

PILLAGING OF CHARITABLE ASSETS: EMBEZZLEMENT AND FRAUD

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The title of this paper was chosen by the planners of today's conference. In a compliant mood, I agreed to it knowing that it was not intended to withstand deep legal analysis, particularly given the fact that I know little of the intricacies of fraud examinations and far less about criminal law. Initial doubts about the "Pillaging" aspects were quickly reinforced when I turned to Black's Law Dictionary and found that the definition of "pillaging" is "plunder"¹ - and the definition of "plunder" is "pillaging".² My Webster's 3350 page Second Edition, given to me in 1937, the year it was published, was a natural next stop. There pillaging is defined as: " 1. to strip of money or goods by open violence; 2. to seize as booty; and 3. to acquire by robbery or spoilage".³ That, at least, was not circular, and with the addition of "robbery", I was comfortable with proceeding.

To be fair, there is a factual basis for Harvey's and Jill's request that I address criminal scandals. In 2003 my colleague Andras Kosaras and I published the results of a survey of allegations of wrongdoing by fiduciaries of charitable organizations contained in press reports published between 1995 and 2002.⁴ A copy of the article is attached as Appendix A. Our computer search produced 104 reports of criminal activity and 54 involving breaches of fiduciary duty, with 6 of them falling in both categories.⁵ This survey was confined to acts of charitable fiduciaries – directors, trustees, corporate officers - and

The author wishes to acknowledge with thanks the contributions of Jamie Brough, Luisa Grillo-Chope, Andras Kosaras and Derek Valz to this study.

¹ BLACK'S LAW DICTIONARY 1185 (8th ed. 2004).

² *Id.* at 1193.

³ WEBSTER'S NEW INTERNATIONAL DICTIONARY, UNABRIDGED (2d ed. 1937).
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⁴ Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORG. TAX REV. 25 (2003).

⁵ *Id.* at 25.

provided some insights into the nature of wrongdoing in the sector, the perpetrators, the organizations involved and the sanctions imposed by the courts.⁶

After agreeing to write this paper, I thought it would be interesting to conduct a similar, if less extensive, survey of reports of alleged and proven criminal wrongdoing by employees of charities other than officers, directors or trustees, the subject of the original surveys. Accordingly, we scanned press reports published in 2003, looking for allegations of or proven criminal activity by employees and found 32 incidents. The details of this survey are attached in Appendix B and are summarized below, following an expanded set of what are hoped to be useful definitions of the criminal and abusive activities that are the subject of the survey and of this paper.

DEFINITIONS OF CRIMES

As noted, the definitions of pillaging and plunder led ultimately to the term “robbery.” It, in turn, is defined in Black's as the illegal taking of property from the person of another or in the person's presence, by violence or intimidation.⁷ Similar, but more pertinent to this study, is the crime of "theft" which is defined as the unlawful taking of, or exercising control over, property of another with purpose to deprive him thereof.⁸ Theft has two components: larceny and embezzlement. Larceny, originally a common law crime, has now been codified in almost every state. It entails taking and carrying away the personal property of another with the intent to deprive the possessor of it permanently.⁹ Embezzlement is similar, the difference being that it encompasses the wrongful appropriation of personal property that is lawfully in the possession of the defendant.¹⁰ Embezzlement is wholly a creation of statutory law, intended to fill the gap in the definition of larceny. It is the more common crime committed by fiduciaries and employees of charities and thus the most suitable component of the title of this study.

⁶ *Id.*

⁷ BLACK'S LAW DICTIONARY 1354 (8th ed. 2004).

⁸ *Id.* at 896.

⁹ *Id.* at 1185.

¹⁰ *See id.* at 561.

When considering crimes and their prosecution, one must look to both federal and state law. There is no federal crime of theft in cases in which a wrongdoer is alleged to have stolen funds from a charity, as the federal theft statute applies only to the taking of property belonging to the federal government. Federal crimes involving misappropriation of charitable funds are, therefore, limited to those coming within the parameters of specific federal statutes defining specific crimes. This includes misappropriation of funds received pursuant to a federal grant program or contract with a federal agency, mail and wire fraud, interstate transportation of stolen property, making false statements to government agencies, violating statutes dealing with specific areas such as labor standards and SEC rules, and, in the tax area, attempts to evade or defeat a tax.

Since 1984, sanctions for federal crimes have been under the jurisdiction of the United States Sentencing Commission which sets guidelines for the judiciary in regard to sentencing of both individual and organizational offenders. The standards have been the subject of much controversy and fairly frequent modification.¹¹ The most recent changes have come about by virtue of a directive in the Sarbanes-Oxley Act to the Sentencing Commission to review a number of guidelines, including those relating to fraud and obstruction of justice.¹² As a result, guideline sentences in aggravated cases of fraud have been significantly increased.

Fraud, unlike theft, may be a civil or criminal act. It is defined in Black's as a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.¹³ Under tax law, fraud has two aspects. Civil fraud is an intentional, but not willful, evasion of taxes. Criminal fraud, in contrast, involves willful evasion of taxes, although the distinction between the two is often difficult to make. In the accounting literature, the phrase "fraud and abuse" refers to acts that are both criminal and bordering on criminal.¹⁴ Wells divides these acts into three major categories: asset appropriations, corruption and fraudulent statements, with the first being the most

¹¹ See 1 KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY §§ 1.12, 1.16, 1.18 (2d ed. 1992 & Supp. 2003).

