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## **Policing the Good Guys: Regulation of the Charitable Sector through a Federal Charity Oversight Board**

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# POLICING THE GOOD GUYS: REGULATION OF THE CHARITABLE SECTOR THROUGH A FEDERAL CHARITY OVERSIGHT BOARD

*Terri Lynn Helge\**

*Recently, public confidence in the charitable sector has eroded due to a barrage of media reports on scandals and abuses. The principal parties charged with regulation of the charitable sector, the Internal Revenue Service and state attorneys general, are saddled with bureaucratic constraints that make it difficult to enforce the laws governing the fiduciary responsibilities of charity managers. Substantial reform in the regulation of charitable organizations is necessary to curb the reported abuses that have undermined confidence in the charitable sector.*

*Some advocate expanding private regulation of the charitable sector to improve enforcement of the fiduciary responsibilities of charitable managers. While some of these private regulatory alternatives have had success in isolated situations, none are satisfactory in providing comprehensive and effective oversight of the charitable sector. Overall, the policies underlying oversight of charitable organizations support maintaining primary responsibility for their regulation in a centralized authority. However, the financial, political, institutional, and agency constraints imposed on the Internal Revenue Service and state attorneys general make them unlikely to implement enough internal reform to be an ongoing, effective enforcement presence in the charitable sector.*

*This Article advocates the creation of a new, federal, quasi-public agency that would be the principal regulator of the charitable sector. The new agency would be a self-funded, independent, and proactive regulator that would serve the dual purposes of curbing the abuses that have eroded public confidence in the sector and educating charity managers of their obligation to be responsible stewards of charitable resources. The proposed agency would be primarily responsible for enforcing federal tax laws aimed at influencing fiduciary behavior of charity managers and preserving charitable assets for public benefit. Its formation,*

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\* Associate Professor of Law, Texas Wesleyan University School of Law. The author is very grateful for the helpful comments and suggestions from participants in the Charity and Nonprofit Organizations Session of the 2009 Annual Meeting of the Law and Society Association, including Cliff Fleming, Evelyn Lewis, and Richard Schmalbeck, and participants in the Texas Wesleyan University School of Law faculty colloquium. The author is also grateful to Texas Wesleyan University School of Law for its support of this Article through the provision of a summer research grant.

*therefore, would separate oversight of charity governance from the tax collection function, thus harmonizing the United States with other countries that have established independent charity oversight agencies.*

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INTRODUCTION

*“We have the wrong paradigm. We think of ourselves as the angelic sector; we can do no wrong.”<sup>1</sup>*

The importance of the charitable sector for our collective economic and societal well-being cannot be overstated.<sup>2</sup> The charitable sector employs more of the American workforce than the auto and financial industries combined,<sup>3</sup> and collectively accounts for over \$2 trillion in wealth.<sup>4</sup> In addition, the charitable sector provides vital services that private for-profit organizations, and the government, are unable or unwilling to provide. A recent commentary on the financial plight of the charitable sector noted that “[i]f the [American] nonprofit sector were a country, it would have the seventh largest economy in the world. We cannot afford for it to go the way of Iceland, whose financial system collapsed.”<sup>5</sup>

Yet, government officials pay relatively little attention to the regulation of the individuals responsible for managing charitable organizations. As a result, there has been an increase in the reports of abuses in the charitable sector.<sup>6</sup> These reports are not limited to local or unknown

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<sup>1</sup> Debra E. Blum, *Bequests, Celebrities, Foundation, and the Economy: a Conference Notebook From National Research Meeting*, CHRONICLE OF PHILANTHROPY, NOV. 23, 2008, <http://philanthropy.com/news/updates/index/php?id=6368> (quoting David Horton Smith, founder of the Association for Research on Nonprofit Organizations and Voluntary Action).

<sup>2</sup> Cf. Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 MICH. L. REV. 1312, 1313 (2002) (book review) [hereinafter Sidel, *New State Activism*] (stating that the charitable sector is “‘integral to the national economy and a valued part of [our] social fabric . . . [It] embodies the philanthropic goodness, conviviality, cultural excitement, and democratic spirit of the American people . . . [and] has provided a valued social location in which groups can operate without pecuniary obsessions and with measures of success that are not necessarily related to financial profitability.’” (quoting NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR 2 (2001))).

<sup>3</sup> BRUCE REED ET AL., QUIET CRISIS: THE IMPACT OF THE ECONOMIC DOWNTURN ON THE NONPROFIT SECTOR 3 (2009), [www.civicenterprises.net/pdfs/quietcrisis.pdf](http://www.civicenterprises.net/pdfs/quietcrisis.pdf).

<sup>4</sup> Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective*, STATISTICS OF INCOME BULLETIN 110 (Winter 2008), <http://www.irs.gov/pub/irs-soi/tehistory.pdf>; Molly F. Sherlock & Jane G. Gravelle, *An Overview of the Nonprofit and Charitable Sector*, Congressional Research Service Report No. R40919 (Nov. 18, 2009), at 11.

<sup>5</sup> REED, *supra* note 3, at 3.

<sup>6</sup> The lack of effective enforcement of applicable laws in the charitable sector creates an environment ripe for abuse. See, e.g., MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 471 (2004) [hereinafter FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS] (“[F]iduciaries bent on reaping private benefit or careless in their management will not alter their behavior if they believe

charitable organizations, but have also exposed large national organizations such as the United Way,<sup>7</sup> the Smithsonian Institute,<sup>8</sup> and the American Red Cross.<sup>9</sup> The types of reported abuses range from criminal embezzlement and fraud to civil wrongdoings such as breach of fiduciary duty, failure to carry out the mission of the organization, and negligent mismanagement of assets.<sup>10</sup> Since 1995, the reported abuses have resulted in the depletion of over \$1.2 billion in charitable funds.<sup>11</sup> Of this

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government is not carrying out its regulatory function.”); *id.* at 11 (“Some of [the] organizations were formed by individuals who intended to and did use them for private benefit, resulting in diversion of substantial sums.”). *But see* James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 *FORDHAM L. REV.* 567, 572–74 (2008) [hereinafter Fishman, *Wrong Way Corrigan*] (alleging that the increased sense of fraud and abuse in the charitable sector may be the result of increased transparency in an electronic age as opposed to actual increase in incidents of wrongdoing).

<sup>7</sup> See *United States v. Aramony*, 88 F.3d 1369, 1373–76 (4th Cir. 1996) (noting that the former head of the United Way was fired in 1992 and later convicted of fraud for using over \$600,000 of United Way’s funds to finance a lavish lifestyle for himself and his companion); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 *J. CORP. L.* 631, 633–35 (1998) (describing in detail the United Way controversy).

<sup>8</sup> See Jacqueline Trescott & James V. Grimaldi, *Smithsonian’s Small Quits in Wake of Inquiry*, *WASH. POST*, Mar. 27, 2007, at A1 (chronicling excessive salary, large expense allowances, and lavish trips on the Smithsonian’s dime for its former chief officer).

<sup>9</sup> See Johnny Rex Buckles, *When Charitable Gifts Soar Above Twin Towers: A Federal Income Tax Solution to the Problem of Publicly Solicited Surplus Donations Raised for a Designated Charitable Purpose*, 71 *FORDHAM L. REV.* 1827, 1828 (2003) (noting that the American Red Cross faced a public outcry when it attempted to redirect “surplus” contributions for the aid of victims of the terrorist attacks of September 11, 2001, to a fund to relieve victims of future terrorist attacks); Stephanie Strom, *Senators Press Red Cross for a Full Accounting*, *N.Y. TIMES*, Dec. 30, 2005, at A17 (describing congressional inquiry into American Red Cross governance practices after widespread public criticism of the agency’s slow response in providing aid to Hurricane Katrina victims).

<sup>10</sup> See generally Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoings by Officers and Directors of Charities: A Survey of Press Reports 1995–2002*, 42 *EXEMPT ORG. TAX REV.* 25, 25 (2003) [hereinafter Fremont-Smith Study] (summarizing press accounts from 1995–2002 of alleged criminal and civil wrongdoings by charity managers who have primary fiduciary responsibility to their respective charitable organizations). This study chronicled 152 reported incidents of wrongdoing by charity fiduciaries in the charitable sector, noting that 104 involved criminal activity and 54 involved civil wrongdoing. See *id.* at 25. All but two of the criminal cases involved stealing money from the charity or diverting charitable funds for their personal benefit. See *id.* at 28. Additionally, the study reported on how the prohibited activity initially came to light, accounting for approximately half of the incidents of wrongdoing. See *id.* at 29, 31. None of these cases came to light as a result of investigation by state attorneys general or audit by the IRS. Rather, insiders or investigative journalists were the first to uncover a substantial majority of these incidents. See *id.* at 31. Other incidents of prohibited activity were uncovered by other government agencies conducting audits of the organization for their own purposes. See *id.*

<sup>11</sup> The total amount involved was reported at \$1,279,039,532, with \$106,202,000 attributed to civil wrongdoings, which represented the amount recovered from civil wrongdoings. See Fremont-Smith Study, *supra* note 10, at 27–31. The total amount of depletion in charitable assets attributed to civil wrongdoings could not be determined. See *id.* Approximately \$1.1 billion of the depletion in charitable assets is attributed to four Ponzi-type schemes

amount, only half has been recovered through enforcement actions.<sup>12</sup> Sensationalized media reports of wrongdoings in the charitable sector create the impression that the abuses are pervasive.<sup>13</sup> Moreover, when a popular charitable leader commits misconduct, “the shockwave can topple the charity and ripple throughout the [charitable] sector.”<sup>14</sup> The extent of the wrongdoing is difficult to determine, in part because there is little policing of charitable activities nationwide.<sup>15</sup>

In response to the reported abuses in the charitable sector, the Senate Finance Committee sought to reform the federal tax laws applicable

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targeted at the charitable sector during this time period—Foundation for New Era Philanthropy, Baptist Foundation of Arizona, Greater Ministries International, and Mid-America Foundation. *Id.* at 25–26, 28. A report in the *Chronicle of Philanthropy* asserts that the Fremont-Smith Study significantly underestimates the scope of abuses in the charitable sector. See Brad Wolverton, *Study: Charity Fraud Exceeds \$1 Billion*, *CHRON. OF PHILANTHROPY*, Nov. 27, 2003, at 26.

<sup>12</sup> Fremont-Smith Study, *supra* note 10, at 27–29.

<sup>13</sup> See Goldschmid, *supra* note 7, at 633 (asserting that reports of self-dealing and duty of loyalty violations undermine the trust and goodwill necessary for the charitable sector to thrive); Joel Fleishman, *Accountability: To Whom and For What Purposes*, Address at the Waldemar A. Nielsen Issues in Philanthropy Seminar Series, Georgetown University (Oct. 4, 2002), available at [http://cpnl.georgetown.edu/doc\\_pool/Nielsen0202Fleishman.pdf](http://cpnl.georgetown.edu/doc_pool/Nielsen0202Fleishman.pdf). Professor Fleishman warns:

Let me also make clear that no one I know believes that nonprofit malfeasance is widespread. It clearly is not! But every time there is a high profile instance of fraud or serious mismanagement, the fragile tissue of public trust in nonprofits frays a bit, and remember that it is that public trust in nonprofits on which the generous tax benefits enacted by Congress and State legislatures ultimately rest. Let the public trust erode substantially, and it will not be long before some lawmakers, whipped up by the investigative journalists, begin to wage a crusade to slap the nonprofit sector with punitive fines or perhaps even a heavy-handed accountability-enforcement mechanism.

Make no mistake about it. The tissue of public trust is not only fraying, but it is beginning to tear a bit. According to Independent Sector’s most recent poll, only 64% of Americans believe nonprofit organizations act honestly and ethically in using funds donated by others. That leaves 36% of Americans who believe differently, and remember that the essence of the charitable nonprofits is altruism—benefiting others, so more than a third of Americans doubt the bona fides of the nonprofit sector.

*Id.* at 2. In addition, recent Senate Finance Committee hearings on federal regulation of the charitable sector, state reform initiatives, and attempts at private enforcement of the charitable sector suggest considerable wrongdoing in the sector. See Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information Be Utilized Effectively?*, 40 *NEW ENG. L. REV.* 447, 453–55 (2006) [hereinafter Chester, *Improving Enforcement Mechanisms*].

<sup>14</sup> Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Non-profit and For-Profit Organizational Forms*, 40 *N.Y. SCH. L. REV.* 457, 467–68 (1996) [hereinafter Brody, *Agents Without Principals*]; see also Fremont-Smith Study, *supra* note 10, at 25 (discussing the effects of charitable misconduct).

<sup>15</sup> See Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important Is It and How Extensive Should It Be?*, 37 *REAL. PROP. PROB. TR. J.* 611, 628 (2002) [hereinafter Chester, *Grantor Standing*].

to charitable organizations. In June 2004, the staff of the Senate Finance Committee issued a bipartisan white paper proposing legislative action to reform the charitable sector.<sup>16</sup> Subsequently, the Senate Finance Committee held hearings<sup>17</sup> and solicited input from the Independent Sector, a coalition of various nonprofit groups, regarding the reform needed in the charitable sector.<sup>18</sup> The Independent Sector's Panel on the Nonprofit Sector issued a final report of its recommendations for reform in June 2005.<sup>19</sup>

The Senate Finance Committee debated several proposed reforms for the charitable sector, and this debate culminated in the enactment of the Pension Protection Act of 2006 on August 17, 2006.<sup>20</sup> The Pension Protection Act, however, falls short of actually reforming the charitable sector as a whole because it merely imposes more stringent requirements on a targeted subset of the charitable sector.<sup>21</sup> In effect, the Pension Protection Act compounds the complexity of the existing set of rules that govern charitable organizations. Since most charitable organizations are managed by uncompensated volunteers,<sup>22</sup> many of whom are unfamiliar with the complexities of the federal tax laws governing charitable organi-

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<sup>16</sup> See Staff of the Senate Finance Committee, *Tax Exempt Governance Proposals: Staff Discussion Draft* (June 2004), available at <http://finance.senate.gov/sitepages/2004HearingF.htm/hearings2004.htm> (last visited Nov. 7, 2009).

<sup>17</sup> See, e.g., *Charity Oversight and Reform: Keeping Bad Things from Happening to Good People*, Hearing before the Sen. Comm. On Finance, 108th Cong. (June 22, 2004), available at <http://finance.senate.gov/sitepages/hearing062204.htm>.

<sup>18</sup> See Letter from Senator Charles E. Grassley and Senator Max Baucus to Dana Aviv, President of the Independent Sector, dated Sept. 22, 2004 (reprinted in PANEL ON THE NON-PROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 110 (2005), [http://www.nonprofitpanel.org/Report/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf)).

<sup>19</sup> See PANEL ON THE NONPROFIT SECTOR, *supra* note 18.

<sup>20</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in scattered sections of 26 and 29 U.S.C.).

<sup>21</sup> See Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 *FORDHAM L. REV.* 765, 777-78 (2008) (noting that the Pension Protection Act provisions prohibiting loans to insiders of charitable organizations were unnecessary and ineffective); Fishman, *Wrong Way Corrigan*, *supra* note 6, at 587-89; Terry W. Knoepfle, *The Pension Protection Act of 2006: A Misguided Attack on Donor-Advised Funds and Supporting Organizations*, 9 *FLA. TAX REV.* 221, 223, 256-63 (2009) (arguing that the new restrictions imposed on donor advised funds and supporting organizations are unnecessary because the reports of abuses that prompted the new restrictions could have been adequately addressed through enforcement of prior law).

<sup>22</sup> Katherine O'Regan and Sharon M. Oster, *Does The Structure and Composition of The Board Matter?: The Case of Non-Profit Organizations*, 21 *J.L. ECON. & ORG.* 205, 215 (2005). Typically, charitable directors spend less time than their for-profit counterparts in performing their directorial duties. See *id.* at 212, which states:

In this sample, the mean percentage of board meetings attended [by nonprofit directors] was 71%; this is low relative to the corporate setting in which any director of a public company who attends less than 75% of board meetings must be reported in the annual report to shareholders. Similarly, the estimate by board members of an average 42 hours per year spent on board activity is low relative to a recent survey

zations,<sup>23</sup> these new rules will serve as a trap for the unwary. This in turn will increase the risk of noncompliance by charitable organizations.

While reform of the federal tax laws governing charitable organizations may be necessary, first, the systemic problem of lack of regulatory oversight of the charitable sector needs to be fixed.<sup>24</sup> By all accounts, oversight of the charitable sector as a whole is minimal; regulation by state officials is nonexistent in a majority of jurisdictions, and regulation by the IRS is cursory at best.<sup>25</sup> The barrage of media reports on scandals and abuses in the charitable sector, combined with the perception of lax regulation, has eroded public confidence in the charitable sector.<sup>26</sup> Public confidence in the sector's integrity is essential to its survival since it

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suggesting that outside corporate directors spend an average of 157 hours per year on board matters.

<sup>23</sup> Cf. James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 396 (1986) [hereinafter Fishman, *Standards of Conduct*] (observing that nonprofit board members typically are selected based on a variety of reasons having very little to do with their responsibilities as directors, such as their ability to fundraise, their social or political connections, and their notoriety).

<sup>24</sup> Cf. Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559, 584 (2005) (emphasizing that charity managers who knowingly breach their fiduciary duties are unlikely to improve their behaviors due to increased sanction if "the likelihood of detection of [the] abuse and enforcement of [the] fiduciary duty is (or is perceived to be) quite low.").

<sup>25</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 2; Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L. J. 937, 939 (2004) [hereinafter Brody, *Parochialism*] (observing that "as a practical matter, few state attorneys general have the funding and inclination to engage in aggressive charity enforcement"); Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 452 (noting the "increasingly obvious . . . need for better policing methods for charities" given the ineffectiveness of the state attorneys general); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 623 (1999) (surmising that "[t]he worst abuses receive attention, but many problems probably go undetected or unaddressed"); Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 601 (1981) (observing that "in most states there has been little effort to exercise even the substantial powers that the attorney general already has"); Reiser, *supra* note 24, at 598–606 (noting the "significant resource and structural issues unique to the nonprofit context" that make enforcement difficult); Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, 25 EXEMPT ORG. TAX REV. 413, 413 (1999) (stating that the state attorneys general "tend to allocate their scarce regulatory resources to other more politically potent portions of their domains" (internal quotations omitted)); accord Fremont-Smith Study, *supra* note 10, at 33 (after surveying press accounts of wrongdoings in the charitable sector over a seven-year time period with noticeably minimal roles played by the state attorneys general and IRS in the enforcement actions, the authors concluded: "Given the apparent rate of success of the prosecutors, it is likely that enhanced enforcement programs would increase the amount of funds recovered and could well have a positive deterrent effect.").

<sup>26</sup> See Paul C. Light, *How Americans View Charities: A Report on Charitable Confidence*, 2008, The Brookings Institution Issues in Governance Studies 1, April 2008, [http://www.brookings.edu/~media/Files/rc/papers/2008/04\\_nonprofits\\_light/04\\_nonprofits\\_light.pdf](http://www.brookings.edu/~media/Files/rc/papers/2008/04_nonprofits_light/04_nonprofits_light.pdf) (noting that public confidence in charities remains at contemporary lows due at least in part to the media reports of charitable scandals).



relies heavily on gratuitous contributions of cash, property, and services.<sup>27</sup> Substantial reform in the regulation of charitable organizations is thus necessary to curb the reported abuses that have undermined public confidence in the charitable sector.

To restore public confidence in the charitable sector, there must be responsible oversight of the sector,<sup>28</sup> that is, vigorous enforcement of the federal tax laws applicable to charitable organizations that govern fiduciary behavior. Currently, the principal parties responsible for regulating the charitable sector, the Internal Revenue Service and the state attorneys general, are saddled with bureaucratic constraints that make it difficult to enforce the laws governing the fiduciary responsibilities of charity managers. The inherent financial, institutional, political, and agency constraints imposed on these governmental agencies make them unlikely to implement enough internal reform to constitute an ongoing, effective enforcement presence in the charitable sector.

Therefore, to enhance effective and efficient oversight of the charitable sector, it is necessary to establish a new organization that will enforce the federal tax laws applicable to charitable organizations. Specifically, this Article proposes the creation of a federal quasi-public agency to serve as the principal regulator of the charitable sector. The agency would be self-funded, independent, and proactive. It would serve the dual purposes of curbing the abuses that have eroded public confidence in the sector and educating charitable managers of their obligations to be responsible stewards of charitable resources. The proposed agency would be primarily responsible for enforcing federal tax laws aimed at influencing fiduciary behavior of charity managers and preserving charitable assets for public benefit. Its formation, therefore, would separate oversight of charity governance from the tax collection function, thus harmonizing the United States with other countries that have established independent charity oversight agencies.

Part I.A of this Article develops the historical and policy reasons for vesting the regulation of the charitable sector almost exclusively in governmental agencies such as the IRS and the state attorneys general. Part I.B discusses the modern limitations on these governmental agencies' abilities to effectively regulate the charitable sector. Part II of this Article discusses the alternative forms of private regulation of the charitable sector that have been explored in practice and in scholarship. While some of these private enforcement alternatives have had success in isolated situations, none are satisfactory in providing comprehensive and

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<sup>27</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 472 ("The nonprofit sector exists and thrives because the public believes in its integrity.").

<sup>28</sup> See Gary, *supra* note 25, at 595 (arguing that restoration of public confidence requires adequate enforcement of fiduciary duties of charity managers).

effective oversight of the charitable sector. Overall, the policies underlying oversight of charitable organizations support maintaining centralized regulation of the charitable sector.

Part III.A of this Article constructs alternative quasi-public regulatory models by analogy to existing administrative processes in other fields, and evaluates their effectiveness in regulating their targeted areas. The formation of an alternative federal quasi-public regulatory body would successfully address the limitations on pure governmental regulation of the charitable sector. Accordingly, Part III.B develops the critical aspects of the proposed quasi-public regulatory body that would be responsible for regulating the federal tax laws governing charitable organizations.

### I. HISTORICAL AND POLICY REASONS FOR VESTING REGULATION OF THE CHARITABLE SECTOR IN GOVERNMENTAL AGENCIES

To understand the issues surrounding the oversight of the charitable sector, it is necessary to first describe the fiduciary standards applicable to charity managers. These fiduciary standards are the duty of care, the duty of loyalty, and the duty of obedience.<sup>29</sup> These standards vary somewhat depending on whether the charity is formed as a nonprofit corporation or a trust.<sup>30</sup> The nonprofit corporation is the predominant form of charitable organization in the United States.<sup>31</sup> Accordingly, this Article will focus primarily on the fiduciary duties owed by directors and officers to a nonprofit corporation.

The duty of care requires a charity director to discharge his responsibilities in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes is in the best interests of the organi-

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<sup>29</sup> See Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1424–75 (1998) [hereinafter Brody, *Limits*]. Some commentators argue that the duty of obedience is not a separate duty but rather an aspect of the duty of care. See, e.g., FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 225–26; Brody, *Limits*, *supra*, at 1475. Others argue for the necessity of a separately articulated duty of obedience. See, e.g., Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. LAW 43 (2008); Melanie DiPietro, *Duty of Obedience: A Medieval Explanation for Modern Nonprofit Governance Accountability*, 46 DUQ. L. REV. 99, 102 (2007); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transferring Obedience into Fidelity*, 76 FORDHAM L. REV. 894, 918–27 (2007). For purposes of discussion, the duty of obedience will be treated as distinct from the duty of care.

<sup>30</sup> See generally Brody, *Limits*, *supra* note 29, at 1415–29 (discussing the differences between trust and corporate forms of charitable organizations, and noting that although the trust standards of fiduciary duty are generally stricter than the corporate standards, the modern trend is towards convergence).

<sup>31</sup> See Evelyn Brody, *Charity Governance: What's Trust Law Got to Do with It?*, 80 CHI.-KENT L. REV. 641, 641 n.1 (2005) [hereinafter Brody, *Charity Governance*].

zation.<sup>32</sup> Likewise, the degree of skill required is that of the ordinary prudent person, that is, the basic directorial attributes of common sense, practical wisdom, and informed judgment.<sup>33</sup> The duty of care also presupposes that a director is acting without a disabling conflict of interest.<sup>34</sup> If a director faithfully discharges the duty of care, the director is not liable for harm to the charity resulting from the director's decisions.<sup>35</sup>

A director can fail to discharge the duty of care in two ways: by failing to supervise or by failing to make an informed decision.<sup>36</sup> Adequate supervision means that the director actively participates in the charity's governance, such as by regularly attending board meetings,<sup>37</sup> reviewing minutes and other materials disseminated to board members,<sup>38</sup> meeting periodically with senior management,<sup>39</sup> periodically reviewing the charity's financial statements and annual information returns (IRS Form 990),<sup>40</sup> and asking questions of outside experts such as accountants and attorneys when appropriate.<sup>41</sup> Thus, a director who sits back and does nothing cannot claim lack of responsibility for a poor decision made by co-directors.<sup>42</sup> To make an informed decision, a director must be adequately informed about the material aspects of a proposed transaction before approving it.<sup>43</sup>

The duty of care thus relates to the decision-making *process*.<sup>44</sup> If a director acts in good faith and satisfies the requisite standard of care, a court generally will not review the action, even if it proves disastrous to the charity.<sup>45</sup> Thus, compliance with the duty of care protects a director

<sup>32</sup> See REVISED MODEL NONPROFIT CORP. ACT § 8.30 (3d ed. 2008); Fishman, *Standards of Conduct*, *supra* note 23, at 399.

<sup>33</sup> See Brody, *Limits*, *supra* note 29, at 1423–29.

<sup>34</sup> See *Stern v. Lucy Webb Hayes Nat. Train. Sch. for Deacon. & M.*, 381 F. Supp. 1003, 1014 (D.D.C. 1974); Brody, *Limits*, *supra* note 29, at 1423–29.

<sup>35</sup> The main difference between the trust standard of care and the corporate standard of care is that in the former a trustee may be liable for breaches resulting from mere negligence while the latter requires a minimum of gross negligence. See Brody, *Limits*, *supra* note 29, at 1421–28; Fishman, *Standards of Conduct*, *supra* note 23, at 402; *cf.* Gallick v. Balt. & Ohio R.R. Co., 372 U.S. 108, 119 n.6 (1963) (“[I]t is said that negligence is the failure to observe ordinary care, and ordinary care is that degree of care which people of ordinary prudence and sagacity use under the same or similar circumstances. What would ordinarily prudent persons have done under like circumstances?”) (quoting, with approval, jury instructions from trial court).

<sup>36</sup> See Fishman, *Standards of Conduct*, *supra* note 23, at 391–92.

<sup>37</sup> See *id.* at 399–400.

<sup>38</sup> See *id.*

<sup>39</sup> See *id.*

<sup>40</sup> See *id.*; see also FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 316.

<sup>41</sup> See REVISED MODEL NONPROFIT CORP. ACT § 8.30(f)(2) (3d ed. 2008).

<sup>42</sup> See Brody, *Limits*, *supra* note 29, at 1458.

<sup>43</sup> See Fishman, *Standards of Conduct*, *supra* note 23, at 400–01.

<sup>44</sup> Sugin, *supra* note 29, at 913.

<sup>45</sup> See Brody, *Limits*, *supra* note 29, at 1443–44; Sugin, *supra* note 29, at 915.

from liability for decisions that, with the benefit of hindsight, turn out to be wrong.<sup>46</sup> Often, a charity manager's wrongdoing that results in the loss of charitable assets is not solely attributable to a breach of the duty of care.<sup>47</sup> Such a breach, however, results in inadequate board governance, which in turn creates an environment that makes embezzlement, misappropriation of charitable funds, and self-dealing possible.<sup>48</sup>

The duty of loyalty requires the charity director to place the interests of the organization ahead of his own personal interests.<sup>49</sup> In the corporate setting, a conflict-of-interest transaction is not flatly prohibited,<sup>50</sup> but should be carefully scrutinized.<sup>51</sup> Before engaging in a conflict-of-interest transaction with a charitable organization, the director should disclose all material facts relating to his personal interest in the transaction to the board of directors, and a majority of disinterested directors should approve the transaction only after concluding that it is fair and reasonable to the charity.<sup>52</sup>

The duty of obedience requires a director to adhere to the governing documents of the organization and to faithfully adhere to its mission.<sup>53</sup> As explained by Daniel Kurtz: "A director is charged with carrying out the purposes of the organization, as expressed in the legal documents creating and defining its mission . . . . [D]iversification of charitable resources to other goals, no matter how laudable, [is] not legally justifiable."<sup>54</sup>

## A. *Rationales for Exclusive Government Enforcement of the Charitable Sector*

### 1. State Attorneys General

Historically, regulation of the charitable sector has been vested almost exclusively in government agencies.<sup>55</sup> Government enforcement of

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<sup>46</sup> See Fishman, *Standards of Conduct*, *supra* note 23, at 399.

