident on what basis directors can exercise control over the corporation, in which members are left relatively passive despite their *prima facie* significance as an institution in nonprofit governance.

The flaw of the legal provision in this regard leads to confusion and ambiguity in practice. The aforementioned surveys of the management and operation of NPO *hōjins* (and unincorporated associations), periodically undertaken by the *Naikakufu*, have constantly found a variety of people in the category of *kai'ins* in nonprofit corporations. In this context, *kai'ins* seems to include *shains* (members with votes) as well as supporting members without votes, both individual and corporate.⁵⁷ Over 70% of the respondents mention *shains* as their *kai'in*, followed by 56% of them pointing to “those engaged in activities,” namely, those people and organizations who would most likely provide services to the clients and users of the corporation. Other types include those people and organizations who are engaged in executive management, recipients of services, and supporting mem-

57. The definition of *kai'in* is not clear in the reports, but a wide definition can be inferred, as the report of 2004 for example finds nearly half of the responding nonprofit corporations had less than ten members while nearly one-quarter of them had less than ten *shains* (despite the legal requirement for at least ten). *Naikakufu supra* note 16, at 57-58, 69.

bers who would provide labor or funds. In other words, *shain* and *kai'in* can be any of the following: (1) volunteers who provide services, (2) service recipients and users, (3) managers and directors, and (4) donors. Clearly each of these classes have very different relationships with, and stakes in, the nonprofit corporations. It seems unreasonable and illogical that the NPO Law in effect bundles these classes of people together as *shains* and exclusively gives them the voting rights on three of the most important issues of a corporation, namely, amendment to the charter, corporate merger, and dissolution.

B. THE STRUCTURE OF NONPROFIT GOVERNANCE—
THE RELATIONSHIP BETWEEN DIRECTORS AND
THE MEETING OF MEMBERS

A more serious flaw in the law is its provisions relating to directors. There are at least three problems. Firstly, Art. 16 provides that directors represent the corporation and all of its activities, which may be limited by charters, with no reference to “the board of directors” anywhere in the statute. Art. 8 (applying Art. 43 of the Civil Code) clarifies that the corporation has legal powers and obligations, and Art. 17 provides that all the activities of the nonprofit corporation are to be decided by a majority of directors, unless otherwise defined in the charter. Nevertheless, without express provisions governing the board of the directors, there remains a doubt as to whether a director (out of three at least) acting on his/her own has authority over decision-making on behalf of the corporation. This might be a semantically-obsessive interpretation, but the provision of Art. 17 may not be sufficient to remove this doubt altogether, because the Japanese language does not distinguish most nouns, including the word *riji* (director), in singular and plural forms. Art. 16 mentioned above thus may refer to one director as representing the corporation.

This vagueness leads to the second problem—while torts committed by directors will be deemed those of the corporation (Art.8, applying Art.44 of the Civil Code), there is no clear definition of the directors’ duties, obligations, and liabilities in either the statute or case law. Thirdly, and even more significantly from the viewpoint of the present paper, the law has no provision on the election and appointment of directors. The details of the election and appointment process may be set out in charters, but considering the prime importance of the Members Meeting described earlier, albeit with some reservations, the Meeting should have the exclusive power to elect and appoint the directors of the corporation. The lack of this provision is significant, leading to the almost unrestrained power of directors. Together with the

lack of a board defined in the NPO Law, it is possible for two out of three self-elected directors in a nonprofit to have a casual conversation and decide on a specific action on behalf of the corporation. The Law does not require that there be minutes of meetings for members or other interested parties to monitor, and there are no fiduciary duties imposed on directors. In sum, the degree of informality involved in this corporation code seems to be very large.

It is helpful to compare this situation with corporate governance in for-profit business. Typically corporation law provides shareholders with the voting right to elect directors who they believe could best manage the company in which they have invested. In practice, individual shareholders may not always be interested in or knowledgeable about individual candidates, and would agree with the proposals put forward by the incumbent board. Shareholders are generally happy to delegate management decisions to whom they elect, and the separation of ownership and management made in such a way serves for efficiency and effectiveness. In fact, one can critically characterize the general meeting of shareholders as "ceremonial" and "rubber-stamping."⁵⁸ In statutory terms, the board is accountable to shareholders for its decisions and actions. Thus, accountability within the corporation is clearly defined, following the reverse direction of power delegation. While in practice the 'agent,' namely, the management, may not always act in the best interest of the principal (i.e. shareholders), the supremacy of such a model has been well established.

A guidebook recently published for Japanese practitioners on nonprofit management erroneously assumes a similarity between corporate governance as described above and nonprofit governance in Japan.⁵⁹ In the way shareholders elect directors/officers, who then appoint the Chairman of the Executive Officers and executive directors, in Japanese nonprofits, members are supposed to elect the board of directors, who then appoint the Secretary General (or the Executive Director) and paid staff. However, this is an ideal for nonprofit management the author normatively recommends, but it does not reflect either the structure imposed by the law or the prevalent practice in Japan today.

The law provides neither for the appointment and dismissal of directors, as has been mentioned before, nor a link between the Member Meeting and the organizational representation made by directors. Moreover, while Art. 20 provides for details on those individuals who would be disqualified as directors such

58. ODA, *supra* note 19, at 234 (referring to corporate governance in Japan).

59. SAKAMOTO, *supra* note 9, at 30-31.

as those with recent criminal records and so forth, the law is largely silent on duties and obligations of directors. Art. 2 (1)*ro* provides that no more than one-third of directors may receive compensation; this provision, however, defines what is "not-for-profit," rather than serving as a constraint on the qualification of a director. Another provision relevant to directors is that no more than one-third of directors may be members of the same family, nor may more than two directors be of the same family (Art. 21). While both provisions probably help to prevent the use of a nonprofit as a conduit of another organization of personal interest, the law critically lacks provisions on the fiduciary duty of directors to their organizations.

The agent's responsibility for the principal is generally codified in Art. 644 of the Civil Code, which provides that the agent is obliged to act as a "good manager" to meet the intent of delegation, and the agent must report to the principal on the progress and outcome of the delegated act (Art. 645). These provisions apply, however, only where there is a manifestation of consent by the principal to the agent that the agent shall act on behalf of the principal and that the agent has consented to so act (Art. 643, Civil Code). In the NPO Law, however, agency relationship does not appear to be established as directors are not appointed by members. While the Commercial Code further provides for fiduciary duties of directors (Art. 254[3]) as well as for conflicts of interest and self-dealing (Arts. 264 and 265), there is no mention of these in the NPO Law. Some commentators suggest that the NPO Law implicitly assumes fiduciary duties of directors, including the duty of care, the duty of loyalty, and the duty of obedience,⁶⁰ but this interpretation seems to over-stretch the statutes. In short, there is no chain of internal accountability completed; it now seems odd to give the voting rights on the three corporate affairs, which greatly matter to organizational survival, to the member meeting. Thus the NPO Law leaves us wondering what structure of accountability it presumes that the nonprofit corporation will implement.