¹² *Id.* at § 1.16 (Supp. 2003).

¹³ BLACK'S LAW DICTIONARY 685 (8th ed. 2004).

¹⁴ JOSEPH T. WELLS, CORPORATE FRAUD HANDBOOK: PREVENTION AND DETECTION 2 (2004).

common, but causing the least losses, while fraudulent statements are relatively rare but cause far greater losses. In all of them, the crimes involved are those described above; the common element that places them in the category of fraud is that each involves a person who seeks gain with the use of deception.¹⁵ Thus, Wells describes the common elements of fraud as follows: the activity is clandestine, it violates the employee's fiduciary duties to the organization, is committed for the purpose of the employee's direct or indirect financial benefit, and involves the employer's assets, revenues or reserves.¹⁶

Zack in his study, Fraud and Abuse in Nonprofit Organizations, divides fraud into two broad categories distinguished by the identity of the party that is injured: fraud *on* nonprofits and fraud *by, for or through* nonprofits.¹⁷ Fraud *on* nonprofits includes both internal fraud, committed by insiders and involving misappropriations and acts of corruption or abuse, and external fraud, committed by outsiders such as vendors, subrecipients, grant applicants and competitors. In the second category, crimes *by* nonprofits are those carried out by insiders on behalf of the organization; crimes *for* nonprofits are acts by insiders intended to benefit the organization, such as misrepresentations of its activities by fundraisers; while crimes *through* nonprofits are schemes involving insiders who take advantage of their positions to carry out frauds against outside parties, for example an employee's use of a donor's credit card information for the employee's personal benefit.¹⁸

Abuse is not a legal term. It is used, particularly in the accounting literature, to describe acts that do not meet the legal definition of fraud, or fall within a definition of another crime but "clearly represent an inappropriate act and unacceptable behavior."¹⁹ Zack provides as a common example the occasional use by an employee of his organization's equipment for nonbusiness purposes, an act that is probably not criminal yet one that an organization should not tolerate.²⁰

¹⁵ *Id.* at 45-47.

¹⁶ *Id.* at 1.

¹⁷ GERARD M. ZACK, FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION 6-8 (2003).

¹⁸ *Id.* at 6, 8.

¹⁹ *Id.* at 7.

²⁰ *Id.*

2003 SURVEY RESULTS: CRIMINAL ACTS BY EMPLOYEES OF CHARITIES

The 2003 survey of instances of alleged criminal acts by employees was conducted, as was the earlier one, by means of a computer search through Lexis-Nexis, using key words “charity,” “nonprofit,” “non-profit,” “not for profit,” “scandal,” “theft,” “embezzle,” “arrest,” “employee,” “pilfering,” “larceny,” and including only incidents first reported during that calendar year. Thirty-two reports were identified in which employees were implicated in criminal activity involving a charity. The employees held a wide variety of positions, including secretary, executive director, bookkeeper, treasurer, finance chief and in two instances unspecified responsibilities. Guilty pleas were entered in 24 of the cases, no contest in two, and convictions were obtained in 3 instances. There were three reports of alleged theft with no information as to subsequent action, while three cases were said to be the subject of ongoing government investigations, one by HUD and two by local police departments. Of the cases, three were for federal fraud crimes, twenty-eight involved state theft crimes and one state prosecution was for “misapplication of charitable funds”. This involved a senior vice president of Florida Atlantic University Foundation who pleaded guilty to a misdemeanor charge of falsifying records for “using” \$42,000 of the Foundation’s funds to purchase a car as a parting gift for the University’s president.²¹ Prison sentences ranged from 14 years for the bookkeeper of the Tippecanoe County Child Care agency in Indiana for theft of \$234,000²² to six months house arrest for a minister who pleaded guilty to theft of \$44,000 and who was permitted to leave home to continue his church ministry.²³ In the FAU Foundation case, the defendant received one year of probation and was ordered to provide 20 hours of community service.²⁴ Prison sentences were ordered in 16 cases, although they were suspended in two instances. Probation was ordered in five other cases, and both prison and probation in three others.

²¹ Jennifer Peltz & Neil Santaniello, *Ex-FAU Official Pleads Guilty*, SUN-SENTINEL (Fort Lauderdale, FL), Sept. 23, 2003, at A1.

²² Joe Gerrety, *Bookkeeper’s Guilt Could Cost Her 14 Years Or None*, J. & COURIER (Lafayette, IN), Dec. 3, 2003, at A1; *Pride Before the Fall: Preventing White-Collar Hit*, J. & COURIER (Lafayette, IN), Mar. 28, 2004.

²³ Jennifer Donatelli, *Pastor Avoids Jail in Theft Case*, MD. GAZETTE, Aug. 23, 2003, at A2; *Pastor Pleads Guilty to Felony Theft from Women’s Shelter*, BALTIMORE SUN, May 6, 2003, at 3B.

²⁴ Peltz & Santaniello, *supra* note 21.