<sup>47</sup> See *id.* at 395.

<sup>48</sup> See Brody, *Limits*, *supra* note 29, at 1441.

<sup>49</sup> Fishman, *Standards of Conduct*, *supra* note 23, at 423.

<sup>50</sup> Under the trust standard of the duty of loyalty, the charitable trustee is prohibited from engaging in any act of self-dealing with the trust, no matter how fair or reasonable the transaction may be to the charity. See Brody, *Limits*, *supra* note 29, at 1419–20; Fishman, *Standards of Conduct*, *supra* note 23, at 432–34.

<sup>51</sup> See *Stern v. Lucy Webb Hayes Nat. Train. Sch. for Deacon. & M.*, 381 F. Supp. 1003, 1014 (D.D.C. 1974).

<sup>52</sup> See REV. MODEL NONPROFIT CORP. ACT § 8.60 (3d ed. 2008); Fishman, *Standards of Conduct*, *supra* note 23, at 423.

<sup>53</sup> BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 135–36 (9th ed. 2007).

<sup>54</sup> DANIEL L. KURTZ, *BOARD LIABILITY: A GUIDE FOR NONPROFIT DIRECTORS* 85 (1988).

<sup>55</sup> For a historical account of the regulation of the charitable sector in England and the United States, see David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 U.

charities is rooted in the English common law power of *parens patriae*, which imposes on the representative of the sovereign the exclusive duty to enforce charitable trusts.<sup>56</sup> This principle was adopted in the United States with respect to charitable trusts and corporations,<sup>57</sup> and the power to regulate charitable organizations is vested in the state attorneys general.<sup>58</sup> Over the past century, the attorney general's role as the "exclusive party" responsible for regulating the sector has eroded to that of

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FLA. J. L. & PUB. POL'Y 131 (2000). Mr. Patton, then-Assistant Attorney General, Office of the Ohio Attorney General, observed:

When courts and commentators consider charitable enforcement reform, common law traditions and exclusivity of attorney general enforcement stand as obstacles to hinder innovation and experimentation . . . . When history is examined, however, it is apparent that the law of charitable enforcement has been fluid and malleable in responding to the needs and vagaries of society over time. In short, the traditional common law role of the attorney general is not so fixed and formidable as to preclude charitable enforcement reform.

*Id.* at 132.

<sup>56</sup> The attorney general enforces charitable trusts because of the trust's benefits to the general public. Such an "amorphous mass of individuals" could not enforce a charitable trust in the manner that a "beneficiary of a private trust motivated by natural self interest" would. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 301. Accordingly, the power to enforce charitable trusts was vested in the Crown, as *parens patriae*, or father of his country. *Id.* The attorney general, as the Crown's representative, had the power to supervise the actions of charitable trustees, and to bring action for any breach of trust by a charity manager in a court of equity. This enforcement power of the attorney general extended to all assets held for charitable purposes, regardless of the legal form—corporation, trust, or association—in which such assets were held. *Id.*

<sup>57</sup> See Mary Grace Blasko, Curt S. Crossley, and David Lloyd, *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 40–41 (1993) ("[T]he state, as *parens patriae*, superintends the management of all public charities and trusts, and in these matters acts through her attorney general." (quoting *People ex rel. Ellert v. Cogswell*, 45 P. 270, 271 (Cal. 1896))); Brody, *Parochialism*, *supra* note 25, at 938 (noting that the administration of trust and corporate charities varies slightly from state to state).

<sup>58</sup> See GEORGE GLEASON BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 411 (3d ed. 2001). In some states, the authority of the attorney general to enforce the charitable sector is governed by statute. See, e.g., CAL. CORP. CODE § 9505 (West 2005); CAL. GOV'T CODE § 12598(a) (West 2005); CONN. GEN. STAT. ANN. § 3-125 (West 2000); GA. CODE ANN. §53-12-115 (1997); IDAHO CODE ANN. § 67-1401(5) (2001); ME. REV. STAT. ANN. tit. 5, § 194 (West 2002 & Supp. 2003); MASS. GEN. LAWS ch. 12, § 8 (2003); MICH. COMP. LAWS ANN. § 14.254 (West 2004); MINN. STAT. ANN. § 501B.41 (West 1996); N.Y. EST. POWERS & TRUSTS LAW § 8-1.1(f) (McKinney 2006); N.Y. NOT-FOR-PROFIT CORP. LAW § 112 (McKinney 2006); N.C. GEN. STAT. § 36A-52(c) (2003); N.D. CENT. CODE § 59-04-02 (2003); OHIO REV. CODE ANN. § 109.24 (West 2002); OHIO REV. CODE ANN. § 1719.12 (West 1994); S.D. CODIFIED LAWS § 55-9-5 (2001); TENN. CODE ANN. § 48-51-701 (2002); WIS. STAT. ANN. § 701.10(3) (West 2001). In the absence of such statutory authority, the attorney general holds the power to enforce the charitable sector as a common-law incident of the office. See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 305–06.

being a “necessary” or “indispensable party,”<sup>59</sup> or merely a party who must be put “on notice.”<sup>60</sup>

Since the attorney general’s authority to enforce the fiduciary duties of charity managers is virtually exclusive, the effectiveness of state regulation of the charitable sector depends almost entirely on the manner in which the attorney general performs his enforcement function.<sup>61</sup> The state attorney general has the power to redress breaches of fiduciary duty, misappropriation of charitable funds, mismanagement of the charitable organization, and fraud in the solicitation of charitable funds.<sup>62</sup> The attorney general does not, however, have the right to manage a charity:

[P]roper state enforcement action over fiduciary decision-making reduces to a single rule: The role of the attorney general and the courts is to guard against charity fiduciaries’ wrongdoing, and not to interfere in decision-making carried out in good faith . . . . To this end, an attorney general is vested with the authority to seek to correct breaches of fiduciary duty that have not otherwise been remedied by the board. However, the attorney general is not a “super” member of the board.<sup>63</sup>

While the enforcement power of the state attorney general has been rooted in the common law for centuries,<sup>64</sup> it was only after World War II

<sup>59</sup> Blasko et al., *supra* note 57, at 43–44. “Simply put, the attorney general need no longer be a plaintiff, but must at least be offered the opportunity to be heard.” *Id.* at 44.

<sup>60</sup> In some jurisdictions, the attorney general does not need to be made a party so long as the attorney general is given notice of the case and an option to intervene. *See id.*

<sup>61</sup> Currently, state regulation of charity fiduciary laws varies greatly from “a virtual ceding of nonprofit monitoring to the Internal Revenue Service” to “aggressively exercis[ing] [state] powers to monitor, oversee and regulate the nonprofit sector.” Sidel, *New State Activism*, *supra* note 2, at 1312.

<sup>62</sup> *See REVISED MODEL NONPROFIT CORP. ACT* § 1.70(b) (3d ed. 2008); FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 53–55, 305–11, 372–73; Brody, *Parochialism*, *supra* note 25, at 947. The state attorney general’s enforcement powers are extensive:

The range of court actions that an attorney general may request a court to take to enforce fiduciary duties is as broad as the powers of the court to devise remedies for breach of fiduciary duties. He may request accountings, removal of trustees, dissolution of corporations, forced transfer of corporate property, or a combination of these. He may ask the court to force charitable fiduciaries to restore losses caused by breach of duty and to return profits made in the course of administering the trust. He may seek to enjoin trustees from further wrongdoing or from continuing certain specific actions. Furthermore, transactions involving a breach of the duty of loyalty may be voided at the option of the attorney general unless he decides it is in the public interest to affirm them. The attorney general . . . may bring actions requesting modification or deviation from the terms of a trust or cy pres application of the funds.

FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 309.

<sup>63</sup> Brody, *Parochialism*, *supra* note 25, at 1034.

<sup>64</sup> *See* FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 301.

that some states gave the attorney general power to obtain information as to a charitable organization's existence and administration.<sup>65</sup> This movement was prompted by the perception that the state attorney general did not have enough information regarding the existence and operation of the charitable organizations within its jurisdiction to adequately determine whether any violations or neglect had occurred.<sup>66</sup> The State of New Hampshire initiated the movement in 1943 by enacting a statute that authorized the attorney general to require charitable organizations to file reports and other information about the organization's existence and activities with the attorney general's office.<sup>67</sup> Currently, many states require that charitable organizations register their existence,<sup>68</sup> and file annual state information reports with the attorney general.<sup>69</sup> Many states also require charitable organizations to provide copies of their annual federal information returns,<sup>70</sup> annual audited financial statements,<sup>71</sup> or some combination of the foregoing to the state attorney general.<sup>72</sup>

Despite the implementation of disclosure requirements by states, over the past fifty years, state regulation of the charitable sector has focused on the regulation of charitable solicitation activities.<sup>73</sup> Regulation of wrongdoings by charity managers is a secondary concern.<sup>74</sup> For example, in 1970, ten states required registration and annual reports from charities that did not engage in solicitation activities.<sup>75</sup> By 2003, this number had grown only to eleven.<sup>76</sup> Of these eleven jurisdictions, most exempt schools and hospitals—a significant segment of the charitable

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<sup>65</sup> *Id.* at 54, 311–12.

<sup>66</sup> See Comment, *Supervision of Charitable Trusts*, 21 U. CHI. L. REV. 118, 124–28 (1953).

<sup>67</sup> See 1943 N.H. LAWS 259, 261 (providing for the authority of the attorney general to prepare and maintain a register of public trusts, and requiring trustees of public trusts to annually file a report with the attorney general). At the same time, federal regulation of the charitable sector was expanding, but there was little coordination between federal and state enforcement efforts. See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 54.

<sup>68</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 476–95, app., tbl. 1, col. 5.

<sup>69</sup> See *id.* at 476–95, app., tbl. 1, col. 7.

<sup>70</sup> See *id.* at 496–511, app., tbl. 1, col. 15.

<sup>71</sup> See *id.*

<sup>72</sup> See *id.* at 476–511, app., tbl. 1.

<sup>73</sup> See *id.* at 55.

<sup>74</sup> See Fremont-Smith Study, *supra* note 10, at 25 (noting that very few states police charity managers with respect to compliance with their duties of loyalty and care). As a result of this study, the authors concluded: “[I]t would appear that there is more that could be done to correct abuses [of the duties of loyalty and care], particularly if more attorneys general were interested in, willing, and possessed of sufficient funds to bring fiduciaries to court.” *Id.* at 32.

<sup>75</sup> FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 55.

<sup>76</sup> *Id.*

sector<sup>77</sup>—from the filing requirement.<sup>78</sup> Private foundations, though required by federal law to submit copies of their federal annual information return to their respective state attorneys general,<sup>79</sup> make up less than ten percent of the charitable sector.<sup>80</sup> Therefore, the forty jurisdictions that do not require annual reporting from non-soliciting charities do not receive any information, and thus cannot discern breaches of fiduciary duties from a substantial majority of charitable organizations.

The primary rationale for vesting regulation of the charitable sector in the government is the public nature of charitable organizations.<sup>81</sup> Charitable funds are held for the public benefit.<sup>82</sup> In order to preserve these public funds, the state attorney general, as representative of the people of the state, has exclusive power of enforcement.<sup>83</sup>

A concomitant reason for government enforcement of the charitable sector is that private persons do not have a vested interest in a charity.<sup>84</sup>

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<sup>77</sup> In 2005, educational institutions and hospitals formed approximately 20% of the number of registered public charities; but as a percentage of revenues and expenditures in the charitable sector, educational institutions and hospitals represented approximately 70% of registered public charity resources. See Amy Blackwood et al., *The Nonprofit Sector in Brief 4*, tbl. 2 (2008), <http://nccsdataweb.urban.org/kbfiles/797/Almanac2008publicCharities.pdf>; accord Sherlock & Gravelle, *supra* note 4, at 9 (noting that hospitals comprise less than one percent of the charitable sector but account for 41% of the sector's revenues and 29% of its assets while higher-education organizations which comprise less than one-half of one percent of the charitable sector account for eleven percent of the sector's revenues and 21% of its assets).

<sup>78</sup> See, e.g., CAL. GOV'T CODE § 12583 (West 2005) (exempting schools and hospitals); N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(b)(4)–(5) (McKinney 2006) (exempting schools and hospitals); OHIO REV. CODE ANN. § 109.31 (LexisNexis 2007) (exempting schools).

<sup>79</sup> See Treas. Reg. § 1.6033-3(c) (1985).

<sup>80</sup> See Paul Amsberger et al., *supra* note 4, at 111–14. IRS records showed approximately 933,000 active public charities existed in 2004. *Id.* at 111. Not all public charities are included in this count because some charities, like churches, do not need to apply for recognition of tax-exempt status with the IRS. *Id.* The same year, approximately 77,000 private foundations filed Form 990-PF, the annual information return that all private foundations are required to file. See *id.* at 114. Therefore, of the approximately 1,010,000 registered charitable organizations in 2004, 77,000, or 7.6%, were private foundations. As of July 2009, there were approximately 987,500 registered public charities and 116,000 registered private foundations, resulting in private foundations comprising approximately 10.5% of registered charitable organizations. See Sherlock & Gravelle, *supra* note 4, at 3, tbl.1; accord Hansmann, *supra* note 25, at 603 (noting that most charities are not private foundations).

<sup>81</sup> BOGERT, *supra* note 58, § 411; accord James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 258–59 (2003) [hereinafter Fishman, *Charitable Accountability*] (observing that state attorney general standing to enforce fiduciary duties of charity managers stems from the public benefit charities provide).

<sup>82</sup> See Fishman, *Charitable Accountability*, *supra* note 81, at 255–56; Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 433 (1960) (“The man on the street and the enlightened foundation president have this much in common: Both know that charitable funds are public funds.”).

<sup>83</sup> See Blasko et al., *supra* note 57, at 43–47 (describing the authority of the attorney general to regulate the proper operation of charitable organizations).

<sup>84</sup> See *Sarkeys v. Indep. Sch. Dist. No. 40*, Cleveland County, 592 P.2d 529, 534 (Okla. 1979); Karst, *supra* note 82, at 436–37.



Donors part with their property when they give it to a charity, and thus have no further interest in it.<sup>85</sup> Beneficiaries of a charity are not ascertainable by nature.<sup>86</sup> Often, no individual can show that he will benefit from the charitable organization, and thus he has no interest in the charity's assets.<sup>87</sup> Ultimately, it is the general public that benefits from charitable programs and services, and not merely individual recipients of charitable aid.<sup>88</sup> Accordingly, vesting enforcement power in a single authority, such as the state attorney general, is preferable to granting standing to countless, shifting, and indeterminate members of the general public.<sup>89</sup>

In addition, there is concern that if government is not the principal regulator of the charitable sector, charitable organizations could be embroiled in vexatious litigation; they would be constantly harassed by suits brought by parties with no stake in the charity.<sup>90</sup> Regardless of whether such suits would be widespread if typically allowed, courts use the mere possibility of their occurrence to deny standing to private citizens.<sup>91</sup>

Finally, government regulation protects the charity's resources and ensures that its dollars are spent on the charity's philanthropic purpose.<sup>92</sup> Conceptually, a charity operates for the public benefit and therefore must be protected from harassment and loss.<sup>93</sup> Defending litigation by private parties may result in the dissipation of a charity's funds.<sup>94</sup> Thus, imposing limits on private party standing and vesting enforcement power in the

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<sup>85</sup> See Karst, *supra* note 82, at 446.

<sup>86</sup> See *Sarkeys*, 592 P.2d at 534.

<sup>87</sup> See Karst, *supra* note 82, at 436–37 (“[I]n the typical case, no one knows who a beneficiary will be until the charity confers a benefit on him, and after such benefit is conferred he has no right to expect further benefits, and thus no remaining interest in the charity’s funds.”).

<sup>88</sup> BOGERT, *supra* note 58, § 411.

<sup>89</sup> *Id.*

<sup>90</sup> See, e.g., *Sarkeys v. Indep. Sch. Dist. No. 40, Cleveland County*, 592 P.2d 529, 534 (Okla. 1979) (“If a third party were permitted to sue as a matter of right, the charity could be subjected to frequent, unreasonable and vexatious litigation, the court dockets could become clogged, and the trust assets could be wasted in unnecessary attorney fees.”); cf. Hansmann, *supra* note 25, at 609 (“[I]t makes sense to deny standing to [donors] only if the consequence would be large numbers of spite suits, strike suits, or suits filed through sheer idiocy—which are presumably what the courts and commentators have in mind when they raise the specter of “harassing” litigation—or of suits that, though based on a real grievance, are feebly litigated and thus do more harm than good. Yet it appears extraordinarily unlikely that suits of this nature would ever become a sufficiently significant problem to outweigh the benefits of enlisting [donors] into the enforcement effort.”).

<sup>91</sup> BOGERT, *supra* note 58, § 414. *But cf.* Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 476 (alleging that the frivolous lawsuit is largely a myth and that private parties bringing suits are motivated by altruism and the desire to curb egregious abuses in the charitable sector).

<sup>92</sup> See Blasko et al., *supra* note 57, at 42.

<sup>93</sup> *Id.*

<sup>94</sup> See *id.* at 41–42.

state attorney general is necessary.<sup>95</sup> A single party, the state attorney general, is in a better position to consolidate redundant actions, eliminate actions for minor infractions, and correct serious breaches of fiduciary duties.<sup>96</sup> The state attorney general's gate-keeping function assures that a charity's resources are conserved for its charitable mission.<sup>97</sup>

## 2. Internal Revenue Service

The IRS's power to regulate the charitable sector stems from the tax exemption afforded to charitable organizations in the Internal Revenue Code.<sup>98</sup> As a condition of receiving tax exemption, charitable organizations agree to abide by the rules contained in the Internal Revenue Code, which restrict such organizations' ability to engage in activities, such as political advocacy,<sup>99</sup> commercial business activity,<sup>100</sup> and certain activities that constitute breaches of fiduciary duty under the applicable state law.<sup>101</sup> For example, private foundations are prohibited from engaging in self-dealing with foundation "insiders."<sup>102</sup> The Internal Revenue Code penalizes insiders who engage in prohibited self-dealing transactions and foundation managers who knowingly approve such transactions.<sup>103</sup> Under state law, a self-dealing transaction may result in a

<sup>95</sup> *See id.*

<sup>96</sup> *See id.*

<sup>97</sup> *Id.* at 42.

<sup>98</sup> *See* I.R.C. § 501(a) (2006) (providing for exemption from federal income tax for charitable organizations described in section 501(c)(3) of the Internal Revenue Code); FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 53–54. The regulation of the charitable sector was exclusively done by the states until the enactment of the federal tax laws applicable to charitable organizations beginning in the early 20th century. *See* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 53–54. IRS enforcement of fiduciary behavior by charity managers did not gain significance until the passage of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 613. *See* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 54. Prior to the enactment of the Tax Reform Act of 1969, the sole sanction available to the IRS to correct behavior by charity managers was revocation of the charity's tax-exempt status, "a sanction that in some circumstances was meaningless and in all cases did not prevent wrongdoers from continuing to manage the charity." *Id.* The reforms implemented in the Tax Reform Act of 1969 represent

a landmark in the history of the government regulation of charity, containing strict limitations that went to the heart of foundation administration. Of even wider import for the entire charitable sector was the fact that the act changed the sanctions for noncompliance, imposing meaningful penalties in the form of excise taxes not only on the charities themselves, but on their fiduciaries, and in the case of the self-dealing provisions, on the persons who profited from the self-dealing rather than on the foundations themselves, thereby preserving charitable assets for future public benefit.

*Id.* at 79.

<sup>99</sup> *See* I.R.C. §§ 501(c)(3), 4912, 4955.

<sup>100</sup> *See id.* §§ 511–14.

<sup>101</sup> *See infra* notes 380–86 and accompanying text.

<sup>102</sup> *See* I.R.C. § 4941.

<sup>103</sup> *See id.*

breach of the fiduciary duty of loyalty owed by an insider to a charitable organization,<sup>104</sup> and such breach is enforceable by the state attorney general.

The IRS has authority to grant federal tax exemption, enforce its rules governing exempt charitable organizations, and revoke the federal tax exemption of charitable organizations that abuse its rules.<sup>105</sup> Notably, the IRS, unlike the attorney general, does not have the authority to remove directors and officers for breach of fiduciary duty or to enjoin a charitable organization from taking action that may result in improper use of charitable assets.<sup>106</sup> However, The IRS uses the threat of revocation of tax-exempt status to compel charitable organizations to make internal governance changes such as replacing managers or implementing policies to curb breaches of fiduciary duties and other abuses.<sup>107</sup>

The IRS's increasing involvement in charity governance<sup>108</sup> is evident in its redesign of the federal annual information return required of tax-exempt charitable organizations (Form 990).<sup>109</sup> A charitable organi-

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<sup>104</sup> See *supra* notes 49–52 and accompanying text.

<sup>105</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 459–66.

<sup>106</sup> The Senate Finance Committee whitepaper proposed reforming federal tax law to grant the IRS authority to remove a charitable director or officer who engaged in prohibited self-dealing, conflict of interest transactions, or excess benefit transactions. See Staff of the Senate Finance Committee, *supra* note 16, at 16. Additionally, the whitepaper proposed vesting the United States Tax Court with equity powers to ensure that charitable assets are preserved for philanthropic activities, including the power to enjoin activities. See *id.* at 19. Neither of these proposals were included in the Pension Protection Act and were not considered by Congress.

<sup>107</sup> See Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 543–45 (1999) [hereinafter Brody, *Bishop Estate*]. The threat of revocation of tax-exempt status is a powerful tool: “[F]ew charities, small or large, can afford such a high stakes gamble by challenging the IRS over their very claims to exemption. Until the case is resolved in court, donations could dry up, tax-exempt bond covenants could be breached, and local governments might challenge property tax exemption.” *Id.* at 545.

<sup>108</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 459–66; Brody, *Limits*, *supra* note 29, at 1414; Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613, 618 (2005) (noting that the once distinct lines of state enforcement of fiduciary behavior and federal enforcement of tax laws have been blurred with increasing authority delegated to the IRS to monitor and enforce breaches of fiduciary duties among charity managers). But see James J. Fishman, *Stealth Preemption: The I.R.S.’s Nonprofit Corporate Governance Initiative*, 29 VA TAX REV. (forthcoming 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1494932](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494932) [hereinafter Fishman, *Stealth Preemption*] (arguing that the IRS’s increasing probe into charity governance is a “stealth preemption” of traditional state regulation of nonprofit corporate law).

<sup>109</sup> See I.R.S. Instructions for Form 990 (2008), available at <http://www.irs.gov/pub/irs-pdf/i990.pdf>. Private foundations are required to file Form 990-PF. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 409. All other charitable organizations are required to file Form 990 or Form 990-EZ. *Id.* Churches and charitable organizations that normally receive less than \$25,000 in annual gross receipts are exempt from filing Form 990 or Form 990-EZ. *Id.* at 410. Charitable organizations that are exempt from filing and are not

zation's Form 990 must be made available for public inspection.<sup>110</sup> Form 990 plays a "pivotal role" in financial disclosure by charitable organizations: "Not only is it the primary source of information for the Internal Revenue Service, but it is used as the basic annual report for state charities offices and as the basic data source for research on the sector, and also serves as the primary source of information for potential donors . . ." <sup>111</sup> Due to its shortcomings in providing adequate information for effective monitoring of charitable organizations, Form 990 was redesigned in 2008 to require disclosure of substantially more information regarding a charitable organization's governance practices.<sup>112</sup>

The development of the IRS as federal regulator of the fiduciary duties of managers of charitable organizations was fortuitous.<sup>113</sup> The Internal Revenue Code provisions regulating charities were originally aimed at preventing the abuse of tax exemption in the charitable sector.<sup>114</sup> With the enactment of the Tax Reform Act of 1969, which radically altered the requirements for tax exemption for private foundations,<sup>115</sup> including authorizing the IRS to police certain behaviors considered to be breaches of state law fiduciary duties, the enforcement landscape of the IRS with respect to the charitable sector forever changed.<sup>116</sup>

What occurred was in fact the transformation of a part of the IRS from a tax-collecting agency to one with broad power to control fiduciary behavior. By including in the [Internal Revenue Code] standards of behavior for fiduciaries developed under the common law to assure loy-

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churches, however, are required to report their existence to the IRS annually using Form 990-N. Notification Requirement for Tax-Exempt Entities Not Currently Required To File, 74 Fed. Reg. 140, 36395 (July 23, 2009) (to be codified at 26 C.F.R. pt. 1).

<sup>110</sup> I.R.C. §§ 6033, 6104 (West Supp. 2009).

<sup>111</sup> FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 411.

<sup>112</sup> I.R.S. Background Paper: Summary of Form 990 Redesign Process (August 19, 2008), available at [http://www.irs.gov/pub/irs-tege/summary\\_form\\_990\\_redesign\\_process.pdf](http://www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf); see also Fishman, *Stealth Preemption*, *supra* note 108, at 22–33 (describing the revisions to Form 990 which address corporate governance issues).

<sup>113</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 377–78 ("The fact that the federal role has evolved within the tax policing system is a matter of historical accident rather than a conscious assignment of responsibility to the tax authorities. . . . The history of federal regulation . . . illustrates a lack of deliberation in the development of the Service as regulator . . ."); Brody, *Limits*, *supra* note 29, at 1439 ("De facto, and against its core competency (and likely preference), the [IRS] comes to operate, at least in part, as a uniform, super-regulatory board."); Fishman, *Wrong Way Corrigan*, *supra* note 6, at 581 ("The complex system of federal charity regulation has not developed with a particular logic or plan, but largely in response to the perceived abuse of charitable status.").

<sup>114</sup> See S. REP. NO. 81-2375 § VIII(A)(1) (1950), reprinted in 1950 U.S.C.C.A.N. 3053, 3081.

<sup>115</sup> FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 79.

<sup>116</sup> See *id.* at 114.

alty and prevent recklessness in the handling of charitable assets, Congress imposed on the Service a set of goals that would never have been considered a part of the taxing function as recently as 1950.<sup>117</sup>

With the enactment of the intermediate sanction regime in 1996, applicable to public charities, the IRS's authority to regulate behaviors of charitable managers was finally expanded to the vast majority of charitable organizations.<sup>118</sup>

## B. *Modern Limitations on Government Regulation of the Charitable Sector*

While the policies supporting government regulation of the charitable sector are strong, there are many limitations on the government's ability to effectively carry out this role. These limitations include financial, institutional, political, and agency constraints.

### 1. Financial Constraints

Government entities lack adequate funding and qualified personnel to enforce existing laws.<sup>119</sup> Very few states attempt to ensure that charitable fiduciaries obey their duties of loyalty and care.<sup>120</sup> In a majority of states, staffing levels dedicated to oversight of the charitable sector are

<sup>117</sup> *Id.*

<sup>118</sup> *See id.* at 459–60.

<sup>119</sup> *See* Gary, *supra* note 25, at 593. Professor Gary explains that:

While the powers of the attorney general are substantial, the extent of the supervision of the attorney general is limited. . . . In some states, several assistant attorneys general form a charitable division of the attorney general's office. . . . In other states, however, one assistant attorney general supervises the nonprofit sector as only one part of his or her assignment. Hawaii has reported 0.5 attorneys working with charities, and many states do not list any attorneys specifically assigned to charitable matters.