Practitioners may argue that while the law may be imperfect, corporate charters can have a clear structure of accountability, and their argument may well have a case in point. Some nonprofits choose to define in their charters that the Member Meetings have the right for the election, appointment, dismissal of the directors, and that the Meetings give consent to the remuneration and duties of the directors. Hamaguchi, an attorney-at-law in the panel on the NPO Law with Hotta quoted earlier, warns us

60. MIKI HIDEO, AKEGA HIDEKI, AND IKEDA NAOKI, *NPO TO BORANTIA NO JITSUMU [PRACTICAL ASPECTS OF THE NPO LAW AND VOLUNTEERING]* 107 (1998).

of the danger in excessive reliance on charters, particularly because the law stipulates very little on what must be included in charters. He suggests that the legislators did not have the possibilities of private disputes and lawsuits involving nonprofit corporations clearly in mind, and that they gave only limited provisions on the organizational design of nonprofits.⁶¹

C. THE STRUCTURE OF INTERNAL AND EXTERNAL ACCOUNTABILITIES

The above subsection has argued that governance is ill-defined by the NPO Law. In fact, it is more appropriate to explain that governance is confused with management. This paper has used the term "director" in accordance with the meaning given to the term by American corporation law to refer to *riji* in Japanese nonprofits, which is a proper translation. The prevalent practice however is that they may well be more similar to managers or executives. They are often the people who are heavily involved in the day-to-day operation of the organization or even at the forefront of service delivery, particularly in small-scale or young nonprofits. In those cases, the CEO or the Executive Director (*jimukyokuchō*) is likely to be *riji* as well or a member of the Board of Directors, if the corporation has one. The lack of a governing body independent of management again raises the issue of accountability.

Accountability is a difficult concept for the Japanese as exemplified by the fact that there is no indigenous Japanese word for it. It is reasonable to suggest that it was a term introduced to Japan about ten to fifteen years ago in the process of successive reforms in corporate governance and simultaneously in the ongoing reform of the public sector. Still, there is a lot of confusion about this term, and it is often understood that this term means only financial accountability or disclosure of financial information, thus reducing the term to only its technical aspect. Traditional Public Interest Corporations in this regard tend to believe they are accountable only to their supervisory authorities. But in the absence of the strict supervision by government for nonprofits under the NPO Law, nonprofit corporations in the new sector do not know where to turn. It can be said that the obligation of having at least one auditor at a nonprofit is a major improvement, while the Public Interest Corporations need not have any. As another improvement, Arts. 28(2) and 29 provide that nonprofits must submit annual reports to the relevant authorities, and that the reports may be made available to the public for in-

61. Hiroshi Hamaguchi, in *NPO HO KONMENTARU*, *supra* note 51, at 36.

spection. There is also a mechanism of “NPO supervision by the public” set up by the Cabinet Office, whereby the Office informs the nonprofit of a request from the general public for disclosure and makes the response publicly available,⁶² by posting the relevant correspondence and documents between the enquirers and the respondents on the web site of the Office. The threshold of both the number of requests from different individuals and other details to trigger this action are at the discretion of the Office; this, however, is an innovative method of “public” (not governmental) supervision, unusual in the Japanese bureaucratic tradition.

However, none of the above is sufficient as an instrument of installing accountability. As directors represent all the activities of the corporation (Art. 16 of the NPO Law), they seem to be obliged to account for objectives and goals of the corporation, its activities, projects, and programs, as well as its financial status to the outside world. However, directors are self-appointed and do not owe any structural accountability to the members. The lack of the relationship between the Members Meeting and directors has already been mentioned, and there is no provision in the law to fill this gap. If we follow the argument that members do represent the public interest that the nonprofit purports to serve because they have subscribed to it, then it should be the Members Meeting where the final point of internal accountability ends and leads to external accountability. The law in its present form suggests nothing like this, leaving the issue of who accounts for what and to whom unanswered, both internally and externally. Tachibana, a civil servant involved with the drafting of the code, explains that there could be another organ defined by charters:

If an NPO corporation finds it inefficient and cumbersome to call members’ meetings frequently, it might be advisable, for the purposes of effective and swift management, to have a new institution called, for example, a committee of officers or representatives, and give it exclusive power to decide on budgets, principles, and strategic objectives, or the appointment and dismissal of directors. It is necessary to define the name of such a committee and its competence in corporate charters.⁶³

To follow this advice would be even more confusing and mask the importance of organizational accountability. The auditor does have an important responsibility of reporting any misconduct which infringes upon the law or the nonprofit’s charter,

62. Naikakufu [The Cabinet Office], NPO Hô no Unyôhoshin ni tsuite [On the Enforcement of the NPO Law] §2 (Mar. 25, 2003).

63. TACHIBANA YUKINOBU, SHITTE OKITAI NPO HÔ [THE BASICS OF THE NPO LAW] 65 (rev. ed. 2002) (translation by the author).

either to the Members Meeting or to the relevant authority (Art. 18[3]). This is an important provision, but insufficient because it only focuses on *ex post* reporting; it has no function of defining accountability *ex ante* at a structural level. The election of the auditor(s) is again undefined in the law. It is thus possible for directors to appoint somebody who is convenient for their purposes. In short, the NPO Law does not define the accountability of the corporation between members, directors, and auditors, nor the one between the nonprofit and third parties.

IV. NONPROFIT CORPORATION LAWS AND GOVERNANCE IN THE US

So far in this paper I have discussed the emergence of the nonprofit sector in Japan and the significance of the NPO Law to provide a new avenue for the incorporation of citizens' activities for public interest. I have argued that despite the laudable achievement of the legislation it is flawed in failing to provide a solid structure for nonprofit governance and accountability. There is a danger that nonprofits will be governed and managed by the same, self-appointed directors who are not accountable to anyone for an unlimited period of time.

It is instructive to turn our eyes to the law and public policy for nonprofit corporations in the U.S. with its long tradition of private philanthropy and highly developed statutes and cases in this area. However, the following examination of the nonprofit sector in the U.S. will not be uncritical. It aims to tease out problems and gaps between theory and practice by examining the debate concerning nonprofit accountability that has been taking place over the last twenty years. The focus is on corporation law, which is governed at state level. The California Corporations Code (West 1990), which is generally well established and oft-quoted in legal commentaries even in Japan, will form the basis of the discussion below. The Revised Model Nonprofit Corporation Act drafted by the American Bar Association in 1987 will also be referenced where appropriate.

A. BOARD ACCOUNTABILITY—THEORY AND PRACTICE

In the U.S., it is generally understood that the board of directors, as the governing body, is granted the power for major decision-making by the "public" while it delegates management to the senior officers of the organization. However, this prevailing theory has been challenged by a few commentators who argue that the essence of the nonprofit corporation subsists in its members. Also, it has been at odds with what occurs in board governance and management practice. The following examines

the two challenges to the theory on the board as the final point of accountability to the public: one from the theoretical and the other from the practical perspectives.

