

*Whither Regulation?**

Antonia M. Grumbach*

This is an interesting time to be addressing the issue of optimal regulation for the nonprofit tax-exempt sector. It is another period of scrutiny of tax-exempts, brought on by the various scandals covered in the media in the last few years, as well as Senator Grassley's very public investigation and chastisement of certain organizations. None of this is new, however. The history of the charitable sector in this country has been a history of moving forward by fits and starts, often jump-started by public outrage at the behavior, perceived or real, of charitable entities. What perhaps may be new is an increasing focus on the resources devoted to regulation. In addition, there is a renewed sense of the need for self-regulation by the nonprofits themselves and for increased cooperation between certain charitable groups and their regulatory and Congressional overseers.

This paper does not purport to be a scholarly work. It does not discuss tax policy in terms of the rationale for tax exemption nor the rationale for deduction of gifts to charity. This paper, which primarily focuses on Section 501(c)(3) organizations, instead considers the legal and non-legal forces that have sought to heighten standards of nonprofit accountability. It begins by asking basic questions concerning who has an interest in compliance by nonprofits and whether the existing network of federal and state laws addresses those interests. Although the law increasingly has sought to build in

* This paper literally would not have come into being without the efforts of my colleague Alison Lonshein and I owe her an enormous debt of gratitude. I also want to thank Christopher E. Cooper and Ryan Sirianni for rounding up a lot of background information for me.

safeguards to ensure accountability, the relatively rare but egregious cases of insider transactions, excessive compensation and embezzlement continue to be reported in the press.¹ One consequence of this media attention is the popular sentiment that misappropriation of assets is widespread among nonprofits. Regardless of whether this issue is one of perception or is steeped in reality, commentators generally agree that inadequate resources have been devoted to guidance and enforcement. Efforts at self-regulation, which have been reinforced by greater public disclosure, have aimed to compensate for this shortcoming and renew credibility within the sector. The other quite different element in this mix is the internet, which makes possible disclosure on a basis never before contemplated. With disclosure and the power of the public to access information, comes the issue of both the good and the harm that may result to the nonprofit sector.

Who has in interest in compliance by nonprofits?

Public munificence by wealthy citizens and charitable organizations, including churches, has long played an important role in the founding and development of many important public institutions in the United States. This tradition has brought with it an expectation by the general public that the institutions' overseers, *i.e.*, the board, will act with the highest level of integrity to ensure these resources are available for future generations. But public sentiment alone should not dictate policy on nonprofit accountability and transparency. Rather, we need to consider to whom nonprofits should

¹ Whether these cases are indeed rare or whether such misdeeds are more prevalent but go undetected, or if discovered are settled and not reported, is an issue explored in detail in Marion R. Fremont-Smith and Andras Kosaras, "Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002," 42 Exempt Organization Tax Review 25 (2003).

be accountable and whether the laws adequately address those parties' concerns. In light of these organizations' tax-exempt status and diverse sources of support, there are three main groups with a particular interest in compliance – the Treasury, the states attorneys general on behalf of donors, beneficiaries and the general public, and the general public itself.

Nonprofit organizations are granted tax-exempt status because it is understood that their assets will be dedicated for beneficial purposes, whether for charitable, educational, scientific, religious, social welfare, or recreational ends, to regulate a particular profession, or to promote some other ideal thought to be for the betterment of the community. Granting tax exemption to organizations serving the public good has a long history. Indeed, since the fourth century the Christian church and clergy justified their tax-exempt status and other privileges to Roman imperial authorities by the charitable care they provided to the poor.² Questions of accountability and oversight likewise arose then as today, and early examples of court challenges to exempt status and uses of charitable assets for personal gain are documented. For example, Anthanasius of Alexandria was accused of privately selling grain that the emperor Constantine had granted to the church for relief of the poor.³

As our notion of charity and other causes worthy of tax exemption have expanded in modern times, so too has the value of assets held by nonprofit organizations. According to a recent estimate by the Internal Revenue Service (the "IRS"), tax-exempt organizations (excluding churches) hold over \$3 trillion in assets that are not contributing

² See Peter Brown, *Poverty and Leadership in the Later Roman Empire* (University Press of New England 2002) ("Poverty and Leadership") pp. 30-35.

³ See *Poverty and Leadership*, p. 32 (citing Athanasius, *Apologia contra Arianos* 18.2).

to the federal fisc.⁴ Moreover, individuals and for-profit corporations are eligible for income tax deductions for contributions made to Section 501(c)(3) organizations, further detracting from revenues the IRS might otherwise have collected. It therefore should go without saying that the IRS has a definite interest in compliance by nonprofits, not only that they are operating for exempt and not commercial purposes, but also that their assets are not being used to serve private interests – that is, through inurement, excessive compensation, unfair self-dealing practices, or earmarking. United States taxpayers have a similar interest since taxpayers are, in effect, subsidizing the tax-exempt benefits enjoyed by these organizations.

Individual and for-profit donors, as well as private foundation grantors, have an interest in seeing that their contributions and grants are used for their intended purposes. While the nonprofit donee must have discretion and control over the ultimate disposition of these donated assets, such discretion is limited by federal and state law, and contributors should be entitled to some satisfaction that their gifts will be used for the intended public purpose. A nonprofit's beneficiaries also have an interest, albeit a self-interested one. Beneficiaries want assurances that that the organization's assets are properly managed and spent in a manner that maximizes the beneficiaries' own benefit. Claims by beneficiaries to oversight arguably are tenuous since a tax-exempt charity is expected to serve an indefinite charitable class. As it happens, this tension between

⁴ See June 28, 2007 letter of Kevin M. Brown, Acting Commissioner of the IRS, to the Honorable Charles E. Grassley, Ranking Member, Committee on Finance, United States Senate (the "2007 Brown letter"), p.3, available at <http://finance.senate.gov/sitepages/grassley.htm> (see link to IRS letter on compliance problems in tax-exempt area). Of that amount, approximately \$2.4 trillion in assets were held by Section 501(c)(3) organizations (excluding churches) in 2006. See Treasury Inspector General for Tax Administration, "Screening Tax-Exempt Organizations' Filing Information Provides Minimal Assurance that Potential Terrorist-Related Activities are Identified" (Ref. No. 2007-100-982) May 21, 2007 ("Treasury Inspector General"), p. 1.

indefiniteness and enforcement of charitable trusts was well recognized in the nineteenth-century by the courts but, as discussed below, the states now uniformly recognize the power of state attorneys general to enforce beneficiaries' rights, as well as to protect the interests of donors and the public.⁵

Having established the parties with strong claims to oversight rights – the IRS, the states attorneys general on behalf of donors and beneficiaries and the general public, and the general public itself – the following sections discuss the development of federal and state laws that have increasingly sought to define those interests and promote accountability.

Laws Governing Nonprofit Accountability

Oversight of the affairs of a nonprofit organization begins with the board of directors or, in the case of a charitable trust, the trustees. It is well known that directors, as fiduciaries, must exercise care and loyalty not only in safeguarding the organization's assets, but also with respect to the organization's charitable programs and administrative operations. Directors of nonprofit corporations are expected to be informed, participate at meetings, use independent judgement, act in the best interests of the organization, and comply with all legal requirements. Failure to observe these practices lies at the core of some of the more recently highly publicized cases, such as the Smithsonian, American University and Adelphi University.⁶ An organization's board, however, provides only the first layer of oversight over management's day to day operations. This section discusses

⁵ S.F.D., Jr., "Notes: The Enforcement of Charitable Trusts in America: A History of Evolving Social Attitudes," 54 Va. L. Rev. 436, 441-458; Marion R. Fremont-Smith *Governing Nonprofit Organizations, Federal and State Law and Regulation* (Harvard University Press 2004) ("Fremont-Smith") pp. 44-48.