Those working in . . . New York, Connecticut, and Massachusetts . . . report that inquiries or complaints from dissenting board members, employees, beneficiaries or other members of the public, including the press, are much more likely to trigger investigations than reviews of the annual reports conducted in the attorney general's office. In determining which cases to pursue, the attorneys consider the amount involved, the size of the organization, the impact on the public, and the egregiousness of the conduct. The worst abuses receive attention, but many problems probably go undetected or unaddressed.

*Id.* at 622–24; *see also* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 445–46; Blasko et al., *supra* note 57, at 939, 947; Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA L. REV. 1113, 1123, 1128–30 (2007).

<sup>120</sup> *See* Gary, *supra* note 25, at 596 (explaining that although some state and federal laws on charitable management do exist, the lack of oversight caused by unidentified beneficiaries often leaves control of the charitable organization to one or a few persons, who are able to “seek private benefit at the expense of the nonprofit”).

minimal and have remained relatively static for over forty years.<sup>121</sup> A consequence of inadequate staffing at the state level is the lack of “bureaucratic expertise,” which could otherwise be utilized to influence legislative reform needed to improve accountability in the sector.<sup>122</sup> Although some charities are required to file annual disclosure reports with the attorney general, these reports are not the source of most investigations.<sup>123</sup> Instead, whistleblower complaints and media reports of wrongdoing are more likely to trigger investigations.<sup>124</sup> Even in states that successfully regulate charitable organizations, the state attorneys general cannot possibly investigate all the complaints received.<sup>125</sup> This severe lack of government resources results in the prosecution of only the most egregious of abuses.<sup>126</sup>

The police role has by default fallen on the IRS,<sup>127</sup> which, until recently, has had few tools to correct misbehavior.<sup>128</sup> Even with the ex-

<sup>121</sup> In 1977, only eight states had one or more full-time attorneys regulating charitable organizations, thirty-one states had one or two part-time attorneys, and eleven states had no attorneys assigned to regulation of the charitable sector at all. Blasko et al., *supra* note 57, at 48. Thirty years later, approximately three-fourths of the states had one or fewer full-time equivalent attorneys dedicated to the oversight of the charitable sector, and the number of states having no attorneys assigned to the oversight of the charitable sector had grown to seventeen. Jenkins, *supra* note 119, at 1128.

<sup>122</sup> *Id.* at 1129–30.

<sup>123</sup> Nina J. Crimm, *A Case Study of A Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L. J. 1093, 1185 (2001); accord Fishman, *Charitable Accountability*, *supra* note 81, at 263 (observing that most information filed with the state attorneys general do not get reviewed by anyone).

<sup>124</sup> Crimm, *supra* note 123, at 1185.

<sup>125</sup> See Gary, *supra* note 25, at 624 (noting that enforcement of the charitable sector by the state attorneys general has been sporadic).

<sup>126</sup> Blasko et al., *supra* note 57, at 39. In all fairness, when criticizing the level of attorney general resources dedicated to the enforcement of the charitable sector, one should ask: “In comparison to what?” Areas in which the attorney general spends more resources may need more attention, such as consumer protection and capital markets. If attorney general offices spent more resources on oversight of the charitable sector at the expense of oversight of capital markets, more serious reputational harm may result from allowing abuses in capital markets to go unchecked. See Atkinson, *supra* note 29, at 683.

<sup>127</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 450, stating:

[I]n actuality it is the federal government and, specifically, the Internal Revenue Service that regulates . . . the nonprofit sector today . . . . The importance of the federal regulatory scheme cannot be overemphasized. One has only to consider that in two-thirds of the states regulation of charities is minimal or nonexistent, and even in the eleven jurisdictions with active enforcement programs, the federal rules set an important minimum standard for compliance.

<sup>128</sup> Prior to the enactment of the intermediate sanction regime to penalize certain self-dealing transactions between public charities and their insiders, the only tool at the IRS’s disposal to combat alleged violations on the prohibition of private inurement was the revocation of the organization’s exempt status. See Gary, *supra* note 25, at 629–30. This tool was rarely used, and even if it was, the IRS had no authority to impose sanctions on the insider who improperly benefitted at the charity’s expense or to require the insider to reimburse the private inurement received to the charity. See *id.* at 630.

pansion of the enforcement tools available to the IRS, the IRS has woefully failed to keep pace with the tremendous growth of the charitable sector. Thus, while the number of registered charitable organizations<sup>129</sup> exploded from 220,074 in 1974<sup>130</sup> to 1,186,915 in 2007,<sup>131</sup> the number of tax-exempt organization returns that have been audited by the IRS substantially decreased over the same time period.<sup>132</sup> Additionally, de-

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<sup>129</sup> “Charitable organizations” are organizations that are exempt from federal income tax under Section 501(a) of the Internal Revenue Code by virtue of being described in Section 501(c)(3) of the Internal Revenue Code. I.R.C. § 501(a) (2006). Organizations described in Section 501(c)(3) include those that are

organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . .

*Id.* § 501(c)(3). Under state law, a charitable organization may be formed as a trust, a non-profit corporation, an unincorporated association, or a nonprofit limited liability company. *See, e.g.,* Gary, *supra* note 25, at 609. While the organizational form may impact the enforcement remedies for breach of fiduciary duty and other misappropriation of charitable assets under state law, *id.*, the various organizational forms which a charity may undertake are largely a distinction without a difference for federal tax law purposes. Rather, federal tax law further subdivides charitable organizations into “public charities” and private foundations. *See* I.R.C. § 509(a); Gary, *supra* note 25, at 631. Public charities include those organizations that are classified as such simply because of the nature of their activities, such as churches, schools, hospitals, and certain medical research organizations, and those organizations that receive more than one-third of their annual support from the general public, either in the form of charitable donations or program service revenues. *See* I.R.C. §§ 509(a)(1)–(2), 170(b)(1)(A)(i)–(iv). Public charities also include those charitable organizations that are organized and operated to support one or more public charities described in the preceding sentence. *See id.* § 509(a)(3). An example of a supporting organization is an endowment foundation formed as a separate entity to hold investment funds and receive donations that are used to provide programs, services, and other forms of support to a school or hospital. *See id.* § 170(b)(1)(A)(iv). A private foundation is any charitable organization that cannot be classified as a public charity, and is typically formed and controlled by an individual or family. *See id.* § 509(a).

Charitable organizations, other than private foundations, receiving less than \$5,000 in gross revenues each year are not required to register as charitable organizations with the IRS. *See id.* § 508(c)(1)(B). In addition, churches, conventions or associations of churches, and certain other religious organizations are not required to register as charitable organizations with the IRS. *See id.* § 508(c)(1)(A); IRS DATA BOOK 2007, at 54 n.1. It is estimated that about half of the nation’s approximately 350,000 religious organizations that are exempt from the registration requirement choose to do so anyway. *See* Blackwood et al., *supra* note 77, at 1. If unregistered religious organizations were included in the count, it is estimated that the charitable sector is currently comprised of approximately 1.4 million charitable organizations.

<sup>130</sup> Marcus S. Owens, *Charity Oversight: An Alternative Approach*, (The Hauser Ctr. for Nonprofit Orgs., Harvard Univ., Working Paper No. 33.4, 2006), at 4.

<sup>131</sup> IRS DATA BOOK 2007, at 54 tbl.25.

<sup>132</sup> In 1970, the IRS examined 8,500 “tax-exempt organization returns.” Owens, *supra* note 130, at 3. These returns included the annual information return required of all reporting charitable organizations (Form 990, Form 990-EZ, and Form 990-PF), certain returns of split-interest trusts and trusts with charitable accumulations (Forms 5227 and 1041-A), and returns reporting taxable income and tax from certain political activities (Form 1120-POL). *See id.* at 5 (citing IRS Data Book 2005, at 33 tbl.14). In 2008, this number had decreased by almost

spite the vast growth in the charitable sector over the past 35 years, the staffing of the IRS exempt organizations division has remained relatively static.<sup>133</sup>

The IRS has recently made considerable effort to increase its regulatory presence in the charitable sector, but consistent and comprehensive regulation of the charitable sector is not attainable with the IRS's current level of resources.<sup>134</sup> Congress has yet to provide any indication that it intends to increase appropriations for IRS oversight of the charitable sector in the foreseeable future.<sup>135</sup> In 1969, a two percent excise tax on the net investment income of private foundations was implemented on the basis that it would serve as an "audit fee" that would fund the increased cost of supervision of the charitable sector by the IRS.<sup>136</sup> The net invest-

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two-thirds to 2,946. IRS DATA BOOK, 2008, at 33 tbl.13. As a percentage of all tax-exempt organizations returns filed, the audit rate is currently 0.33% (2,946 returns examined out of 888,412 returns filed). *See id.* Similarly, in a study conducted by the General Accounting Office of IRS audits of returns of tax-exempt organizations between 1996 and 2001, the General Accounting Office noted that the number of annual returns filed by tax-exempt organizations increased by twenty-five percent over this time period but the number of audits of tax-exempt organizations' returns decreased by fifteen percent. GEN. ACCOUNTING OFFICE, IMPROVEMENTS IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES 21 (2002). The General Accounting Office believed that IRS restructuring to a "market segment" approach would correct this problem. *See id.* at 23. The IRS restructuring, however, has not kept up with the pace of growth in the sector. Since 2001, the last year in the General Accounting Office Study, the number of tax-exempt organizations returns filed has increased from 783,582 to 888,412 in 2008 (or by 13%) while the number of audits of tax-exempt returns has increased only slightly from 2,894 to 2,946 (or by 2%) over the same time period. *Compare* IRS DATA BOOK 2008, at 33 tbl.13, *with* IRS DATA BOOK 2002, at 26 tbl.14.

<sup>133</sup> *See* STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO RECOMMENDATIONS OF THE NATIONAL COMMISSION ON RESTRUCTURING THE INTERNAL REVENUE SERVICE ON EXECUTIVE BRANCH GOVERNANCE AND CONGRESSIONAL OVERSIGHT (Comm. Print 1997) at 60–61. Similar observations were made again in 2000 and 2002. *See* STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., REPORT OF INVESTIGATIONS OF ALLEGATIONS RELATING TO INTERNAL REVENUE SERVICE HANDLING OF TAX-EXEMPT ORGANIZATION MATTERS (Comm. Print 2000) at 120–21; U.S. GEN. ACCOUNTING OFFICE, IMPROVEMENTS IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES 23 (2002).

<sup>134</sup> *See* Owens, *supra* note 130, at 6 ("IRS staffing and the other resources dedicated to [charitable] organization oversight have fallen or remained stagnant, and there is no evidence that historic levels have been adequate to ensure that significant abuses can be addressed in a timely manner."). Professor Karst made a similar observation in 1960: "[T]he simple task of checking over the returns of exempt organizations is staggering, and regular comprehensive investigation of the activities of such organizations is beyond the Service's wildest dreams under present (and foreseeable) conditions of staffing." Karst, *supra* note 82, at 442.

<sup>135</sup> *See* FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 378 (noting that previous efforts to increase federal regulation of the charitable sector have been thwarted because Congress would not provide additional appropriations to enhance regulatory programs).

<sup>136</sup> *See* STAFF OF JOINT COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 (Comm. Print 1970) at 29 (justifying the new tax on the basis that private foundations "share some of the burden of paying the cost of government, especially for more extensive and vigorous enforcement of the tax laws relating to exempt organizations").



ment income excise tax, however, has never been dedicated to funding IRS regulation of charitable organizations.<sup>137</sup> Since its enactment, the amount of net investment income excise tax has far exceeded the annual budget of the exempt organizations division of the IRS, at times by as much as five to ten times the division's annual budget.<sup>138</sup> Congress has considered, but ultimately rejected, proposals to require that the net investment income excise tax be dedicated to the supervision of the charitable sector.<sup>139</sup> Even if resources for the IRS exempt organizations division were increased, the IRS is still unlikely to be an effective regulator of the charitable sector due to other constraints facing the agency.<sup>140</sup>

## 2. Institutional Constraints

A second limitation on government regulation of the charitable sector is the disparity between the procedures necessary to effectively enforce charitable laws and the procedures necessary to conduct the principal responsibilities of the state attorneys general and the IRS. Within both of these government regulatory bodies, oversight of the charitable sector is only a subset of broader responsibilities.<sup>141</sup> Regulation of the charitable sector is a small subset of the state attorney general's larger role as a consumer protector. In their role as consumer protectors, state attorneys general view their "biggest problem" in the charitable sector as deceptive charitable solicitations.<sup>142</sup> The allocation of state attorneys general's resources in the oversight of the charitable sector primarily, if not exclusively, to regulation of charitable solicitation supports this view.<sup>143</sup> The procedures and resources necessary to detect fraud in solicitation activities do not necessarily enable the state attorneys general to detect breaches of fiduciary duties by charity managers, because often, the regulation of charitable solicitation practices focuses on the conduct of paid solicitors who have no control over the management of the charitable organization.<sup>144</sup> Additionally, because many char-

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<sup>137</sup> See H.R. Rep. No. 105-599, at 210 (Conf. Rep.), reprinted in 1998 U.S.C.C.A.N. 288, 305; Owens, *supra* note 130, at 6.

<sup>138</sup> See *infra* note 494.

<sup>139</sup> See CARE Act of 2003, S. 476, 108th Cong., 1st Sess. (2003); Charitable Giving Act of 2003, H.R. 7, 108th Cong. 1st Sess. (2003); see also FREMONT-SMITH, GOVERNING NON-PROFIT ORGANIZATIONS, *supra* note 6, at 446 (noting that Congress has routinely resisted dedicating the excise tax on private foundation net investment income to funding the regulation of the charitable sector, instead preferring to retain control over such funds as part of its general appropriations power).

<sup>140</sup> See Owens, *supra* note 130, at 10.

<sup>141</sup> Silber, *supra* note 108, at 633.

<sup>142</sup> Brody, *Parochialism*, *supra* note 25, at 947.

<sup>143</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 443.

<sup>144</sup> See *id.* at 443, 445.

ities do not solicit funds from the public, their operations go virtually unchecked by the state attorneys general.<sup>145</sup>

A similar bureaucratic problem exists with IRS oversight of the charitable sector. The IRS's primary responsibility is the collection of federal taxes, including income tax, estate and gift taxes, employment tax, and excise tax.<sup>146</sup> Although there is a specialized division within the IRS<sup>147</sup> that is responsible for regulating the tax laws that affect charitable organizations (the exempt organizations division), this division still shares the same procedures and administrative framework as the IRS as a whole.<sup>148</sup> Since charitable organizations are generally exempt from federal income tax,<sup>149</sup> procedures designed to ensure the fair collection of tax will have no effect on them.<sup>150</sup> The Internal Revenue Code attempts to regulate the charitable sector through a series of excise taxes designed to discourage unwanted behaviors.<sup>151</sup> Regulation of fiduciary behavior is completely different from regulation of income tax collection.<sup>152</sup> Thus, many have called into question the wisdom of placing governance-oriented regulation under the responsibility of a revenue-oriented agency.<sup>153</sup>

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<sup>145</sup> See *id.* at 444.

<sup>146</sup> See Hansmann, *supra* note 25, at 604.

<sup>147</sup> With the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5, 18, 26, 29, and 42 U.S.C.), Congress established the Employee Plans/Exempt Organizations Division (EP/EO) of the IRS, which regulates all tax-exempt entities, including pension plans, charitable organizations, and other nonprofit organizations which are exempt from federal income taxation under Section 501(a) of the Internal Revenue Code. See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 465. The personnel in the EP/EO division were trained to handle the special concerns of tax-exempt entities. See *id.* at 465–66. In 1999, the EP/EO division assumed responsibility for oversight of the tax exemption afforded to government entities. See *id.* at 465. As a result, a new Tax-Exempt/Government Entity Division (TE/GE) was created. See *id.* at 389, 465. TE/GE currently has responsibility for enforcement of the federal tax laws applicable to charitable organizations. See *id.* at 466.

<sup>148</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 389–90.

<sup>149</sup> See I.R.C. §§ 501(a), 501(c)(3) (2006); FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 58.

<sup>150</sup> See Owens, *supra* note 130, at 7–9 (noting that the IRS systems and procedures are designed to support its primary role—tax collector—and are ill-adapted to address disclosure based information returns—the primary return required of charitable organizations).

<sup>151</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 280–83.

<sup>152</sup> See Hansmann, *supra* note 25, at 604–05 (observing that use of the excise tax system to compel behavior of fiduciaries is an “unusual exception to the normal system of penalties that is used to secure compliance with virtually all other provisions of the tax code”).

<sup>153</sup> See, e.g., Marion Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, in THE FUTURE OF THE NONPROFIT SECTOR 75, 86 (Virginia A. Hodgkinson et al. eds., 1989):

[T]he [IRS] is not the most appropriate agency to regulate the [charitable] sector. It lacks the more refined tools for compelling compliance available to state equity courts. It is not well placed to police disclosure provisions. Even if granted equity-

Even within the exempt organizations division of the IRS, the primary purpose for examining the returns of exempt organizations is to determine payment of employment tax and unrelated business income tax (analogous to the corporate income tax) rather than to detect misuse of charitable assets and other wrongdoings by charity managers.<sup>154</sup> In 2002, the IRS restructured the exempt organizations division to implement a “market segment” approach.<sup>155</sup> At this time, the Service believed that by dividing exempt organizations into market segments (such as healthcare and education) and treating each segment separately, exempt organizations personnel could better profile and address areas of non-compliant behavior in each segment and thereby increase the efficiency of charitable sector regulation.<sup>156</sup> Since the market segment approach was implemented, however, the examination of tax-exempt organizations’ returns, where noncompliant behaviors by charity managers could potentially be detected, has increased by a mere two percent.<sup>157</sup> In contrast, the examinations of “related taxable returns,” where exempt organizations report traditional tax items such as employment tax and unrelated business income tax, have more than doubled from 2,384<sup>158</sup> to 4,915<sup>159</sup> (or by 106%) over the same time period.<sup>160</sup>

The internal structure of the IRS is also an impediment to the effective regulation of the charitable sector, as evidenced by its personnel constraints. As a government agency, the IRS is constrained to the government pay scale for compensation of IRS personnel.<sup>161</sup> As a result, the IRS is often unable to offer competitive compensation packages to attract quality accountants, attorneys, and other professionals with spe-

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type powers, its staff is neither by training nor by inclination situated to enforcement that is not designed to raise revenue.

<sup>154</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 419, 455.

<sup>155</sup> See *id.* at 414.

<sup>156</sup> See *id.*

<sup>157</sup> See *supra* note 132.

<sup>158</sup> IRS DATA BOOK 2002, at 26 tbl.15.

<sup>159</sup> IRS DATA BOOK 2008, at 33 tbl.13.

<sup>160</sup> Compare IRS DATA BOOK 2002, at 26 tbl.15 with IRS DATA BOOK 2008, at 33 tbl.13. The theme of emphasizing traditional tax items over detection of abuse by charity managers is also exemplified by a recent study of IRS Coordinated Examination Program (CEP) audit cases. See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 419. The CEP is designed to audit organizations having “more than \$50 million of assets and gross receipts, a number of controlled or related entities, and that possess national stature.” *Id.* at 417. Between 1991 and 2001, the IRS closed 202 CEP audit cases and uncovered very few instances of abuse substantial enough to warrant revocation. *Id.* at 419. Rather, the deficiencies assessed were primarily related to employment tax underreporting and misreporting of allocations for purposes of the unrelated business income tax. See *id.*

<sup>161</sup> See Owens, *supra* note 130, at 7.

cialized expertise for the exempt organizations division.<sup>162</sup> Additionally, recruitment of personnel within the IRS to serve increased need for enforcement is hindered by its internal structure. For example, when the IRS experienced a shortage of personnel to review the ever increasing influx of exemption applications, the IRS shifted personnel from the audit division to determinations.<sup>163</sup> Recruitment of personnel for the transfer was difficult partly because of the IRS's internal policies on promotions—the promotion potential is lower for personnel in the determinations division than it is for personnel in the audit division.<sup>164</sup> Furthermore, the transferred personnel lacked experience in exempt organizations matters.<sup>165</sup> The transfer of personnel had a negative impact on the perception of the IRS as an effective regulator.<sup>166</sup> According to the then-director of the IRS exempt organizations division, the shift of IRS personnel “gave rise to a perception that the Service is not out there looking, which impedes voluntary compliance.”<sup>167</sup> The difficulty the IRS encountered in shifting its personnel to be responsive to the shifting needs for oversight of the charitable sector is “illustrative of the difficulties inevitably encountered in effecting major changes within a large bureaucracy, particularly for a branch with specialized functions and goals that do not fit easily within the framework of a large entity.”<sup>168</sup>

Furthermore, some regulators appear confused about their role in the oversight of the charitable sector. For example, in Arizona, where charity regulation is nonexistent, a chief counsel of the Consumer Protection and Advocacy Section in the Arizona Attorney General's office claimed: “We don't regulate charities in Arizona . . . . I'm not aware of any state law or regulation covering corporate governance of nonprofits.”<sup>169</sup> If the persons charged with regulating the charitable sector are unaware that they have that authority, the current structure for oversight of the charitable sector is fundamentally flawed.

### 3. Political Constraints

A third limitation on government's ability to effectively regulate the charitable sector is the perceived political favoritism in the selective enforcement of charitable laws. Political slant is embedded in the institu-

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<sup>162</sup> See Owens, *supra* note 130, at 7 (noting that in 2006, the maximum annual compensation of the highest level of career employee in the IRS was approximately \$145,000—the same average annual compensation offered to first or second year associates at large law firms).

<sup>163</sup> See Fremont-Smith, *Governing Nonprofit Organizations*, *supra* note 6, at 392.

<sup>164</sup> See *id.*

<sup>165</sup> See *id.* at 392–93.

<sup>166</sup> See *id.* at 393.

<sup>167</sup> Carolyn Wright Lafon and Christine J. Harris, *EO Division Faces Challenges Two Years into Reorganization*, 35 EXEMPT ORG. TAX REV. 16, 16 (2002).

<sup>168</sup> FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 393.

<sup>169</sup> Harvey Lipman, *A Risky Mix for Charity*, CHRON. PHILANTHROPY 29 (May 16, 2002).

tional nature of the enforcement agencies at both the state and federal levels.<sup>170</sup>

When it comes to the attorney general's regulation of the charitable sector, all politics is local. In the vast majority of jurisdictions, the state attorney general is an elected official or political appointee.<sup>171</sup> Thus, political forces and local concerns are likely to influence the state attorney general.<sup>172</sup> For instance, in cases where charitable organizations of national interests decided to relocate to another jurisdiction, the local attorneys general opposed the relocation, elevating local interests over national or public at large interests.<sup>173</sup>

Recently, the Pennsylvania Attorney General's involvement in an investment decision made by the trustees of the Milton Hershey School Trust (Trust)—a charitable trust benefitting the Milton Hershey School for Needy Children (the School) in Hershey Pennsylvania—illustrates that the state attorney general is not immune to the influence of local politics on decisions to intervene in charity matters. In 2002, the trustees voted to sell the Trust's controlling interest in the Hershey Company, in a takeover bid by a competitor, in order to diversify the Trust's investment portfolio.<sup>174</sup> Initially, the Pennsylvania Attorney General's office seemed to support the trustees' decision to sell the Hershey Company

<sup>170</sup> Silber, *supra*, note 108, at 634.

<sup>171</sup> See Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence From Hershey's Kiss-Off*, 100 COLUM. L. REV. 749, 751 (2008) ("[T]he typical state attorney general is an elected political official for whom the supervision of charitable organizations has little political payoff."); Silber, *supra* note 108, at 634; National Association of Attorneys General, *Frequently Asked Questions*, [http://www.naag.org/how\\_does\\_one\\_become\\_an\\_attorney\\_general.php](http://www.naag.org/how_does_one_become_an_attorney_general.php) (last visited Nov. 2, 2009). The National Association of Attorneys General reports that the attorney general is elected in forty-three jurisdictions and is appointed by the governor in five states. National Association of Attorneys General, *supra*.

<sup>172</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 446–47 (noting a trend of increasing politicization in state regulation of charities by the attorney general since the 1990s). Professor Evelyn Brody states that "[p]olitical cynics believe that 'A.G.' stands not for 'attorney general' but for 'aspiring governor.'" Brody, *Parochialism*, *supra* note 25, at 946. Professor Manne observes that the state attorney general is "a highly political office, and the government's agenda with respect to enforcement of charity obligations is unlikely to include detached matters of efficiency, and may reflect a political ideology inimical to the aims of certain nonprofit organizations." Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 251 (1999).

<sup>173</sup> See Brody, *Parochialism*, *supra* note 25, at 968.

<sup>174</sup> See Klick & Sitkoff, *supra* note 171, at 752–55. The trustees' decision to diversify the Trust's portfolio was consistent with fulfilling their duty of care. By all accounts, the Trust's portfolio lacked diversification and was heavily invested in Hershey Company stock, subjecting the Trust's portfolio to uncompensated risk that could be easily avoided by diversification. See *id.* at 772–75. Typically, state trust law would require a trustee to diversify the trust's portfolio under the prudent investor standard. Pennsylvania law, however, exempted the Trust from the general requirement that charitable trusts diversify their portfolio. See Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 650 U. PITT. L. REV. 1, 6 (2003) [hereinafter Sidel, *Struggle for Hershey*].

stock.<sup>175</sup> But the Pennsylvania Attorney General, who was running for governor at the time, was concerned about the effect such a sale would have on the local community given its close ties to the Hershey Company.<sup>176</sup> Therefore, he sought to enjoin the sale asserting that it would lead to lay-offs and plant closings that would harm the central Pennsylvania community.<sup>177</sup> The Pennsylvania Attorney General's changed stance came about after his opponent in the gubernatorial race publicly denounced the proposed sale, and local opposition to the proposed sale grew, including requests made by the School's alumni association for the Attorney General to remove the trustees for fiscal waste.<sup>178</sup> When the Attorney General obtained a preliminary injunction barring the proposed sale, the trustees abandoned their plans to sell the Hershey Company stock.<sup>179</sup> A few months later, the Pennsylvania Attorney General lost the election to his opponent who openly opposed the sale from the beginning.<sup>180</sup> The Hershey Trust case illustrates that when the political stakes are high, the state attorney general may be willing to put aside what is best for the charity in favor of what is politically salient.

State attorneys general are inherently political. They direct their office to "ignore cases that are politically dangerous" and to pursue matters that are "politically irresistible" even though such matters may implicate mere business decisions of charity managers.<sup>181</sup> State attorneys general are reluctant "to move in an aggressive and timely fashion when to do so might be politically difficult—despite abundant grounds for concerns about damage to the public interest."<sup>182</sup> In 2001, for example, the media reported that a key employee who resigned from Citizen Education Fund, a charitable organization located in Illinois and led by Reverend Jesse Jackson, received a generous severance package.<sup>183</sup> The reports also disclosed that the departing employee had recently given birth, out of wed-

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<sup>175</sup> See *id.* at 768–69; Sidel, *Struggle for Hershey*, *supra* note 174, at 13. A few months prior to the announcement of the proposed sale, staff from the Pennsylvania Attorney General's office met with the trustees and encouraged them to diversify the Trust's investment portfolio, which at that time was heavily invested in Hershey Company stock. See Klick & Sitkoff, *supra* note 171, at 768, 772.

<sup>176</sup> See Klick & Sitkoff, *supra* note 171, at 755.

<sup>177</sup> See *id.* at 755–56, 771.

<sup>178</sup> See *id.* at 770; Sidel, *Struggle for Hershey*, *supra* note 174, at 14–15.

<sup>179</sup> See Klick & Sitkoff, *supra* note 171, at 798.

<sup>180</sup> See *id.* at 770.

<sup>181</sup> Brody, *Parochialism*, *supra* note 25, at 947–48.