As to theory, although having never prevailed in the literature, the argument has been made that in corporation law the members, in fact, not the trustees, constitute the *body corporate*. Professor Oleck, an authority on nonprofit corporation law, states as a matter of fact:

Ultimate "ownership" of a nonprofit organization and of its assets is in the members, in a membership organization. The member's right to vote is his basic means of control.⁶⁴

He believes that fundamental power to adopt or to change purposes and rules (e.g. articles and bylaws) in a nonprofit corporation is conferred upon the members,⁶⁵ in the same way as it is in Japan. In relation to theories of corporations, he supports the "realist, or enterprise, or symbol theory," which posits that corporate powers, namely the bundle of rights and capacities to act in a particular manner, are vested in the artificial legal entity and so spelt out in statutes.⁶⁶ For him, this legal entity is equal to membership, whereas the corporate powers are exercised by the board of directors in most situations. While interesting and refreshing, this line of argument remains neither elaborated with supporting evidence nor theoretically sophisticated. To begin with, the above-quoted sentence specifically refers to membership organizations, but does not mention those nonprofit corporations without members. Secondly, what is precisely meant by the term "ownership" in the writings by Oleck and his followers⁶⁷ is not entirely clear. Thirdly, why members in nonprofit organizations, particularly those for public interest, should be "owners" is not explained. For Oleck, the existence of nonprofit organizations without members is a deplorable problem, but why that is so is under-explored.

As Professor Hansmann argues in his book that examines various forms of firms, ownership of a corporation generally involves two elements: control of the organization and the right to residual earnings. Nonprofit organizations are distinctive in that they are statutorily barred from distributing their profits to members, officers, and directors despite the control these classes of

64. Howard L. Oleck, *Proprietary Mentality and the New Nonprofit Corporation Law*, 20 CLEV. ST. L. REV. 145, 155 (1971).

65. HOWARD L. OLECK, *NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS*, §274, at 761 (5th ed. 1988).

66. *Id.*, §274, at 760.

67. *E.g.*, David R. Maraghy, *Internal Control Trends in Nonprofit Organizations*, in *TRENDS IN NONPROFIT ORGANIZATIONS LAW* 57 (Howard L. Oleck ed., 1977).

people have over the corporation. Thus, by definition, according to Hansmann, nonprofit organizations have no owners.⁶⁸ He explains that nonprofit firms are held in trust by “managers” (i.e. directors in this context) for its “customers” (i.e. broadly-defined beneficiaries in this context).⁶⁹

Although Hansmann’s economic argument is interesting, it does not coincide with the existence of statutory provisions in a number of state corporation laws that do not expressly prohibit asset distribution to members on corporate dissolution, a fact that Hansmann himself acknowledges and calls “an enormous loophole in the nondistribution constraint.”⁷⁰ He also points out, in a different work, that the restriction on profit distribution, clearly embodied in most state laws, is not strenuously enforced.⁷¹ Oleck elaborates this problem in a comprehensive guide to nonprofit corporation law to criticize the laws:

In the case of California, the statute of 1980 still allowed directors not only to effectively own the nonprofit corporation’s assets but ultimately to benefit personally from its corporation. First, in a nonprofit corporation formed without a provision for members, the directors were assumed to be the sole members. Then as member/directors, they were permitted to establish a reasonable salary for themselves. Third, under the statute a nonprofit corporation may operate a business for profit as long as it is incidental to the corporation’s main purpose. Last, these member/directors may vote to dissolve the corporation and then as members be entitled in its distribution.⁷²

It must be noted, however, that the Income Tax Regulations of the Internal Revenue Service (IRS) stipulate that no assets of the public-interest, nonprofit corporation, upon dissolution, may be distributed to its members or shareholders in order for the corporation to qualify for tax exemption.⁷³ For most nonprofits, it is obviously important to have the federal tax exemption status under the Internal Revenue Code: it not only exempts them from federal taxes on income (provided that the income is from activities substantially related to the purpose of the organiza-

68. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 228 (1996).

69. *Id.*

70. Henry, B. Hansmann, *Reforming Nonprofit Corporation Law*, 120 U. PA. L. REV. 497, 574 (1981).

71. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 873-74 (1980).

72. Oleck, *supra* note 65, at 762 (citations omitted). Oleck’s first point seems to relate to the current CAL. CORP. CODE §5310 (providing that directors are deemed as members if the corporation has no members), while his second point relates to §5235. The third point relates to §§5111, 5410, and §5233 permitting self-dealing of directors, albeit in restrictive ways. The final point is embodied in §§6610, 6713.

73. Income Tax Regulations, 1.501(c)(3)-1(b)(4).

tion's tax exemption), or on investment income, but also allows taxpayers (who itemize deductions) to deduct the amount of cash and the fair market value of property contributed to 501(c)(3) nonprofits. Because the IRS recognizes however that state laws often lack the requirement for non-distribution upon dissolution, it has published guidelines to identify circumstances where an express dissolution clause for charitable nonprofits is required.⁷⁴ In the states which do not have statutes that will satisfy the "organizational test" applied by the IRS (a total of forty-two states plus the District of Columbia,) nonprofits are required to, and most do in practice, have an express qualifying distribution or liquidation clause in the charter of the corporation to qualify for tax privileged status.⁷⁵

What seems to bother Oleck, nonetheless, is his observation that corporation laws for nonprofits do not fully take the specific features of nonprofits on board, being instead more or less the adaptations of corporation laws for businesses. As another illustration of his point, the California Corporation Code provides that nonprofit corporations *may* have members,⁷⁶ in which case they have certain rights such as the vote to appoint candidates for directors⁷⁷ and the vote to elect directors.⁷⁸ However, the statute makes it clear that it is possible for nonprofit corporations not to have members with voting rights.⁷⁹ Oleck calls this a "gross misconception"⁸⁰ of nonprofit corporation law and deplores the existence of the state laws which have "blindly followed"⁸¹ the Revised Model Nonprofit Corporation Law,⁸² allowing nonprofits to set themselves up without members. His concern is that this model allows donors and their family members to both nominate themselves as directors and to have a full control of the corporations, thereby using nonprofits, in the guise of charity, to benefit from tax privileges. More specifically, the California Corporation Code seems to allow such an arrangement in §5520(d), which removes the formality required by the pre-1980 California

74. IRS, 1981 EO CPE Text E. "The Cy Pres Doctrine: State Law and Dissolution of Charities", available at <http://www.irs.gov/pub/irs-tege/eotopice81.pdf> (last visited Jan. 12, 2006). The IRS however disclaims the authority of this paper originally published for technical training purposes. <http://www.irs.gov/charities/article/0,,id=113070,00.html> (last visited Jan. 12, 2006).

75. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, §4.3(b), at 58 (7th ed. 1998).

76. CAL. CORP. CODE, §5310(a) (1990).

77. Only when there are more than 500 members (CAL. CORP. CODE, §5521 (1990)).

78. CAL. CORP. CODE, §5056 (1990).

79. CAL. CORP. CODE, §5310 (1990).

80. Oleck, *supra* note 65, at 761.

81. *Id.*

82. REVISED MODEL Nonprofit CORP. ACT §11.6.03. (1987).

Corporation Code of donors and their families, when they are both members and self-elected directors, to sit in the two meetings and play different roles.⁸³ It is generally said that a corporation with no membership tends to be the most prevalent in practice, at least in California.⁸⁴ Although there are no statistics available on the proportion of nonprofit organizations with (or without) members in the whole sector, the general understanding is that most are without members.