The total amount alleged to have been stolen was \$7,099,600. Restitution was ordered by the courts in 17 instances, for a total of \$5,196,112. The largest amount involved, \$1,900,000, was stolen from the Michigan organization, Capital Area United Way, by its “finance chief” who pled guilty to forgery and participating in illegal monetary transactions.²⁵ She was sentenced to four years prison and required to pay restitution in the amount of \$2.08 million.²⁶ At the other extreme, the “chief” of the Yadkinville Volunteer Fire department pled guilty to two counts of larceny for embezzling \$1,209. (He received two 45 day suspended sentences and five years probation.).²⁷ The second largest amount involved was \$690,000; there were 10 instances in which the amount stolen was between that sum and \$234,000, and there were three between \$169,000 and \$124,000. In ten instances the amount involved ranged between \$82,000 and \$35,000, and at the lowest end of the scale, there were five between \$30,000 and the \$1,209 from the Volunteer Fire Department described above.

As in the prior surveys of allegations of wrongdoing by officers and directors, a wide range of organizations was involved. Included in the 2003 survey were six athletic groups, five human services agencies and five civic and community development organizations, four each of hospitals and health care agencies and federated and cause-related fundraising organizations, two educational and arts organizations and two public housing agencies. No foundations were implicated.

Of interest in this and the earlier study were the number of instances in which the persons implicated had been involved in prior wrongdoing. In one case, a defendant was found guilty in a single action of theft from two different, unrelated charities, \$124,000 from a speech and hearing center of which she was the finance manager, and \$65,000 from a youth football association for which she also served as treasurer. The newspaper reported that she had also been charged with stealing \$9,800 from a for-profit organization of which

²⁵ Tim Martin, *Ex-Charity Worker Faces Sentencing*, LANSING ST. J. (Pa.), June 16, 2003, at A1; Christine MacDonald, *Ex-Charity Worker Gets 4 Years*, LANSING ST. J. (Pa.), June 17, 2003, at A1.

²⁶ Christine MacDonald, *Ex-Charity Worker Gets 4 Years*, LANSING ST. J. (Pa.), June 17, 2003, at A1.

²⁷ *Former Yadkinville Fire Chief Pleads No Contest to Misdemeanor*, WINSTON-SALEM J. (NC), Aug. 1, 2003, at B2.

she was also the treasurer.²⁸ In four instances in which defendants were convicted of theft, evidence was produced during trial of prior criminal convictions. In two others, a husband of one defendant and the boyfriend of another were each convicted of theft. Of the unresolved cases, one of them came to light when the charity involved brought suit against its accounting firm alleging that it should have uncovered during audit theft of \$591,000. According to the press report, it was alleged in the suit that this same accounting firm had also performed the audit for another charity from whom its managing director had stolen \$445,000.²⁹

As to the investigating and prosecuting agencies, in three instances the United States Attorney prosecuted the cases, one involving the District of Columbia where his role is analogous to that of a district attorney; state attorneys general prosecuted two cases; more than two thirds were handled by a district attorney. Of the three under investigation, one was being conducted by a federal agency, two by local police. As noted above, there was also one allegation of theft that was contained in a suit brought by a charity against its auditors.

With a few exceptions, these results are not markedly different from those in the earlier study. The major difference is in the nature of the charities involved. In the earlier study, health and human service agencies constituted just over half of the total,³⁰ while in the new study, they were the second largest group at five, exceeded only by athletic organizations. There were five civic and community groups and four each of federated campaigns and hospital and healthcare agencies. It is not possible to draw meaningful conclusions from these differences.

The outcome of the cases was similar in both studies – successful prosecutions - upholding the theory that the cases that are brought are confined to those in which success is most likely. Strong support for this conclusion is found in the fact that of the 32 instances in the 2003 survey, there were 26 guilty pleas or no contests and three convictions. In the

²⁸ Keith Herbert, *Montco Embezzler Sentence to Jail*, PHILADELPHIA INQUIRER, Apr. 21, 2004, at B04; Keith Herbert, *Woman Pleads Guilty to Thefts from School, Football League*, PHILADELPHIA INQUIRER, Dec. 19, 2003, at B13.

²⁹ Jon Burstein, *Food Bank Sues Accountants, Alleges Inadequate Auditing*, SUN-SENTINEL (Fort Lauderdale, FL), Nov. 4, 2003, at B1.

³⁰ See Fremont-Smith & Kosaras, *supra* note 4, at 27, 30-31.

earlier survey, prosecutions of officers and directors were conducted almost equally by federal and state agencies in contrast to the actions brought against employees in which, with but two exceptions, state district attorneys brought the actions. Finally, the amounts involved were not comparable, the difference being in large part attributable to the Ponzi schemes uncovered in the earlier years.

The caveats noted in our first survey apply equally to this new one: namely, that the information comes from press reports which cannot be considered comprehensive; that much information about wrongdoing is not made available to the public by the prosecuting agencies; and that many incidents are handled internally by the organizations that have been victimized and are never brought to light. Of note is the relatively small number of incidents, particularly when viewed in light of the number of charities and the paucity of cases involving religious organizations. Beyond that, as noted above, one hopes that the results are viewed, as they are intended to be, as a snapshot of this aspect of the sector, the manner in which the government regulates, and the high degree of success that has resulted from the prosecution of employees who have stolen or otherwise criminally diverted funds from charitable organizations.

THE NATURE AND EXTENT OF FRAUD IN THE UNITED STATES: RECENT SURVEYS BY THE ASSOCIATION OF CERTIFIED FRAUD EXAMINERS

Insight as to the nature and extent of fraud in the United States has been provided since 1996 by the Association of Certified Fraud Examiners (ACFE), a membership organization of accountants who specialize in this aspect of their profession. In 1996, ACFE published a “Report to the Nation on Occupational Fraud and Abuse” that was based on analysis of data on fraud cases submitted by 2608 fraud examiners.³¹ That report has been supplemented by two Surveys, one issued in 2002 and another in 2004, the results of which have, with minor exceptions, substantiated the findings in the original Report.³² The 2004

³¹ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE (1996).