<sup>182</sup> Silber, *supra* note 108, at 617; see also Crimm *supra* note 123, at 1194 ("[I]f investigations were undertaken, the attorneys general would make powerful enemies; if punishment followed, attorneys general would make vindictive enemies of the richest and most influential people and organizations in the state; and if attorneys general were successful in ending abuses, the 'wells of charity' would dry up, and the attorneys general who might suffer politically.").

<sup>183</sup> See Silber, *supra* note 108, at 613.

lock, to Reverend Jackson's child.<sup>184</sup> The organization's annual information return, however, did not disclose as required the employee's salary and severance benefits.<sup>185</sup> After a brief investigation, the Illinois Attorney General gave Citizen Education Fund a mere "slap on the wrist," allowed the organization to amend its state disclosure report, and then closed the investigation.<sup>186</sup> A vocal conservative critic of Reverend Jackson, Bill O'Reilly, alleged that the Democratic Illinois Attorney General, who at the time was running for governor, allowed his political aspirations to influence the investigation of Citizen Education Fund.<sup>187</sup>

Many have also criticized the IRS for susceptibility to political influence. The Commissioner of the IRS is a political appointee.<sup>188</sup> Critics allege that the IRS exercises its wide discretion to inappropriately target charitable organizations that expressed views contrary to those of the then-current administration. In 2003, for example, the IRS, under the administration of President George W. Bush, reinstated the tax-exempt status of two charitable organizations with close ties to former Republican House Speaker Newt Gingrich.<sup>189</sup> These exemptions had earlier been revoked by the IRS under the Clinton administration in 1996 and 2000 on the grounds that the organizations improperly benefitted the Republican Party.<sup>190</sup> The IRS denied allegations that political influence caused its reconsideration of the tax-exempt status of these organizations; yet the IRS refused to release any documents relating to its decision.<sup>191</sup>

The Service was, yet again, accused of political influence when, in 2005, it began investigating All Saints Church in Pasadena, California.<sup>192</sup> The Service alleged that a guest preacher's sermon violated the absolute prohibition on political candidate advocacy by charities.<sup>193</sup> The sermon,

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<sup>184</sup> *See id.*

<sup>185</sup> *See id.*

<sup>186</sup> *See id.* The activities of Citizen Education Fund also called into question its tax-exempt status as a charitable organization under federal law. *See id.* at 614 ("The American Conservative Union . . . formally requested that the IRS launch proceedings that could have led to the revocation of [Citizen Education Fund's] exempt status, but the IRS declined to pursue the matter.").

<sup>187</sup> *See id.* at 613.

<sup>188</sup> *Id.* at 634.

<sup>189</sup> *See* Christine J. Harris, *Talk with IRS Reps Offers More Insight into Review of Gingrich Groups*, 2003 TAX NOTES TODAY 118-4 (June 19, 2003).

<sup>190</sup> *See id.*

<sup>191</sup> *See id.*

<sup>192</sup> *See* Rebecca Trounson, *IRS Ends Church Probe but Stirs New Questions*, LOS ANGELES TIMES, Sept. 24, 2007, at A1.

<sup>193</sup> *Id.*; *see* Letter from the IRS to All Saints Church (June 9, 2005), <http://aschu.convio.net/pdf/IRS%20Letter%20to%20All%20Saints.pdf>. *See generally* Johnny Rex Buckles, *Not Even a Peep? The Regulation of Political Campaign Activity by Charities through Federal Law*, 75 U. CIN. L. REV. 1071, 1071-78 (2007) (discussing the prohibition on political campaign activity on charities and noting the investigation of All Saints Church).

given two days before the 2004 Presidential election, was titled “If Jesus Debated Senator Kerry and President Bush.”<sup>194</sup> The sermon seemed to advocate that Senator Kerry was the better candidate and that parishioners should cast their votes on election day for Senator Kerry, though at no point did the guest preacher explicitly tell the parishioners to vote for Senator Kerry.<sup>195</sup> About one year after the 2004 election, in which President Bush was re-elected, the IRS launched a lengthy investigation into All Saints Church’s possible violation of the political campaign prohibition.<sup>196</sup> The IRS closed the investigation in September 2007.<sup>197</sup> While the IRS found that All Saints Church had engaged in impermissible political campaign activity, the IRS did not impose any excise taxes and did not revoke the church’s tax-exempt status.<sup>198</sup> All Saints Church alleged that it was the target of the investigation in the first place because of the views expressed during the sermon, which condemned certain actions of the Bush administration.<sup>199</sup> The church requested that the Department of Justice examine whether improper political influence compelled the IRS to investigate its activities, and the church demanded an apology from the IRS.<sup>200</sup>

#### 4. Agency Constraints

Finally, the government’s lack of personal stake in the outcome of the enforcement action results in ineffective regulation of the charitable sector. These agency constraints are especially problematic when the behavior sought to be regulated is the fiduciary duties of charity managers:

[T]he Anglo-American judicial system relies on an individual’s self-interest to assure compliance with the law. The existence of ascertained individuals who will look after their own interests is a basic component of all fiduciary relationships. The laws are so framed that reliance

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<sup>194</sup> See Rev. Dr. George F. Regas, Rector Emeritus, Sermon at All Saints Church: If Jesus Debated Senator Kerry and President Bush (Oct. 31, 2004), [http://aschu.convio.net/archives/sermons/\(10-31-04\)%20If%20Jesus%20Debated.pdf](http://aschu.convio.net/archives/sermons/(10-31-04)%20If%20Jesus%20Debated.pdf).

<sup>195</sup> See Trounson, *supra* note 192, at A1.

<sup>196</sup> See *id.*; Letter from the IRS to All Saints Church (June 9, 2005), <http://aschu.convio.net/pdf/IRS%20Letter%20to%20All%20Saints.pdf>.

<sup>197</sup> See Trounson, *supra* note 192, at A1.

<sup>198</sup> See *id.*

<sup>199</sup> See Rev. J. Edwin Bacon, Jr., Sermon at All Saints Church: Called to Freedom at 2–3 (Sept. 23, 2007), [http://www.allsaints-pas.org/site/DocServer/Keeping\\_the\\_Main\\_Thing\\_the\\_Main\\_Thing.pdf?docID=2561](http://www.allsaints-pas.org/site/DocServer/Keeping_the_Main_Thing_the_Main_Thing.pdf?docID=2561).

<sup>200</sup> Letter from Marcus S. Owens, Attorney for All Saints Church to Mr. J. Russell George, Treasury Inspector General for Tax Administration (Sept. 21, 2007), [http://www.allsaints-pas.org/site/DocServer/Letter\\_to\\_Treasury\\_Inspector\\_General\\_092107.pdf?docID=2543](http://www.allsaints-pas.org/site/DocServer/Letter_to_Treasury_Inspector_General_092107.pdf?docID=2543); Letter from Marcus S. Owens, Attorney for All Saint’s Church to Linda E. Stiff, Acting Commissioner, Internal Revenue Service at 1 (Sept. 21, 2007), [http://www.allsaints-pas.org/site/DocServer/Letter\\_to\\_IRS\\_Commissioner\\_092107.pdf?docID=2542](http://www.allsaints-pas.org/site/DocServer/Letter_to_IRS_Commissioner_092107.pdf?docID=2542).



is placed on the beneficiaries of a private trust or on the shareholders of a business corporation to call into action the enforcement machinery of the courts.<sup>201</sup>

The case study of the Pennsylvania Attorney General's interference with the investment decision of the trustees of the Milton Hershey School Trust<sup>202</sup> illustrates an inherent problem: where an agency receives no incentive for ensuring that charitable assets are managed and maintained for the public good, it may easily overlook this mandate when the interests of its constituents conflict with the best interests of the charity. The Pennsylvania Attorney General expanded its regulatory role to "exploring the negative effects of charitable and philanthropic activity on communities and the public that go well beyond safeguarding trustee fidelity to fiduciary duty and the interests of the beneficiaries that regulators are traditionally required to safeguard."<sup>203</sup> In this case, what was best for the charity gave way to what was best for the regulator and the regulator's constituents. Professors Klick and Sitkoff observed that the personal and community conflicts of interest made "monitoring by the state attorneys general . . . inadequate to ensure that resources held by tax-exempt and therefore publicly-subsidized charitable trusts [were] deployed in efficient pursuit of a bona fide charitable purpose for the public good."<sup>204</sup>

From the standpoint of financial resources, political capital, and other economic concerns, there is little incentive for the state attorneys general or the IRS to increase the budgetary resources dedicated to the oversight of the charitable sector. For example, as a tax collection agency, the IRS may focus its increased enforcement efforts on taxpayers suspected of evading federal income taxes. In return for the increased financial resources dedicated to this enforcement area, the IRS may reap the benefit of additional tax revenues. In addition, if successful, Congress may look favorably on this enforcement area and grant additional budgetary appropriations in the next fiscal year. For example, if the IRS collected an additional \$50 million in tax revenues after increasing enforcement resources by \$5 million, think about what the IRS could do with another \$25 million in financial resources. This kind of "return on budgetary capital" would not occur if increased budgetary resources were dedicated to the enhanced monitoring of the charitable sector.<sup>205</sup>

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<sup>201</sup> FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 304.

<sup>202</sup> *See supra* notes 174–80 and accompanying text.

<sup>203</sup> Sidel, *Struggle for Hershey*, *supra* note 174, at 2–3.

<sup>204</sup> Klick & Sitkoff, *supra* note 171, at 817–18.

<sup>205</sup> *See* Hansmann, *supra* note 25, at 604. Professor Hansmann explains that strict enforcement of the nondistribution constraint would not produce more tax revenue; "it will simply ensure that less of a nonprofit's income goes to its managers and more goes to the purposes for which the patrons have contributed their funds." *Id.*; *cf.* Joel L. Fleishman, *Public Trust in*

Even though the IRS may assess excise taxes for wrongdoings by charity managers, the amount of excise taxes imposed on charitable organizations and their managers is significantly less than one percent of the total amount of tax revenues collected by the IRS each year.<sup>206</sup> Besides, the IRS may reduce or waive excise taxes imposed on charitable managers in order to encourage reformation of the charity's internal policies.<sup>207</sup> The state attorneys general are in an even worse position to economically justify increased enforcement in the charitable sector because state law often does not authorize state attorneys general to impose fines on charity managers who breach their fiduciary duties unless the breach rises to the level of criminal activity.<sup>208</sup> Any money the attorney general recovers from the breach of fiduciary duty is paid directly to the injured charitable organization. Furthermore, as political agents, the state attorneys general do not have strong incentive to increase enforcement efforts because active supervision has little political payoff outside of isolated incidents.<sup>209</sup> Thus, the charitable sector needs supervision by agents with better incentives.<sup>210</sup>

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*Not-for-Profit Organizations and the Need for Regulatory Reform*, in PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172, 188 (Charles T. Clotfelter & Thomas Ehrlich eds., Indiana University Press 1999) [hereinafter Fleishman, *Public Trust*] (noting that, as a tax collecting agency, "it is not surprising that the IRS would find it expedient to pay less attention to the tax-exempt organizations, which by definition, do not pay taxes, than to those entities from which taxes are collected").

<sup>206</sup> In 2007, the IRS collected approximately \$5.5 million in excise taxes imposed on charitable organizations and their managers, excluding the excise tax on private foundation net investment income. See I.R.S., "Excise Taxes Reported by Charities, Private Foundations, and Split-Interest Trusts on Form 4720, Calendar Year 2007, available at <http://www.irs.gov/pub/irs-soi/07pf00et.xls>. The same year, the IRS collected total tax revenues of approximately \$2.7 trillion. IRS DATA BOOK 2008, at 3 tbl.1. Thus, in comparison to total tax collections, the excise taxes aimed at influencing fiduciary behavior of charity managers and preserving charitable assets are negligible.

<sup>207</sup> See, e.g., FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 261–64 (reporting that in the high-profile investigation of malfeasance and collusion by former trustees of a Hawaiian charitable trust that operated the Kamehameha Schools (the Bishop Estate Trust), the IRS initially asserted \$65 million in taxes; but the IRS agreed to settle for approximately \$9 million in a settlement agreement that required the replacement of the five corrupt trustees and payment by the removed trustees of an excise tax of \$40,000 each). As a general matter, the IRS is authorized to abate the excise taxes imposed on charity managers, other than the first-tier self-dealing excise tax imposed on the self-dealer, if the violation was due to reasonable cause and not to willful neglect and the violation was corrected in a timely matter. See I.R.C. § 4962 (West Supp. 2009).

<sup>208</sup> See *supra* note 62 and accompanying text describing the enforcement powers of the state attorney general.

<sup>209</sup> See Klick & Sitkoff, *supra* note 171, at 749.

<sup>210</sup> See *id.* at 818–19.

### C. Summary

The fundamental policy reasons for vesting regulation of the charitable sector in the government remain strong.<sup>211</sup> Charities are organized and operated for the public benefit. Placing exclusive standing in the government satisfies the dual concerns of maintaining an enforcement mechanism to address malfeasance and protecting charitable resources from harassment and interference.<sup>212</sup> Professor Fleishman emphasizes the need for continued government regulation of the charitable sector:

[W]ithout government monitoring and enforcement of laws proscribing fraud and self-dealing, among other objectionable behavior that damages us all, the good guys will observe the rules, the bad guys will flout them with impunity, and, if enough bad guys get away with it, the arena of private action will be vitally undermined.<sup>213</sup>

There is almost universal agreement that the state attorneys general fall short in fulfilling their responsibility to regulate the charitable sector now, and they are not expected to improve in the foreseeable future.<sup>214</sup> There have been similar concerns expressed about the IRS.<sup>215</sup> Due to the inherent financial, institutional, political, and agency constraints imposed on these governmental agencies, the internal reform necessary to make the state attorneys general and the IRS an ongoing and effective enforcement presence in the charitable sector is unlikely to occur.

Any reform of government regulation of the charitable sector is further hindered by the “halo effect.”<sup>216</sup> The “halo effect” stems from the notion that charitable status is a sign of trustworthiness bestowing a “halo” on the organization, regardless of merit.<sup>217</sup> Essentially, the current government regulators resist implementing internal reform because of the common conception that the charitable sector exists to “do good” and that the people who serve in the sector, often without pay, have only the best intentions.<sup>218</sup> The idea is that these selfless, high-profile, and

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<sup>211</sup> See Blasko et al., *supra* note 57, at 40 (“The common law rule of standing . . . continues to have strong theoretical foundations.”).

<sup>212</sup> See *id.* at 42.

<sup>213</sup> Fleishman, *Public Trust*, *supra* note 205, at 177.

<sup>214</sup> See *supra* note 25.

<sup>215</sup> See, e.g., Fleishman, *Public Trust*, *supra* note 205, at 185; Owens, *supra* note 130, at 4–10.

<sup>216</sup> See Crimm *supra* note 123, at 1096–97 (noting that the “halo” perception of the charitable sector provides an indication that charities are “providers of good,” “trustworthy institutions,” “altruistic, compassionate or caring in nature,” “benevolent,” and “beyond reproach”).

<sup>217</sup> See Brody, *Agents Without Principals*, *supra* note 14, at 460.

<sup>218</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 2 (“In part, [the] failure to provide meaningful regulation has been justified on the grounds that, because [charitable organizations] are formed to ‘do good,’ the people who run [charitable

important members of the community should not be bothered by the threat of lawsuit and liability.<sup>219</sup> Thus, vigorous oversight of these “do-gooders” is unnecessary when other evils exist within the jurisdiction of the government regulator.<sup>220</sup> As long as this perception of the charitable sector exists, comprehensive reform by existing government agencies is unlikely.

There must be serious consideration of alternatives to the current government regulation if the charitable sector is to remain successful.<sup>221</sup> Professor Fleishman aptly makes this point:

For the long-run good of the sector, we cannot continue to rely on an inadequately staffed and insufficiently powerful IRS, the vagaries of inadequately staffed and usually not-very-interested offices of the state attorneys general which, in any event, have difficulty in policing a sector which routinely crosses state and national boundaries many times a day, the limited scope and vision of voluntary watchdog agencies, . . . and the investigatory, inflammatory press.<sup>222</sup>

Continuing the status quo will harm not only the charitable organizations that comprise the sector, but also the public, which ultimately benefits from the vibrant existence of the charitable sector.

## II. PRIVATE REGULATION OF THE CHARITABLE SECTOR

Traditionally, a member of the general public has no standing to enforce a charitable gift or mismanagement of charitable assets, even though such an individual may be a donor or beneficiary of the charitable organization.<sup>223</sup> This is due to the fact that private individuals are not

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organizations] will likewise ‘do good’; they will not profit at the organization’s expense nor be reckless in their management of its assets.”).

<sup>219</sup> See Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 466–70.

<sup>220</sup> *Cf. id.* at 450 (noting that comprehensive regulation of the charitable sector by the state attorneys general and the IRS has not been “politically possible” due at least in part to the widely-held belief that charitable managers are selflessly “doing good”).

<sup>221</sup> *Cf. Patton*, *supra* note 55, at 134–44 (noting that since the fourteenth century, situs and methods for enforcement of the law of charity have been reevaluated and reassigned numerous times in response to claims of corruption and ineffectiveness of the then-current enforcement mechanism).

<sup>222</sup> Fleishman, *Public Trust*, *supra* note 205, at 185.

<sup>223</sup> See, e.g., *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 518, 645–46 (1819) (denying standing to both students of Dartmouth College and its donors for alleged breach of fiduciary duties by the trustees of the college); *Grant v. Trinity Health-Michigan*, 390 F. Supp. 2d 643 (E.D. Mich. 2005) (holding that a suit for enforcement against a charitable hospital by beneficiaries—uninsured patients who claimed that the hospital charged uninsured patients substantially higher rates than insured patients—could not be maintained); *Carl J. Herzog Found., Inc. v. Univ. of Bridgeport*, 699 A.2d 995 (Conn. 1997) (holding that a suit for enforcement of a charitable trust could not be maintained by a donor of the

natural direct stakeholders in the financial management of the charitable organization.<sup>224</sup> As a fundamental matter, a charitable organization is confined by a “nondistribution constraint”<sup>225</sup>—the prohibition on the distribution of the net earnings of the charitable organization to any member, director, trustee, or officer of the organization. Accordingly, unlike their for-profit counterparts, charitable organizations lack “watchdog” shareholders who have a financial incentive to monitor the actions of their directors and trustees.<sup>226</sup>

Lax enforcement of the charitable sector by state attorneys general has led courts to reevaluate the traditional rule denying standing to private individuals, and forced them to consider increasing the circumstances under which private individuals are allowed to bring enforcement actions against charitable organizations.<sup>227</sup> In particular, courts have granted standing to private parties when convinced that such parties have sufficient “interest” in the outcome of the proceeding to warrant their involvement, thus negating the traditional justification for limited standing—preventing vexatious litigation by disinterested parties.<sup>228</sup>

#### A. *Members of a Charitable Organization*

When a charitable organization is formed as a membership non-profit corporation, members of the corporation may have standing to

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charitable trust); *Weaver v. Wood*, 680 N.E.2d 918 (Mass. 1997) (holding that membership in a charitable organization by itself is not sufficient to convey standing to enforce claims of mismanagement of the organization); see also RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. d (1959) (“The mere fact that as members of the public they benefit from the enforcement of the trust is not a sufficient ground to entitle them to sue, since a suit on their behalf can be maintained by the Attorney General.”).

<sup>224</sup> Cf. Manne, *supra* note 172, at 227–28 (observing that unlike for-profit companies where self-enforcement mechanisms are in place to help supplement government regulation, “in the nonprofit world, owners are not well-defined; their voting rights are questionable or nonexistent; charitable goals are ambiguous, or at least difficult to quantify; no significant second-order markets operate; and the residual claimants are either unable to monitor effectively or unwilling to do so”).

<sup>225</sup> Professor Hansmann describes the so-called “nondistribution constraint” as follows:

A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors and trustees. By “net earnings” I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to the organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides, whether or not that person exercises some control over the organization. It should be noted that a nonprofit organization is not barred from earning a profit . . . . It is only the distribution of profits that is prohibited.

Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838–39 (1980).

<sup>226</sup> See Fishman, *Standards of Conduct*, *supra* note 23, at 408–09.

<sup>227</sup> See Chester, *Grantor Standing*, *supra* note 15, at 611; Hansmann, *supra* note 25, at 607–08.

<sup>228</sup> See Blasko et al., *supra* note 57, at 52.

bring suit against the directors of the corporation for breach of fiduciary duty with respect to the management of the corporation.<sup>229</sup> The members' suit is in the nature of a derivative action because it is brought to enforce the fiduciary duties the charity directors owe to the organization itself rather than to the individuals bringing the suit.<sup>230</sup> Some jurisdictions statutorily grant standing to members of a nonprofit corporation,<sup>231</sup> while others recognize such standing through case law.<sup>232</sup> The jurisdictions that grant standing to members of a charitable corporation recognize that these members have an interest distinct from that of the general public.<sup>233</sup> In several jurisdictions, however, standing for members of a nonprofit corporation to enforce breach of fiduciary duties by the directors has been denied on the grounds that breach of fiduciary duties involves the public interest and not a member's private interest in the corporation.<sup>234</sup>

Conversely, the law has historically recognized the right of shareholders of for-profit corporations to bring derivative actions to enforce the fiduciary duties of the corporation's directors and officers. A shareholder's ownership interest in a for-profit corporation not only grounds the shareholder's standing for the derivative action, but typically carries voting rights—proportional to the shareholder's ownership interest—in the election of the directors of the corporation.<sup>235</sup> Accordingly, "shareholder derivative suits may be viewed as a last-ditch exercise of corporate power by those in whose hands that power ultimately lies, and for those who will ultimately benefit from the suit."<sup>236</sup>

In the for-profit context, shareholder derivative suits "are brought to redress injury sustained by, or to enforce a duty owed to, the corporation" by its managers, such as wasted corporate assets, gross mismanagement, self-dealing, excessive compensation, and usurped corporate

<sup>229</sup> See Deborah A. DeMott, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 2.12 (2003).

<sup>230</sup> See *id.* §§ 2.2, 2.12.

<sup>231</sup> See, e.g., CAL. CORP. CODE § 5710 (West 2005); N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a) (McKinney 2006); GA. CODE ANN. § 14-3-741 (2003); ILL. COMP. STAT. § 17.80 (2006); MICH. COMP. LAWS § 450.2491–2493 (West 2004); see also REVISED MODEL NON-PROFIT CORP. ACT § 13.02 (3d ed. 2008) (allowing for derivative suits for breaches of fiduciary duties by members having five percent of the vote or fifty in number, whichever is less).

<sup>232</sup> See, e.g., *Leeds v. Harrisonon*, 72 A.2d 371 (N.J. Ch. 1950). The common law generally does not permit member derivative actions without board participation. See, e.g., *Basich v. Board of Persons*, 493 N.W.2d 293 (Minn. Ct. App. 1992); *Voelker v. St. Louis Mercantile Library Ass'n*, 359 S.W.2d 689 (Mo. 1962).

<sup>233</sup> See *Blasko et al.*, *supra* note 57, at 54–55.

<sup>234</sup> See, e.g., *Weaver v. Wood*, 680 N.E.2d 918 (Mass. 1997); *Lopez v. Medford Cmty. Ctr.*, 424 N.E.2d 229 (Mass. 1981); *Voelker v. Saint Louis Mercantile Library Ass'n*, 359 S.W.2d 689 (Mo. 1962); *Nacol v. State*, 792 S.W.2d 810 (Tex. Ct. App. 1990).

<sup>235</sup> *Atkinson*, *supra* note 29, at 671.

<sup>236</sup> *Id.*

opportunity.<sup>237</sup> The derivative suit serves two purposes: deterring misconduct by corporate managers and compensating for corporate loss.<sup>238</sup> Additionally, it provides an important supplement to government regulation of mismanagement by corporate fiduciaries.<sup>239</sup> The damages received from the suit are paid to the corporation rather than to the individual shareholders who instituted the suit.<sup>240</sup> The shareholders, however, maintain an interest in the outcome of the derivative action, because, as financial stakeholders in the equity of the corporation, shareholders suffer indirect injury created by injury to the corporation.<sup>241</sup> Thus, they enjoy a corresponding indirect financial benefit when recovery is paid to the corporation, as that payment increases the residual worth of the corporation and the value of the corporation's stock.<sup>242</sup>

Derivative suits in the charitable sector are distinctly different from derivative suits in the for-profit sector.<sup>243</sup> Charities, unlike their for-profit counterparts, do not have shareholders with a proprietary interest in the corporation's residual net worth.<sup>244</sup> In order to be organized as a nonprofit corporation and recognized as exempt from federal income tax, the charity is prohibited from distributing dividends or other forms of "net earnings" to its members or other insiders.<sup>245</sup> Thus, while some charities have members who elect the directors of the charity, these members do not realize any benefit from an increase in the charity's net worth that results from a derivative action brought by the members.<sup>246</sup>

While member standing to regulate a charitable organization may initially seem like a plausible solution to the enforcement problem, there are severe limitations to its effectiveness. Most charitable organizations are not formed as membership nonprofit corporations.<sup>247</sup> Accordingly, this enforcement mechanism will not apply to the majority of charitable organizations. Even for those charities formed as membership corporations, voting power is not linked to any economic contribution to the

<sup>237</sup> See Blasko et al., *supra* note 57, at 53.

<sup>238</sup> See *id.*

<sup>239</sup> See Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 468 ("[T]he derivative action may offer the only effective remedy in those circumstances in which a control group has the ability to engage in self-dealing transactions with the corporation.").

<sup>240</sup> Blasko et al., *supra* note 57, at 53.

<sup>241</sup> See *id.*

<sup>242</sup> See Atkinson, *supra* note 29, at 671.

<sup>243</sup> See Brody, *Limits*, *supra* note 29, at 1430 (noting that "the nonprofit structure cannot be equated with the business corporation in which shareholders having a direct financial interest ultimately decide the fate of the board").

<sup>244</sup> See Blasko et al., *supra* note 57, at 54.

<sup>245</sup> See I.R.C. § 501(c)(3) (2006); REV. MODEL NONPROFIT CORP. ACT § 6.40(a) (3d ed. 2008).

<sup>246</sup> See Atkinson, *supra* note 29, at 671.

<sup>247</sup> See Evelyn Brody, *Entrance, Voice, and Exit: The Constitutional Bounds of the Right of Association*, 35 U.C. DAVIS L. REV. 821, 860 (2002); Manne, *supra* note 172, at 250.

charity. Typically, each member receives one vote without a requirement that the member contribute to the equity of the corporation. Therefore, unlike the for-profit world, where voting power is proportional to contribution, allocation of control in the charitable sector is much less standardized.<sup>248</sup> Furthermore, in cases where charitable organizations are formed as membership nonprofit corporations, often there is substantial overlap between the membership and the composition of the board of directors, making it unlikely members will bring suit against the board for breaches of fiduciary duty.<sup>249</sup>

In addition, there is a strong financial disincentive for member derivative actions in the charitable sector. Members bear the costs of litigation for their derivative suit.<sup>250</sup> The financial disincentive is compounded by the requirement that members receive no pecuniary interest if the suit is successful. Both state law<sup>251</sup> and federal tax law<sup>252</sup> prohibit a charitable nonprofit corporation from distributing profits of the corporation to its members. Accordingly, any recovery received from a successful outcome inures solely to the benefit of the charitable corporation without any corresponding financial benefit to the members of the charitable corporation. Absent a strong moral motivation to institute the suit, members are financially discouraged from enforcing the fiduciary duties of the directors of the charitable organization through private suit.

### B. *Directors or Trustees of the Charitable Organization*

Directors of a charitable nonprofit corporation, like members, also have standing to bring suit against co-directors for breach of fiduciary duty.<sup>253</sup> Likewise, trustees of a charitable trust have standing to bring suit against co-trustees for breach of fiduciary duty.<sup>254</sup> Since these individuals bring suit in a representative, rather than an individual, capacity, they have an interest distinct from that of the general public.<sup>255</sup> Courts have granted standing for co-managers to redress breaches of fiduciary

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<sup>248</sup> See Atkinson, *supra* note 29, at 671–72.