⁶ See, e.g., "Smithsonian Report Confirms Leadership Crisis, Grassley Says," 2007 TNT 120-44 (June 21, 2007); "Grassley Comments on American University Oversight," 2005 TNT 232-52 (Dec. 5, 2005); Bruce Lambert, "New York Regents Oust 18 Trustees from Adelphi U.," NYT (Feb. 11, 1997) p. A1.

some of the key legal developments aimed at strengthening accountability of boards and officers.⁷

The Internal Revenue Code and the Role of the IRS

The IRS's regulatory authority over nonprofits has significantly expanded over the last forty years. Its enhanced role is due largely to new provisions of the Internal Revenue Code (the "Code") that were enacted to correct past abuses, both real and perceived. More recently, however, the IRS's oversight function has extended beyond strictly tax issues.

Marion Fremont-Smith provides a fascinating summary of the Congressional committees and investigations, starting from the earliest days of the Internal Revenue Code, that looked at various aspects of charitable entities and their activities.⁸ Perhaps the most far reaching committee was the Patman Committee, as the Select Committee on Small Business, was officially known. Beginning in 1962, the Patman Committee held hearings and issued reports on foundations, their business dealings, their economic partners and the dereliction of the IRS in properly monitoring and regulating foundations. The cause and result of the Patman Committee was a profound distrust of foundations by Congress and the public, and the need to strengthen the IRS. The ultimate outcome was the Tax Reform Act of 1969, which enacted the private foundation rules of Chapter 42 and thereby drew a definitive line between private foundations and public charities.⁹

These new Code provisions enhanced IRS oversight of the charitable, financial and

⁷ A full and excellent account of the history and development of the laws affecting nonprofits may be found in Marion Fremont-Smith's *Governing Nonprofit Organizations*. This paper does not delve into the differing standards for directors of nonprofit corporations and trustees of charitable trusts.

⁸ See Fremont-Smith, pp. 67-76.

⁹ See Tax Reform Act of 1969, P.L. 91-172 § 101(b).

administrative affairs of private foundations. Private foundations were now subject to an annual payout requirement and stricter grantmaking procedures; the self-dealing and excess business holding rules significantly restricted, and in some cases prohibited, a private foundation's ability to engage in investments and other transactions in which the foundation's directors, officers, managers and substantial contributors had an interest. The 1969 Act essentially aimed to impose high standards of accountability by ensuring that a private foundation's funds were indeed used for their intended charitable beneficiaries and not in potentially, though not necessarily, abusive transactions with foundation insiders. Despite major concerns voiced by the private foundation community, the Chapter 42 provisions have proven to be quite manageable.

It has been only in the last ten years or so that Congress has focused on the need for greater accountability of public charities. In 1996, Congress adopted the intermediate sanctions provisions, which impose an excise tax on directors, officers, key staff and other disqualified persons of public charities and social welfare organizations who receive excessive compensation or other undue consideration in transactions with their organizations.¹⁰ Although comparable to the self-dealing rules applicable to private foundations under Code Section 4941, the intermediate sanctions rules are less arbitrary and therefore somewhat more vague and broad in terms of the transactions falling within their ambit. Donor advised funds and supporting organizations were rendered more accountable under the Pension Protection Act of 2006, which extends the application of intermediate sanctions to new categories of disqualified persons and prohibits transactions

¹⁰ See Taxpayer Bill of Rights 2 (1996), P.L. 104-168, § 1311.

by donor advised funds that would benefit donors, donor advisors, investment advisors and their families or businesses more than incidentally.¹¹

Other legislation has primarily aimed at keeping the operations and activities of charities focused on their legitimate charitable purposes to ensure that they do not engage in activities not permitted under Code Section 501(c)(3), such as political campaign activity, substantial lobbying or substantial commercial activities in competition with for-profit entities.¹² From this very brief account of only some of the legislative activity involving nonprofits, it is clear that the IRS's role with respect to the charitable sector and its accountability is one that has traditionally focused on tax law.

Presently, however, the IRS is extending its sphere of influence beyond the objectives of federal tax law. In February 2007, as the Senate pursued its targeted investigations into the governance and other practices of charitable organizations,¹³ the IRS issued a draft paper entitled "Good Governance Practices for 501(c)(3) Organizations."¹⁴ The draft paper proposes that charitable organizations voluntarily adhere to nine principles of governance, which in turn recommend adoption of policies addressing conflicts of interest, ethics, whistleblower situations, and document retention, as well as standards of care and loyalty in order to promote accountability and transparency. In this regard, the draft paper is consistent with existing state law and

¹¹ See Pension Protection Act of 2006, P.L. 109-280 ("Pension Protection Act"), § 1232.

¹² See Omnibus Budget Reconciliation Act, P.L. 100-203, § 10711 (1987) (clarifying prohibition against political campaign activities); Tax Reform Act of 1976, P.L. 94-455 § 1307(a) (enacting Code § 501(h)); Revenue Act of 1950, P.L. 814, 81st Cong., 2d Sess., § 301(a) (enacting Code § 511).

¹³ See, e.g., Press Release of Senator Chuck Grassley, Feb. 16, 2007 (discussing proposed legislation to reform and strengthen the Red Cross's governance), available at <http://finance.senate.gov/sitepages/grassley.htm>; Letter of Senator Chuck Grassley to John G. Roberts, Jr., Chancellor of the Smithsonian Institution, Feb. 21, 2007, available at <http://finance.senate.gov/sitepages/grassley.htm>.

¹⁴ IRS website at <http://www.irs.gov/charities/charitable/article/0,,id=167626,00.html>

follows many of the practices promoted by the self-regulatory initiatives discussed below. What is novel, however, is that the IRS has made a formal statement on governance, traditionally thought to be a matter for the states. In promulgating these "good governance practices," the IRS seems to be echoing the sentiment of the Senate, which has cited "poor governance at the core of problems at charities."¹⁵ As IRS Acting Commissioner Kevin M. Brown has stated, "[w]e remain convinced that an independent, empowered and engaged board of directors is the key to insuring that a tax-exempt organization serves public purposes, and does not misuse or squander the resources in its trust."¹⁶ The IRS has recently reiterated its position that governance issues fall within its purview.

To the extent that empowering and educating boards in better governance practices will solve problems with tax compliance, the IRS does have a valid interest in a charity's governance practices, and the draft paper may serve to reinforce certain basic practices in states where guidance and enforcement are particularly lacking. IRS guidance on governance practices, however, should remain voluntary to prevent any conflict with states, like California, New York, Illinois and Massachusetts, where there is a developed body of nonprofit law and active attorneys general.

A second non-tax area of regulation in which the IRS is now involved is monitoring the international activities of exempt organizations with an eye towards

¹⁵ IRS website at <http://www.irs.gov/charities/charitable/article/0,,id=167626,00.html>; Letter from Max Baucus, Chairman, and Charles E. Grassley, Ranking Member, on behalf of the Senate Finance Committee, to Henry Paulson, Secretary, Department of Treasury, May 25, 2007.

¹⁶ 2007 Brown Letter, p. 3. *See also* remarks of IRS Tax Exempt and Government Entities Commissioner Steven T. Miller on April 23, 2008 before the Georgetown Seminar Exempt Organizations Panel, 2008 TNT 80-27.

enforcing United States anti-terrorism law. This new oversight function is much harder to support even though statutorily mandated.