³² See ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2002 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE (2002); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE (2004).

Survey contained analysis of 508 cases in which the median loss was \$100,000, with approximately 15% of cases resulting in the loss of at least \$1 million, and an estimated cost of fraud of \$600 billion annually.³³ Of the perpetrators, 68% were employees, 12.4% were managers, and 12.4% were “owner/executives”.³⁴ Median loss from employees was \$62,000 per incident, for managers it was \$140,000 and for owner/executives \$900,000.³⁵ As to the criminal history of the perpetrators, 82.9% had no prior convictions while 11.6% did and 5.5% had been charged but not convicted.³⁶

The survey also included information on the percent of cases and median loss by type of organization, dividing the universe into public companies, private companies, government and not-for-profit organizations. The largest number of incidents occurred in private companies, 41.8% of the total with a median loss of \$122,000. The next largest category, government, accounted for 30.3% of the cases, with a median loss of \$100,000; for public companies the percent of cases was 12.2 and the median loss \$100,000. Finally, for the nonprofit sector, the percent of cases was 15.8% and median loss was \$37,500.³⁷ The only category in which there was significant deviation from the 2002 study was in the median loss by public companies, which was \$150,000 in the earlier study.³⁸

The surveys also elicited information about the impact of four antifraud measures on median loss: background checks, anonymous reporting mechanisms, internal audits or internal fraud examinations, and external audits. Anonymous reporting mechanism had the greatest impact on median losses in both surveys, although it was the least common antifraud mechanism, with just over a third of the organizations having such structures in place at the time of the fraud.³⁹ In contrast, external audits, which were the most common antifraud measures (relied on by almost 3/4 of the organizations surveyed) appeared to have the least impact on median losses and, in the 2004 Survey, organizations with external

³³ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 5, 15 (2004).

³⁴ *Id.* at 30.

³⁵ *Id.*

³⁶ *Id.* at 36.

³⁷ *Id.* at 5.

³⁸ *Id.* at 17.

³⁹ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 18, 26-27 (2004).

audits had higher median losses than those that were not audited.⁴⁰ Wells notes, “Of course, there are a number of other facts that help determine the size of loss an organization suffers, but the fact remains that external audits showed the lowest corresponding percentage difference in median loss of any of the antifraud measures for which we tested.”⁴¹

Participants in the surveys were also asked to rank the effectiveness of nine specific fraud prevention measures: strong internal controls was ranked the highest, followed by willingness to prosecute and regular fraud audits. Ethics training for employees and workplace surveillance were at the bottom of the list, although the differences were not substantial.⁴² Wells acknowledged the limited effect of codes of ethics, but nonetheless strongly recommended their adoption on the basis that they make enforcement easier to legally justify. He noted that this can be of particular value in cases coming within the federal sentencing guidelines under which, as described below, punishment of a corporation may be reduced if it has procedures in place to prevent and to detect and report criminal conduct.⁴³

Finally, the survey results indicated that, contrary to general assumptions, employers are not reluctant to refer allegations of crimes against them to prosecutors. Thus, criminal referrals were made in just over three-quarters of the reported cases.⁴⁴ This number was somewhat lower than that in the earlier survey,⁴⁵ leaving unanswered the question of whether the likelihood of referral was a deterrent factor.

CORPORATE CRIMINAL LIABILITY

In each of the incidents described in our studies of criminal activities, the wrongdoers were individuals and the “punishments” – fines, prison terms, probation, restitution, removal from office - were applied to them personally. None of them involved legal actions against either the nonprofit organization with which the individual defendants

⁴⁰ *Id.* at 29.

⁴¹ WELLS, *supra* note 14, at 37.

⁴² *See id.* at 45.

⁴³ *See id.* at 410-11.

⁴⁴ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 38 (2004).

⁴⁵ *Id.*

were associated, or with the fiduciaries of the organization who were responsible for its actions – trustees, directors, officers. This is not surprising. The law affords extraordinary protection to these fiduciaries and it is the rare prosecutor who will undertake legal action when the burden of proof is exceptionally high.⁴⁶ As to actions against the charity itself, in rare instances, state attorneys general have brought civil suits against charitable corporations seeking dissolution and transfer of corporate assets to another charitable entity in cases in which this appeared to be the best means for preserving the funds. In terms of the charity, these actions are not considered punitive, *per se*.

This does not mean that charitable corporations are immune from criminal prosecutions. Under early common law no corporation, charitable or not, could be sued for the acts of its fiduciaries, employees or shareholders, but as the corporate form became more common, the doctrine was eroded.⁴⁷ The earliest cases imposing liability involved public entities, such as towns, parishes and counties, and by the mid-nineteenth century, corporations were being indicted for breach of duties consisting of inaction. At the same time, for-profit corporations were being held liable in tort for the acts of their agents and it was not long before the courts held that liability would apply in cases of misfeasance.⁴⁸ This was in direct contrast to the rule applicable to charities, however, which afforded complete protection from liability for torts.⁴⁹

In the United States, the courts easily accepted the concept of corporate liability in cases involving both nonfeasance and malfeasance, although initially resisting claims of liability based on offences requiring intent such as treason, felony, perjury and violent crimes. The first cases upholding liability dealt with crimes requiring general intent, but by the end of the nineteenth century, there were no bars to holding corporations liable for the entire range of crimes attributable to natural persons.⁵⁰ Immunity from torts for charities persisted until the end of the nineteenth century and it is now in effect only in

⁴⁶ See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS ch. 4 (2004); *see also id.* at 432-38.