<sup>249</sup> See Crimm, *supra* note 123, at 1182.

<sup>250</sup> Cf. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 233–34 (noting that even in states permitting member derivative suits, there is an absence of an active plaintiff's bar that would profit from bringing such suits).

<sup>251</sup> See, e.g., REV. MODEL NONPROFIT CORP. ACT § 6.40(a) (3d ed. 2008).

<sup>252</sup> See I.R.C. § 501(c)(3) (2006).

<sup>253</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 334; see also *Holt v. Coll. of Osteopathic Physicians and Surgeons*, 394 P.2d 932, 936–37 (Cal. 1964); *Gilbert v. McLeod Infirmary*, 64 S.E.2d 524, 528–29 (S.C. 1951).

<sup>254</sup> See Karst, *supra* note 82, at 443–44; see also *Eunich v. Korean Found., Inc.*, 176 N.E.2d 692, 698–99 (Ill. App. Ct. 1961); RESTATEMENT (SECOND) OF TRUSTS § 200 cmt. e (1959) (“If there are several trustees, one or more of them can maintain a suit against another to compel him to perform his duties under the trust . . .”).

<sup>255</sup> See Blasko et al., *supra* note 57, at 55.



duties by their counterparts because “[t]he charity’s own representative has at least as much interest in preserving charitable funds as does the Attorney General.”<sup>256</sup> Granting standing to a director or trustee, however, raises a “circularity problem.”<sup>257</sup> To allow suit by a disappointed director or trustee thwarts the general principle that the organization is governed by a majority of its trustees or directors.<sup>258</sup> Therefore, in granting standing, courts must be careful to distinguish true claims of fiduciary wrongdoing from grievances for differences of opinion.

Reliance on co-manager enforcement of fiduciary duties fails on other fronts. Enforcement by co-directors and co-trustees of a non-profit corporation involve the same limitations as enforcement by members.<sup>259</sup> Any recovery received from the successful outcome of the suit would inure solely to the benefit of the charitable organization.<sup>260</sup> Although the costs of litigation in suits instituted by a director or trustee may occasionally be paid from the charitable organization’s funds, the director or trustee receives no financial benefit from the successful outcome of the suit. Furthermore, if the malfeasance occurs at the director or trustee level, and there was collusion among the directors or trustees to commit the malfeasance, it is unlikely that the directors or trustees will be reliable enforcement mechanisms.<sup>261</sup> Additionally, a director or trustee may be ignorant about the wrongdoing or the law permitting the director or trustee to bring suit, or may be intimidated by stronger co-managers or a coalition of co-managers.<sup>262</sup>

### C. *Special Interest Doctrine*

Some courts have granted standing to private individuals to bring suit against charitable organizations under the special interest doctrine.<sup>263</sup> According to the special interest doctrine, a private individual, with interests distinct from those of the average donor, beneficiary, or the general

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<sup>256</sup> *Holt*, 394 P.2d 936 (quoting Karst, *supra* note 82, at 444).

<sup>257</sup> Brody, *Limits*, *supra* note 29, at 1433.

<sup>258</sup> *See id.*

<sup>259</sup> *See Crimm*, *supra* note 123, at 1182.

<sup>260</sup> *See supra* notes 245–46 and accompanying text.

<sup>261</sup> *See Karst*, *supra* note 82, at 445 (“[T]here remains the possibility that all the charities fiduciaries will agree on a breach of duty. The public still needs outside watchdogs.”). *See generally* Samuel P. King & Randall W. Roth, *BROKEN TRUST: GREED, MISMANAGEMENT & POLITICAL MANIPULATION AT AMERICA’S LARGEST CHARITABLE TRUST* (Univ. of Haw. Press 2006) (chronicling the extensive self-dealing and other collusive mismanagement of charitable assets of the Bishop Estate Trust between 1997 and 1999 by its trustees).

<sup>262</sup> *See Crimm supra* note 123, at 1182.

<sup>263</sup> *See* RESTATEMENT (SECOND) OF TRUSTS § 391 (1959); Blasko et al., *supra* note 57, at 59.

public, has standing to bring an enforcement action.<sup>264</sup> The doctrine is used to expand standing to those individuals who exhibit a “particularized and justified involvement” in the success of the charity’s mission.<sup>265</sup> “Correctly applied, the special interest exception creates enforcement opportunities for private parties, and enables them to act as private attorneys general, while still avoiding the most important policy pitfalls associated with lax standing rules.”<sup>266</sup>

In determining whether to grant standing to a private party under the special interest doctrine, courts have considered five factors.<sup>267</sup> First, courts consider the nature of the acts complained of and the remedy sought.<sup>268</sup> When the plaintiff complains of extraordinary acts that “pervert” the stated charitable mission of the organization and does not seek to personally benefit from the outcome of the suit, the plaintiff enjoys a better chance of obtaining standing.<sup>269</sup> Second, courts consider the presence of fraud or misconduct on the part of the charitable organization or its managers.<sup>270</sup> Courts are more willing to grant standing to private individuals when they can demonstrate that charity managers committed fraud or abused their fiduciary responsibility.<sup>271</sup> Third, courts consider whether the state attorney general is available to enforce the alleged breach, and even if available, the attorney general’s likely effectiveness.<sup>272</sup> The nature and level of the attorney general’s involvement in the case can significantly influence the court’s decision to grant or deny standing to the private party.<sup>273</sup> Fourth, courts consider the nature of the benefitted class and its relationship to the charitable organization.<sup>274</sup> In particular, the private individual seeking suit must show not only that he is a beneficiary of the charitable organization, but also that he has a direct interest, distinct from that of the general public and other beneficiaries.<sup>275</sup> Finally, courts may consider case-specific objective factors,

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<sup>264</sup> See *Weaver v. Wood*, 680 N.E.2d 918, 923 (Mass. 1997); *Associated Students v. Or. Inv. Council*, 728 P.2d 30, 32 (Or. Ct. App. 1987); RESTATEMENT (SECOND) OF TRUSTS § 391 (1959).

<sup>265</sup> *Blasko et al.*, *supra* note 57, at 60–61.

<sup>266</sup> *Id.* at 61.

<sup>267</sup> See *id.*

<sup>268</sup> *Id.*

<sup>269</sup> See *id.* at 61–63.

<sup>270</sup> *Id.* at 61.

<sup>271</sup> See *id.* at 64.

<sup>272</sup> See *id.* at 67.

<sup>273</sup> See *id.* at 67–68 (“The Massachusetts Attorney General’s office, for instance, has a division dedicated to charities enforcement, and the Massachusetts courts, presumably not by coincidence, have a long history of denying private plaintiff standing in favor of exclusive official enforcement.”).

<sup>274</sup> *Id.* at 61.

<sup>275</sup> See *id.* at 70.

and the social desirability of allowing the private party to bring suit.<sup>276</sup> Specifically, courts are more willing to grant standing under the special interest doctrine when there appears to be an egregious wrong that would otherwise go uncorrected.<sup>277</sup>

In any given situation, whether standing would be granted to a private individual under the special interest doctrine is unclear; the determination is both jurisdiction and court specific. Because courts enjoy substantial discretion in applying the above enumerated factors, a court that wants to reach a decision that is seemingly inconsistent with precedent can use the factors as justification.<sup>278</sup>

### 1. Private Suits by Donors

In the typical case, a donor seeks standing to enforce restrictions placed on the use of a charitable trust.<sup>279</sup> Ordinarily, the donor is granted standing only where the donor specifically reserves the right to enforce the restriction in the donation instrument.<sup>280</sup> Most donations, however, are not documented by an enforceable gift instrument because if a donor reserves the right to retake his donation if it is not used for its intended purpose, no deduction will be allowed for the charitable gift for tax law purposes.<sup>281</sup> Thus, since donors typically do not retain any interest in their property after they contribute it to a charitable organization,<sup>282</sup> courts deny them standing to sue the fiduciaries of the organization.<sup>283</sup>

Recently, some courts have extended standing to donors who failed to execute an enforceable gift instrument that would allow them to enforce their restrictions.<sup>284</sup> One notable case of the extension of donor

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<sup>276</sup> See *id.* at 74.

<sup>277</sup> *Id.* at 75.

<sup>278</sup> See *id.* at 78–81 (identifying three hypothetical situations in which the special interest doctrine might be analyzed in contemporary times, noting in the second example how standing under the special interest doctrine may be denied under a traditional approach but granted under a more flexible approach).

<sup>279</sup> See Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable Donor Standing*, 41 GA. L. REV. 1183 (2007) [hereinafter Brody, *Dead Hand*] (examining the evolution of donor standing to enforce donor-imposed restrictions on charitable gifts).

<sup>280</sup> The common law rule has long been that the donor does not have standing to enforce the terms of the charitable gift unless he retains an interest in the donated property. See *Herzog Found. v. Univ. of Bridgeport*, 699 A.2d 995, 998 (Conn. 1997); RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. e (1959).

<sup>281</sup> See Brody, *Dead Hand*, *supra* note 279, at 1214.

<sup>282</sup> See *id.* at 1209–10; Chester, *Grantor Standing*, *supra* note 15, at 614–15.

<sup>283</sup> See Blasko et al., *supra* note 57, at 41.

<sup>284</sup> *E.g.*, *L.B. Research & Educ. Found. v. UCLA Found.*, 29 Cal. Rptr. 2d 710, 716 (Cal. Ct. App. 2005); *Smithers v. St. Luke's-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 436–38 (N.Y. App. Div. 2001). *But see* *Prentis Family Found. v. Barbara Ann Karmanos Cancer Inst.*, 698 N.W.2d 900, 913–14 (Mich. Ct. App. 2005).

standing is *Smithers v. St. Luke's-Roosevelt Hospital Center*.<sup>285</sup> In that case, Brink Smithers, a recovering alcoholic, pledged \$10 million to St. Luke's-Roosevelt Hospital Center (Hospital) to establish the Smithers Alcoholism Center as a home-like facility separate and apart from the Hospital setting.<sup>286</sup> The Hospital purchased the facility location with the first \$1 million installment of the gift in 1973,<sup>287</sup> and Mr. Smithers funded \$5 million of the gift until 1978 when his relationship with the Hospital became strained and he accordingly told the Hospital that he would make no further payments on the gift.<sup>288</sup> The Hospital and Mr. Smithers reconciled in the early 1980s, with the Hospital agreeing to strictly adhere to the terms of the original gift.<sup>289</sup> They memorialized the terms of the gift in a letter dated October 24, 1983.<sup>290</sup> Under the terms of the letter, the final installment of the gift was to be used as an endowment fund exclusively for the Smithers Alcoholism Center.<sup>291</sup>

Shortly after Mr. Smithers' death in 1994, the Hospital announced that it was moving the alcohol treatment facility into the Hospital and selling the separate facility.<sup>292</sup> In addition, the Hospital cancelled a gala ball intended to raise money for the Smithers Alcoholism Center and at which Mr. Smithers' wife was to be presented an award in Mr. Smithers' honor.<sup>293</sup> Mrs. Smithers learned that the Hospital had used monies from the endowment fund for its general operations, and she demanded that the Hospital provide an accounting of the endowment fund.<sup>294</sup>

After an investigation by the New York Attorney General prompted by Mrs. Smithers, the Hospital returned \$5 million to the endowment fund, without lost income, and agreed to transfer the proceeds from the sale of the facility to the endowment fund.<sup>295</sup> The Hospital also agreed to use the endowment fund, as previously promised, exclusively for the Smithers Alcoholism Center.<sup>296</sup>

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<sup>285</sup> *Smithers*, 723 N.Y.S.2d at 438.

<sup>286</sup> *Id.* at 427. The Smithers Alcoholism Center is the predecessor to the Betty Ford Clinic style of alcohol and drug rehabilitation centers.

<sup>287</sup> *See id.* at 427.

<sup>288</sup> *See id.*

<sup>289</sup> *See id.* at 427-28.

<sup>290</sup> *See Smithers v. St. Luke's-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 428 (N.Y. App. Div. 2001).

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* at 428-29.

<sup>293</sup> *See id.*

<sup>294</sup> *Id.* at 429 ("The Hospital at first resisted disclosing its financial records, but Mrs. Smithers persisted, and in May 1995 the Hospital disclosed that it had been misappropriating monies from the Endowment Fund since before Mr. Smithers's death, transferring such monies to its general fund where they were used for purposes unrelated to the Smithers Center.").

<sup>295</sup> *See id.* at 429-31.

<sup>296</sup> *Smithers v. St. Luke's-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 429 (N.Y. App. Div. 2001).

The sole issue in the *Smithers* case was whether Mrs. Smithers, as personal representative of Mr. Smithers' estate, had standing to enforce the terms of Mr. Smithers' charitable gift to the Hospital.<sup>297</sup> The court held that standing for Mrs. Smithers was appropriate in this case.<sup>298</sup> Specifically, the court noted that the attorney general and the donor had concurrent standing to enforce the terms of the charitable gift because the donor is more likely than the attorney general to be vigilant in enforcing his intent.<sup>299</sup> Also, the court was sympathetic to Mrs. Smithers because of the deficiencies in the attorney general's supervision and the fact that her motivation was not for pecuniary gain, but to vindicate her husband's vision.<sup>300</sup>

The *Smithers* case illustrates that donors have a more vested interest than the attorney general in ensuring that the terms of a charitable gift are carried out. Without Mrs. Smithers' diligence, the attorney general would not have pursued the Hospital's misappropriation of funds and failure to comply with the express terms of the charitable gift.<sup>301</sup> Donors like Mrs. Smithers have a personal interest in seeing that their charitable donations are used for their intended purposes, and thus have a strong incentive to ensure that the charitable donee is not misappropriating funds.<sup>302</sup>

The modern trend to grant donors standing to enforce the specific terms of their gifts,<sup>303</sup> however, has not expanded to permit donors to

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<sup>297</sup> *Id.* at 431.

<sup>298</sup> *See id.* at 436.

<sup>299</sup> *See id.* at 435–36.

<sup>300</sup> *See id.* at 434–35.

<sup>301</sup> *See id.* at 434. In reviewing the chronology of the attorney general's investigation of the allegations of the Hospital's misuse of the Smithers endowment fund, the court noted:

Indeed, it was Mrs. Smithers's accountants who discovered and informed the Attorney General of the Hospital's misdirection of Gift funds, and it was only after Mrs. Smithers brought her suit that the Attorney General acted to prevent the Hospital from diverting the entire proceeds of the sale of the building away from the Gift fund into its general fund. The Attorney General, following his initial investigation of the Hospital's administration of the Gift, acquiesced in the Hospital's sale of the building, its diversion of the appreciation realized on the sale, and its relocation of the rehabilitation unit. . . . Absent Mrs. Smithers's vigilance, the Attorney General would have resolved the matter between himself and the Hospital in that manner and without seeking permission of any court.

*Id.* at 434.

<sup>302</sup> *Cf.* Karst, *supra* note 82, at 446–47 (claiming that a main reason to grant standing to a charity's founders and substantial donors to the charity is their deep commitment to the mission of the organization).

<sup>303</sup> *See generally* Edward C. Halbach, Jr., *Standing to Enforce Trusts: Renewing and Expanding Professor Gaubatz's 1984 Discussion of Settlor Enforcement*, 62 U. MIAMI L. REV. 713, 725–27 (2007) (advocating increased donor standing to enforce the terms of charitable gifts); Reid Kress Weisbord, *Reservations About Donor Standing: Should the Law Allow Charitable Donors to Reserve the Right to Enforce a Gift Restriction?* 42 REAL PROP., PROB. & TR. J. 2 (Feb. 2007) (same).

bring suit to redress alleged breaches of fiduciary duty, fraud, and other misappropriation of charitable funds that do not relate to the donor's gift.<sup>304</sup> This limitation makes sense as the donor's gift is not an equity contribution to the charity whereby the donor expects to retain a vested interest.<sup>305</sup> Thus, the modern trend only furthers enforcement of the charity manager's duty of obedience, which requires that the donated funds be used in accordance with the donor's intent. It does not provide additional enforcement support for the vast majority of wrongdoings reported in the charitable sector.<sup>306</sup>

## 2. Private Suits by Charitable Beneficiaries

Generally, no private individual has standing to bring an enforcement action against a charitable organization merely because the individual is within the class of persons who may benefit from the charity.<sup>307</sup> Allowing enforcement suits by charitable beneficiaries poses an inherent problem—to be a charity, the organization must be formed to serve a charitable class, which by definition is an unascertainable group of beneficiaries.<sup>308</sup> Hence beneficiaries are a fluctuating class of persons, and no individual beneficiary has a vested interest in a charitable corporation.<sup>309</sup>

Suits by charitable beneficiaries are permitted only in the most unusual of circumstances. To maintain standing, the beneficiary must be “a member of a small identifiable class” and “have a direct and defined interest, distinct from that of the general public.”<sup>310</sup> Simply showing that the individual is among the class of persons who *may* benefit from the charity, or even that the individual is currently receiving or has in the

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<sup>304</sup> Cf. Halbach, *supra* note 303, at 717–21 (noting that the special interest doctrine is dependent upon the type of action pursued, and a beneficiary who may be granted standing to enjoin a charity from diverting funds from its stated purpose may not be granted standing to remedy alleged mismanagement generally or breach of fiduciary duty).

<sup>305</sup> See Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701, 711 (2008) (“[U]nlike shareholders, charitable nonprofit donors make a gift and generally expect no return of or on their investment . . . [T]he primary expected return is in the form of an existing tax deduction and that return generally exists regardless of lackluster nonprofit corporate governance.”).

<sup>306</sup> Cf. Fremont-Smith Study, *supra* note 10 (surveying press reports of wrongdoings by charity managers over a seven-year period, and noting that the reported incidents primarily involved either criminal activity such as theft of charitable funds for personal wrongdoings, or civil wrongdoings involving breaches of the duties of loyalty and care, such as self-dealing, failure to carry out the charity's mission, and mismanagement of charitable funds, or a combination of both).

<sup>307</sup> See *Robert Schalkenbach Found. v. Lincoln Found., Inc.*, 91 P.3d 1019, 1025–27 (Ariz. Ct. App. 2004); RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. c (1959).

<sup>308</sup> See RESTATEMENT (SECOND) OF TRUSTS § 200 cmt. b (1959).

<sup>309</sup> See Blasko et al., *supra* note 57, at 71–74.

<sup>310</sup> *Id.* at 70.

past received benefits from the charity is insufficient, by itself, to justify standing.<sup>311</sup>

In *Stern v. Lucy Webb Hayes National Training School*, patients of Sibley Hospital were certified as a class without objection and allowed to bring suit against the directors of the hospital for breach of the duties of loyalty and care.<sup>312</sup> In a later, unrelated case, the court of appeals criticized the granting of standing to the patients of Sibley Hospital:

Judge Green's memorandum opinion reflects that he had considerable difficulty with his colleague's decision in the *Stern* case, both as to the question to whom the directors' duties were owed, and the related if not identical issue of who had standing to enforce them. He treats the *Stern* decision as constituting "novel precedent" and representing the "outer limits" of the imposition of liability on directors of non-profit corporations . . . .<sup>313</sup>

The court further searched for the rationale behind granting standing to patients of the hospital to enforce breach of fiduciary duties by the directors in light of the attorney general's inaction in this case: "[A]s plausible an explanation as we can devise[,] it was considered that someone ought to be able to enforce the [directors'] duties in litigation, and if the patients could not, there was no one else."<sup>314</sup> In the vast majority of cases since the Sibley Hospital case, patients have routinely been denied standing to challenge the management decisions of the hospital's managers.<sup>315</sup>

In the case of beneficiary standing, because any recovery received inures solely to the benefit of the charitable organization, there is no certainty that the plaintiff in the suit will ultimately benefit.<sup>316</sup> Further, because the beneficiary bringing the suit has neither vested interest in the charity nor guarantee that he will become or continue to be a beneficiary

<sup>311</sup> See *id.* at 71 ("[E]ven when a class of potential beneficiaries is small and distinct enough that its members appear to have an interest distinguishable from the public's, . . . the 'special interest' doctrine [ ] require[s] that the complaining plaintiffs also show an immediate threat of injury." (quoting *Hooker v. Edes Home*, 579 A.2d 608, 615 (D.C. Cir. 1990))).

<sup>312</sup> See *Stern v. Lucy Webb Hayes Nat'l Training Sch.*, 367 F. Supp. 536 (D.D.C. 1973).

<sup>313</sup> *Christiansen v. Nat'l Sav. & Trust Co.*, 683 F.2d 520, 527 (D.C. Cir. 1982).

<sup>314</sup> *Id.* at 528.

<sup>315</sup> See, e.g., *Grant v. Trinity-Health Michigan*, 390 F. Supp. 2d 643, 652–53 (S.D. Mich. 2005); *Sabeta v. Baptist Hosp. of Miami, Inc.*, 410 F. Supp. 2d 1224, 1235–36 (S.D. Fla. 2005); *Amato v. UPMC*, 371 F. Supp. 2d 752, 757 (W.D. Pa. 2005); *Lorens v. Catholic Health Partners*, 356 F. Supp. 2d 827, 834 (N.D. Ohio 2005); *Burton v. William Beaumont Hosp.*, 347 F. Supp. 2d 486, 494 (E.D. Mich. 2004).

<sup>316</sup> Cf. *Atkinson*, *supra* note 29, at 693 ("[P]rivate parties . . . trying to keep charitable fiduciaries within the legal bounds of benefitting the public . . . are providing a typical public good. Such goods include external benefits, benefits that the citizen suing pays for but that others enjoy . . .").

in the future, he must be motivated by altruism rather than the thought of personal gain.<sup>317</sup>

Furthermore, the interests of a particular beneficiary bringing suit may not be representative of, and may even differ significantly from, the collective interest of all current or potential beneficiaries.<sup>318</sup> Even in those cases where the interests of the beneficiaries bringing suit do not differ from the collective interests of all beneficiaries, individual beneficiaries are ill equipped to adequately judge whether a charitable organization as a whole is fulfilling its mission.<sup>319</sup>

#### D. *Relator Actions*

An individual who cannot maintain standing under the special interest doctrine is left with the sole remedy of reporting the wrongdoing and attempting to persuade the attorney general to bring suit.<sup>320</sup> In some cases, the attorney general could grant the individual standing to proceed with the suit by appointing him a “relator.”<sup>321</sup> California codified the procedure for obtaining relator status through regulation.<sup>322</sup>

If the attorney general grants relator status, the relator generally takes an active part in the proceeding and is responsible for court costs and other expenses of litigation.<sup>323</sup> This requirement effectively allows the attorney general to use private resources to pursue the claim, increasing the attorney general’s enforcement resources.<sup>324</sup> The attorney general, however, retains control of the action and can withdraw, dismiss, or compromise it at any time, or take over its prosecution.<sup>325</sup> Furthermore, a relator cannot maintain a suit if the attorney general declines to pro-

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<sup>317</sup> See *id.*; cf. *Smithers v. St. Luke’s-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 434 (N.Y. App. Div. 2001) (“Without possibility of pecuniary gain for himself or herself, only a [donor] with a genuine interest in enforcing the terms of a gift will trouble to investigate and bring this type of action.”).

<sup>318</sup> Atkinson, *supra* note 29, at 693.

<sup>319</sup> See Brody, *Agents Without Principals*, *supra* note 14, at 523.

<sup>320</sup> See Blasko et al., *supra* note 57, at 43.

<sup>321</sup> See *id.* at 49 (explaining that “[a] relator is a party who is allowed to proceed in the name of the people or the attorney general when the power to sue otherwise resides wholly in that official”); see also *Brown v. Memorial Nat’l Home Found.*, 162 Cal. App. 2d 513, 538 (Cal. App. 1959) (defining a relator as “[a] party in interest who is permitted to institute a proceeding in the name of the People or the attorney general when the right to sue resides solely in that official”).

<sup>322</sup> See CAL. CODE REGS. tit. 11 §§ 1–2 (West 2005). There are no reported cases in which a relator has brought suit against a charitable organization under this provision.

<sup>323</sup> See Blaško et al., *supra* note 57, at 49.

<sup>324</sup> See Atkinson, *supra* note 29, at 684.

<sup>325</sup> See RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. a (1959); FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 325; Blasko et al., *supra* note 57, at 49.



ceed.<sup>326</sup> Thus, the use of relator status is entirely within the discretion of the state attorney general.

Several commentators speculate that the requirement for the relator to personally bear all expenses of litigation with no potential for personal benefit from a successful outcome of the suit effectively precludes an individual from pursuing the action.<sup>327</sup> Since the attorney general ultimately maintains control of the suit, another hindrance to the relator action is that the suit is not free from political conflicts of interest.<sup>328</sup> Accordingly, the same ills that burden attorney general enforcement infect relator enforcement: the decision whether to grant relator status may be politically motivated, and the limited resources of the attorney general's office makes investigation of the relator's complaint and supervision of the suit difficult.<sup>329</sup>

### E. *Visitor Programs*

At common law, the founder of a charitable organization was given a power of visitation, which enabled the founder, or another appointed by the founder, to redress abuses and neglect by the charitable organization.<sup>330</sup> The idea of visitation is explained in *Allen v. McKean* as follows:

Every founder of [a charitable] corporation, (that is the *fundator perficiens*, or person, who originally gives to it funds and revenues), and [each of] his heirs, have (sic) a right to visit, inquire into, and correct all irregularities and abuses, which may arise in the course of the administration of its funds, unless he has conferred (as he has the right to do) the power upon some other person. This power is commonly known by the name of the [visitatorial] power, and it is a necessary incident to all [charitable] corporations; for, these corporations being

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<sup>326</sup> See Blasko et al., *supra* note 57, at 50 (referencing *People ex rel. Vivisection Investigation League v. Am. Soc'y for the Prevention of Cruelty to Animals*, 20 A.D.2d 762 (N.Y. App. Div. 1964)).

<sup>327</sup> See, e.g., James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 674 (1985) [hereinafter Fishman, *Agenda for Reform*]. Professor Fishman proffers a solution to this problem in the establishment of a fund under the supervision of the state attorney general that would compensate attorneys who represent relators in suits to enforce fiduciary duties of charity managers. *Id.*

<sup>328</sup> See Blasko et al., *supra* note 57, at 48.

<sup>329</sup> See *id.* at 48-50.

<sup>330</sup> See *Phillips v. Bury*, 91 Eng. Rep. 900, 903 (1694) ("[I]f the founder has not appointed any visitor, then the law appoints the founder and his heirs to be visitors . . . Patronage and visitation both arise from the founder; and the office of the visitor by the common law is to judge according to the statutes of the [charitable organization], to expel and deprive upon just occasions, and to hear appeals . . .").

composed of individuals, subject to human frailties, are liable, as well as private persons, to deviate from the end of their institution; and therefore ought to be liable to some supervision and control. But what is the nature and extent of this [visitorial] power? Is it a power to revoke the gift, to change its uses, to divest (sic) the rights of the parties entitled to the bounty? Certainly not. It is a mere power to control and arrest abuses, and to enforce a due observance of the statutes of the charity.<sup>331</sup>

One justification for the visitorial power is that charitable organizations, unlike for-profit organizations, lack owners who are available to hold the organization's directors and officers accountable.<sup>332</sup> Thus, the power of visitation serves as a substitute; it allows the founder to monitor the charity's affairs in a manner similar to the way shareholders monitor the affairs of the corporations in which they are owners.<sup>333</sup>

There are several problems with the common law visitorial power. First, the indefinite and expansive scope of visitorial powers called into question who had ultimate authority over management of the charitable funds—the fiduciaries, with their ostensibly granted management authority, or the visitor.<sup>334</sup> Second, the visitorial power was automatic and therefore may have been contrary to the founder's intent to vest full authority with the charity managers.<sup>335</sup> Finally, the power of visitation was hereditary, which means that the founder's heirs also had the power of visitation unless otherwise provided by the donor.<sup>336</sup> Vesting visitorial powers in the founder's heirs proved problematic for effective oversight

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<sup>331</sup> *Allen v. McKean*, 1 F. Cas. 489, 497 (C.C.D. Me. 1833) (No. 229); accord *FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 338 (describing the power of visitation as follows:

[A]t one time the distinction was made between the *fundatio incipiens*, the granting of the charter by the state, and the *fundators perficiens*, the donation of funds by individuals. The *fundators perficiens* were given the right to enforce the faithful execution of the charity. They were permitted not only to prescribe rules for the management and administration of the trust at the time of donation, but to specify methods for the governance and control of trustees, for the inspection of their proceedings, and for the correction of abuses. Similarly, where an individual founded and gave property to a charitable corporation, he was allowed to reserve or confer on others the power of visitation.)