Shortly after the September 11 terrorist attacks, the assets of three United States charities – The Holy Land Foundation, Global Relief Fund and Benevolence International Foundation – were frozen pursuant to President Bush’s Executive Order blocking the assets of persons and entities determined to be terrorists, or to conduct activities in support of terrorism, and prohibiting United States persons from engaging in transactions with such persons and entities, including making contributions of funds, goods and services.¹⁷ The alleged links between these charitable organizations and foreign terrorist groups has led to what seems to be a widely held government perception that United States charities play a "crucial role" in financing terrorism.¹⁸ Interestingly, this is not the first time that charitable organizations have been under government scrutiny for allegedly engaging in "subversive" and "un-American" activity. During the McCarthy era, congressional committees were formed for the purpose of investigating whether charitable organizations, and in particular private foundations, were promoting leftist politics and propaganda through their activities.¹⁹ The recommendations of those earlier committees, however, never were implemented whereas in November of 2003, Congress enacted Code

¹⁷ See Executive Order 13224 (September 24, 2001); *Holy Land Foundation for Relief and Development v. Ashcroft*, 219 F. Supp. 2d 57 (D.D.C. 2002), *aff'd* 333 F.3d 156 (DC Cir. 2003); *Global Relief Fund, Inc. v. O’Neill*, 207 F. Supp. 2d 779 (D.D. Ill. 2002), *aff'd in part* (7th Cir. 2002); *Benevolence International Foundation v. Ashcroft*, 200 F. Supp. 2d 935 (N.D. Ill. 2002). Holy Land Foundation and five of its officers have since been brought to trial on counts of conspiracy, money laundering and providing financial support to Palestinian charities purportedly controlled by Hamas. See, e.g., Leslie Eaton, "Prosecutors Say a Charity Aided Terrorists Indirectly," NYT (Sept. 18, 2007).

¹⁸ Letter from Charles E. Grassley and Max Baucus of Senate Finance Committee to Mark Everson, Commissioner of IRS dated December 22, 2003, requesting tax files of twenty-five charitable organizations believed to have links with terrorism. Available at <http://finance.senate.gov/sitepages/grassley2004> (see link to Records Sought about Tax-Exempt Organizations for Committee’s Terror Finance Probe).

¹⁹ See Fremont-Smith, pp. 69-72 (discussing the investigations and reports of Cox Committee (1952) and Reece Committee (1953)).

Section 501(p), which suspends the tax-exempt status of any organization that is designated a terrorist or supporter of terrorism.²⁰

The IRS's heightened interest in charities' international activities and potential links to terrorism also is reflected in the redesigned Form 990. The redesigned return makes clear that foreign grants includes not just grants to organizations formed under the laws of another country, but also grants to US organizations that have foreign branch offices or conduct more than half of their activities abroad or for the benefit of foreign persons, and grants that are primarily for the benefit of foreign persons.²¹ It additionally asks about the organization's grants, fundraising programs, and office and employees outside the United States, all of which are to be described in greater detail in a separate schedule.²²

The IRS additionally is playing an active role in monitoring charitable organizations for possible terrorist links. At present the IRS is manually screening over 80,000 Forms 1023 and 300,000 Forms 990 and 990-PF on an annual basis for possible terrorist activity or support.²³ Potential matches against a terrorist list are not initially forwarded to other branches of the Treasury, such as the Office of Foreign Assets Control ("OFAC"), or government agencies responsible for tracking terrorist activity, but instead are further investigated by the IRS.²⁴ Despite some preliminary concerns of possible links with terrorism, none of the organizations that filed a Form 1023 during the period

²⁰ See Military Family Tax Relief Act of 2003, P.L. 108-121, § 108(a). The tax-exempt status of seven organizations has been suspended to date. See <http://www.irs.gov/charities/charitable/article/0,,id=141459,00.html>.

²¹ See new Form 990, Part IV and Schedule F..

²² See new Form 990, Part IV and Schedule F.

²³ See Treasury Inspector General, p. 1. A strategy for automatic screening is under development. See Treasury Inspector General, p. 8.

²⁴ See Treasury Inspector General, p. 5.

October 1, 2005 through September 5, 2006 or a Form 990 for 2003 ultimately was found to have ties to terrorism, although two cases were still under review as of December 2006.²⁵

Devoting the IRS's limited resources to counter-terrorism activity seems misguided. Counter-terrorism it is not related to the IRS's traditional function of enforcing tax rules intended to insure that nonprofits operate for purposes forming the basis of their tax-exemption. While it is certainly in everyone's interest to prevent diversion of charitable assets for terrorist purposes, the same might be said with respect to any criminal activity, yet the IRS is not otherwise responsible for monitoring charities for potential criminal involvement, nor should it be. Other departments of the government are responsible for criminal investigations and enforcing trade sanctions, and surely OFAC, the State Department, the Justice Department, the Central Intelligence Agency, the Federal Bureau of Investigation, not to mention Homeland Security, could address the relatively few cases of alleged terrorist links from the tax-exempt sector.

*Role of State Attorneys General: Oversight on Behalf of Beneficiaries, Donors and the General Public*²⁶

Even though the public, like the IRS, has an interest in ensuring that nonprofit organizations are operating for public purposes in return for their tax-exempt status, members of the general public generally do not have standing in the courts to enforce compliance. Members of the public demonstrating a special interest in the organization, such as beneficiaries and donors, have on occasion been recognized by the courts, but they too are generally denied the opportunity to enforce compliance through

²⁵ See Treasury Inspector General, p. 5.

²⁶ This discussion of state attorneys general focuses primarily on the State of New York.

the courts.²⁷ The interests of donors, beneficiaries and the public instead are primarily looked after by the states' attorneys general and, to a lesser extent, the courts.

Most state attorneys general have broad discretionary powers – broader than that of the IRS – to conduct investigations and bring court actions to protect and enforce charitable dispositions on behalf of unnamed charitable beneficiaries and donors.²⁸ In New York, for example, the attorney general plays a supervisory role to ensure that charitable assets are properly administered. The attorney general must approve the sale or disposition of all or substantially all of certain nonprofit corporations' assets, as well as investigate particular transactions and relationships of trustees or directors of nonprofit corporations and may remove trustees, directors and officers for cause.²⁹ The attorney general additionally may initiate proceedings to enjoin unlawful transfers of corporate assets or to set aside unlawful conveyances where the transferee knew of the unlawfulness.³⁰ Furthermore, the attorney general may sue directors and officers of corporations whose conduct constitutes a breach of a fiduciary duty and results in misappropriation of corporate assets.³¹

These powers are largely governance related. And as a spate of governance failures in the nonprofit sector has come to light and prompted increased attention, attorneys general, like the IRS, are focusing on excessive officer compensation and related-

²⁷ See, e.g., *Smithers v. St. Luke's Roosevelt Hospital Center*, 281 A.D.2d 127 (NY App. Div. 1st Dept. 2001); also see Fremont-Smith, p. 331, notes 126, 129, and 132.

²⁸ See Fremont-Smith, pp. 305-307 and Appendix, Table I (also noting the states in which the attorney general's enforcement powers are limited to charitable trusts or certain types of transactions or accountings).

²⁹ See New York Not-for-Profit Corporation Law ("N-PCL") §§ 510-511 and 714(c); New York Estates, Powers and Trusts Law ("EPTL") § 8-1.4(i).

³⁰ See N-PCL § 720(a)(2) and (3).

³¹ See N-PCL §§ 112(a)(4) and 706(a); N-PCL § 720(a) and (b) (suits against directors and officers); also see *Spitzer v. Grasso*, 42 A.D.3d 126 (NY App. Div. 1st Dept. May 8, 2007).

party transactions that may result in private benefit, among other issues.³² In New York, for instance, the office of the attorney general has sent letters in the last several years to nonprofit organizations requesting additional information regarding compensation practices, the use of family-related investment advisors and other transactions reported on the Form 990. The breadth of the New York attorney general's powers to pursue litigation in such matters, however, may have been curtailed in May 2007 when the Appellate Division held in *Grasso v. Spitzer* that the attorney general did not have the power to bring certain actions against directors and officers of the New York Stock Exchange in connection with excessive compensation paid to its former President and Vice Chairman of the Board, Richard Grasso.³³ According to the court, the enforcement provisions of the Not-for-Profit Corporation Law are comprehensive in nature.³⁴ The court consequently dismissed the four claims brought by the attorney general that did not allege fault (*i.e.*, bad faith or knowledge of unlawfulness) since actions on those claims were not expressly provided for in the Not-for-Profit Corporation Law.³⁵ Prior to the Grasso decision, it was generally thought that the Attorney General had broader *parens patriae* powers to protect the State and enforce the Not-for-Profit Corporation Law.³⁶

Apart from ensuring proper administration of charitable assets, state attorneys general, as well as the courts, serve to protect donor intent. The attorney general may bring an action in court against a charitable organization or specific

³² David Biemesderfer & Andras Kosaras, *The Value of Relationships Between State Charity Regulators & Philanthropy* (Council on Foundations, Forum of Regional Associations of Grantmakers 2006) (http://www.givingforum.org/s_forum/sec.asp?CID=2983&DID=7037) ("Biemesderfer & Kosaras") at 2.