⁴⁷ *See generally* 1 BRICKEY, *supra* note 11, at §§ 2.02-.04.

⁴⁸ *See id.* at § 2.04.

⁴⁹ *See generally* GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 402 (Rev. 2d ed. 1991 & Supp. 2001).

⁵⁰ *See id.* at §§ 2.08-.09.

Massachusetts where recovery from a charity for a tort is subject to a monetary limit of \$20,000 per case.⁵¹

It is now well settled that a corporation may be liable for the acts of its officers and directors, its managers and supervisors, as well as subordinate employees, subject to the limitations that their acts were undertaken in the course and scope of their employment. The only exception is in the rare case of crimes requiring affirmative criminal intent, where there is an added condition, namely, that the employees acted for the ostensible purpose of benefiting the corporation. Further, a corporation can be held guilty of criminal activity even if management had no knowledge of or did not participate in the criminal activities of its employees or agents.⁵²

CORPORATE LIABILITY UNDER THE INTERNAL REVENUE CODE

As a policy matter, when corporate liability is extended to criminal acts of charitable corporations, the result is regressive – constituting as it does the diversion of funds to federal or state treasuries at the expense, not of the principals responsible for the corporation’s wrongdoing, but of the general public for whose benefit the assets were being administered. In some instances this will be a deterrent to prosecutors.

Such considerations are ignored, however, in the context of the Internal Revenue Code. In fact, by virtue of the fact that regulation is conducted within the taxing scheme, loss of exemption, illogical as it may be, was the sole sanction available to the Service for violation of Code provisions by public charities until 1996 when section 4958 was adopted. Under this section the IRS can impose excise taxes on a disqualified person who received an excess benefit from a charity over which he was in a position to exercise substantial influence and under certain circumstances on the charity managers who approved the transactions.⁵³ Although the sanctions for violation of the prohibitions against self-dealing by private foundations that have been in effect since 1970 are also imposed on a self-dealer, violations by private foundations of the other restrictions in

⁵¹ MASS. GEN. LAWS ch. 231, § 85K.

⁵² See 1 BRICKEY, *supra* note 47, at § 4.01.

⁵³ See I.R.C. § 4958 (originally enacted as Taxpayer Bill of Rights 2 Act, Pub. L. No. 104-168, sec. 1311(d)(1), (2), 110 Stat. 1452 (1996)(amending Internal Revenue Code of 1986)).

Chapter 42 relating to payout, excess business holding, jeopardy investments and taxable expenditures result in levies on the charity's assets, with loss of exemption remaining, in all instances, the "ultimate sanction". It is also the case that foundation managers who approve of a transaction knowing it was prohibited may also be subject to excise taxes.

Although not a criminal sanction, loss of exemption in some circumstances may constitute a more devastating sanction than the criminal sanctions available under federal statutes. There is a dichotomy however, in the application of this sanction in situations involving the criminal acts of fiduciaries and employees of charities. Prof. Harvey Dale refers to this as the "Turtle Shell" dilemma – querying whether the turtle's shell (the corporate form) should shield a charitable corporation from attribution to it of criminal activity by its officers, directors or employees or offering no protection so that their acts will be considered the acts of the corporation and as such constitute grounds for revocation of its exemption on the basis that they resulted in private inurement or private benefit? In the 1997 case, *Variety Club Tent No. 6 Charities, Inc. v. Commissioner*,⁵⁴ the issue was raised, but the court provided no meaningful analysis. At issue was the question of whether the charity's exemption should be revoked on the grounds that criminal acts by its treasurer and an employee-member were attributable to the corporation, thus constituting prohibited inurement of the charity's assets or income to these individuals. The court noted that neither party to the suit nor the court through its own efforts had found any court opinion in the inurement area involving theft from an organization by an insider, nor did it find any help in the regulations.⁵⁵ It then turned to what it considered to be Congressional intent, finding that the acts of the insiders were not to be considered the act of the charity, and thus did not constitute inurement.

...that inurement means the *intentional* conferring of a benefit cannot be allowed to mean that there is no inurement unless "all the organizations' officers and board members have actual knowledge of, and affirmatively act to cause the prohibited benefit." By the same token, we do not believe that the Congress intended that a

⁵⁴ 74 T.C.M. (CCH) 1485 (1997).

⁵⁵ *Id.* at 34.

charity must lose its exempt status merely because a president or a treasurer or an executive director of a charity has skimmed or embezzled or otherwise stolen from the charity, at least where the charity has a real-world existence apart from the thieving official.⁵⁶

The court concluded that the charity did have such a real-world existence, so that the thefts did not constitute inurement of its net earnings.⁵⁷ In short, under some circumstances the acts of insiders will constitute corporate action, while in others they will not. Absent was any discussion of the principles underlying corporate liability under criminal or civil law or an adequate rationale for attribution, there being no precedent in either criminal law or the Code for the concept of a “real world existence”.