<sup>332</sup> See, e.g., *State ex. rel. Pittman v. Adams*, 44 Mo. 570, 578 (1869).

<sup>333</sup> See *Chester, Improving Enforcement Mechanisms*, *supra* note 13, at 473.

<sup>334</sup> *Atkinson*, *supra* note 29, at 695; accord *Karst*, *supra* note 82, at 446 (alleging that the power of visitation undermines one's responsibility as a charity manager). *But see* *Chester, Improving Enforcement Mechanisms*, *supra* note 13, at 473 (arguing that the courts provided a check on the visitor if the visitor "overstepped the bounds of the office" by unduly interfering with the management decisions appropriately reserved to the charity's board of directors).

<sup>335</sup> *Atkinson*, *supra* note 29, at 695.

<sup>336</sup> *Id.*

of the charity because the heirs could lose interest, pass away, or at the other extreme, be overly meddlesome in the managerial affairs of the charity.<sup>337</sup>

Today, the power of visitation has largely fallen out of use.<sup>338</sup> While Professor Chester advocates the resurgence of the power of visitation,<sup>339</sup> Professor Karst would give it a “swift statutory burial” on the basis that it did not permit the directors to direct.<sup>340</sup>

#### F. *Monitoring by a Private Organization through Voluntary Contractual Relationships*

Professor Manne advocates the creation of private for-profit monitoring companies that would oversee both the financial and charitable aspects of a charitable organization’s operations pursuant to a contract between the monitoring company and the charitable organization.<sup>341</sup> Standing for supervision by the monitoring company would lie through the enforcement of a breach of contract between the monitoring company and the charitable organization; the contract would specifically grant the monitoring company the right to sue to rectify perceived breaches of fiduciary duties by charity managers or failure to carry out the charity’s mission.<sup>342</sup> Professor Manne argues that a profit motive would incentivize the monitoring agency to diligently monitor the charity and concerns about reputation in the public eye would incentivize charities to engage private monitoring companies.<sup>343</sup>

While Professor Manne’s proposal is interesting, he recognizes that there are several impediments that make this proposal unlikely to serve as a comprehensive solution to the ineffectiveness of current government oversight of the charitable sector.<sup>344</sup> First, because the effectiveness of the monitoring company to enforce the fiduciary duties of charity managers is based in private contract and not public law, a new “market” for external regulators of charitable organizations would need to be created,

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<sup>337</sup> *Id.*

<sup>338</sup> See *Wier v. Howard Hughes Med. Inst.*, 407 A.2d 1051, 1057 (Del. Ch. 1979); Brody, *Dead Hand*, *supra* note 279, at 1203–05. *But see* N.Y. EST. POWERS & TRUSTS LAW § 8-1.3(a) (McKinney 2006) (allowing for administrative control by those “founding, endowing and maintaining” certain charitable organizations); UNIF. TRUST CODE § 405(c) (providing that “[t]he settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust”).

<sup>339</sup> See Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 476.

<sup>340</sup> See Karst, *supra* note 82, at 446.

<sup>341</sup> See Manne, *supra* note 172, at 253–55.

<sup>342</sup> *Id.* at 253.

<sup>343</sup> See *id.* at 253–55.

<sup>344</sup> See *id.* at 254–64 (enumerating potential impediments to the effectiveness of his proposal).

and the results are unpredictable.<sup>345</sup> Second, the risk of collusion between the monitoring company and the charity exists, which would undermine public confidence in the effectiveness of the private monitoring companies.<sup>346</sup> A notable example of the catastrophic results of collusion between a private entity and an independent monitor in the for-profit sector is Enron's collusion with its independent auditor, Arthur Andersen, LLP, in the presentation of Enron's financial statements.<sup>347</sup> Ultimately this collusion resulted in the collapse of Enron,<sup>348</sup> the demise of 89-year old accounting giant Arthur Andersen, LLP,<sup>349</sup> and the erosion of public confidence in the effective regulation of capital markets.<sup>350</sup> Without effective oversight of the independent monitors, therefore, the risk of collusion goes unchecked. Professor Manne's proposal does not suggest a mechanism to oversee the private monitoring companies,<sup>351</sup> but even if an oversight system were put in place, the question remains: Who would be best suited to oversee the private monitoring companies? As the current government regulators of the charitable sector have proven to be inadequate regulators,<sup>352</sup> it is doubtful that these government regulators would be effective regulators of the proposed private monitoring companies. Third, because engaging a private monitoring company to oversee a charity's operations would be costly to implement,<sup>353</sup> smaller

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<sup>345</sup> See *id.* at 254–61 (identifying potential concerns of a new market for private external regulators such as the long-term nature of the contract and corresponding barriers to early termination of the relationship, reluctance of voluntary directors and officers to serve a charity because of increased potential for being sued, the inefficiency of the market for charitable contributions, and the belief that the status quo is good enough).

<sup>346</sup> *Id.* at 261–62.

<sup>347</sup> See generally Neal F. Newman, *Enron and the Special Purpose Entity. Use or Abuse? The Real Problem – The Real Focus*, 13 *LAW. & BUS. REV. AM.* 97, 97–118 (2007) (describing how Enron used special purposes entities and the accounting rules to its advantage to falsely paint a picture of financial health). Professor Newman concludes that collusion between Enron and its independent auditor and others explains the false financial reporting:

[T]he overarching point to appreciate is that Enron's mis-accounting had nothing to do with ambiguities in the accounting literature and everything to do with the complicit and coordinated efforts of Enron and those involved with its financial reporting process to achieve the accounting results that were a departure from the true economic substance of the underlying transactions that Enron's financial reporting purported to reflect.

*Id.* at 118.

<sup>348</sup> See *id.* at 97, 112.

<sup>349</sup> See David Stout, *Conviction of Arthur Andersen is voided*, *N.Y. TIMES* (online ed.), June 1, 2005; David Barboza, *Enron's Many Strands: Founding Families; Where Pain of Arthur Andersen Is Personal*, *N.Y. TIMES*, Mar. 13, 2002, at C6.

<sup>350</sup> See Newman, *supra* note 347, at 97.

<sup>351</sup> Professor Manne briefly remarks: "In such instance there may be a continued role for the attorneys general (and even the Department of Justice)." Manne, *supra* note 172, at 261. But he does not elaborate any further on what role these agencies might take in oversight of the private monitoring companies.

<sup>352</sup> See *supra* notes 119–222 and accompanying text.

<sup>353</sup> See Manne, *supra* note 172, at 263.

and newer charities may find implementing private monitoring agencies to be cost-prohibitive.<sup>354</sup> Finally, Professor Manne's proposal is not a universal solution because charitable organizations would need to voluntarily seek out these contractual monitoring relationships. Therefore, many may choose not to because of cost constraints,<sup>355</sup> and others may choose not to because they simply do not want another oversight body looking over their shoulders.<sup>356</sup>

### G. *Private Regulation Has Limited Effectiveness*

Even though standing is denied in the large majority of cases where a private individual seeks to bring suit against a charitable organization, in the cases where standing is granted, the primary factor in granting standing is the lack of effective enforcement by the state attorney general or other government official.<sup>357</sup> It is widely recognized that attorneys general rarely pursue their enforcement rights with the same zeal as private parties.<sup>358</sup> This should not, however, be the sole justification for extending standing to private parties.

While some of the private regulation alternatives have had success in isolated situations, none are satisfactory in providing comprehensive and effective oversight of the charitable sector. Any increase in private standing is unlikely to result in enough private action to be a serious complement to government enforcement. Initially, there is a problem in ensuring sufficient personal benefit from the successful outcome of the suit brought by a private individual to justify the individual's litigation expenses.<sup>359</sup> Because the successful outcome exclusively benefits the charity and the general public, a "free-rider" problem exists in private actions to enforce charity managers' fiduciary duties. As Professor Atkinson explains, private enforcement is itself a public good—benefits that the individual bringing suit pays for but others enjoy for free—and therefore brings about a free-rider problem with the result that the public good is supplied by private individuals at only sub-optimal levels.<sup>360</sup>

Due to diversity among charities, some private enforcement mechanisms will not be applicable to all charities, and the roles those private

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<sup>354</sup> See *id.* at 263–64.

<sup>355</sup> See *id.*

<sup>356</sup> See *id.* at 255.

<sup>357</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 331–33.

<sup>358</sup> Brody, *Limits*, *supra* note 29, at 1431.

<sup>359</sup> Cf. Jaclyn A. Cherry, *Update: The Current State of Nonprofit Director Liability*, 37 DUQ. L. REV. 557, 571 (1999) (noting that because damages flow back to the charitable organization itself, there is little incentive for private individuals to maintain enforcement suit, even if private standing is expanded).

<sup>360</sup> Atkinson, *supra* note 29, at 693.

parties play with respect to particular charities will vary greatly as well.<sup>361</sup> Because the determination of standing is an inherently factual inquiry, there is inconsistency in the application of the standing doctrine to private parties from jurisdiction to jurisdiction. Furthermore, the extending of standing to private parties within the same jurisdiction lacks uniformity, even in cases with virtually identical facts.<sup>362</sup>

Professor Brody questions whether expansion of the standing doctrine to private parties would result in more effective regulation of the charitable sector:

The public appears uneducated about the fiscal needs of charities, as many people express surprise that nonprofit managers are paid at all and reveal ignorance of charities' productive demands . . . . A public that does not understand cost constraints cannot perform effective oversight. A public whose oversight focuses on the wrong considerations induces charities to adopt inefficient and ineffective behaviors.<sup>363</sup>

Furthermore, expansion of private standing will encourage disgruntled persons (whether members, donors, or beneficiaries) to use the threat of suit to attempt to force charity managers to take courses of action that may be considered beneficial by the disgruntled person, but do not reflect the best interests of the general public.<sup>364</sup> To avoid this inherent conflict of interest, it is better to leave enforcement authority in the hands of government officials who represent the interests of the general public and who have no individual interest that would color their enforcement action.

### III. MOVING TOWARD A NEW GOVERNMENT REGULATORY MODEL

Even with its flaws, government regulation of the charitable sector is preferable to private regulation. However, the current government regulators of the charitable sector face financial, institutional, political, and agency constraints that severely hinder their regulatory efforts. In the foreseeable future, the IRS and state attorneys general are unlikely to implement enough internal reform to adequately address these constraints and become an ongoing, effective enforcement presence in the

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<sup>361</sup> *Id.* at 662–63.

<sup>362</sup> See Blasko et al., *supra* note 57, at 64–67 (comparing ostensibly similar fact patterns in a given jurisdiction, and noting that standing was denied to private parties where there was no allegation of fraud and granted in the cases in which fraud was alleged).

<sup>363</sup> Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 502 (1996).

<sup>364</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 449; Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 458.

charitable sector. Therefore, to enhance effective and efficient oversight of the charitable sector, a new enforcement agency is necessary.

As an initial matter, one must consider whether a new enforcement agency should be created at the state or federal level. Traditionally, enforcement of the fiduciary duties of charity managers was within the purview of state enforcement.<sup>365</sup> Transferring the authority to regulate charities to the federal level may create concerns similar to those expressed after the enactment of the Sarbanes-Oxley Act in 2002, namely encroachment of state rights.<sup>366</sup> Although there has been extensive criticism of the Sarbanes-Oxley Act and its resulting “federalization of corporate governance,”<sup>367</sup> these criticisms are not equally applicable to federal regulation of the charitable sector. This is partly due to weaknesses in state regulation of the charitable sector and the lack of private monitoring mechanisms comparable to those available for public companies.<sup>368</sup>

In 1960, Professor Karst proposed that each state create an independent state board to regulate charitable organizations in the state’s jurisdiction.<sup>369</sup> The proposed board would:

- (1) replace the attorney general in his supervisory capacity, by (a) maintaining a registry of all charities operating in the state, (b) collecting and evaluating periodic reports to be required of all charities required to register, perhaps with some exceptions, (c) investigating possible breaches of fiduciary duty, and (d) calling abuses of fiduciary responsibility requiring remedial action directly to the attention of the proper court; (2) advise and consult with charity managers in (a) planning for future programs for operation and selection of projects, and (b) organizing the management and investment of funds; (3)

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<sup>365</sup> See Fishman, *Wrong Way Corrigan*, *supra* note 6, at 578.

<sup>366</sup> For example, Professor Fishman argues that regulation of fiduciary behavior of charity managers should be conducted primarily at the state level and opposes the “migration of fiduciary oversight to federal level.” *Id.* at 594.

Historically, fiduciary norms have been matters of state law. Moreover, at the state or local level, regulation will be carried out at a more meaningful scale if members of the charity’s community can monitor, educate, and where necessary, put into place the larger mechanisms that institute accountability . . . . Local efforts are more responsive to our constitutional structure of federalism, which increasing federal regulation of state responsibilities undermines.

*Id.* This view, however, fails to take into account charities with national concerns and concerns about public parochialism and paternalism. See Brody, *Parochialism*, *supra* note 25, 968–84.

<sup>367</sup> Aprill, *supra* note 21, at 780.

<sup>368</sup> See *id.* at 780–91.

<sup>369</sup> See Karst, *supra* note 82, at 433.

take responsibility for effectuating new schemes of the operation of obsolete charities and the consolidation of charities of uneconomic size; (4) administer a statewide system of control over the solicitation of funds, which would either coordinate or supersede municipal control; (5) cooperate with tax officials, both state and federal, by reporting to them abuses which appear to call for withdrawal of tax exemption.<sup>370</sup>

Since Professor Karst's proposal, regulation of the charitable sector has increasingly become incumbent upon the IRS.<sup>371</sup> Expanding state regulation would be counterproductive because many states lack the resources necessary to adopt such proposals.<sup>372</sup> Furthermore, the lack of uniformity in state regulation of the charitable sector makes state regulation an ineffective way to police an increasingly multi-jurisdictional charitable sector. While it is true that a large majority of charitable organizations are organized and operate in states that actively regulate the charitable sector, "the disparity between states with active programs and those without fosters forum-shopping and creates inconsistencies that make regulation exceedingly difficult."<sup>373</sup> Accordingly, continued reliance on state regulation of the charitable sector would prove ineffective in promoting public confidence in the sector.<sup>374</sup> Professor Fremont-Smith sums up this concept as follows:

Although one might have considered delegating regulation to the states at some time during the 1950s, the growth of the nonprofit sector and its complexity since that time and the concomitant overriding federal interest in its operations, combined with the failure of the states

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<sup>370</sup> *Id.* at 449.

<sup>371</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 377 ("[S]ince the 1950s, the regulatory authority of the federal government has been expanded so that it is effectively the primary source of regulation, extending to matters that had previously been in the exclusive province of the states, and in many instances, preempting state regulation by conditioning tax exemption upon compliance with federal standards of behavior.").

<sup>372</sup> See *supra* notes 119–26 and accompanying text.

<sup>373</sup> FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 444.

<sup>374</sup> See Karst, *supra* note 82, at 481 (observing that an advantage of federal regulation of the charitable sector is that only one agency would need to be created, as opposed to state regulation, where regulatory reform would require independent determinations made by 51 jurisdictions). *But see* Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Philanthropy in the 21st Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. (forthcoming Mar. 2010), available at <http://ssrn.com/abstract=1481287> (evaluating proposals to reform enforcement of the charitable sector using an institutional choice framework and concluding that "the strongest candidate for more effective regulation of charity governance is a state-level entity that is connected to but maintains a degree of independence from the attorney general's office in each state").



to provide effective enforcement, have rendered this question moot.<sup>375</sup>

To improve oversight of the charitable sector, the focus must turn to improving the regulation of federal tax laws. Thus, Professor Fishman observes: "The charitable sector's exemption from taxation is an expense borne by all taxpayers. Nonprofits may be exempt from taxation, but they should not be exempt from responsibilities that go along with such benefits."<sup>376</sup> While some may question the wisdom and effectiveness of particular provisions of the Internal Revenue Code applicable to charitable organizations, there are four fundamental reasons for using the existing federal tax law as the starting point for improved oversight.

First, federal tax laws are uniformly applicable to all charitable organizations, while state laws applicable to charitable organizations vary depending on the law of the state in which the charity is organized and the law of the state in which the charity operates, if different.<sup>377</sup> For example, Professor Fremont-Smith has noted that the federal tax laws applicable to charities "comprise the federal tax counterpart of the state law duties of loyalty and care. They are by default the only restrictions on fiduciary behavior actively enforced. Equally important, they apply uniformly in all jurisdictions, thereby setting a nationwide minimum standard of behavior."<sup>378</sup> Accordingly, a benefit of federal regulation of the charitable sector is evaluation of charitable behavior on uniform guidelines rather than on subjective and variable facts such as local attorney general availability and the private standing doctrine.<sup>379</sup>

Second, the federal tax laws contain provisions that prohibit many of the reported abuses in the charitable sector, such as breaches of the fiduciary duties of care and loyalty.<sup>380</sup> For example, the federal tax law prohibits tax-exempt organizations from engaging in excess benefit

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<sup>375</sup> FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 461.

<sup>376</sup> Fishman, *Agenda for Reform*, *supra* note 327, at 678.

<sup>377</sup> See Brody, *Limits*, *supra* note 29, at 1435. Professor Brody notes that the federal tax laws restricting the activities of charitable organizations have "profoundly influenced the operations of the charitable sector." *Id.* at 1438.

<sup>378</sup> FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 241.

<sup>379</sup> See Blasko et al., *supra* note 57, at 83.

<sup>380</sup> Admittedly, the overlap of the breach of fiduciary duty under state law and the penalties addressing breach of fiduciary duty under federal tax law is not a perfect fit and in some cases would be over-inclusive and in others under-inclusive. See Bishop, *supra* note 305, at 764-75; accord Brody, *Bishop Estate*, *supra* note 107, at 545 (noting that the excess benefit transaction regime does not apply to charity managers who breach the duty of care; thus, the only remedy at IRS disposal for misconduct such as spending funds on noncharitable purposes, accumulating excess income, and imprudent investment of charitable assets, is revocation (or threat of revocation) of tax-exempt status). However, the standard of fiduciary duty embodied in the federal tax laws, even with all its flaws, serves as a uniform standard for all charitable organizations, and thus is an important starting point for comprehensive oversight of the charitable sector.

transactions,<sup>381</sup> which are transactions between the organization and an insider that results in the insider receiving more than fair and adequate consideration for the transaction.<sup>382</sup> Similarly, private foundations are generally prohibited from engaging in self-dealing transactions with insiders of the foundation.<sup>383</sup> These provisions reflect federal standards of behavior pertaining to the duty of loyalty. In addition, the definition of “charitable organization” under Section 501(c)(3) of the Internal Revenue Code requires “exclusive” application of the organization’s resources to charitable purposes and limits incidental private benefits to individuals.<sup>384</sup> This provision embodies some aspects of the duties of care and obedience.<sup>385</sup> Finally, the Internal Revenue Code prohibits private foundations from engaging in “jeopardizing investments,”<sup>386</sup> thus embodying a federal standard of care with respect to the investment of private foundation assets.

Third, vigorous oversight of tax-exempt status under federal law can strengthen state regulation of the charitable sector. Under federal tax law, egregious abuses ultimately result in the loss of the charitable organization’s tax-exempt status. Without this status, the organization cannot engage in charitable solicitation or charitable gaming activities, which can be abused by charitable organizations and are exclusively regulated by state law.<sup>387</sup> Furthermore, the IRS, unlike the state attorney general, cannot compel a charitable organization to correct governance breaches;<sup>388</sup> but the IRS’s threat to revoke the tax-exempt status of chari-

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<sup>381</sup> See I.R.C. § 4958 (West Supp. 2009).

<sup>382</sup> See *id.*; Treas. Reg. § 53.4958-4 (2002).

<sup>383</sup> See I.R.C. § 4941 (2006).

<sup>384</sup> See *id.* § 501(c)(3).

<sup>385</sup> See Fishman, *Charitable Accountability*, *supra* note 81, at 238–39.

<sup>386</sup> See I.R.C. § 4945 (2006).

<sup>387</sup> See FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 55, 370–74 (state regulation of charitable solicitations); Glenn Cunningham & Amy Henchey, *Update on Gaming Activities*, 1996 EO CPE Text, available at <http://www.irs.gov/pub/irs-tege/eotopicd96.pdf> (regulation of charitable gaming activities); see also I.R.S., *Update on Fundraising*, 1986 EO CPE Text, available at <http://www.irs.gov/pub/irs-tege/eotopicg86.pdf>, which explains:

The conduct of bingo games can be a lucrative enterprise. With a relatively low overhead, a prize distribution subject to the organization’s control, and a potentially high profit margin, bingo may attract entrepreneurs of all varieties, some of whom may wish to mask themselves as charities to satisfy state and local gambling laws. Needless to say, the potential for abuse exists, and each case should be examined for evidence of a substantial private purpose or of inurement even if the commensurate test for distributions to charity is otherwise met.

*Id.* at 8.

<sup>388</sup> In 1977, the Treasury Department advocated investing the United States District Court with broad equity powers to redress fiduciary misconduct by charity managers. Brody, *Bishop Estate*, *supra* note 107, at 568. This idea was revisited in 2004 when the discussion draft prepared by the staff of the Senate Finance Committee again advocated for broad equity powers in federal courts to strengthen IRS regulation of the charitable sector. See Staff of the

ties under IRS investigation may influence those charities to make IRS-mandated governance changes.<sup>389</sup> Additionally, federal law has recently been revised by the Pension Protection Act to increase information sharing between federal and state officials with respect to the regulation of the charitable sector.<sup>390</sup> In particular, the IRS is now authorized to release information to state charity officials regarding final determination on exempt status, proposed refusals to recognize exempt status, proposed revocation of exempt status, notice of deficiencies regarding the transfer of charitable assets upon the termination of a private foundation, the excise taxes applicable to private foundations, and the excise tax on excess benefit transactions applicable to public charities.<sup>391</sup> Accordingly, strengthened regulation of the federal tax laws can serve as a channeling function for resource-strapped state attorneys general of cases worthy of investigation at the state level. Moreover, state attorneys general now rely much more on the IRS to regulate the charitable sector.<sup>392</sup>

Finally, the granting of tax exemption to a charitable organization is a “stamp of approval” that signals to the general public that the organization is trustworthy. The United States Court of Appeals for the Ninth Circuit noted that “when the IRS revokes the tax exempt status of organizations which do not meet 501(c)(3) requirements, it serves as a public trust function in assuring the public that 501(c)(3) tax exempt status is conferred and retained only by organizations engaged in appropriately charitable activities.”<sup>393</sup> Maintaining public confidence in the charitable sector is thus directly linked to strong enforcement of the federal tax laws applicable to charitable organizations.

### A. *Alternative Quasi-Public Regulatory Models*

To determine the best structure for a new enforcement agency to regulate the charitable sector, this Article first considers three alternate regulatory models: the advisory model, the accreditation model, and the enforcement model. Each of these models has been explored in practice or in scholarship for the regulation of the charitable sector. This part

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Senate Finance Committee, *supra* note 16. Neither proposal was reflected in any bill considered by Congress.

<sup>389</sup> See Silber, *supra* note 108, at 627 (“Notwithstanding the absence of federal power to obtain equitable decrees, the [IRS] has excise tax power and the power to revoke exemptions in order to conform subpar behavior to IRS standards.”); Brody, *Bishop Estate*, *supra* note 107, at 543 (noting that such governance changes have included the adoption of compensation committees, conflicts of interest policies, and other governance policies, as well as resignation and replacement of the charitable managers alleged to have committed the wrongdoing).

<sup>390</sup> See Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in scattered sections of 26 and 29 U.S.C.).

<sup>391</sup> See I.R.C. § 6104(c) (2006).

<sup>392</sup> Brody, *Limits*, *supra* note 29, at 1439.

<sup>393</sup> *Universal Life Church v. United States*, 128 F.3d 1294, 1298 (9th Cir. 1997).

discusses each of the three models and evaluates their effectiveness in providing comprehensive and effective oversight of the charitable sector.

### 1. Advisory Model

An advisory model of regulation supplements regulation by a government agency by providing additional resources to discover and investigate alleged violations by the constituents the agency is charged with overseeing. Importantly, the ability of the advisory panel to sanction violations it discovers is limited; prosecution of the violation in a court of equity and the ability to sanction fines generally remains with the government regulator.

For example, Professor James Fishman recommended establishing state advisory commissions to expand state regulation of the charitable sector.<sup>394</sup> Each state advisory commission would be composed of fifteen unpaid citizens; eight citizens would be appointed by the governor and seven would be appointed by the state attorney general for three-year terms.<sup>395</sup> The state advisory commission would serve under the guidance and control of the state's attorney general.<sup>396</sup> It would have the power to receive and investigate complaints, hold hearings, request documents, and subpoena witnesses.<sup>397</sup> In addition, the commission would have the power to publicly exonerate a charity, to agree to a private settlement, or to recommend that the attorney general prosecute.<sup>398</sup> The commission's hearings and settlement would be kept confidential to protect the reputation of the charities involved.<sup>399</sup>

At one time, two states—South Carolina and West Virginia—had created “Commissions on Charitable Organizations” to enhance regulation of their charitable sectors. The South Carolina commission included the Secretary of State and six representatives of the public, including donors, charity recipients, and a representative of a charitable organization.<sup>400</sup> The West Virginia commission was comprised of the Secretary of State, the Attorney General, and other state officials and appointees.<sup>401</sup> In both states, the commission's role was largely advisory. The commissions had the power to conduct investigations, hold hearings, and make

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<sup>394</sup> See Fishman, *Wrong Way Corrigan*, *supra* note 6, at 594–96; Fishman, *Charitable Accountability*, *supra* note 81, at 272–75. Professor Fishman models his proposed state advisory commissions after the old English Charity Commission of the early 19th century. See Fishman, *Charitable Accountability*, *supra* note 81, at 275–79. For a description of the old English Charity Commission, see *infra* note 430.

<sup>395</sup> Fishman, *Wrong Way Corrigan*, *supra* note 6, at 595.

<sup>396</sup> See *id.* at 594.

<sup>397</sup> See *id.* at 594–95.

<sup>398</sup> See *id.* at 595–96.

<sup>399</sup> See *id.* at 595.

<sup>400</sup> See Blasko et al., *supra* note 57, at 50–51.

<sup>401</sup> See *id.*

policy recommendations for improved regulation of the charitable sector.<sup>402</sup> The commissions were not authorized to bring suit to correct wrongdoings uncovered in the course of their investigations, however, and so had to turn the cases over to the state attorney general to proceed with any enforcement action. A 1995 report on the effectiveness of the West Virginia commission concluded that the commission's limited ability to effectively assist in the regulation of the charitable sector called for the termination of the commission.<sup>403</sup> Similarly, the South Carolina commission now appears to be defunct.

The use of state advisory commissions, if widely adopted, would only exacerbate the lack of uniformity among the states in the oversight of the charitable sector.<sup>404</sup> In addition, it is doubtful that the state commissions can be operated at minimal costs, as Professor Fishman suggests, and this would consequently aggravate the problem of devoting inadequate financial resources to charitable sector oversight.<sup>405</sup> Furthermore, the appointment of commissioners by the governor or state attorney general, both elected officials, would further politicize the process by which charities are regulated in the states.<sup>406</sup> Finally, relying on the attorney general to prosecute wrongdoings found by the commission invokes all of the previously discussed financial, institutional, political, and agency constraints. In effect, the state advisory commission is a "super-relator" that, without the authority to control the disposition of the investigation, lacks the teeth necessary to compel settlement of cases that involve significant wrongdoing. At best, the commission would correct abuses only at the margins.