As reflected in the lack of data, there is scant literature in the U.S. to discuss the role of members in a public interest, nonprofit corporation. Where reference is made to it, it is only brief and minor. In a similar vein, one rarely comes across issues relating to members in the meaning of corporation law in the nonprofit management literature; rather, most of the writings are on the governing board, the executive, and volunteers. The lack of attention to members coincides with a public perception in the U.S. that member-based organizations are for mutual benefit, rather than for public benefit. It is an established understanding that, in public-benefit nonprofit governance, the board of directors has fiduciary responsibilities for the assets and missions given to them and that the board is the final point of internal accountability. The executive director appointed by the board has to put the mission and organizational goals into implementation and engage in day-to-day operation of its programs. However, it is (or should be) the board that establishes both basic organizational and management policies and procedures of organization, and reviews the executive's performance. Consequently, the board is accountable for all the activities undertaken by the corporation. To ensure public accountability, nonprofits are required to disclose their approved applications for recognition of tax-exempt status and annual information returns for public inspection.⁸⁵ In addition, the attorneys general of the states have the power to bring nonprofits to lawsuits for any serious offence against the statutes regulating charities or for the abuse of corporate privileges.⁸⁶

Those working in the widely-defined nonprofit sector in Japan have admired the elegance of such a structure in the U.S. .

83. James R. Andrews, *Procedures for Electing Directors of Nonprofit Corporations Pursuant to the New Nonprofit Corporation Law*, 13 U. S. F. L. REV. 857, 863-64 (1979).

84. *Id.*, at 864; Thomas Silk, *The Legal Framework of the Nonprofit Sector in the United States*, in THE JOSSEY-BASS HANDBOOK OF NONPROFIT LEADERSHIP AND MANAGEMENT 63, 76 (Robert D. Herman & Associates eds., 2d ed. 2004).

85. I.R.C. § 6104(a)(1), (b), (d) (2002).

86. *E.g.*, CAL. CORP. CODE §6511 (1990) (specifically, 6511(a)(1) relates to charities and 6511(a)(2) relates to abuse of privileges).

Particularly, they are impressed with the autonomy the board is given, as it greatly differs from the general subordination of the boards of the Public Interest Corporations to their respective supervisory authorities. The Public Interest Corporations feel compelled to respond to the demands of the authorities rather than to those of the public whom they are supposed to serve. The wishes of major donors and founders are also dominant in determining the organization's direction, leaving the Japanese boards far from being autonomous. In this respect, it is reasonable that they have a high regard for their American counterparts.

However, they tend to study the board and nonprofit governance in the U.S. in search of an ideal model with uncritical eyes, failing to recognize the volume and profundity of the debates that have long continued on nonprofit governance. It is important for us to pay attention to the criticism often heard in the U.S. that boards in practice do not always function in the way its normative model suggests they should: boards are either too powerful or incompetent, not really overseeing the executive. This is particularly true for those nonprofits without voting members, which is probably the majority in the sector, as boards appoint themselves with the frequent corollary that the nonprofit becomes a self-perpetuating club of local dignitaries gathered on nonprofit boards.⁸⁷ Hospitals, universities, orchestras, and museums are among the most prestigious in the nonprofit sector, easily recruiting business leaders and wealthy people in their geographical area.

Thus, whether the board is truly accountable in practice has been a topic of heated discussion for a long time. A Japanese mission to the U.S. to study nonprofit governance heard the statement that nonprofit boards are accountable to the public time and again, and the members of the team were genuinely impressed with the image of accountability.⁸⁸ However, it is widely known that in the U.S. boards tend to function poorly in practice, despite their important responsibility.⁸⁹ According to Miller, who conducted qualitative research at twelve nonprofits in the U.S., only three organizations had members who consistently acknowledged and elaborated on the boards' accountability

87. Melissa Middleton, *Nonprofit Boards of Directors: Beyond the Governance Function*, in *THE NONPROFIT SECTOR, A RESEARCH HANDBOOK* 141, 145 (Walter W. Powell ed., 1987).

88. See Hiroshi Asamura, *Beikoku Hieiri Soshiki no Yakuwari to Soshiki Un'ei no Genjō* [The Role of Nonprofit Organizations and their Management in the US], *KŌEKI HŌJIN* [PUB. INT. COPR.] Sept. 2002, at 18, 22 (2002); Hisakazu Dohi, *Gabanansu to akauntabiritii* [Governance and Accountability], *KŌEKI HŌJIN* [PUB. INT. COPR.] Jul. 2002, at 2, 7 (2002).

89. Middleton, *supra* note 87, at 141.

to the community at large. Very often, the board members interviewed had to ponder for a long time, finally responding that they were accountable to themselves.⁹⁰ Another reply made by a board president to the question “To whom is the board accountable?” was “no one”, since the nonprofit in question was not member-based.⁹¹ Miller still pushed the interviewee and insisted that his/her board had the responsibility of oversight. The president responded by speaking of a “fiduciary responsibility to oversee the financial health of the organization.”⁹² It is questionable however whether even the financial accountability mentioned here is adequately performed, as board members often are unsure about how to read financial reports and agree, without a fuss, with the financial reporting presented by the relevant board member and the treasurer.⁹³

Such ambiguity of board accountability has been highlighted as a public policy issue, particularly since the 1990s with financial scandals involving high-profile nonprofits in the U.S. . A most well-known one concerned the United Way of America,⁹⁴ while similar scandals involved universities and hospitals. The parallel scandals in the business sector (involving such companies as Enron and WorldCom) in recent years have led to legislative reform to strengthen corporate governance, which has had an impact on the nonprofit sector.⁹⁵ The last few years have seen Congressional hearings to investigate the appropriateness of federal tax law to govern the nonprofit sector, with a view to eliminating the excessive tax concessions granted to wealthy people for their donations to charities.⁹⁶ Of particular concern currently are the valuation of appreciated properties donated to charitable organi-

90. Judith L. Miller, *The Board As a Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards*, 12 NONPROFIT MANAGEMENT & LEADERSHIP 429, 441 (2002).

91. *Id.* at 441.

92. *Id.*

93. *Id.* at 441-42.

94. See *Aramony v. United Way*, 28 F.Supp.2d 147 (S.D.N.Y. 1998), *aff'd*, *rev'd* and remanded in part 191 F.3d 140 (2d Cir. 1999).

95. See ABA COORDINATING COMMITTEE ON NONPROFIT GOVERNANCE, GUIDE TO NONPROFIT CORPORATE GOVERNANCE IN THE WAKE OF SARBANES-OXLEY (2005)(applying Sarbanes-Oxley governance principles to nonprofit organizations); BoardSource, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (2003).