³³ See *Spitzer v. Grasso*, 42 A.D.3d 126.

³⁴ See *Spitzer v. Grasso* at 137-138.

³⁵ See *Spitzer v. Grasso* at 139-141, 144.

³⁶ See *Spitzer v. Grasso* at 148-149, 152 (dissenting opinion).

individuals who fail to apply solicited funds in a manner that is "substantially consistent" with the organization's purposes or the purposes for which the solicitation was made.³⁷

With respect to institutional and endowment funds, only the donor or a court may release donor imposed restrictions concerning their use.

Under the Uniform Management of Institutional Funds Act ("UMIFA"), which has been adopted in various forms by most states, the donor's consent is required before a charitable organization may release an institutional fund from restrictions regarding its use or investment.³⁸ If the donor's consent cannot be obtained due to "death, disability, unavailability, or impossibility of identification," the organization must apply to a court for release.³⁹ The court may release the fund from restrictions after the attorney general has had an opportunity to be heard if the court finds that the restriction is "obsolete, inappropriate, or impracticable."⁴⁰ Such procedures, however, are not available to change an endowment fund into a fund that is not an endowment fund in order that it may be spent down.⁴¹ Rather, endowment funds, as well as restricted assets of a trust, generally are held to a higher *cy pres* standard.⁴² In New York, the court, with the donor's consent if he or she is alive, may reform imposed restrictions only if "circumstances have

³⁷ See New York Executive Law ("Executive Law") § 175.2(e). The New York attorney general furthermore regulates and oversees charitable solicitations made in New York, requiring charitable organizations and their fundraising consultants to register and file annual reports and include specific disclosures on written solicitations. See Executive Law §§ 172, 172-b and 174-b. The attorney general also is empowered to bring actions against charitable organizations and individuals, including outside fundraisers, who engage in fraudulent solicitations or otherwise violate any provision of New York's solicitation laws. See Executive Law §§ 175.2(c), (d), and (e) and 175.5.

³⁸ See UMIFA § 7(a); also see N-PCL § 522(a).

³⁹ UMIFA § 7(b); also see N-PCL § 522(b).

⁴⁰ UMIFA § 7(b); also see N-PCL § 522(b). As of 2004, quasi *cy pres* relief is available for restricted assets of a charitable corporation in Arizona, California, Connecticut, Illinois, Maryland, Massachusetts, Missouri, Pennsylvania and Texas, in addition to New York. See Fremont-Smith, p. 184 and Appendix Table 2.

⁴¹ See UMIFA § 7(b); also see N-PCL § 522(b).

⁴² See, e.g., N-PCL § 522(d); EPTL § 8-1.1(c).

so changed since the execution of an instrument making a disposition for religious, charitable, educational or benevolent purposes as to render impracticable or impossible a literal compliance with the terms of such disposition" and direct that the assets be administered and applied in a manner that "will most effectively accomplish its general purposes, free from any specific restriction, limitation or direction."⁴³

In 2006, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). UPMIFA updates UMIFA by applying modern prudence standards to the management and investment of institutional funds and expenditures made from endowment funds, as well as modifies the circumstances under which donor imposed restrictions on institutional funds may be modified.⁴⁴ UPMIFA would apply the higher cy pres standard to modify the use of any institutional fund, thus giving greater deference to donor intent.⁴⁵ UPMIFA, however, would expand the circumstances under which cy pres relief could be obtained to include situations in which maintaining the donor's restriction would be wasteful.⁴⁶ For funds valued at less than \$25,000 and established at least twenty years earlier, UPMIFA would allow the organization to apply cy pres without going to court upon giving sixty days notice to the state attorney general.⁴⁷ This provision relaxes cy pres procedures if the costs of obtaining a court order would be great relative to the value of the institutional fund.⁴⁸ Even if a restriction is released pursuant to these abbreviated procedures, the

⁴³ EPTL § 8-1.1(c).

⁴⁴ See UPMIFA, Prefatory Note at pp. 1-4.

⁴⁵ See UPMIFA § 6(c) and comment at p. 34.

⁴⁶ See UPMIFA § 6(c) and comment at p. 34.

⁴⁷ See UPMIFA § 6(d) and comment at pp. 34-35.

⁴⁸ See UPMIFA, comment to Section 6(d) at 34-35.

organization still must continue to use the assets in a manner that is consistent with donor intent.⁴⁹

Protecting donor intent is appropriate, and the UPMIFA modifications in this area should be seriously considered by the states. States attorneys general and the courts have to grapple with the tension which exists between donor intent and restrictive, and perhaps impractical, not to say obsolete, manifestations of the "dead hand." It is often a delicate balance between adherence to a donor's restrictions and a charity's need for flexibility. Having state attorneys general enforce donor intent is generally preferable to giving donors standing which could lead to frivolous suits by angry donors. The problem, of course, lies with the inadequacy of resources devoted by the states to attorney general oversight, and it is because of the inadequate resources that scholars continue to discuss the issue of granting donors standing in some limited context or providing "relative" status under certain circumstances. The counter argument of the waste of charitable assets in defending against these suits is also a valid one.

Membership Corporations: Internal Oversight

As commentators and the media have focused their discussion of nonprofit oversight on the role of the board, transparency, and the regulatory authorities, the oversight function of a nonprofit corporation's membership has tended to be overlooked. A voting membership potentially has significant powers, which if exercised could serve as a useful check on actions of the board and officers. Members not only elect the organization's directors, but they also are empowered to remove directors with and without cause under many state statutes. Membership approval furthermore is required

⁴⁹ See UPMIFA § 6(d) and comment at 34.

with respect to certain actions taken by the board, such as mergers and dissolutions. In addition, New York affords members of a not-for-profit corporation the opportunity to review the corporation's books and records, provided the review is for legitimate corporate purposes such as to investigate questionable financial practices, embezzlement, or increased administrative expenses.⁵⁰ In some states, members additionally may challenge unlawful actions by bringing derivative suits in the courts.⁵¹ Members of New York not-for-profit corporations are permitted to bring derivative actions against directors and officers who have engaged in misconduct, a breach of fiduciary duty or other illegal action.⁵² As in the context of business corporations, derivative suits may not be brought to challenge actions taken in good faith since the business judgment rule applies to decisions of nonprofit directors and officers in most states.⁵³

The ability of the membership to raise public awareness of potential corporate misdeeds and seek redress in the courts was recently highlighted in a case involving the Albright-Knox museum. In that case, a minority of the museum's membership challenged the board's decision to deaccession more than 200 works of

⁵⁰ See N-PCL § 621, *Mayer v. National Arts Club*, 223 A.D.2d 440 (NY App. Div. 1st Dept. 1996). While the N-PCL limits members' right of review to the minutes of the proceedings of its members, list or record of members, and most recent financial statements, New York courts have permitted the examination of corporate documents not expressly authorized by statute. See e.g. *Cuva v. United States Tennis Association Eastern, Inc.*, 831 N.Y.S.2d 347 (NY S. Ct. 2006) (election ballots); *Wells v. League of American Theatres and Producers, Inc.*, 183 Misc. 2d 915, 920 (NY S. Ct. 2000) ("It is in the court's discretion to exercise its authority to limit or expand the scope of members' inspection of corporate records to the material necessary to protect their interest in the corporation.").