A Technical Advice Memorandum issued in December 1998 accepted the criteria applied in the *Varsity Club* decision without further amplification.⁵⁸ At issue was revocation of the exemption of an amateur athletic association on numerous grounds, one of which was that there was inurement to insiders based on misappropriation by two insiders that constituted larceny. The charity had argued that this was not inurement because it was theft. In rejecting this argument, the ruling held that the insiders, a founding officer of the corporation and his wife who constituted two of its three directors, controlled and were able to divert the charity’s funds without oversight by the other member of the board. The Service’s position was that the misappropriated funds were used by insiders and thus constituted prohibited inurement. The TAM refers to two cases, *The Labrenz Foundation, Inc. v. Commissioner*, 33 T.C.M. 1374 (1947), and *Harding Hospital, Inc. v. United States*, 505 F.2d 1068 (1974), in both of which exempt organizations were formed to conduct what had been private medical practices, the same activities their founder-directors had carried on prior to creation of the charity.⁵⁹ In neither case was criminal activity involved.

⁵⁶ *Id.* at 35.

⁵⁷ *Id.* at 36.

⁵⁸ Tech. Adv. Mem. 98-51-001 (Aug. 20, 1998).

⁵⁹ *See id.* at 42-45.

The TAM concluded by distinguishing the instant situation from that in the Varsity Club case:

The inurement in this situation differs from that in the Variety Club Tent No.6 Charities, Inc. v. Commissioner, *supra*, in that there were no controls implemented and the insiders controlled the organization and were actively involved in the management of the organization. As a charitable organization, there is no real-world existence apart from [the three directors, two of whom had committed the thefts].⁶⁰

The regulations under section 4958 did address the application of the excess benefit limits in situations in which a disqualified person has benefited at the expense of a charity by virtue of his criminal act. An excess benefit is defined in the regulations as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.” The regulation then indicates that an economic benefit may be treated as not “excess” if the value of the consideration (including the performance of services) provided to the organization by the disqualified person equals the value of the economic benefit provided to the disqualified person by the charity. However, the regulation then provides, “...in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services”, thereby denying a disqualified person an argument that his services to the organization might reduce or eliminate any excess benefit that arises from the theft or fraud. The rationale for this provision is self-apparent. The concern would be if it were interpreted as providing a shield for a charity in the face of a claim that the benefits received by virtue of the criminal acts of insiders did not constitute private inurement or benefit or, in Dale’s analogy, the turtle should always be protected by his shell. The problem, however, arises, as Dale has pointed out, that the result under section 4958 in the case of theft or fraud should be different from that under the general prohibitions against private inurement and benefit contained in section 501(c)(3) of the Code which sets forth the basic conditions for exemption. Application of the principles of corporate criminal

⁶⁰ *Id.* at 44-45.

liability uphold the position that the corporate form should not provide a shield. If there are to be exceptions to this general rule, the rationale for them requires further consideration.

PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS

In 1999, the Department of Justice issued a set of principles designed to provide guidance in making decisions whether to prosecute business organizations.⁶¹ They were subsequently revised in 2003 to indicate increased emphasis on and scrutiny of the authenticity of a corporation's cooperation in an investigation.⁶² The principles are based on the premises that prosecution of corporations should be rare occurrences, and that among the factors to be considered in deciding to prosecute, cooperation and corporate compliance mechanisms are to be given great weight, as will be corrective actions taken after discovery of wrongdoing. New in the revision is a recommendation to consider the role of the board of directors. More specifically, prosecutors may review whether the board independently reviews management's proposals or merely serves as a rubber stamp; whether management provides sufficient information to the board to enable it to exercise independent judgment; whether internal audit controls are adequate to ensure independence and accuracy; and whether the board has established an adequate information and reporting system to enable management and the board to make informed decisions about the corporation's compliance with the law.⁶³ Although it would appear that these principles are upholding what would now be considered "best practices" for any corporation, I suggest they warrant greater attention from charities than it would appear they are receiving.

ACCOUNTING RULE 99 AND ITS POTENTIAL EFFECT ON CHARITIES

In 2002, the Auditing Standards Board of the American Institute of Certified Professional Accountants, responding to the revelations of corporate scandals involving Enron and similar companies, revised its guidelines relating to fraud in financial statements,

⁶¹ U.S. Dept. of Justice, Federal Prosecution of Corporations (June 16, 1999), *available at* <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html>.

⁶² U.S. Dept. of Justice, Principles of Federal Prosecution of Business Organizations (January 20, 2003).

⁶³ *See id.*

effective for audits of periods beginning on or after December 15, 2002.⁶⁴ The purpose of the new guidelines was to provide guidance to auditors as to how to fulfill their responsibility to plan and perform audits in a manner that would permit the client to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by fraud or error.⁶⁵ The standard contained a description of fraud and its characteristics. It stressed the need for professional skepticism in the conduct of audits, and required, as part of the audit planning, a discussion of how and when the organization's financial statements might be susceptible to material misstatements due to fraud. Auditors are now required to obtain information needed to identify risks of fraud, to evaluate them, and the company's programs designed to control fraud. Thus, the scope of inquiry was expanded, and more direct questions were to be directed toward senior management than to the board or audit committee.