96. *Charity Oversight and Reform: Keeping Bad Things From Happenings to Good Charities: Hearing on Nonprofit Abuses Before the Finance Comm.*, 108th Cong (2004); *Charities and Charitable Giving: Proposals for Reform: Hearing Before the Finance Comm.*, 109th Cong (2005). See also *Charitable Contributions for September 11: Protecting Against Fraud, Waste, and Abuse: Hearing before the Subcomm. on the Oversight and Investigations of the House Comm. on Energy and Commerce*, 107th Cong (2001) [hereinafter *Charitable Contributions for September 11*].

zations, the so-called Donor-Advised Funds and supporting organizations misused as tax shelters, and conversion of nonprofits to for-profit corporations and its impact on charitable interests and assets.⁹⁷ All of these incidents, when considered together, call for enhanced policing, tax law enforcement, and self-regulation to improve governance and public accountability for nonprofit organizations. It has been pointed out that boards are lousy about oversight, being unaware of the unlawful acts of their executive directors. There is a general perception that the structure of nonprofit governance with the board at the pinnacle is considerably weaker and less effective than corporate governance, despite the large amount of gifts and tax benefits given to nonprofits.⁹⁸ The series of scandals and criticisms on nonprofit governance has led to three major arguments for reform, which can be summed up as follows: (1) to query the adequacy of fiduciary responsibilities of the board, (2) to strengthen societal oversight for nonprofits, and (3) to grant standing for group action by "stakeholders" of nonprofits. Each is examined below.

B. STATUTORY STANDARDS OF CONDUCTS AND STANDARDS OF JUDICIARY REVIEW

The first proposal made by commentators to strengthen nonprofit governance and accountability has been related to the standards of conduct as provided by corporation law for nonprofits. In the California Corporation Code, for example, §5231(a) provides that:

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

The above provision firstly involves the duty of care, which is about the basic competency of directors in performing their functions with the skills and care expected of ordinarily prudent men in similar circumstances and in like positions. Secondly, the provision refers to the duty of loyalty, meaning the director must pursue the goal of the corporation as opposed to his/her own private interest. Thirdly the duty of obedience, which ensures the maintenance of charitable purposes on which the nonprofit is

97. Staff Discussion Draft, the Finance Comm, *available at* <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

98. Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 J. CORP. L. 631, 623 (1998).

based.⁹⁹ It must be noted, however, that these are more or less the same as the duties of directors for commercial businesses.¹⁰⁰ There is a view that nonprofit directors should be held to the higher standard of conduct than trustees in trust law are, although the opposing view is equally strong that such a high standard is unreasonable as the directors are normally not compensated for their services. It is also thought that very high standards or harsh sanctions may inhibit nonprofit directors from taking risks and supporting innovative projects.¹⁰¹ Historically, however, American nonprofits were founded as charitable trusts with vast amounts of assets dedicated to their charitable causes. "Trustees" rather than board directors in these cases were to make sure that the will of the donor (or his/her heirs) was pursued, and they were held to a high standard of conduct defined by trust law. The relaxation of this responsibility took place between the late nineteenth century and the early twentieth century, as "charities" started to use the form of nonprofit corporation rather than trusts.¹⁰² The New York Not-For-Profit Corporation Law enacted in 1970 to supersede the Membership Corporation Law finalized the relaxation of those standards by lowering the standard of conduct for nonprofit directors so that they were equivalent to the standards applied to for-profit business directors.¹⁰³ In California, likewise, §5231(a) as applied to nonprofit directors is exactly the same as §309(a) of the Corporation Code, which is applied to their counterparts in the business sector.

It is important to distinguish standards of conduct from standards of judicial review that are applied to the behavior of directors *ex post*. In the case of business directors, the duty of care is provided in corporation law, but when it comes to litigation over the misconduct of directors, a different set of standards is applied by courts in determining whether they are liable or not. The discrepancy of the standards for judicial review purposes and those for conduct is unusual in American law,¹⁰⁴ but in principle gross negligence, which is a very low standard, protected further by the Business Judgement Rule of common law, is the standard for directors in for-profit corporations. In other words, it is extremely

99. Rob Atkinson, *Unsettled Standing: Who(else) Should Enforce the Duty of Charitable Fiduciaries?*, 23 J. Corp. L. 655, 661 (1998); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 234-237 (2003).

100. James J. Fishman, *The Development of Nonprofit Corporation and an Agenda for Reform*, 34 EMORY L.J. 617, 649-50 (1985).

101. Goldschmid, *supra* note 98, at 637.

102. Fishman, *supra* 100, at 649-50.

103. *Id.*

104. Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L.REV. 437, 437-38 (1993).

difficult to prosecute a director of a business corporation for his/her negligence as long as he/she conforms to the other two duties. It follows that the duty of care for directors of businesses is only a matter of ethics, with little substance to it. As we turn to nonprofits in particular, there is no clear-cut guidance on this issue either in statutes or in case law. However, it has been observed that the case law concerning this sector is following the relaxing trend already seen in the business sector.¹⁰⁵ This is in line with the argument of Fishman that the nonprofit corporation law is converging with that of business corporations, losing its root in trust law, at the expense of ignoring the distinctiveness of the nonprofit sector.¹⁰⁶

C. GOVERNMENT REGULATION OF THE NONPROFIT SECTOR

The second proposal made by commentators to enhance nonprofit accountability has been about public policy regulation of the sector. Under the current government system relating to the supervision of nonprofits, the IRS regulates the sector in effect. At the point of incorporation by state law, the nonprofit nature of the organizational mission is examined, but this is not a big deal. It is far more important for nonprofits to obtain tax-exempt and tax-deductible status under federal tax law, which is determined by the IRS. The IRS also has the power to seek revocation of the status or impose penalties if the organization violates one or more of the requirements for the applicable tax-exempt status.¹⁰⁷ Japanese commentators generally consider the separation of incorporation and tax privileges as healthy and admirable; they believe that the automatic granting of tax treatment in the case of the Public Interest Corporation is one major reason why Japanese government has been reluctant to grant incorporation *per se*, and it gives government a high degree of discretionary power in the processing of applications.¹⁰⁸ In the U.S., in contrast, there is a view that the IRS, an authority in charge of federal tax matters, should not intervene into the oversight of nonprofits, which by definition, does not possess a competence.¹⁰⁹ A problem has also been pointed out that, despite

105. Denise P. Lee, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L.REV. 925, 937-39, 942-43 (2003).

106. Fishman, *supra* note 100.

107. HOPKINS, *supra* note 75, §24.6, at 587.

108. See, e.g., Amemiya's comments in the panel discussion, NPO HO KON-MENTĀRU *supra* note 51, at 62.

109. See, e.g., Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L.REV. 537 (1999) (discussing the incident of the Kamehameha Schools Bishop Estate receiving a "threat" from the IRS to revoke the tax exemption status unless the Estate adopted management changes the agency specified in the course of negotiating "closing agreements").

the IRS scrutiny at the point of application for the exemption status, no review is statutorily required thereafter.¹¹⁰ More fundamentally, as Professor Ellman argues, the laws applicable to nonprofits other than corporation law usually have their own purposes and standards; hence, policy issues related to the nonprofit corporation code can and should be dealt with in isolation from the benefits and sanctions provided elsewhere.¹¹¹