⁵¹ Derivative actions are authorized by statute in New York, Georgia, Illinois and Michigan See Fremont-Smith, p. 336 (citing N-PCL § 623, Ga. Code Ann. § 14-3-741; 805 Ill. Comp. Stat. 5/7.80; Mich. Comp. Laws §§ 450.2491-2493). Other states, such as New Jersey, Ohio and California have recognized derivative suits by members under common law. See Robert Hammel Brownlee, "Notes: Membership Rights in Nonprofit Corporations: A Need for Increased Legal Recognition and Protection," 29 Vand. L. Rev. 747, 770 (1976).

⁵² See N-PCL §§ 623, 720.

⁵³ See e.g., *Morris v. Scribner, Jr.*, 508 N.E.2d 136, 139-140 (NY 1987); *Alpert v. National Association of Securities Dealers, LLC*, 7 Misc. 3d 1010A (NY S. Ct. 2004).

ancient art that were "peripheral" to the "museum's core mission as a modern and contemporary art institution."⁵⁴ The members not only questioned the board's decision in the media, but also initiated an action against the board of directors, the president and the executive director, to prevent the sale.⁵⁵ Although the members did not prevail on the merits of their case, their challenge serves as an example of how the actions of dissident members can challenge and perhaps enhance the integrity of the board's decision-making process by promoting above-board procedures and a high degree of transparency.⁵⁶ The old style membership structure of many cultural institutions founded in the late 19th and early 20th centuries furthermore provided an opportunity for donors to ensure that the organization's assets were properly administered and used in a manner that was consistent with donor intent since those memberships largely consisted of the organization's contributors.

This layer of internal oversight, however, has been diluted over time as nonprofits have moved away from the membership structure. As organizations have increased in size, many voting memberships have been converted into non-voting

⁵⁴ Charles W. Banta, "Why We Had to Sell Ancient Works of Art," WSJ (Letter to the Editor), May 3, 2007, p. A15.

⁵⁵ See Tom L. Freudenheim, "In the Fray: Shuffled Off in Buffalo," WSJ, November 15, 2006, p. D14; *Dennis v. Buffalo Fine Arts Academy*, 15 Misc.3d 1106A (NY S. Ct. March 21, 2007). The members alleged that (i) the procedures followed by the board in approving the sale violated the bylaws, (ii) the proposed sale would violate the museum's certificate of incorporation, which defines the museum's purposes more broadly as "maintaining a collection of painting, sculpture and other works of art and encouraging the advancement of education and cultivation of art," as well as the museum's collection management policy and strategic plan, (iii) the proposed deaccession was a misappropriation and waste of corporate assets, and (iv) the sale would violate donor intent.

⁵⁶ Other derivative suits in New York have alleged, among other things, unreasonable compensation, unfair self-dealing transactions, use of corporate funds for personal purposes, and violation of state statute and diversion of corporate funds for impermissible purposes. See *Hoffert v. Dank*, 86 Misc.2d 384 (NY S. Ct. 1976), rev. by 55 A.D.2d 518 (NY App. Div. 1st Dept. 1976) (unreasonable compensation); *Jacobs v. Gladstone*, 84 A.D.2d 651 (NY App. Div. 3rd Dept. 1981) (self-dealing); *Clark v. Trois*, 21 A.D.3d 439 (NY App. Div. 2nd Dept. 2005) (misappropriation of corporate assets); *Morris v. Scribner, Jr.*, 508 N.E.2d 136 (violation of state statute and diversion of corporate assets).

memberships; and even where members have retained their voting rights, their meetings often are relatively *pro forma*, following an agenda set by the board and with a vast majority of members voting by proxy, much like shareholder meetings of business corporations. Large membership organizations furthermore can be cumbersome to administer. The annual members' meeting can be costly and is viewed as having little practical benefit. Moreover, there is the fear of exposure to distracting litigation by minority members. As illustrated by the Albright Knox case, a determined minority can be, in a board's view, disruptive, cause costly litigation, and embarrass the board and the organization in the media. Internet access and blogs furthermore can enable a small group to organize quickly and run an effective campaign against board actions. The risk of such exposure has caused many nonprofit corporations to concentrate their decision-making powers with the board of directors.

Enforcement: Resources and Guidance

Although there is an extensive network of federal and state laws aimed at promoting accountability of nonprofit entities, the extreme cases of excessive compensation, self-dealing and other misappropriations of assets that periodically crop up in the press continue to fuel the common perception that nonprofits are not largely compliant.⁵⁷ Some of the relatively minor wrongdoings, however, are not so much the

⁵⁷ See, e.g., Kathleen Teltsch, "Suit Names Levitt Foundation Head," NYT (July 2, 1981) p. B3; Peter Applebome, "Scandal Spurs Interest in Swaggart Finances," NYT (Feb. 25, 1988) p. A12; Ronald Smothers, "Bakker and Ex-Aide Are Charged with Defrauding Donors to PTL," NYT (Dec. 6, 1988) p. A1; Ralph Blumenthal, "A \$1 Million fund Tapped by Ritter to Make 4 Loans," NYT (Mar. 6, 1990) p. A1 (Covenant House); Felicity Barringer, "United Way Finds Pattern of Abuse by Former Chief," NYT (Apr. 4, 1992) p. 1; Karen W. Arenson, "Former United Way Chief Guilty in Theft of More than \$600,000," NYT (Apr. 4, 1995) p. A1; Bruce Lambert, "Reporter's Notebook; Examining Adelphi President's Perks, From a Mercedes to a Million-Dollar Condo," NYT (Aug. 12, 1996); Terry Pristin, "Co-Founder of Hale House is Dismissed with a

result of any intent to take advantage of nonprofit assets for personal gain, but rather ignorance or misconceptions about the law and the duties of a board. How to properly educate boards and how to regulate charities and enforce the existing laws is a daunting proposition, particularly in light of the scarcity of available resources.

As the regulatory body to which nonprofits apply for tax exemption and submit annual information reports (Forms 990 and 990-PF), the IRS has the tools to review the conduct of most nonprofit organizations. The IRS additionally has broad authority to conduct general audits of nonprofits. The problem therefore is not lack of opportunity or specific enforcement tools, but, rather declining attention given to tax-exempts. For example, although the number of returns filed by tax-exempt entities rose by 48% from 1996 to 2006, the number of returns examined by the IRS fell by 35%.⁵⁸

This lack of focus on tax-exempts also is reflected in the inadequate resources devoted to enforcement measures. It is well known that the revenue generated by the excise tax imposed on the net investment income of private foundations under Code Section 4940 was intended to be used for "more extensive and vigorous enforcement of the tax laws related to exempt organizations."⁵⁹ Although the Section 4940 tax generates significant revenues, those amounts have been added to the Treasury's general revenues and have never been specifically allocated to the IRS's exempt organization

Stinging Rebuke," NYT (May 18, 2001) p. B3; Laurie Goodstein and Stephanie Strom, "Survey Finds Embezzlement in Many Catholic Dioceses," NYT (Jan. 5, 2007) p. A5.

⁵⁸ See U.S. Joint Committee on Taxation, *Report of Investigation of Allegations Relating to Internal Revenue Service Handling of Tax-Exempt Matters* (JCS-3-00), at 61 (March 2000); Internal Revenue Service, *Internal Revenue Service Data Book 2006*, Publication 55B at 4, 32, Washington, DC, March 2007. Interestingly, the 2006 tax-exempt examination rate of 0.8% is roughly the same as the overall examination rate. See IRS, *Data Book* at 23.