## 2. Accreditation Model

An accreditation model of regulation establishes "minimum standard" policies and procedures that must be followed for accreditation, and conducts periodic review of compliance with accreditation standards.<sup>407</sup> Typically the accreditation agency has no enforcement power in terms of authority to sanction fines or bring suit in a court of equity. But the accreditation agency may nonetheless compel compliance be-

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<sup>402</sup> See *id.*

<sup>403</sup> See Office of the Legislative Auditor of West Virginia, *Preliminary Review of the Commission on Charitable Organizations: Court Decision and Infrequency of Meetings Renders Commission Ineffective* (Jan. 6, 1995), available at [http://www.legis.state.wv.us/Joint/PERD/perdrep/PE94\\_13\\_13.pdf](http://www.legis.state.wv.us/Joint/PERD/perdrep/PE94_13_13.pdf).

<sup>404</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 464.

<sup>405</sup> See *id.* at 334.

<sup>406</sup> See *id.*

<sup>407</sup> See, e.g., George B. Sheperd & William G. Sheperd, *Scholarly Restraints? ABA Accreditation and Legal Education*, 19 CARDOZO L. REV. 2091, 2128-53 (1998), (describing the ABA accreditation process).

cause the organization's retention of certain benefits may be contingent on the organization maintaining accreditation.<sup>408</sup>

For example, law schools in the United States seek accreditation by the American Bar Association Council of the Section of Legal Education (ABA). In order to receive and maintain accreditation, a law school must comply with numerous objective standards, established by the ABA, relating to the operations of the law school.<sup>409</sup> The law school must also submit to periodic site visits by ABA inspection teams designed to monitor continuing compliance with the ABA's standards.<sup>410</sup> While the validity of some of these standards has been questioned,<sup>411</sup> virtually all U.S. law schools still seek ABA accreditation. ABA accreditation is desirable because it affords substantial benefits to law schools. In particular, in order for its law students to receive Federal student aid, the law school must be ABA-accredited.<sup>412</sup> Furthermore, in the vast majority of states, only individuals that graduate from an ABA-accredited law school may sit for the state bar exam.<sup>413</sup>

Currently, there is no shortage of accreditation and "watchdog" groups in the charitable sector. Charity "watchdog" groups are external review organizations, such as the BBB Wise Giving Alliance,<sup>414</sup> and

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<sup>408</sup> See Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, Conference Notes, Norman A. Sugarman Memorial Lecture, Mandel Center for Nonprofit Organizations Case Western Reserve University (Mar 16, 1999), available at [http://www.qual990.org/np\\_account.html](http://www.qual990.org/np_account.html).

<sup>409</sup> See generally ABA STANDARDS AND APPROVED PROCEDURES FOR APPROVED LAW SCHOOLS (2009–2010 ed.); Sheperd & Sheperd, *supra* note 407, at 2128–53 (describing at length the ABA accreditation process).

<sup>410</sup> See ABA Section of Legal Education and Admissions to the Bar, *The Law School Accreditation Process*, at 8–11, available at [http://www.abanet.org/legaled/resources/13665\\_ABA\\_accred\\_web150.pdf](http://www.abanet.org/legaled/resources/13665_ABA_accred_web150.pdf).

<sup>411</sup> See Brody, *Agents Without Principals*, *supra* note 14, at 525 (criticizing that not all of the ABA standards bear on the quality of legal education); Sheperd & Sheperd, *supra* note 407, at 2097 ("The [ABA] accreditation system has imposed harms at all levels of legal education. . .").

<sup>412</sup> See 20 U.S.C. §§ 1001–99 (2006) (requiring institutions of higher education to be accredited by a nationally recognized accrediting agency in order to participate in Federal student assistance programs, such as the Federal Stafford loan program); ABA Section of Legal Education and Admissions to the Bar, *supra* note 410, at 3. The ABA Council of the Section of Legal Education and Admissions to the Bar is recognized by the Department of Education as the accrediting agency for juris doctorate programs.

<sup>413</sup> See Brody, *Agents Without Principals*, *supra* note 14, at 525; Shepard & Shepard, *supra* note 407, at 2129.

<sup>414</sup> The BBB Wise Giving Alliance (Alliance) monitors certain national charitable organizations that solicit contributions from the public, compiles in-depth evaluative reports on these charities based on the Alliance's comprehensive Standards for Charity Accountability, and publishes a quarterly magazine, the Wise Giving Guide. Better Business Bureau, About BBB Wise Giving Alliance, <http://www.bbb.org/us/Wise-Giving/> (last visited Nov. 2, 2009). Charities that meet the Alliance's standards can apply to participate in the Alliance's National Charity Seal program. *Id.*

Charity Navigator,<sup>415</sup> which monitor and disseminate information about charities that solicit funds from the general public.<sup>416</sup> Various specialized accreditation groups also exist and the accreditation criteria vary widely across these groups.<sup>417</sup> Specialized accreditation bodies are predominant in the fields of education and healthcare.<sup>418</sup>

Current accreditation and watchdog groups focus on rating the “worthiness” of a charitable organization for the benefit of potential donors with the thought that the ratings will give donors information about which charities deserve their contributions.<sup>419</sup> Contrary to common perception, the charitable sector is not primarily supported by donations from private donors. Rather, charitable organizations receive a substantial majority of their receipts from service fees,<sup>420</sup> dues, and sales of products.<sup>421</sup> Private donations make up less than one-fifth of total charitable receipts.<sup>422</sup> Thus, many charitable organizations rely very little on private donations to operate their programs. For these charities, accreditation or watchdog group rating of the charity’s worthiness, good or bad, would have little impact.

If the focus of accreditation is to regulate through donor choice, accreditation is not likely to have a significant impact on the behavior of charity managers. One may argue that the existence or lack of accreditation will enhance enforcement because donors will speak with their dol-

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<sup>415</sup> Charity Navigator evaluates and rates, on a scale from zero to four stars, the financial health of approximately 5,000 charities based on criteria developed by Charity Navigator. Charity Navigator, Overview, <http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=628#> (last visited Nov. 2, 2009).

<sup>416</sup> See Carl Bialik, *Charity Rankings Giveth Less Than Meets the Eye*, WALL ST. J., Dec. 19, 2008, at A13; Megan Greenwell, *New Way to Rate Charities Sought*, THE WASH. POST, Nov. 24, 2001, at B1.

<sup>417</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 466–70.

<sup>418</sup> Atkinson, *supra* note 29, at 694. For example, the Joint Commission on Accreditation of Healthcare Organizations serves as the largest hospital accreditation body. See Brody, *Agents Without Principals*, *supra* note 14, at 525.

<sup>419</sup> See Bialik, *supra* note 416.

<sup>420</sup> Service fees include revenues such as admission fees charged to patrons of museums, health service fees charged to patients of hospitals and residents of skilled nursing facilities, and tuition charged to students of educational organizations. See Blackwood et al., *supra* note 77, at 3.

<sup>421</sup> See Arnsberger et al., *supra* note 4, at 110 (noting that program service revenues made up 70% of total revenues earned by charities in 2004); Blackwood et al., *supra* note 77, at 3 fig.4 (showing that approximately 70% of public charity revenues came from fees for services and goods in 2005).

<sup>422</sup> For example, of the approximately \$1.5 trillion in total revenues reported on Forms 990 by charitable organizations in 2004, approximately \$250 billion (or 17%) was in the form of charitable contributions and grants. See Arnsberger et al., *supra* note 4, at 127; see also Blackwood et al., *supra* note 77, at 3 fig.4 (reflecting that, in 2005, approximately 12.3% of public charity revenues came from private donations and another 9% came from government grants).

lars and give only to those charitable organizations that maintain accreditation. Yet studies of donor choice conducted thus far do not support this view.<sup>423</sup> Charitable organizations that have the resources and that want to demonstrate their integrity will voluntarily seek accreditation.<sup>424</sup> Charitable organizations that do not rely heavily on private donations for their operations can justify not seeking accreditation on the grounds that the cost of maintaining accreditation outweighs the benefits. Smaller charities similarly may conclude that the cost of accreditation is simply too high.<sup>425</sup> In addition, charitable organizations whose managers want to use the organization for private gain will not seek accreditation,<sup>426</sup> but will instead adopt the argument of the service-provider and smaller charities that the costs outweigh the benefits. Thus, lack of accreditation provides no real information about the integrity of a charity's managers; the reason behind a charity's lack of accreditation may be that the charity's managers decided that pursuing accreditation would not be cost-effective or it may be that managers do not want third parties monitoring their actions.

Reliance on accreditation groups to regulate fiduciary behavior of charity managers is misguided. These accreditation bodies may be concerned about issues other than how government agencies monitor charitable funds for the public benefit. Furthermore, accreditation agencies often adopt unhelpful standards that must be maintained for the charity to be accredited.<sup>427</sup> The diverse nature of the charitable sector compounds the problem; it would be difficult, if not impossible, to establish meaningful across-the-board accreditation standards for the charitable sector as a whole.<sup>428</sup> Finally, participation in accreditation groups by charitable organizations is typically voluntary,<sup>429</sup> and compliance with accredita-

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<sup>423</sup> See Reiser, *supra* note 24, at 603. Most donors do not investigate performance measures for the financial or governance practices of a charity before making their donations. *Id.* at 603, n.176.

<sup>424</sup> See Fishman, *Wrong Way Corrigan*, *supra* note 6, at 593.

<sup>425</sup> See *id.*

<sup>426</sup> See Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, Conference Notes, Norman A. Sugarman Memorial Lecture, Mandel Center for Nonprofit Organizations Case Western Reserve University (Mar 16, 1999), available at [http://www.qual990.org/np\\_account.html](http://www.qual990.org/np_account.html). (contending that voluntary accreditation is unlikely to reach the rogues: "For those individuals, what is needed is the threat of force and coercion . . . and these deterrents can only be legitimately provided by the government.").

<sup>427</sup> See Brody, *Agents Without Principals*, *supra* note 14, at 525 (noting that "[a]n organization seeking accreditation might make major structural sacrifices, perhaps reflecting a power struggle over the accreditation body itself").

<sup>428</sup> Cf. Fishman, *Charitable Accountability*, *supra* note 81, at 269 ("[The] breadth of the nonprofit sector and its depth, that is, the number of organizations within each subset, are so vast that private groups cannot produce sector-wide normative change on their own.").

<sup>429</sup> See FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 467-68.



tion standards can be costly; thus, universal participation in private accreditation groups is unlikely.

### 3. Enforcement Model

In the enforcement model of regulation, the regulatory body has authority to promulgate rules, investigate breaches of these rules, and bring enforcement actions for wrongdoings. Additionally, the regulatory body's enforcement powers are mandatory and extend to all members of the sector that are regulated by the body. Two examples of the enforcement model of regulation—the Charity Commission for England and Wales and U.S. self-regulatory organizations—provide illuminating insight into possible alternative enforcement models of regulation for the charitable sector in the United States.

#### a. The Charity Commission for England and Wales

Established by law as the independent regulator and registrar of charities in England and Wales,<sup>430</sup> the Charity Commission for England and Wales (English Charity Commission) has broad regulatory power in addition to quasi-judicial powers over charitable fiduciaries.<sup>431</sup> The seven principles governing the English Charity Commission's work are: accountability; independence; proportionality; fairness; consistency; diversity; equality; and transparency.<sup>432</sup> The English Charity Commission has three main goals: "(1) to ensure that charities can operate for their exempt purposes within an effective legal, accounting and governance framework; (2) to improve charities' governance, accountability, effi-

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<sup>430</sup> A predecessor to the English Charity Commission was created in 1812. *Id.* at 32. Its initial purpose was to investigate and record all charitable trusts in England and Wales, and was created in response to misuse and abuse of charitable trusts, which, prior to the creation of the Commission, were regulated solely by the attorney general. *Id.* The Commission would give evidence of its investigations to the attorney general, who in turn would commence proceedings to correct the alleged abuse. *Id.* Even though the early Commission met some resistance in Parliament, the implementation of the Commission resulted in improved administration of charitable trusts and revealed the need for regular supervision of the charitable sector. *Id.* at 33. The English Charity Commission was formally established by The Charitable Trusts Act of 1853. *Id.* For about a century, the English Charity Commission functioned primarily to receive complaints on abuses, correcting some of them under their powers, and referring others to the attorney general for adjudication. *Id.* at 34. In 1960, the English Charity Commission was overhauled and the supervisory powers of the English Charity Commission were substantially enlarged, and a new relationship between the English Charity Commission and Parliament was created to facilitate the introduction of new legislation to improve regulation of the sector. *Id.* at 35. Currently, the Charity Commission for England and Wales obtains its authority to regulate misconduct and mismanagement in the charitable sector from the Charities Act of 1993. *See id.* at 35.

<sup>431</sup> Concededly, the scale of the English Charity Commission's regulatory efforts is much smaller than that of the IRS. *See id.* at 465.

<sup>432</sup> *Id.* at 43.

ciency, and effectiveness; and (3) to identify and address abuses and poor practices.”<sup>433</sup>

The English Charity Commission is independent of other government departments in England, including HMRC (Her Majesty’s Revenue and Customs, formerly Inland Revenue), which is equivalent to the U.S. Internal Revenue Service.<sup>434</sup> The governing body of the English Charity Commission includes representatives from the charitable sector, who are appointed by the Home Secretary.<sup>435</sup> The English Charity Commission determines charitable status, maintains a registration of charities, monitors the charitable sector to ensure compliance, investigates alleged wrongdoings, publishes outcomes of formal inquiries, and provides a list, for the general public, of charities that are in default.<sup>436</sup> In addition, the commission educates the charitable sector on proper compliance with charitable laws and provides guidance on “best practices.”<sup>437</sup>

The English Charity Commission has been the primary regulator of the charitable sector in England and Wales for over a century.<sup>438</sup> During this period, two thorough reviews of its effectiveness in regulating the charitable sector have been conducted. These reviews resulted in reform of the commission’s regulatory power and increase in the scope of its regulatory authority.<sup>439</sup> Importantly, after each study was conducted, the English Charity Commission was granted additional authority, thus confirming the wisdom of vesting regulation of the charitable sector in an independent regulatory body.<sup>440</sup> Moreover, several other countries, including Scotland, have used the English Charity Commission as a model for the oversight of their charitable sector.<sup>441</sup>

<sup>433</sup> Crimm, *supra* note 123, at 1193.

<sup>434</sup> See PETER LUXTON, *THE LAW OF CHARITIES* 422 (Judith Hill ed. 2001).

<sup>435</sup> See Crimm, *supra* note 123, at 1193.

<sup>436</sup> See LUXTON, *supra* note 434, at 431–80 (describing in detail the authority and responsibilities of the English Charity Commission); Crimm, *supra* note 123, at 1193.

<sup>437</sup> See LUXTON, *supra* note 434, at 464; Crimm, *supra* note 123, at 1193.

<sup>438</sup> See *supra* note 430. See generally Fishman, *Charitable Accountability*, *supra* note 81, at 731–36 (describing the predecessor to the English Charity Commission formed in the early nineteenth century).

<sup>439</sup> See FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 35–36 (describing the *Report of the Committee on the Law and Practice Relating to Charitable Trusts* (London: Her Majesty’s Stationary Office, 1952), commonly referred to as the “Nathan Report,” and the Strategy Unit Report, Cabinet Office, *Private Action, Public Benefit: A Review of Charities and the Wider Not-for-Profit Sector* (September 2002), available at [www.strategy-unit.gov.uk](http://www.strategy-unit.gov.uk)).

<sup>440</sup> Cf. Debra Morris, *New Charity Regulation Proposals for England and Wales: Overdue or Overdone?*, 80 *CHI.-KENT L. REV.* 779 (2005) (noting some of the difficulties encountered by the English Charity Commission in conducting its duties).

<sup>441</sup> Established in 2005, the Office of the Scottish Charity Regulator is modeled after the English Charity Commission and has similar goals, powers, and responsibilities. See Office of the Scottish Charity Regulator, *Vision and Objectives*, <http://www.oscr.org.uk/Vision%20and%20objectives.stm> (last visited Nov. 2, 2009). Likewise, Northern Ireland is in the process of

### b. Self-Regulatory Organizations

Another analogous example of the enforcement model is the network of self-regulatory organizations (SROs) that complement the oversight of the public securities market by the Securities and Exchange Commission (SEC). Responsibility for oversight of the securities market falls principally on the SEC.<sup>442</sup> The SEC, however, is assisted in its responsibilities by a series of related private-sector organizations that exercise regulatory responsibilities, which include establishing and enforcing requirements for the conduct of the activities in question.<sup>443</sup> These SROs include the Public Company Accounting Oversight Board (PCAOB),<sup>444</sup> the Financial Industry Regulatory Authority (FINRA),<sup>445</sup> and Municipal Securities Regulatory Board (MSRB).<sup>446</sup>

The PCAOB was established under the Sarbanes-Oxley Act of 2002<sup>447</sup> to regulate the independent auditors of publicly-traded companies under the general supervision of the SEC.<sup>448</sup> Accounting firms that conduct audits for public company clients are required to register with the PCAOB.<sup>449</sup> The PCAOB's purpose is to protect investors by overseeing the auditors of public companies that are subject to securities regulation.<sup>450</sup> Thus, the PCAOB monitors the relationship between the independent auditor and the public company,<sup>451</sup> and oversees auditors to ensure that the audit is conducted with rigor. The PCAOB is funded by annual registration fees from the auditing firms it regulates, and by annually allocated "accounting support fees" from public companies.<sup>452</sup> The PCAOB is authorized to establish accounting standards, inspect audit firms for compliance, conduct independent investigations of violations of the public accounting standards by independent auditors, and institute

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establishing its Charity Commission for Northern Ireland, which is modeled after the English Charity Commission. *See* Charity Commission for Northern Ireland, Charities Commission, [http://www.dsdni.gov.uk/charities\\_commission.htm](http://www.dsdni.gov.uk/charities_commission.htm) (last visited Nov. 2, 2009).

<sup>442</sup> *See* Owens, *supra* note 130, at 10.

<sup>443</sup> *See id.*

<sup>444</sup> *See* 15 U.S.C. § 7201-64 (2006).

<sup>445</sup> *See id.* § 780-3. FINRA was created in 2007 by the merger of the National Association of Securities Dealers (NASD) and the New York Stock Exchange's regulatory commission. *See* FINRA, About the Financial Industry Regulatory Authority, <http://www.finra.org/AboutFINRA/> (last visited Nov. 2, 2009).

<sup>446</sup> *See* 15 U.S.C. § 780-4(b).

<sup>447</sup> Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act), Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>448</sup> *Id.* §§ 101-09, (codified at 15 U.S.C. §§ 7211-19) (establishing the Public Company Accounting Oversight Board and defining its duties). The PCAOB is organized as a nongovernmental, nonprofit entity subject to SEC oversight. 15 U.S.C. § 7211(a)-(b).

<sup>449</sup> 15 U.S.C. § 7212.

<sup>450</sup> 15 U.S.C. § 7211(a) (2006).

<sup>451</sup> *See id.* § 7211.

<sup>452</sup> *See id.* §§ 7212, 7219.

disciplinary proceedings for such violations.<sup>453</sup> The PCAOB has the power to impose a wide range of sanctions, including suspension or revocation of SEC registration for public companies in violation of the rules, and the imposition of civil fines ranging from \$100,000 to \$15 million.<sup>454</sup>

FINRA regulates brokers and brokerage firms who are required to be members of FINRA.<sup>455</sup> The majority of FINRA's governing body is drawn from outside the securities industry, which ensures public involvement and transparency in its operations.<sup>456</sup> FINRA derives its enforcement powers from the Securities Exchange Act of 1934, as amended, which authorizes the SEC to approve FINRA-promulgated standards and rules.<sup>457</sup> Although FINRA is not structurally part of the federal government, it exercises substantial oversight authority. For example, by virtue of its relationship with the SEC, FINRA has the power to sanction those who transgress its rules and levy fines.<sup>458</sup> Enforcement actions taken by FINRA may be appealed first to the SEC and then to a federal courts.<sup>459</sup>

To maximize the effectiveness and efficiency of regulation of the charitable sector, the enforcement model of regulation is preferable to the advisory or accreditation models. The enforcement model vests authority to promulgate rules and to bring enforcement actions for wrongdoings in the agency that has developed specialized expertise. Consolidation of rule-making authority and authority to sanction transgressions in one agency provides efficiencies in the administration of those rules; a second agency does not have to interpret the rules of another agency to enforce the law, as would be the case with the advisory model. An agency with specialized expertise in the charitable sector could better tailor enforcement rules to suit the unique aspects of the charitable sector—in particular, the lack of private interests with standing to enforce breaches of fiduciary duties. Finally, under the enforcement model of regulation, the rules promulgated by the enforcement agency apply universally to all organizations within the charitable sector. This in turn assures comprehensive oversight of the charitable sector. Accordingly, the new agency this Article proposes would follow the enforcement model of regulation.

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<sup>453</sup> *Id.* § 7211(c).

<sup>454</sup> *See id.* § 7215.

<sup>455</sup> *See id.* § 780-3(b)(8).

<sup>456</sup> *See* FINRA, FINRA Board of Governors, <http://www.finra.org/AboutFINRA/Leadership/P009756> (last visited Nov. 2, 2009).

<sup>457</sup> *See* 15 U.S.C. § 78s(b) (2006).

<sup>458</sup> *See id.* § 780-3.

<sup>459</sup> *See id.* §§ 78s(d), 78y.

B. *Creation of a New Federal Charity Oversight Board to Regulate Charitable Organizations*

Over the past 50 years, there has been consideration of moving regulation of the charitable sector from the purview of the IRS. The Filer Commission, in 1975, strongly endorsed retaining the IRS as the principal regulator of charitable organizations.<sup>460</sup> But the commission also recommended the creation of an independent quasi-public agency, with no regulatory powers, that would monitor and support the charitable sector and serve as its advocate before Congress.<sup>461</sup> Ultimately, a wholly voluntary organization, the Independent Sector, was formed in 1980 to serve as the sector's advocate rather than the quasi-public agency envisioned by the Filer Commission.<sup>462</sup>

In 1999, Professor Joel Fleishman proposed three alternative enforcement improvements for the charitable sector. His third and "last resort" proposal was the establishment of an independent government agency similar to the SEC or Federal Trade Commission.<sup>463</sup> The new "U.S. Charities Regulatory Commission" would be charged with all aspects of regulation of nonprofit organizations except the determinations of tax exemption, deductibility of charitable contributions, and enforcement of the unrelated business income tax because, as Fleishman asserted, these functions are inextricably a part of the tax collection process.<sup>464</sup> Specifically, the proposed federal agency would

keep tabs on the procedural—not substantive—functioning of not-for-profit organizations so as to assure the public that tax exemption is not used as a shield for fraudulent or illegal purposes. It would be empowered to investigate instances of alleged wrongdoing, it would have the power to subpoena, and it could institute civil or criminal proceedings as appropriate on its own mo-

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<sup>460</sup> FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 461.

<sup>461</sup> *See id.* at 81–82, 461–62. Four years earlier, the Pearson Commission recommended the establishment of a national Advisory Board on Philanthropy, which would evaluate the performance of charities and the effectiveness of government regulation and propose improvements for the sector. This proposal was not adopted. *See id.* at 80–81.

<sup>462</sup> *See id.* at 462.

<sup>463</sup> *See* Fleishman, *Public Trust*, *supra* note 205, at 172. Professor Nina Crimm also advocates this approach. *See* Crimm, *supra* note 123, at 1192–94 (suggesting the creation of a "new, independent, unbiased, and strong oversight agency, not beholden to politicians and powerful citizens" to monitor charitable organizations and their managers. This new agency would be independent of the IRS, thus allowing the IRS to be "free to return to its primary duties as a collector of revenues.").

<sup>464</sup> *See* Fleishman, *Public Trust*, *supra* note 205, at 189. Professor Fleishman notes that, ideally, determination of exempt status would be made by the new U.S. Charity Commission, but was concerned with the loss of 90 years of IRS institutional experience in exempt organization tax matters. *See id.*

tion. It would be charged with supervising interstate charitable solicitation, and creating the guidelines and disclosure requirements necessary to ensure that charitable solicitation is not used for fraudulent purposes. It would be responsible for monitoring the function of the [not-for-profit] sector as a whole, gathering data and creating databases about the sector, commissioning studies on various aspects of the sector, reporting periodically to Congress on the operation of the sector, issuing regulations to guide the sector in conforming with applicable laws, and making recommendations for legislative changes that may be thought desirable.<sup>465</sup>

Under Fleishman's proposal, charitable organizations would still be required to apply to the IRS for tax exemption and file their annual information returns with the IRS.<sup>466</sup>

Recently, Professor Fleishman has changed his view,<sup>467</sup> and now advocates a proposal by Marcus Owens, a former director of the exempt organizations division of the IRS, to establish a self-regulatory organization under the supervision of the IRS that would function much like the NASD (predecessor to FINRA).<sup>468</sup> Under Owens' proposal, the new self-regulatory organization would have the authority to promulgate rules applicable to charitable organizations and advisors to charitable organizations, process applications for exemptions, and conduct oversight of the charitable sector through examinations.<sup>469</sup> Charitable organizations

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<sup>465</sup> *Id.*

<sup>466</sup> *Id.*

<sup>467</sup> See JOEL L. FLEISHMAN, *THE FOUNDATION: A GREAT AMERICAN SECRET: HOW PRIVATE WEALTH IS CHANGING THE WORLD* 256–59 (2007).

<sup>468</sup> See Owens, *supra* note 130, at 11–15; see also Crimm, *supra* note 123, at 1192–94 (calling for a new federal government agency to monitor the charitable sector with an advisory board made up of representatives of the charitable sector). Some doubt that creation of a new agency, whether governmental or self-regulatory, at the federal level to oversee the charitable sector will ever come to pass. Professor Fremont-Smith states:

Although a similar system [to the English Charity Commission] may have great merit in the United States, it is naïve to think that Congress would remove regulation of charities and other exempt entities from the Service. The integrity of the tax system rests in large part on assuring that it cannot be undermined through the use of exempt entities. In addition, as concluded by critics of the Service, tax exemption for charities is inextricably intertwined with administration of the tax on unrelated business income as well as with the deductibility of contributions for purposes of the income, estate, and gift taxes. Bifurcating regulation at the federal level would add a third regime of regulation that would add immeasurably to complexity and delay.

FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS*, *supra* note 6, at 465.

<sup>469</sup> See Owens, *supra* note 130, at 13. Professor Fishman notes: "Fleishman would have this agency enforce laws and regulations specifically targeting nonprofit fidelity to conflict-of-interest, insider self dealing, transparency and comparable procedural standards enforced by law." Fishman, *Wrong Way Corrigan*, *supra* note 6, at 591.

could appeal adverse findings by the oversight organization to the IRS or the courts.<sup>470</sup> The new oversight organization would be congressionally chartered with a majority of its governing body appointed by the Commissioner of the IRS or the National Association of Attorneys General.<sup>471</sup> Funding for the new oversight organization would be provided in the form of a credit against the net investment income excise tax assessed to private foundations.<sup>472</sup> Public disclosure of the oversight organization's operations and financial records along with regular audits by the General Accounting Office or the Treasury Inspector General for Tax Administration would be required to provide transparency in the oversight organization's actions.<sup>473</sup>

Like Owens and Fleishman, this Article advocates the creation of a self-regulatory organization that would serve as the principal regulator of the charitable sector, with the authority to enforce the federal tax laws applicable to charitable organizations. As further explained below, the structure and authority of the agency proposed herein would differ in significant respects from the agencies proposed by Owens and Fleishman. In particular, the new agency would be a self-funded, independent, and proactive regulator that would serve the dual purposes of curbing the abuses that have eroded public confidence in the sector and educating charitable managers of their obligation to be responsible stewards of charitable resources. The agency proposed herein would function like the PCAOB. Thus, the proposed agency will be referred to as the Federal Charity Oversight Board (Oversight Board).