In legal research, public oversight of nonprofit corporations was examined early in 1960 by a seminal paper by Professor Karst,¹¹² but the issue has attracted much more attention since the 1970s when there was a rapid growth of the sector. The reliance of nonprofit finance on self-earned income has increased, blurring the distinction between nonprofits and for-profits. Henry Hansmann's papers, which discuss public policy oversight of the nonprofit sector and the weakness of nonprofit accountability, have contributed to the growth of the literature.¹¹³ Congressional hearings have periodically been held by different committees on various issues such as the alleged use of private foundations as tax shelters,¹¹⁴ the perceived need for a reform in tax law to encourage charitable contributions by individuals,¹¹⁵ and the concern with the distribution of charitable contributions raised after September 11.¹¹⁶

Among the comments and arguments made by legal scholars, the recommendation made by Professor Fishman is of partic-

110. As long as "there are no substantial changes in the organization's charter, purposes or method of operation." Treas. Reg. § 1.510(a)-1(a)(2); See, e.g., the testimony of George K. Yin, Chief of Staff, Joint Committee on Taxation, Charities and Charitable Giving: Proposals for Reform, *supra* n.97. See also *supra* note 97 (the Staff Discussion Draft prepared for this hearing by Yin's team proposes five-year review of tax-exempt by the IRS). But see the report by Panel on the Nonprofit Sector, Strengthening Transparency Governance Acceptability of Charitable Organizations, a final report to Congress and the Nonprofit Sector, Independent Sector, 33-34 (2005) (arguing against the periodical review for straining resources both for the IRS and nonprofits) available at http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf.

111. Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 1001 (1982).

112. Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L.REV. 433 (1960).

113. Hansmann, *supra* notes 70-71; Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807 (1988-89).

114. *Tax Reform Act of 1969: Hearings Before the Finance Comm. 91st Cong.* (1969). The Reform has established private foundations as a separate category from other charitable organizations in federal tax treatment.

115. *Charitable Contribution Deductions: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the House Finance Comm.*, 96th Cong. (1980).

116. *Charitable Contributions for September 11*, *supra* note 96.

ular interest here.¹¹⁷ As has been discussed in the previous section, a number of commentators are concerned with the general trend in which a lower standard of conduct is being applied to nonprofit directors,¹¹⁸ on the ground that nonprofit governance is weak as it lacks the disclosure requirement under federal securities law and the exposure to the fluctuation of share prices in the market.¹¹⁹ Some commentators also warn of the danger of applying a loose standard to nonprofit directors, like that seen in section 8.31 of the Revised Model Nonprofit Corporation Act,¹²⁰ and some propose a flat ban on any self-dealing of directors at nonprofits.¹²¹ Fishman however qualifies the argument by stating that it is unnecessary to uniformly require a sophisticated type of governance to all nonprofits. According to Fishman, small nonprofits often have no expertise and knowledge about governance, and self-dealing by directors is common. It is unrealistic, impossible, and inefficient to regulate those activities. Furthermore, self-dealing may well be imperative for small-scale, emerging nonprofits as the only way of raising funds necessary for their operation. Small businesses such as closed corporations and partnerships are not required to meet the same standard of governance as that applied to public companies. Likewise, small nonprofits should enjoy lower standards of governance, thereby encouraging their growth into maturity while reducing the task load of the attorney general.¹²²

This is an interesting idea because it takes the sector's diversity, the economic reality of nonprofits, and enforcement capacity into account. Fishman's characterization of this category bears striking resemblance to Japanese nonprofits:

. . . all of whom (i.e. directors) are employees with a strong desire for employee-director control. These inside directors adopt the corporate form of organization only for its tax exempt status and for revenue purposes. In their relationships to each other, the participants are more analogous to partners. The formalities of corporate governance are ignored. The corporate form is but a vehicle to solicit charitable contributions.¹²³

117. Fishman, *supra* note 100.

118. *But see* Goldschmid's argument, *supra* note 98, at 643 ("the absence of enforcement, . . . not the "lowness" of care standards, makes care standards largely aspirational in the nonprofit context").

119. *E.g.*, Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131 (1993); *Developments in the Law - Nonprofit Corporations*, 105 HARV. L. REV. 1579 (1992).

120. *E.g.*, DeMott, *supra* note 119.

121. Hansmann, *supra* note 70, at 569-73. This is related to the earlier Duty of Care discussion.

122. Fishman, *supra* note 100, at 666-68.

123. *Id.* at 667.

As previously mentioned, most nonprofits formed under the NPO Law are very small-scale and young in their incorporated form, a fact that may fit in with the considerable degree of informality involved in the Law. I would argue, however, that it would be important for the Law and nonprofit organizations in Japan to begin creating a better structure for accountability as the sector continues to thrive. As Fishman suggests for American nonprofits, certain definitional characteristics may be just as useful for Japanese nonprofits to distinguish what he terms the Closed Nonprofit Corporation from larger, established nonprofits. Whether a certain percentage of a budget allocated to staff salaries and directors, an index Fishman suggests for U.S. nonprofits, would be meaningful for Japanese nonprofits is questionable because they tend to have no paid staff. Rather, the size of annual expenditure might work as a more effective yardstick.¹²⁴

Returning to the issue of an improved structure for government regulation of nonprofits, Fishman in a later paper proposes the establishment of a Charity Commission under the aegis of each state's attorney general. This would be a neutral, semi-public, semi-private organization to accept claims made by members of the public against nonprofits in their jurisdiction.¹²⁵ More broadly, Professors Ben-Ner and Van Hoomissen propose the establishment of an Office for Nonprofit Organizations (ONPs) in each state, which would take the jobs from the IRS and become the depository of annual reports and financial reports received from nonprofits. ONPs would work as a liaison between nonprofits, donors, volunteers, and the general public.¹²⁶ Thus, the authors go beyond Fishman by embracing an ONP's role as an intermediary that provides organizational support for nonprofits.

D. PARTICIPATION OF STAKEHOLDERS IN GOVERNANCE AND MANAGEMENT

In response to the current limitation of government oversight of the nonprofit sector, the third proposal made for reforming and enhancing nonprofit accountability has been to allow private parties to bring suit for managerial malfeasance.

124. *Id.*

125. Fishman, *supra* note 100, at 272-87. See also Mary Grace Blasko, Curt S. Crossley, and David Lloyd, *Standing to Sue in the Charitable Sector*, 28 U. S. F. L. REV. 37 (1993). According to the authors at 50-51, two states, South Carolina and West Virginia, have "Commissions on Charitable Organizations" to supervise charities, which are largely advisory and administrative and have no standing right to sue charities.

126. Avner Ben-Ner & Theresa Van-Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MANAGEMENT AND LEADERSHIP 393, 408-09 (1994).