⁵⁹ Joint Committee on Taxation, *General Explanation of Tax Reform Act of 1969* (JCS-16-70) (December 3, 1970) p. 29.

activities.⁶⁰ Funding for tax-exempt operations consequently has been dependent on annual congressional appropriations.⁶¹ Although Congress has acknowledged the magnitude and uniqueness of the tax-exempt sector and the resources required by the IRS to effectively regulate tax-exempts, congressional funding has fallen short of the level of revenue generated by the Section 4940 tax and thus the level intended by the 1969 Act.⁶² Yet in the meantime, the number of exempt organizations has dramatically increased, and the IRS's oversight role has expanded to include nonprofit governance and matters of national security. Despite repeated calls by the charitable community and others, the likelihood of the Section 4940 tax revenues being allocated to the IRS for its exempt organization activities seems slim to nonexistent.

Insufficient funding is not the only factor contributing to the IRS's problem with enforcement. In a memorandum to the Treasury Secretary, the Treasury Inspector General for Tax Administration noted that the IRS continues to struggle with workforce issues and is simply too understaffed to handle the amount of work required by the tax-exempt sector.⁶³ In addition, the limited personnel assigned to charities has been shifting

⁶⁰ See Fremont-Smith, p. 387.

⁶¹ See H.R. Conf. Rep. No. 105-599 at 210; Fremont-Smith, p. 387.

⁶² See H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess., at 210; Fremont-Smith, p. 387. Compared with the approximately \$500 million in revenue from the excise tax on the net investment income of private foundations, the IRS tax exempt unit is funded significantly below the level originally intended. See Council on Foundations, Letter to Senator Richard Shelby, Chairman, Subcommittee on Transportation, Treasury and General Government, Committee on Appropriations, June 24, 2004.

⁶³ See J. Russell George, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2006* (October 27, 2005), avail at www.treas.gov/tigta/management/management_fy2006.htm. "Since 1997, the number of tax-exempt organizations on the IRS master-file has increased by more than 355,000. On average and fellow citizens created 39,465 new exempt organizations per year – 180 per day, weekends and holidays included. The total number is now approaching 1.6 million, a figure that does not include most churches." 2007 Brown Letter, p. 3.

from examinations to processing the increasing number of tax-exempt applications.⁶⁴

Increased funding for additional staff and resources, however, may not entirely solve the problem of low examination rates as the IRS anticipates high attrition due to employee retirement.⁶⁵ The IRS has sought to compensate for its waning resources with specific audits or "compliance checks" that target compensation practices and political campaign activities rather than carrying out full-scale audits.

Enforcement at the state level likewise suffers from inadequate resources. In most states, funds are not specifically earmarked to support the attorney general's oversight of charities.⁶⁶ And it seems that as the number of charitable organizations has increased over the last decade, the number of attorneys working dedicated to charitable oversight at the state level has been stagnant.⁶⁷ The lack of financial resources and manpower devoted by the states to oversight of nonprofits and charitable trusts is not a new criticism.⁶⁸

In light of the rapidly increasing number of charities and the likelihood that inadequate resources devoted to enforcement issues will continue into the future, what should be the approach to improve the behavior and therefore, hopefully, the efficacy of

⁶⁴ General Accounting Office, *Improvements Possible in Public, IRS, and State Oversight of Charities*, GAO-02-526 (April 2002) ("GAO 2002"), p. 23.

⁶⁵ General Accounting Office, *Assessment of the 2008 Budget Request and an Update of 2007 Performance*, GAO-07-719T (May 9, 2007) p. 19.

⁶⁶ The 2006 Council on Foundations report notes that among the 11 states with registration and reporting requirements, four states deposit filing fees in the general treasury (Massachusetts, Minnesota, New York, and Rhode Island), and five states follow the Uniform Act and earmark filing fees to charity oversight (California, Illinois, New Hampshire, Ohio, Oregon). Reporting fees among the states can range from free to \$1,500. See Biemesderfer & Kosaras, p. 17

⁶⁷ See Peter Swords and Harriet Bograd, *Nonprofit Accountability: Report and Recommendations* (1997) (<http://charitychannel.com/forums/cyb-acc/accrept.html>) (citing National Association of Attorneys General and National Association of State Charities Officials, *Statistics on the Office of the Attorney General* (1996)); Biemesderfer & Kosaras, p. 17.

⁶⁸ See Brownlee at 772 (noting articles from the 1950s and 1960s).

charitable organizations? One approach might be more official guidance and educational efforts from the IRS and states' attorneys general, like guidance on good governance practices published by some of the more active states and the IRS's recent "Good Governance Practices for 501(c)(3) Organizations."⁶⁹ The New York Attorney General's guidelines, for example, provide a wealth of information and links to other resources that are very useful.

Self-Regulation

The enactment of the Sarbanes-Oxley Act of 2002 following the Enron debacle caused a tremor in the nonprofit sector. While only two of the act's provisions are applicable to nonprofits – the need for a whistleblower policy and a document retention plan that prohibits the destruction of documents if a claim against the charity is likely, Sarbanes-Oxley has had both a greater and lesser effect than might have been anticipated.⁷⁰ Although many directors of nonprofit organizations are business people who are familiar with the requirements of Sarbanes-Oxley, experience has shown that they often do not bring the same level of scrutiny to their nonprofit board work as they presumably do to their normal business activities. So the "trickle down" effect might be less than expected.⁷¹ However, certain provisions in Sarbanes-Oxley, such as those requiring a conflict of interest policy and an independent audit committee, have been met

⁶⁹ See, e.g., "Right from the Start, Responsibilities of Directors and Officers of Not-for-Profit Corporations," and "Internal Controls and Financial Accountability for Not-for-Profit Boards." Attorney General Andrew M. Cuomo, Charities Bureau, www.oag.state.ny.us/charities/charities.html; "The Attorney General's Guide for Board Members of Charitable Organizations," Commonwealth of Massachusetts Office of Attorney General (2007), www.mass.gov.

⁷⁰ See Sarbanes-Oxley Act of 2002, P.L. 107-204 §§ 802, 1107.

⁷¹ But see "Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study," "The Urban Institute Center on Non Profits and Philanthropy," Francie Ostrower (2007) p. 4 (finding that corporate board members bring business corporate practices to the nonprofit boards on which they sit).

by the nonprofit sector with increasing acceptance and have influenced efforts at self regulation.

Current efforts at self regulation fall into three categories: (i) advocacy organizations like Independent Sector, Council on Foundations and BoardSource, which encourage good governance practices across the sector; (ii) organizations that provide a "seal of approval," such as the Better Business Bureau, and are primarily intended to assist potential donors; and (iii) industry-specific accreditation agencies, such as The Joint Commission on Accreditation of Healthcare Organizations, American Association of Museums, and Middle States Commission on Higher Education.

Industry-Specific Accreditation

To take the last category first. The accreditation organizations regulate the operations and administration of specific areas of activity, such as educational institutions, museums, and health care institutions. As part of the accreditation process, an organization often must undertake a "self-study," which generally requires participation by everyone involved in the organization, from the board of directors to the administration and the actual service providers. The board's involvement is often very beneficial in educating directors about their responsibilities and standards of governance. The accreditation site review team, made up of persons from peer institutions, furthermore brings to the accreditation process the judgment of colleagues with real expertise operating the same kind of organization, which can be very valuable in looking objectively at one's own institution. The entire accreditation process often results in the organization making much needed operational changes and can focus the board and management on strategic planning.

"Seal of Approval" Entities

"Seal of Approval" entities certify charities using standards they develop, which generally include governance requirements. The Better Business Bureau Wise Giving Alliance, for example, conducts a national charity seal program and, through its New York Philanthropic Advisory Services, promotes standards of practice which can be found on its website.⁷² Many organizations try to meet the Better Business Bureau standards in order to be "accredited" by it, which may be important to some donors. The Maryland Council of Nonprofit Associations likewise has promulgated "Standards of Excellence – An Ethics and Accountability Code for the Nonprofit Sector."⁷³ With the support of foundations interested in improving the philanthropic sector, the Maryland Council has certified thousands of nonprofits in five states in addition to Maryland. Certifications by these organizations and others generally have the effect of making nonprofits and their boards think about good governance practices.