Zack observed that although the new standard did not make substantial changes in the basic requirements associated with an auditor's responsibility to detect fraud, it represented a "notable improvement" over the standard it replaced by providing auditors guidance for considering the risk of fraud and in designing appropriate audit procedures in response."⁶⁶

Unlike the Sarbanes-Oxley provisions that apply only to companies listed on the stock exchanges, Standard 99 applies to all certified audits, thus increasing oversight of charities without passage of additional legislative measures. It is to be hoped that this more intense focus on fraud will improve detection, as well as act as a deterrent. However, the findings of the ACFE that external audits are not a major source for the detection of criminal acts of employees does make one cautious as to success of the new intensive focus on fraud. There is also anecdotal evidence that compliance with Rule 99 has made the audit process more onerous and has increased its cost.

⁶⁴ AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS (SAS) NO. 99, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT (2002).

⁶⁵ See ZACK, *supra* note 17, at 304-05.

⁶⁶ ZACK, *supra* note 17, at 305.

POTENTIAL IMPACT OF PROPOSALS TO INCREASE CHARITY REGULATION

Since passage of the Sarbanes-Oxley Act in 2002 there have been calls by members of the charitable sector to adopt its rules as a means of increasing accountability. There has also been interest in enacting state statutes to make certain of its provisions a part of state laws governing charities. In May 2004, the California legislature passed a statute (unsigned as of 9/19/04) requiring audits and audit committees for charities with gross receipts of \$2,000,000 or more. As originally drafted by the attorney general, the audit threshold was \$500,000, but objections voiced by the nonprofit community led to the increase.⁶⁷ In New York, in the spring of 2003 the attorney general submitted a bill that would have required officer certification of financial reports from charities with \$3,000,000 or more of assets or \$1 million gross receipts and to establish audit committees. It would also have required any corporation with a board of directors of more than twenty-five members to establish an executive committee.⁶⁸ The Massachusetts attorney general in December 2003 circulated a draft bill that would have adopted the officer certification provisions of Sarbanes-Oxley, but, ironically, would have increased the threshold for required audit for all charities in the state other than religious organizations from the existing \$250,000 to \$750,000.⁶⁹ At the time the draft was circulated and until July 2004, charities with annual gross support and revenue between \$100,000 and \$250,000 were required to have their accounts "reviewed" by an independent auditor and for those with receipts greater than \$250,000 were required to have a full audit. On July 15, 2004, House Bill 4234, a measure not sponsored by the attorney general, was signed into law increasing the threshold for audit to \$500,000.⁷⁰ Although it was unclear in the attorney general's draft, the audit review requirement was intended to remain in effect and extend to charities with receipts which did not meet the threshold for a full audit. As of October 2004, the chances of passage of these bills were unclear. The New York bill was stalled in committee and the Massachusetts bill was being

⁶⁷ See S. 1262, 2003-04 Leg. Sess. (Cal. 2004) (version passed by California Senate on May 25, 2004), available at [ftp://www.leginfo.ca.gov/pub/bill/sen/sb_1251-1300/sb_1262_bill_20040524_amended_sen.pdf](http://www.leginfo.ca.gov/pub/bill/sen/sb_1251-1300/sb_1262_bill_20040524_amended_sen.pdf); S. 1262, 2003-04 Leg. Sess. (Cal. 2004) (version passed by California Assembly on August 25, 2004), available at http://www.leginfo.ca.gov/pub/bill/sen/sb_1251-1300/sb_1262_bill_20040823_amended_asm.pdf.

⁶⁸ See S. 4836, 226th Leg. Sess. (N.Y. 2003).

⁶⁹ Office of Massachusetts Attorney General Tom Reilly, "An Act to Promote the Financial Integrity of Public Charities", Draft 1.0, December 2003. On file with author.

redrafted to take into account the views of the Attorney General's Advisory Committee on Public Charities and other interested members of the public who had objected to a number of its provisions relating to self-dealing and excess benefit transactions, as well as expressing concern as to the cost of compliance with the certification provisions.

It should be noted that if the California bill is signed by the governor, this state will be only the second to require audits of charities that do not solicit funds from the general public. Massachusetts has been unique in including such a requirement in its registration and reporting statute, a law that applies to all charities other than religious organizations. There are only nine other states with similar registration and reporting requirements but none has included any provisions relating to financial statements.

In addition to the Massachusetts and California audit requirements, there are statutes in 36 states, including New York and Massachusetts but not California, which regulate the activities of charities that solicit the general public for contributions. In fourteen of these states, audits are required, four of them with a two-tier requirement such as that in effect in Massachusetts. It might be possible to judge the effect of an audit requirement by reviewing the information available in these states, although comparisons will be extremely difficult due to the fact that the exemptions under these statutes differ widely, with educational organizations, hospitals, and membership organizations exempt from their provisions in a majority of the statutes and a wide range of other organizations exempt in many others.⁷¹

Although studies of the effect of an audit requirement on the detection and prevention of abuses would be valuable, I am not aware of any that have been undertaken and, although I have been interested in this subject for many years, I have not been able to devise a suitable means for making meaningful comparisons. A survey similar to that conducted by ACFE would be useful before more states adopt the Sarbanes-Oxley approach to regulation, particularly if they merely extend audit and officer certification requirements to charities rather than attempt to devise regulatory measures better suited to the nature of charitable organizations than those originally drafted to control publicly traded companies.

⁷⁰H.B. 4234, 183rd Gen. Court, 2004 Sess.(Ma. 2004)

⁷¹ See MARION R. FREMONT-SMITH, GOVERNMENT REGULATION OF CHARITABLE FUNDRAISING (in progress).