Commentators who are unsatisfied with the fictitious structure of nonprofit accountability whereby the board is accountable to the general public and the attorney general represents the public interest have sought a more direct structure of governance for nonprofits. They propose expanding the categories of those with standing to sue to enforce fiduciary duties of charities. While directors generally have the right to derivative suit,¹²⁷ this is rarely exercised.¹²⁸ Instead, the commentators have tried to apply the principle of corporate governance to nonprofits by identifying their "owners" and arguing for their right to control the governing body. "Owners" in this sense are not restricted to founders, but may include donors, volunteers, and service users, who have "economic" transactions with the nonprofit.¹²⁹ Unlike their for-profit counterparts, nonprofit stakeholders are not generally given the right to group action to sue the corporation or directors for their failure to adequately perform their duties.¹³⁰

In some limited ways, the California Corporation Code has expanded the class of private persons with standing rights to include a "person with a reversionary, contractual, or property interest in the assets subject to such charitable trust."¹³¹ Members are also granted a right to bring a derivative suit in California to enforce the rights and purposes of the corporation,¹³² but neither of the above provisions is extended to donors and other stakeholders.¹³³ In the current statutory law, it is only the attorney generals who can bring suit against nonprofit corporations or directors to remedy cases of maladministration of a charity,¹³⁴ a right rarely exercised.¹³⁵ Thus, these stakeholders who put their

127. *E.g.*, CAL. CORP. CODE §5142(a)(3) (1990).

128. Fishman, *supra* note 100, at 669.

129. Volunteers are by definition unpaid, but the time they give can be expressed in pecuniary terms.

130. Lee, *supra* note 105, at 933.

131. CAL. CORP. CODE §5142(a)(4) (1990).

132. CAL. CORP. CODE §§5420(b), 5710 (1990).

133. See Blasko et al, *supra* note 125, at 59-78, for an analysis of the "special interest" doctrine applied from the trust law to the charitable nonprofit sector. The analysis points out four specific elements which seem to have influenced courts' evaluations in granting private parties standing to sue. The elements include: (1) the extraordinary nature of the acts complained of and the remedy sought by the plaintiff, (2) the presence of fraud or misconduct on the part of the charity or its directors, (3) the state attorney general's availability or effectiveness, and (4) the nature of the benefited class and its relationship to the charity, in addition to more general, subjective and case-specific factual circumstances. *Id.*

134. See *id.*, at 45-47 for the variety of the authority given to the attorneys general in different states.

135. Hansmann, *supra* note 71, at 873-74; see also David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 U. FLA. J.L. & PUB. POL'Y 131, 175-76 (2000) ("the current enforcement regime evolved to address abuses of charitable

economic interests (including time spent volunteering) into the nonprofit, have no voice in the management and governance of the organization, unlike shareholders in for-profit businesses.

It happens in practice that major donors tend to have, informally, strong influence even when they are not directors, while there are nonprofits that stipulate that their boards include members of their users. The practice of user representation does not always work well, as the interest of the user may be too narrow and incongruent with the interest of the general public that the organization tries to serve.¹³⁶ Although a board may try to be diverse and representative of various stakes, the problem still remains that the power given to the board, relative to external stakeholders, is unparalleled. Thus, Ben-Ner and Van Hoomissen argue, nonprofit stakeholders should have, analogous to shareholders in businesses and according to the economic investment they make into the organization, votes at the annual general meeting, the right to group action, and the right to run for directorship.

This line of argument for an expanded stakeholder participation is especially appealing to those who are concerned with enhanced public accountability of nonprofits. However, a scrutiny into the rationale, particularly on the issue of derivative suits as undertaken by Professor Atkinson, reveals that none of the rationales for the expansion is sufficiently compelling.¹³⁷ For example, analogizing nonprofit stakeholders to shareholders of for-profit businesses is problematic since defining stakeholders as owners of nonprofits is problematic when they, by definition, own nothing.¹³⁸ Another rationale relies on the political ideal of participatory democracy errs as it considers charities as if they were government entities, even though they are distinctive and independent of government.¹³⁹ The major argument made by Atkinson is that all of the proponents for expansive classes with standing to sue tend to simplify different needs of stakeholders

trusts when charitable trusts were the primary philanthropic vehicle. Nonprofit corporations, however, have joined the charitable trust as a means to harness charitable giving. Nevertheless, the law has lagged behind the rise of the nonprofit corporation and continues to treat both types of philanthropic arrangements in the same manner.") (citations omitted). See also the reservation on such an allegation expressed by Atkinson, *supra* note 99, at 682-83 (arguing that evidence is thin on the allegation and that other areas of public policy may well need more attention and may properly be getting it).

136. Michael Locke, Nasa Begum, & Paul Robson, *Service Users and Charity Governance*, in *THE GOVERNANCE OF PUBLIC AND NONPROFIT ORGANIZATIONS*, *supra* note 7.

137. Atkinson, *supra* note 99.

138. *Id.* at 664-76.

139. *Id.* at 676-86.

and different fiduciary duties. The range of remedies already available and the diversity of the nonprofit sector adds to this complexity. Atkinson does not seem to be explicitly against the expansion *per se*, but cogently rebuts the arguments made for it. Although this seems to leave the debate on nonprofit accountability at an impasse, the concluding remark of Atkinson is instructive:

The question of who should have standing to sue charitable fiduciaries ultimately comes round to what kind of charity we want to have, to what we think charity is, and what we want it to be. . . . But as one who believes that diversity is near the core of charity, I want a law of charity that permits the creation and growth of charities on each of these models.¹⁴⁰

His comments suggest the importance of a law for the nonprofit sector that reflects its diversity and caters to the specific needs of various segments within it.

V. CONCLUSION

This paper has explained how the development of the nonprofit sector in Japan has been expanded, especially since the enactment of the NPO Law in 1998. The significance of the Law has been first and foremost its enabling power for private citizens to act in public interest to incorporate themselves. The previous legal regime did not have an appropriate legal personality for such groups of citizens, hence the Law has been regarded as a major springboard from which a new nonprofit sector is expected to grow.

However, this paper has argued that the NPO Law is flawed with regard to the provisions of internal governance and accountability. While the member meeting (with at least ten members with voting rights) is given an exclusive decision-making power on the three of the most crucial matters for the organization (charter amendment, merger, and dissolution) and members meetings are mandatory, members do not have the right to elect or appoint directors. While directors are "representatives of the corporation," the law fails to define their duties and obligations as well as the relationships between directors, the member meeting, and the executive staff. As a result, directors are left with almost unlimited power to govern (and manage) the corporation as they like. Overall, the NPO Law does not adequately provide for internal governance, failing to perform one of the most important functions of corporation law. The provisions on disclosure, exposure to scrutiny by the general public, and the requirement for an auditor have been a major improvement in

140. *Id.* at 698.

trying to ensure public accountability of nonprofit corporations. This is in sharp contrast to the relevant practice for the Public Interest Corporations, conducted largely at government's discretion and in a way inaccessible to the general public. Nonetheless, it must be noted that these provisions are basically for external accountability, which can only be effective when internal accountability is already in place; they cannot fill the gap if internal accountability was absent in the first place.

At a more fundamental level, the purpose and function of this corporation law is unclear. On the one hand, it seems that the NPO Law, by requiring at least ten *shains* for incorporation and granting certain rights to their meeting, conceptualizes a nonprofit corporation as a mutual benefit nonprofit. Very often, *shains* are indeed service users of the nonprofit corporation (although they may also be volunteer service providers or administrative staff in other cases).