The effect of certification by these "seal of approval" entities is different from the effect of accreditation by industry-specific organizations. Accreditation, or rather the failure to obtain it, has real teeth. An unsuccessful entity may not be eligible for federal funds, such as reimbursement for certain types of services and tuition loan programs, while not being certified by one of the "seal of approval" entities does not have the same practical effect. The real question about the "seal of approval" programs is how they affect fundraising capabilities across the charitable sector. The concern is that they

⁷² See www.newyork.bbb.org

⁷³ See Maryland Association of Nonprofit Organizations, *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector* (2004), available at <http://www.marylandnonprofits.org/html/standards/04>

may disadvantage those nonprofits that are simply too small or too poorly financed to be able to do more than focus on their activities and their constituencies. These organizations may not have the time to worry about compliance with these extra-legal standards or to undergo the certification process even if they are in full compliance.

Advocate Organizations

The final category of self-regulation organizations does not certify charities as meeting certain standards but instead speaks for and represents their nonprofit constituencies. Independent Sector, Council on Foundations, National Council on Nonprofit Associations, and on the local level, in New York City, for instance, The Nonprofit Coordinating Committee, are just a few.⁷⁴ These entities provide educational services in the form of papers, guidelines, workshops, self-study questionnaires, and conferences for administrators and boards of directors on a host of issues involving good governance and tax-exempt status. They are independent of the government and do not have the accreditation power of the industry-specific organizations, but they provide excellent resources for their constituencies trying to improve governance practices and compliance generally.

What is quite interesting about these advocate organizations, and a relatively recent development, is their increasingly important role as a lobbying force and go-between for their nonprofit constituencies and the government. Representation of nonprofits before the government is noteworthy considering that the charitable sector has not always spoken one voice. During the Wright Patman hearings discussed above in

⁷⁴ The New York Attorney General's "Right From the Start" has a fairly comprehensive list of these advocate entities. See www.oag.state.ny.us/charities/charities.html, pp. 11-15.

connection with the Tax Reform Act of 1969, public charities were not particularly concerned about the new, stringent rules that were about to be imposed on private foundations.⁷⁵ In the aftermath of the 1969 Act and the Filer Commission's report of 1977, Independent Sector was formed in 1980 in order to bring together the charitable sector and to provide a forum where it could collectively consider issues concerning nonprofits generally.⁷⁶ Establishing a unified front is not an easy task given the sector's diversity which can produce a myriad of positions on most issues. In 2004, however, Independent Sector formed the Panel on the Nonprofit Sector to 'partner' with Congress to improve governance, accountability and ethical conduct of nonprofits, and to propose reasonable measures that would hopefully forestall draconian legislation under consideration by Congress. This panel, composed of a mix of nonprofit executives and others with expertise in the field, issued two reports containing recommendations for federal and state enforcement, enhanced disclosures in the Form 990, strengthening regulation of donor advised funds and supporting organizations, and practices deriving from Sarbanes-Oxley, among others.⁷⁷ Some of the panel's proposals are reflected in the Pension Protection Act.

In early 2006, Independent Sector's Panel on the Nonprofit Sector formed a Committee on Self-Regulation. The Committee, composed of over thirty individuals from public charities, foundations, academia and regulatory agencies, studied the principles and

⁷⁵ See Fremont-Smith, p. 80.

⁷⁶ See Fremont-Smith, pp. 82-83.

⁷⁷ See Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations (June 2005), available at www.Nonprofitpanel.org/final/Panel_Final_Report.pdf; Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations, a Supplemental Report to Congress and the Nonprofit Sector (April 2006), available at www.nonprofitpanel.org/supplement/Panel_Supplement_Final.pdf.

standards recommended by over fifty self-regulation schemes. In July 2006, the Committee issued an initial draft of its own set of principles that "reflected the practices advanced by many of those systems and the advice of experts in nonprofit law and governance."⁷⁸ Based on comments it received, the Committee issued a revised draft with thirty-one principles addressing legal compliance, public disclosure, governance, financial oversight, responsible fundraising, risk management and ethics. In promulgating these good governance principles, the Committee joined a well respected group of organizations that provides very useful information for nonprofits.⁷⁹

These governance principles and reports on practices among nonprofits, of which I have cited only a bare handful, raise some questions. It seems obvious that the more information which is disseminated, the more likely it is that organizations and their boards will be exposed to guidance and will adopt better practices. Clearly the hope is that greater emphasis on self-regulation will convince government regulators to rely on the sector's ability to regulate itself rather than to legislate further rules, which are probably unnecessary and for which there will continue to be inadequate resources devoted to enforcement. The Panel on the Nonprofit Sector's 2005 report to Congress suggesting proposed legislation is particularly interesting. Rather than merely lobbying against further regulation, one of the nonprofit sector's major players chose to ally itself with the government and propose rules which would improve the charitable sector and which the charitable sector could live by. This strategy may well have served to defuse Congressional

⁷⁸ "Draft Principles for Effective Practice" at http://www.nonprofitpanel.org/slefreg/all_principles_revised.pdf.

⁷⁹ See, e.g., Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study, The Urban Institute's Center on Nonprofits and Philanthropy, Francie Ostower, 2007.

ire and to bring some rational thought to the issues, but it did change the traditional role of entities like Independent Sector. It also may have left certain of Independent Sector's constituents without an advocate. The diversity of the nonprofit sector, particularly in terms of size and wealth, raises a real concern over Independent Sector or any other self-regulation entity acting as representative of all charities. Tiny, grass roots organizations are not in a position to wade through and adopt the Panel's thirty-one principles. While that diversity is acknowledged by the Panel, the principles nevertheless could become a standard which if not met could lead to a nonprofit being considered unworthy.⁸⁰

Disclosure

Disclosure is becoming the newest form of public oversight and enforcement and, given the internet, a revolutionary development that we are only beginning to comprehend. Faced with inadequate resources and a consequent inability to enforce the rules through audits, the IRS is increasingly looking to disclosure to promote not only compliance with the Internal Revenue Code, but it seems also adherence to the principles espoused by the self regulation organizations. Initially focusing on the areas where the IRS perceives the greatest abuses, the IRS redesigned Form 1023, the Application for Recognition of Exemption Under Section 501(c)(3), in 2004, to require greater disclosure

⁸⁰ Mark Sidel has an interesting article on self-regulation of nonprofits which compares self-regulation schemes for charities in India and the Philippines with efforts in the United States, and warns that we must be careful that the stricter, incentive-based (*i.e.* tax-exemption depends upon meeting standards) government allied accountability standards do not prevent smaller or more innovative groups from receiving the financial or regulatory benefits accorded to other nonprofits. We must ensure that stricter self-regulation does not narrow nonprofit autonomy and freedom. And we must be cautious that self-regulation supported and incentivized by government does not become, in effect, a forum of government 'naturalization' of nonprofit governance and management through an ostensible 'self-regulatory process." See Mark Sidel, "Symposium: Who Guards the Guardians?: Monitoring and Enforcement of Charity Governance: The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation?" 80 Chi.-Kent. L. Rev. 803 ("Sidel").

in connection with insider transactions, related entities, and international activities.⁸¹

Heightened interest in these activities is reflected in the newly redesigned Form 990 issued by the IRS.

The IRS's focus on executive compensation is highlighted by the fact that it is addressed in the report summary appearing on page one of the return. Elsewhere the proposed return asks about

- disqualified persons and others earning in excess of \$100,000 from the organization and related organizations, as well as deferred compensation;⁸²
- compensation paid by the organization and related organizations to disqualified persons and highly compensated employees, which is reported in a separate schedule;⁸³ and
- whether the organization followed procedures to establish the rebuttable presumption of reasonableness in setting compensation of the organization's top executives.⁸⁴

The new return also addresses receivables from and payables to disqualified persons.⁸⁵

And in an effort to promote practices that will prevent private benefit, excess benefit and inurement, attention additionally is given to governance practices.⁸⁶

Many of the changes to the Form 990 are welcome additions that will provide a more complete picture of certain practices, such as compensation and

⁸¹ See Form 1023 Parts II, V, VIII.