The question of state audit requirements may become moot if Congress were to adopt certain of the proposals to increase regulation of charities made by the staff of the Senate Finance Committee in July 2004. Among a far-ranging set of recommendations, the Staff Discussion Draft called for mandatory audits of annual reports or of Form 990 for charities with greater than \$250,000 gross receipts and review for those with less than that amount and more than \$100,000, as well as regular replacement of auditors. The IRS would also be directed to promulgate standards for that Form in order to establish much-needed uniformity.⁷²

There is one additional measure in effect in three states, and included as part of a proposed federal certification scheme in the Finance Committee Staff proposals. This is a requirement that there be independent directors on the boards of all public charities. (In the staff proposals, it would be combined with a limit on board size.) Again derived from attempts to reform governance in the for-profit sector, a variant of this proposal was suggested for private foundations in the 1964 Treasury Department Report on Private Foundations. The primary purpose of limits of this nature is not to curtail criminal activities. However, if it were meaningfully policed, it might limit the creation of charities to permit their principals to commit fraud against the government, a practice sufficiently widespread to be of particular note in our studies of press reports of wrongdoing.

Another suggestion made by the Finance Committee staff would prohibit individuals with criminal records from serving as fiduciaries of charitable organizations. This proposal was similar to one made by the National Committee on Responsive Philanthropy in May 2004 in a report in which it identified thirteen individuals implicated in corporate fraud who were serving as fiduciaries of foundations and, in two instances, public charities. Three of the individuals identified in the Report had either been found guilty or had settled their cases at the time of its release, while criminal actions against the others were pending. Among them were officers and directors of corporations identified with the major recent

⁷² See *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before the Sen. Comm. On Finance*, 108th Cong. (2004), available at <http://finance.senate.gov/sitepages/hearing062204.htm>.

scandals, including Enron, Tyco and Global Crossing.⁷³ The Finance Committee staff made two recommendations to deal with the problems raised in the NCRP Report. They would prohibit any individual barred from service on the board of a publicly traded company from serving on the board or as an officer of an exempt organization for five years after conviction, with a penalty on the organization or its officer/members if they knowingly retained a person who was barred from serving. The second proposal was to grant the IRS the authority to require removal of any board member, officer, or employee of an exempt organization who was found to have violated "self-dealing rules, conflicts of interest, excess benefit transactions rules, private inurement rules, or charitable solicitation laws". In addition, the IRS would be permitted to require that such an individual be barred from board service for a period of years and an organization that knowingly retained a barred person would lose exemption or be subject to a lesser penalty. The ambiguity in the proposal will require further attention. As a general recommendation, a bar to service for convicted wrongdoers would serve to improve public perceptions of the charitable sector, whether or not it had any other ameliorative effect. If a bar was enacted at the state level, it would provide additional grounds for prosecution in the cases identified in our two surveys of wrongdoing in which the offenders had been guilty of previously documented crimes involving charities. However, making it a condition of exemption would not per se permit correction.

Finally, when viewed in light of the ACFE's findings as to the success of various preventive measures, there is one provision in the Sarbanes-Oxley Act now applicable to all corporations, for-profit and nonprofit, that is likely to have an affirmative effect in curtailing criminal activity within charities. This is the provision protecting whistleblowers. It is now a crime for anyone to take any action harmful to any person who provides any truthful information relating to the commission or possible commission of a federal offence.⁷⁴ Advisors to charities are recommending that they establish policies to assure compliance with this provisions, and with the prohibition against document destruction which is also now applicable to all corporations.

⁷³ NATIONAL COMMITTEE FOR RESPONSIVE PHILANTHROPY, *SERVING TIME ... ON FOUNDATION BOARDS* (May 2004), *available at* <http://www.ncrp.org>.

CONCLUSION

Evidence from the surveys of press reports of wrongdoing by officers, directors, trustees and employees of charitable organizations indicate a persistent degree of criminal activity. They also indicate a high degree of success in prosecutions, but this may be attributable to the fact that it is these cases that catch the attention of the press. There is no paucity of grounds on which criminal prosecutions can be brought - both state and federal - and there is some evidence that matters referred for prosecution are pursued. It is not possible to gauge whether increased attention to fraud by the accounting profession will be effective in reducing the extent of criminal activity within the nonprofit sector and, in fact, it is far too soon to tell. What is clear is that the proposals of the Senate Finance Committee staff released in June 2004 have mobilized support organizations for the sector, notably Independent Sector, the Council on Foundations, BoardSource, and many others that speak for specific segments of the sector as well as the American Bar Association and members of the accounting profession. They are reassessing the impact and effectiveness of current laws and efforts at self-regulation.

Most of the sector's efforts are directed toward prevention of breaches of fiduciary duty, although, as noted, some will result in a tightening of the criminal laws designed to punish "pillaging". In regard to criminal acts, I am not persuaded that new laws will greatly change the situation. There will always be individuals who take advantage of positions of trust for their private benefit and, for at least a time, their deceptions will go unnoticed. At best one can hope that organizations will become more aware of the risks of fraud that they face and take appropriate steps to impose internal controls that might minimize those risks - or at the least reduce the time it takes before they are discovered.

⁷⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1107, 116 Stat. 745 (2002); *see also id.* at § 1102.