This characteristic becomes clearer by reference to a paper by Ellman on U.S. nonprofit corporations.¹⁴¹ He argues that donors and customers of nonprofits are conceptually separate (but are treated in the aggregate by works of Hansmann), with different needs,¹⁴² a distinction which then would require different corporation codes.¹⁴³ While the "donative" nonprofit (i.e. nonprofits funded mainly by donations) may be suitable to satisfy donors' needs, mutual benefit nonprofits should be structured so as to serve the specific needs of customers. Customers' expectation to nonprofit corporations as opposed to for-profit corporations that provide services of the same type is, according to Ellman, related to their desire for managers with "good judgment and compatible values" that cannot be specified in written form.¹⁴⁴ Then, the strategy of customers would be to have control over the corporation themselves. To meet this need, Ellman proposes that firstly a code specifically for mutual nonprofit corporations should require a minimum percentage of a mutual benefit's revenue be derived from members, thereby discouraging a share of control by non-members.¹⁴⁵ Secondly, the code should provide for some level of participatory democracy by members.¹⁴⁶ But for mutual benefit nonprofits, strict fiduciary rules are less relevant than they are for donative nonprofits, because

141. Ellman, *supra* note 111.

142. See also Atkinson, *supra* note 99, at 665-67, on the same criticism regarding the discussion of a different issue.

143. In California, Mutual Benefit Corporations falls into a separate category (CAL. CORP. CODE, §§7110-8910 (1990)).

144. Ellman, *supra* note 111, at 1035.

145. *Id.* at 1037.

146. *Id.* at 1040-41.

members are in a good position to judge the performance of the corporation as direct users, particularly if they are given the right to control the organization. The NPO Law of Japan, providing a level of member participation and few fiduciary rules, seems to be close to what Ellman argues is suitable for mutual benefit nonprofits.

On the other hand, the NPO Law also follows the U.S. model of public charities, an ideal held by those who have advocated the concept of public-benefit, nonprofit corporations and worked for the legislation. The ideal is mirrored in the consecutive legislation on the special status to qualify for receiving tax-deductible donations from private individuals and corporations, ironically erecting a high hurdle to tax privileges for the sector. One qualification is the "public support" test,¹⁴⁷ whereby a nonprofit must depend on donations for at least one-fifth of its revenue.¹⁴⁸ Another feature of this tax law is that a nonprofit must not devote more than half of its activities per year to member services. Both qualifications are intended to ensure that a nonprofit with tax privileges is truly for public interest. The two pieces of legislation, taken together, remain ambivalent about what type of nonprofit organization they are trying to encourage.

In contrast, the theory on nonprofit accountability and governance in the U.S. is, on its surface, clear. Generally speaking, it is the board of directors that is at the pinnacle of the organizational accountability, owing fiduciary duties to its constituency and the community at large. While this "theory" is a long-established, beautifully-crafted, and well-rehearsed one, the gap between theory and practice has seriously plagued nonprofit board members and executive directors. Recent years have seen frauds and misconducts of some major nonprofits, which have led to societal calls for an enhancement in board governance. Legal commentators have discussed whether the standards of conduct required of nonprofit directors are appropriate, whether the current oversight of nonprofits at state level is adequate, and whether it might be better to empower various stakeholders of nonprofits such as donors and volunteers to participate in governance.

Thus, despite the wide gap in nonprofit corporation law and the sector in the U.S. and Japan, problems of governance are common in both countries. It would be highly unfashionable as

147. This relates to the third of the "public benefit" tests. See *supra* note 41 and accompanying text.

148. A survey of Naikakufu (the Cabinet Office) has shown however that the majority of the responding corporations (71.7%) had donations amounting only to zero to ten percent of their annual income. NAIKAKUFU, *supra* note 41, at 28.

well as theoretically inadequate to argue that public policy for nonprofits in Japan should follow the trend in the U.S., be more alert to the possibility of the abuse of nonprofit status, and enhance governmental regulation and supervision. There is a major difference between the two countries in the tradition of private philanthropy and the role of government in the provision of public services. Also the degree to which nonprofits are privileged in taxation is very different, leaving nonprofits in Japan at a disadvantage in regards to tax-deductible donations against more institutionalized, traditional corporations for public interest. The new law has merely enabled incorporation without leading to extensive tax benefits. Because the culture of encouraging voluntary activities of private citizens has been weak in Japan, any suggestion that nonprofits should be made more accountable might risk the rolling back of a the developing civil society. It is also important to pay attention to a warning in the U.S. that an expansion of social supervision for the nonprofit sector might well harm diversity, an important value and dearly held tradition in American society.¹⁴⁹ Nonetheless, it is all the more important for Japanese nonprofits, when they still enjoy the good public image and reputation, to install an accountable structure of governance and make it work effectively. One scandal might easily shake the faith the public generally seems to have in nonprofits at the moment. It is particularly timely, because the government has been undertaking a fundamental reform of the Public Interest Corporations sector with the possible involvement of related sectors and issues, such as the nonprofit sector we are concerned with.¹⁵⁰

The paper has argued that nonprofit governance is ill-defined in the Japanese law, but interestingly, still has the potential of participatory governance, (the third area of suggestions towards nonprofit reform discussed in the U.S.). The classes of people who should arguably be given votes in nonprofit governance, namely donors, volunteers, and users, coincide with the kinds of people included as *shains* in Japanese nonprofits. Although the NPO Law fails to clearly define the functions and roles of the member meeting, there are some nonprofits that give exclusive power to the member meetings to appoint directors and approve business plans by means of charters. If the Japanese law is amended to further empower the member meeting at least by adding a provision that directors and the auditor(s) should be

149. Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 *NONPROFIT MANAGEMENT AND LEADERSHIP* 141 (1995). The Panel on the Nonprofit Sector, *supra* note 110.

150. The decision of the Cabinet Office, Mar. 29, 2002, available at http://www.kantei.go.jp/foreign/policy/gyokaku/index_e.html.

appointed exclusively by the member meeting, a participatory form of governance envisaged in the U.S. might well be reflected.

For practitioners in the Japanese nonprofit sector, there are more urgent issues of concern on a day-to-day basis such as fundraising and contracting with government agencies. On a more longer-term and sector-wide basis, advocacy for expanded tax privileges for nonprofits is a major preoccupation. However, properly constructing nonprofit governance and ensuring public accountability is crucial to the development of effective management of nonprofits and to the enhancement of their credibility. For these reasons, individual nonprofits should review their charters and organizational structures, unwritten rules, and customs with the purpose of establishing a clear line of accountability. For public policy purposes, it is important to conduct empirical research into the current practice of nonprofit governance and find out the extent to which it is diverse. More specifically, research is required to examine what substance is given to the meeting of members and the relationships between the meeting and other institutions within nonprofits. Statutory amendment then can proceed to define the minimum standard for nonprofit governance by taking the prevalent practice into account and considering efficiency and effectiveness in the encouragement of private activities for the public benefit.