⁸² See new Form 990, Part VII and Schedule J.

⁸³ See new Form 990, Schedule J.

⁸⁴ See new Form 990, Part VI, Section B. The rebuttable presumption, with its acceptance of reliance on comparable compensation for comparable positions at similar organizations, both for-profit and nonprofit, arguably has served only to ratchet up compensation levels by sanctioning the use of these comparative surveys.

⁸⁵ See new Form 990, Schedule L.

⁸⁶ See IRS, TE/GE Division, Background Paper, Redesigned Draft Form 990, Part VI. In the event the organization does engage in an excess benefit transaction, greater disclosure must be made in the Form 990 with respect to the disqualified person, the transaction, and the amount involved, whereas in the current Form 990, the amount of tax owed under Code Section 4958 is combined with taxes under other provisions of the Code and disclosed in detail only in a separately filed Form 4720, which is not posted on the internet.

relationships with affiliated organizations. Concern, however, is raised by certain questions in the areas of governance, transparency and accountability that endorse the practices promoted by the self regulation organizations and imply to the public and perhaps the organization itself that these recommended practices have the force of law. For example, the new Form 990 asks questions about size and composition of the organization's board and in particular whether the board is composed of independent members.⁸⁷ The return furthermore asks whether the organization has adopted conflicts, whistleblower and document retention policies, and whether it has established an audit committee, and makes its governance, financial and tax documents accessible.⁸⁸ The IRS additionally seems to be suggesting that following procedures for establishing a rebuttable presumption of reasonableness when approving executive compensation is now a required legal standard.⁸⁹

The thrust of the new form's carefully crafted emphasis on governance, relationships and compensation seems to reflect the IRS's view of itself as the agency best positioned to promote accountability to all interested parties and the primary importance of the Form 990.⁹⁰ Because of the power of the internet, these new disclosures to the IRS will be public property in no time at all. The consensus seems to be that the redesigned Form 990 is salutary because it informs donors and allows the public at large to review how charities spend their funds and compensate their executives and major independent

⁸⁷ See new Form 990, Part VI.

⁸⁸ See new Form 990, Part VI.

⁸⁹ See new Form 990, Part VI, Section B.

⁹⁰ See IR-2007-117 (June 14, 2007); IRS, TE/GE Division, Background Paper, Redesignated Draft Form 990 at 1. In the process of designing the new Form 990, the IRS backed off disclosures of compensation percentages, fundraising percentages, and other metrics on the summary page. See Fred Stokeld, "Questions on Compensation, Fundraising Percentages to Be Dropped From Draft 990 Summary Page," 2007 TNT 190-11.

contractors. The thinking therefore is that increased transparency will lead not only to more information but also promote better practices if only to avoid potentially embarrassing disclosures. Encouraging compliance in this way will partially take the place of enforcement by the IRS and state attorneys general and thereby compensate for inadequate resources.

While this may seem like a feasible tactic in light of inadequate resources, the IRS should be wary of promoting standards of judgment not rooted in the Code or Treasury Regulations. The new return, for example, seems to imply that there may be internal problems within an organization if it does not have an audit committee or if it considers a large number of transactions pursuant to its conflicts of interest policy, particularly since the new Form 990 does not offer an opportunity to state how many of those transactions were actually entered into or explain how those transactions might have been beneficial to the organization (*e.g.*, the organization benefited from a discount).⁹¹ It is worrisome to consider the impact the new 990's non-tax questions might have in shaping public perception and judgment.

Standards of Accountability and Practice – The Challenges Ahead

This paper began by discussing the various parties having a stake in compliance and accountability of the nonprofit community– the IRS, state attorneys general on behalf of donors and beneficiaries, and the public. Many of these interests are addressed by federal and state law, but due to inadequate funds and staffing devoted to nonprofit compliance, the IRS cannot effectively review activities of individual nonprofits through audits, and state attorneys general likewise are unable to pursue sufficiently the

⁹¹ See new Form 990, Part VI.

interests of beneficiaries and donors. As a result of these regulatory shortcomings and in response to the new culture of corporate accountability and transparency, self regulation has taken a leading role in promulgating new standards. Many of the recommended practices have been endorsed by the IRS, as is demonstrated by the "Good Governance Practices for 501(c)(3) Organizations," the revised Form 1023, and the new Form 990.

It is too soon to tell what the net effect of self regulation and heightened disclosures will be. One good result so far has been that nonprofit organizations are expected to meet higher standards of accountability and transparency with respect to their programs, fundraising and administration. Another positive outcome is that ethical standards also have been raised, particularly when dealing with conflicts of interests, whistleblower situations and employee conduct.

It has been noted that most prior attempts to reform the nonprofit sector through best practices and codes of conduct have raised standards but have not succeeded at reducing abuses.⁹² Current efforts at self regulation, which have been reinforced by the IRS's call for greater disclosure, could similarly result in higher standards but not necessarily compliance. One concern is that organizations will simply adopt model policies drafted by the IRS or a self regulation organization without adapting the policy to the organization's particular needs and capacity for compliance. For example, the Form 1023 asks whether the organization has adopted a conflicts of interest policy. While the instructions are clear that a conflicts policy is not required, it may be much easier for a new organization to adopt the IRS's model than it is to explain why it does not have a policy and describe its procedures for addressing conflict transactions. The IRS model

⁹² See Sidel at 834.

policy, however, may not be appropriate for all nonprofits. For similar reasons, it is important that the "seal of approval" bodies clearly articulate the objectives and requirements of the policies necessary for certification. Where such requirements are ill-defined or ambiguous, member organizations or applicants sometimes become more concerned about what will satisfy the review board than what procedures will be helpful or appropriate to a particular organization.

Adopting a conflicts, whistleblower or document retention policy in order to answer questions in the Form 1023 and Form 990 in a favorable light will not in itself promote greater accountability. Rather, these policies are intended to influence the behavior and decision-making processes of the organization and must be adhered to. Furthermore, an organization that does not follow its own policies will likely be subject to greater exposure than if it had not adopted the policies in the first instance. The new best practices standard therefore is less likely to succeed at promoting greater compliance across the sector if boards and staff do not actively participate in the development of meaningful policies addressing the realities of their respective organizations.

The level of effort, review and sophistication required to adhere in spirit to the practices recommended by the self regulation organizations will be difficult, if not impossible, for many perfectly responsible and effective organizations. Many of these standards will not be feasible for small organizations lacking adequate resources since they are too leanly staffed to make them a priority. A major concern then is not just that many of these good governance practices may be too aspirational, but that they may become considered norms.

This brings us back to transparency, disclosure and the power of the internet. There is some concern that disclosures in the areas of governance, accountability and transparency in the redesigned Form 990 could elevate the self regulations recommendations to new legal standards if a negative answer becomes a basis for audit. These disclosures furthermore will be not just a useful tool for the IRS and state attorneys general. They also will be available to the general public via the internet, and perhaps more importantly to the media, which may misinterpret the actions (or inaction) of smaller, less sophisticated, but perfectly compliant organizations that have not followed the practices suggested by the IRS and self regulation entities. Stories about organizations that operate smoothly, responsibly and effectively do not generally sell papers or draw viewers to the nightly news. Large numbers of charities that are not complying with what a reporter erroneously considers to be a legal requirement makes for a far more interesting story. A big challenge for the charitable sector going forward, and particularly for those interested in good governance and self regulation, is how to educate not only boards of directors, but also the general public and, in particular, the media, so that reporters understand the import or relative insignificance of information disclosed in the annual information return. With transparency and accountability in the charitable sector, as in most areas, so too arises the need for educated users of the information which is revealed, and that is an area with which the charitable sector has not yet really grappled.