### 1. Structure of the Oversight Board

The Oversight Board would be a federally chartered charitable organization, and Congress would have ultimate oversight of the organization.<sup>474</sup> The Oversight Board would be managed by a governing body that would appoint and review the performance of key management officials.<sup>475</sup> The management officials would be charged with overseeing the operations of the Oversight Board and would be required to report, monthly, the performance of the Oversight Board to the governing body. The governing body in turn would be required to report annually to a

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<sup>470</sup> See Owens, *supra* note 130, at 13–14.

<sup>471</sup> See *id.* at 11–12.

<sup>472</sup> See *id.*

<sup>473</sup> See *id.* at 13.

<sup>474</sup> This is similar to the structure of the American Red Cross, a congressionally-chartered charitable organization. See 36 U.S.C.A. §§ 300101–300113 (West 2009). The Congressional Charter for the American Red Cross was amended in 2007 to modernize its governance structure to focus on strategic oversight and good governance. See The American National Red Cross Governance Modernization Act of 2007, Pub. L. No. 110-26, 121 Stat. 103 (2007).

<sup>475</sup> Cf. 36 U.S.C.A. § 300104; Bylaws of the American Red Cross, at 3–4, available at [http://www.redcross.org/www-files/Documents/Governance/bylaws\\_restated.pdf](http://www.redcross.org/www-files/Documents/Governance/bylaws_restated.pdf).

congressional committee (perhaps through the Treasury Inspector General for Tax Administration).<sup>476</sup> In addition, an independent auditor would annually review the operations and financial statements of the Oversight Board and provide its report to the Board's governing body and the congressional committee.<sup>477</sup> All organizations exempt from federal income tax by virtue of being described in Section 501(c)(3) of the Internal Revenue Code would be required to be registered members of the Oversight Board as a condition of receiving and maintaining tax-exempt status.

A significant portion of the governing body of the Oversight Board should be comprised of representatives of various interests in the charitable sector, including donors, beneficiaries, and representatives from the regulated charities themselves. The charity representatives would fairly represent the diverse interests in the charitable sector, and perhaps existing sector coalition groups, such as the Independent Sector,<sup>478</sup> and the Council on Foundations,<sup>479</sup> could appoint various representatives to serve these roles.

Inclusion of the charitable sector's voice in its oversight is vital to the effectiveness of the sector's regulation. The IRS currently seeks input from the charitable sector through its Advisory Committee on Tax Exempt and Government Entities.<sup>480</sup> Establishment of the Advisory Committee signifies recognition of the need for input from the charitable sector in formulating and maintaining an effective regulatory presence over the sector.<sup>481</sup> Inclusion of representatives of the charitable sector in

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<sup>476</sup> Cf. 36 U.S.C.A. § 300110 (requiring the American Red Cross to file an annual report with the Secretary of Defense, who in turn audits the report and submits the audited report to Congress).

<sup>477</sup> Cf. *id.* § 300112 (establishing an internal Office of the Ombudsman which monitors the operations of the American Red Cross and annually reports to the Board of Governors and congressional committees).

<sup>478</sup> The Independent Sector is a nonpartisan coalition of approximately 600 charitable organizations that serves as a leadership forum and legislative advocate for the charitable sector. See Independent Sector, About Us, <http://www.independentsector.org/about/index.html> (last visited Nov. 2, 2009).

<sup>479</sup> The Council on Foundations is a nonprofit association of approximately 2,000 grantmaking organizations that, among other things, acts as a collective voice for grantmaking organizations before legislators and regulators. See Council on Foundations <http://www.cof.org/> (last visited Nov. 2, 2009).

<sup>480</sup> The Advisory Committee was created under the Federal Advisory Committee Act in 1999 and held its first public meeting in June 2002. See FREMONT-SMITH, GOVERNING NON-PROFIT ORGANIZATIONS, *supra* note 6, at 394–95. Members of the Advisory Committee are appointed by the Secretary of the Treasury to serve for two-year terms. See *id.* at 394–95.

<sup>481</sup> Professor Crimm also recognizes the importance of including representatives of the charitable sector and suggests that an advisory committee comprised of representatives from the charitable sector and representatives from states with the greatest concentration of charitable organizations, such as the state attorney general, be formed to supplement her proposed new federal regulatory agency for the charitable sector. See Crimm, *supra* note 123, at 1194.



the governing body would also incorporate the concept of responsive regulation in the oversight of the charitable sector: “[r]esponsive regulation, for its part, emphasizes a dynamic non-adversarial approach where regulators assist regulated actors in complying with the law, and where regulated actors, as a reward for their cooperation, assist regulators in crafting the regulatory environment.”<sup>482</sup> Responsive regulation enhances the oversight of the regulated sector,<sup>483</sup> and is especially vital for a sector like the charitable sector, which has no self-interested private regulators.

Another reason to include charitable sector representatives is that the charitable sector itself is the closest substitute to a private stakeholder for the sound financial management of charitable organizations. As discussed earlier, private self-interest is the best guarantee of enforcing fiduciary duties.<sup>484</sup> Private enforcement also creates a natural system of checks and balances, which has no equivalent in the charitable sector. This is because, regardless of their role within a charitable organization, no private individual has a personal financial stake in the outcome of a proceeding to enforce the fiduciary duties of a charity manager even if the individual were granted standing to proceed with the suit.<sup>485</sup> Any recovery from the wrongdoer is exclusively for the benefit of the charitable organization.<sup>486</sup> While a strong sense of duty to combat injustice may nevertheless prompt some private individuals to maintain suits to enforce breaches if granted standing to do so,<sup>487</sup> many private individuals do not have the corresponding pocketbooks to proceed with litigation.<sup>488</sup> Similarly, the state attorney general does not benefit financially from the successful outcome of a proceeding to correct abuses by charity manag-

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<sup>482</sup> Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 437 (2008).

<sup>483</sup> See *id.* at 439–68 (explaining how incorporation of responsive regulation into a new cooperative tax regulation regime would improve compliance with the federal tax laws generally).

<sup>484</sup> See *supra* notes 201–10 and accompanying text.

<sup>485</sup> See *supra* notes 223–26 and accompanying text.

<sup>486</sup> See Cherry, *supra* note 359, at 571.

<sup>487</sup> See, e.g., *supra* notes 250–52, 265, 301–02, 316–17 and accompanying text.

<sup>488</sup> An example of the significant costs involved in bringing suit against a charity for breach of fiduciary duty is that of *Robertson v. Princeton*, No. C-99-02 (N.J. Super. Ct. Ch. Div. Dec. 12, 2008), in which the Robertson family alleged that Princeton University failed to comply with the terms of a \$35 million restricted gift the Robertsons had made to support the Woodrow Wilson School at Princeton. Detailed information about the lawsuit is available at <http://www.princeton.edu/robertson/about>. The case ultimately settled, and Princeton University was required to reimburse the plaintiff’s \$40 million legal fees incurred during the course of the six-year litigation. See Princeton University, *Settlement retains Princeton’s control, use of Robertson funds* (Dec. 10, 2008), available at <http://www.princeton.edu/robertson/statements/viewstory.xml?storypath=/main/news/archive/S22/81/66C43/index.xml> (last visited Nov. 2, 2009). Princeton estimates that each party would have incurred an additional \$20 million in legal expenses had the case gone to trial. See *id.* Concededly, the *Robertson* case is an extreme example of the litigation costs that could be involved. Yet even litigation costs of \$25,000 or \$100,000 can prove to be a bar to otherwise motivated plaintiffs.

ers.<sup>489</sup> The closest substitute to private individuals' motivation to correct fiduciary behavior and preserve their own financial self-interest is the sector's self-interest in maintaining public confidence in its integrity. In order to retain this confidence, the public must view the charitable sector as a proponent of good charitable governance, having no tolerance for persons who abuse their charitable positions for their own self-interest.

While an entirely self-regulatory model may also promote an environment ripe for abuse,<sup>490</sup> collaboration between the charitable sector and government regulatory agencies in formulating an effective regulatory regime to remedy fiduciary wrongdoings would best fill the void created by the lack of natural self-interested parties. To this end, a majority of the governing body of the Oversight Board would be comprised of representatives from government agencies that have a significant interest in maintaining the integrity of the charitable sector. These constituencies would include the IRS, the state attorneys general, perhaps represented by appointed representatives from the National Association of Attorneys General<sup>491</sup> or the National Association of State Charity Officials,<sup>492</sup> and the federal granting agencies that provide significant funds to the charitable sector.

The agency would be self-funded through the imposition of a mandatory annual fee charged to all tax-exempt charitable organizations required to file an annual information return.<sup>493</sup> The fee would be determined on a sliding scale based on a charity's asset size, gross revenues, or some combination of both, so as not to impose an undue burden on smaller charities. An average \$300 annual fee would result in approxi-

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<sup>489</sup> See *supra* notes 201–10 and accompanying text.

<sup>490</sup> Cf. Fishman, *Wrong Way Corrigan*, *supra* note 6, at 591 (criticizing self regulation by an industry group as "self protection" and arguing that self regulation is ineffective without the threat of substantial government intervention); Chester, *Improving Enforcement Mechanisms*, *supra* note 13, at 451 (observing that although internal regulation of the charitable sector may have worked to curb abuses in some instances, recent abuses have shown that internal regulation is insufficient to comprehensively regulate the sector); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 913–14 (1994) (discussing the problem of capture of self-regulatory organizations by those being regulated in the context of purportedly obsolete agencies).

<sup>491</sup> The National Association of State Attorneys General is a membership organization for the state attorneys general that facilitates interstate cooperation on legal and law enforcement issues. See National Association of State Attorneys General, About NAAG, [http://www.naag.org/about\\_naag.php](http://www.naag.org/about_naag.php) (last visited Nov. 1, 2009).

<sup>492</sup> The National Association of State Charity Officials is an association of state officials charged with the regulation of charitable organizations and charitable solicitation that promotes cooperative state regulation of the charitable sector. See National Association of State Charity Officials, Welcome to NASCOnet.org, <http://www.nasconet.org/> (last visited Nov. 2, 2009).

<sup>493</sup> Notably, churches would be exempt from paying an annual fee, as they are exempt from the requirement to file annual information returns. See I.R.C. § 6033(a)(3)(A)(i) (2006). Nonetheless, churches would be required to register with the Oversight Board.

mately \$300 million in annual operating revenue for the agency—approximately five times that of the current annual operating budget of the exempt organizations division of the IRS.<sup>494</sup> Since the new fee would fund the federal oversight of the charitable sector, the stated justification for the net investment excise tax on private foundations would no longer apply;<sup>495</sup> thus, this excise tax should be repealed.<sup>496</sup> Additionally, the Oversight Board could impose “application fees” on new organizations seeking determination of tax-exempt status (as is the current practice),<sup>497</sup> and the Oversight Board would retain the excise taxes that it collects

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<sup>494</sup> The operating budget of the IRS exempt organizations division was approximately \$61 million in 2001, \$65 million in 2002, \$68 million in 2003, and \$72 million in 2004. See Owens, *supra* note 130, at 6. In comparison, the net investment excise tax collected from private foundations was \$720 million in 2001, \$490.4 million in 2002, \$262.7 million in 2003, and \$468.7 million in 2004. See *id.*; Internal Revenue Service Statistics of Income Division, *Table 1. Domestic Private Foundations: Number and Selected Financial Data, by Type of Foundation and Size of End-of-year Fair Market Value of Total Assets, Tax Year 2004* [hereinafter IRS, Domestic Private Foundations], available at <http://www.irs.gov/pub/irs-soi/04pf01ta.xls>.

<sup>495</sup> See *supra* notes 136–39 and accompanying text.

<sup>496</sup> Given the current state of our economy, one may question whether Congress would repeal any tax at this juncture. However, the net investment income excise tax is a negligible portion of total tax revenues. In 2006, the IRS collected approximately \$796 million in net investment income excise taxes. See IRS, Domestic Private Foundations, *supra* note 494. The same year, the IRS collected total tax revenues of approximately \$2.5 trillion. See IRS DATA BOOK 2006, at 3 tbl.1. Thus, in comparison to total tax collections, the excise tax on net investment income is less than one-tenth of one percent of total tax revenues. Further, the loss of revenue from the repeal of the net investment income excise tax would be partially offset by a reduction in appropriations for the exempt organizations division of the IRS since that division’s responsibilities would be substantially reduced with the creation of the Oversight Board. Finally, charitable organizations often supplement government entities in providing services to individuals that government typically provides. See I.R.C. § 501(c)(3) (2006) (providing that lessening the burdens of government is a charitable purpose warranting exemption from federal income tax). Increased effectiveness in the regulation of the charitable sector through the Oversight Board would result in increased public confidence in the effectiveness and efficiency of the charitable sector. This in turn could result in increased donations to charities and increased utilization of fee-based services provided by charities. To the extent charities are then able to expend more resources on services the federal government is otherwise required to provide, less government appropriations would be required for those government services fulfilled by the charitable sector.

Other commentators who advocate the creation of a new agency to monitor fiduciary behavior of charity managers would give private foundations a credit against their net investment excise tax liability for the mandatory annual fee paid to the new agency or earmark a portion of the net investment income excise tax collected for funding of the new agency. See, e.g., Owens, *supra* note 130, at 11–12; Mayer & Wilson, *supra* note 374, at 69–75.

<sup>497</sup> The IRS imposes “user fees” on prospective charitable organizations that apply for tax exemption. Effective January 3, 2010, the user fee is \$850, but is reduced to \$400 for organizations that anticipate generating revenues of less than \$10,000 annually. Internal Revenue Service, *EO Exemption Application User Fees to Increase in 2010*, available at <http://www.irs.gov/charities/article/0,,id=212562,00.html>. Similarly, the IRS imposes user fees on charitable organizations that request guidance from the IRS in the form of private rulings. See Rev. Proc. 2009-8, 2009-1 I.R.B. 229 (imposing a user fee of \$8,700 for private letter ruling requests made in 2009).

from its enforcement of the federal tax provisions applicable to charitable organizations.<sup>498</sup> These additional revenues would enhance regulatory efforts and educational programs for charity managers maintained by the Oversight Board.

Similar to the English Charity Commission, results of investigations by the Oversight Board would be publicly available.<sup>499</sup> Currently, evaluation of the effectiveness of charitable regulators remains elusive because there is little published information on the redress required by the regulator in many cases. Very few cases involving breach of fiduciary duty have reached the courts.<sup>500</sup> Both charity managers and regulators prefer to settle cases, and have traditionally kept settlements confidential.<sup>501</sup> Professor Brody notes that “[i]nvisibility at the information end of the regulatory spectrum makes it hard to judge the level and the effectiveness of regulators in influencing charity behavior—and whether regulators are motivated by their own or the public’s interest.”<sup>502</sup>

Lack of transparency only breeds public distrust in the effectiveness of the regulator,<sup>503</sup> and this distrust spawns into distrust of the sector as a whole.<sup>504</sup> Since the charitable sector lacks private stakeholders, transparency in the operations of the regulator is necessary to ensure public trust in the efficacy of the regulator. Thus, public scrutiny provides a natural check on the ability of the Oversight Board to carry out its responsibilities effectively. An additional check on the Oversight Board’s exercise of its enforcement power would be the ability to appeal the Board’s final decision through regular judicial channels.

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<sup>498</sup> This would include excise taxes collected from the enforcement of Sections 4941–4965 of the Internal Revenue Code.

<sup>499</sup> Currently, the Internal Revenue Code includes privacy rules that severely limit the ability of the IRS to make public disclosure of their enforcement actions over the charitable sector. See I.R.C. § 6103 (West Supp. 2009) (amended by Pub. L. No. 111-3, 123 Stat. 8 (2009)); Owens, *supra* note 130, at 12–13 (“[S]ection 6103 effectively shields information regarding a tax-exempt organization’s behavior from public scrutiny until the behavior is so violative of federal tax rules that exempt status is revoked.”). As a quasi-public agency, the Oversight Board could be allowed broader disclosure of its enforcement actions in a manner analogous to the publication of FINRA enforcement actions. See Owens, *supra* note 130, at 12.

<sup>500</sup> See Brody, *Parochialism*, *supra* note 25, at 948.

<sup>501</sup> See *id.* at 948–49.

<sup>502</sup> *Id.* at 950. In addition, the lack of publicly available information regarding the enforcement efforts of the state attorneys general and the IRS contribute to the uncertainty regarding the expanse of the abuse in the charitable sector. See Fremont-Smith Study, *supra* note 10, at 25.

<sup>503</sup> See Brody, *Parochialism*, *supra* note 25, at 948–50; cf. Patton, *supra* note 55, at 140 (commenting on the initial great success and later demise of the early English Charity Commissions model of enforcement: “The most significant lesson for the early success of the commissions was, perhaps, the commitment, confidence, and enthusiasm of those who served as commissioners and jurors. However, as this public confidence and enthusiasm waned, the efficacy of the commissions was fundamentally undermined.”).

<sup>504</sup> See *supra* notes 26–28 and accompanying text.

## 2. Authority and Responsibilities of the Oversight Board

The Oversight Board would become the primary regulatory of the federal tax laws applicable to charitable organizations, effectively replacing the IRS in federal regulation of fiduciary behavior by charity managers. In this capacity, the Oversight Board would have a broad base of authority to make initial determinations of the charitable status of organizations seeking federal tax-exemption, receive and examine all annual federal information returns required to be filed (e.g., Form 990, Form 990-EZ, Form 990PF, and Form 990-N), enforce all current excise taxes in the Internal Revenue Code that influence both the fiduciary behavior of charity managers and the preservation of charitable assets for public benefit,<sup>505</sup> investigate and sanction organizations for violations of these provisions, impose and collect sanctions for confirmed violations, and revoke the tax-exempt status of organizations that no longer operate as charitable organizations within the requirements of the Internal Revenue Code.<sup>506</sup> Additionally, the Oversight Board would require “on-time” reporting<sup>507</sup> of key events of charitable organizations, such as the proposed merger of a charitable organization with another organization, or a self-dealing transaction between a charitable organization and its “insiders” that exceed a prescribed threshold. These reports would also be publicly available. Requiring “on-time” reporting of key events would enable the Oversight Board to respond quickly to transactions that could result in the diversion of charitable assets for personal gain, and stop abusive transactions from occurring for up to a year and a half before the annual

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<sup>505</sup> These excise taxes would include the private foundation self-dealing excise tax, the private foundation tax on jeopardy investments, the private foundation excise tax on taxable expenditures, the excise tax on termination of private foundation status, the excise tax on excess benefit transactions between public charities and their insiders, and the prohibition on political campaign activities of charitable organizations and corresponding limitations on lobby activities. See I.R.C. §§ 4911, 4941–48 (2006).

<sup>506</sup> As a starting point, the authority of the Oversight Board has been limited to only those responsibilities exercised by the IRS that are reflected in current law.

<sup>507</sup> “On-time” reporting entails disclosure of the material facts of the transaction through a filing made with the Oversight Board within thirty or sixty days of the occurrence of the transaction required to be reported. Federal securities law requires periodic disclosure of substantial financial and other information in order to assure availability of such information for the protection of investors and prospective investors. See Crimm, *supra* note 123, at 1189–90. In particular, public companies are required to disclose directors’ and principal executive officers’ interests in corporate property and contracts not made in the ordinary course of business as well as corporate financial statements which include management discussion and analysis reports informing investors about management’s future projections of economic performance of the company, including discussion of significant events or transactions that may have an effect on the economic performance of the company which are not reflected in historic information contained in the financial statements. See *id.*

information return disclosing such transaction is filed with the Oversight Board.<sup>508</sup>

The IRS would retain authority to make all determinations regarding validity of claimed charitable contribution deductions by taxpayers,<sup>509</sup> and to enforce the unrelated business income tax,<sup>510</sup> the employment tax,<sup>511</sup> employee benefit plan rules,<sup>512</sup> and similar generally applicable tax rules that are also applied to other tax-exempt and taxable organizations. These responsibilities are consistent with the IRS's predominant function to serve as the collector of tax revenues.<sup>513</sup> While some argue that the determination of charitable status (and the corresponding ability to revoke charitable status) is inextricably intertwined with the efficient administration of the charitable income tax deduction and the unrelated business income tax,<sup>514</sup> it is this Article's contention that the IRS can still effectively enforce these provisions while giving the Oversight Board authority to determine charitable status. For example, in the vast majority of states that afford exemption to state income or franchise taxes and sales taxes, evidence that an organization has been determined to be a charitable organization by the IRS is sufficient to qualify that organization for state tax exemption.<sup>515</sup> In addition, the English tax agency, HMRC, relies on determinations of charitable status by the English Charity Commission to administer the charitable contribution deduction of England's tax laws.<sup>516</sup> The long-standing reliance of these

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<sup>508</sup> Form 990, the annual information return for public charities, and Form 990PF, the annual return for private foundations, are required to be filed on or before the 15th day of the fifth month following the end of the charity's fiscal year, i.e., May 15th for a charity that reports its financial information on a calendar year basis. See I.R.S. Instructions for Form 990 (2008), available at <http://www.irs.gov/pub/irs-pdf/i990.pdf>. In addition, a charity may extend the filing deadline for its annual information return by up to six months, i.e., November 15th for a calendar year-end charity. See *id.* Accordingly, a self-dealing transaction or excess benefit transaction between a charity and its insider that occurs in January may not be reported to the IRS until November 15th of the following year, almost two years after the breach of fiduciary duty occurred.

<sup>509</sup> See I.R.C. § 170 (West Supp. 2009).

<sup>510</sup> See *id.* §§ 511–14.

<sup>511</sup> See *id.* §§ 3401–06.

<sup>512</sup> See *id.* §§ 3101–02, 3121–28.

<sup>513</sup> See *supra* notes 146–60 and accompanying text.

<sup>514</sup> See, e.g., FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 465; Fishman, *Agenda for Reform*, *supra* note 327, at 189.

<sup>515</sup> See, e.g., DEL. CODE ANN. Tit. 20 § 1-314(b)(6) (2008) (granting exemption from franchise tax to any charitable corporation which has been determined by the IRS to be exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code); TEX. TAX. CODE ANN. § 171.063 (Vernon 2008) (same); FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 369 (“In a majority of states, exemption from sales tax as with exemption from other state taxes will be granted upon a showing that the organization is exempt from federal income tax by virtue of being described in section 501(c)(3) of the Internal Revenue Code.”).

<sup>516</sup> See LUXTON, *supra* note 434, at 444–45.

taxing agencies on the charitable status determination made by another government agency illustrates that determination of charitable status by the taxing agency itself is not always an integral aspect of effective tax regulation.

The Oversight Board would have specialized expertise in determining whether an organization's activities comply with the legal notion of "charity."<sup>517</sup> The ability to make this determination is in no way enhanced by an agency's tax collection experience. By vesting this determination with a regulatory body focused solely on advancing laws that ultimately protect the integrity of the charitable sector, it is argued here that deference to the Oversight Board's determination of charitable status would only enhance the administration of the charitable income tax deduction and the unrelated business income tax. Determination of charitable status is just the starting point in administering these provisions. There are still many issues involved in the administration of these two provisions that fit more neatly with the IRS's role as a tax collector and do not depend on the determination of charitable status, such as improper valuations of donated property<sup>518</sup> and expense allocations for purposes of the unrelated business income tax.<sup>519</sup>

The Oversight Board, in conjunction with the Department of Treasury, would also have the authority to issue interpretive regulations of the Internal Revenue Code provisions that it would enforce. Similarly, the Oversight Board would receive authorization to issue interpretive public and private rulings and procedural pronouncements, similar to the interpretive rulings and procedural pronouncements issued by the IRS on tax matters generally.

In addition to its primary regulatory function, a fundamental part of the Oversight Board's responsibilities would include providing education and guidance to the charitable sector regarding appropriate policies and procedures to foster compliance with federal tax laws.<sup>520</sup> Such guidance is necessary to promote voluntary compliance because the vast majority

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<sup>517</sup> See HOPKINS, *supra* note 53, at 156–63 (distinguishing the common law meaning of charity from the federal tax law meaning of charity).

<sup>518</sup> See, e.g., Joint Committee on Taxation, JCS-02-05, *Options To Improve Tax Compliance And Reform Tax Expenditures* (Jan. 29, 2005), at 277–307 (discussing various valuation issues related to the charitable contribution deduction and proposed reforms to address these issues, many of which were incorporated into the Pension Protection Act).

<sup>519</sup> See FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, *supra* note 6, at 295 (observing the need for more precise guidelines for the allocation of expenses to determine a charity's unrelated business income tax liability, "an area in which the rules are unclear and practice varies greatly").

<sup>520</sup> In fact, the IRS currently undertakes educational efforts to inform charitable organizations of their responsibilities to maintain their tax-exempt status and provides newsletters, workshops, and other educational materials for charities on its website. See IRS, Tax Information for Charities & Other Non-Profits, <http://www.irs.gov/charities/index.html?navmenu=menu1> (last visited Nov. 2, 2009).

of charity directors serve as volunteers<sup>521</sup> and may otherwise lack the resources and incentives necessary to become familiar with their duties as responsible charity directors.

### 3. How the Oversight Board Would Improve Oversight of the Charitable Sector

The proposed structure and responsibilities of the Oversight Board squarely address the current financial, institutional, political, and agency limitations impeding the effectiveness of the IRS as regulator of the charitable sector.<sup>522</sup> By correcting these deficiencies, the Oversight Board would substantially improve federal oversight of the charitable sector.

First, the Oversight Board is better equipped to address the financial constraints that hinder IRS enforcement efforts. Because the Oversight Board would be self-funded with annual fees charged to its constituents rather than relying on appropriations from a legislative body, the Oversight Board would be given more flexibility to adjust its resources to meet the regulatory needs of the sector. Initially, the amount of the annual fees would be set to ensure that the Oversight Board received adequate funding to maintain an effective enforcement presence and to hire a sufficient number of qualified personnel to investigate suspected non-compliance thoroughly. As the charitable sector grows, both in size and wealth, the annual fees would correspondingly increase to enable the Oversight Board to add resources to keep pace with the sector's growth.

Second, the creation of a new oversight body would mitigate the institutional constraints that currently bind the IRS.<sup>523</sup> As a separate organization, the internal policies and procedures that bind the IRS would not hamper the Oversight Board in determining how to most effectively enforce the federal tax laws affecting charitable organizations. Therefore, the Oversight Board would be free to develop its own procedures that would be designed to most effectively and efficiently regulate the fiduciary behavior of charity managers.

Additionally, establishing clear primary authority for oversight of fiduciary behavior in a centralized federal agency relieves some inefficiencies in the regulation of the sector that have occurred as a result of the increasing overlap in enforcement jurisdictions of the state attorneys general and the IRS.<sup>524</sup> Professor Silber describes this phenomenon as follows:

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<sup>521</sup> See *supra* note 22 and accompanying text.

<sup>522</sup> See *supra* notes 119–210 and accompanying text.

<sup>523</sup> See *supra* notes 146–68 and accompanying text.

<sup>524</sup> Cf. Silber, *supra* note 108, at 613 (asserting that overlap in the enforcement jurisdiction of the state attorney general and the IRS may lead to weaker oversight of the charitable sector as a whole, and advocating assignment of primary responsibility to enforce any particular issue to one agency or the other”).



Many believe that the overlap increases the probability of prosecuting by one or the other agency and that the ability to “pass the ball” serves a valuable function—allowing the officials to avoid matters that are problematic. Of course, if they both want to pass the ball rather than receive it, the ball may be dropped.<sup>525</sup>

To address concerns about undue political influence,<sup>526</sup> the Oversight Board’s governing body would consist of a diverse group interested in effectively regulating the charitable sector. The agency would be removed from political influences, providing further legitimacy to its enforcement efforts. Including significant representation from the charitable sector within the agency’s governing body would guarantee the agency’s responsiveness to the needs of the charitable sector and its protection against political favoritism.

Similarly, agency constraints would be relieved by inclusion of charitable sector representatives in the Oversight Board’s governing body. As explained previously, the charitable sector itself is the closest substitute to private self-interested watchdogs over violations of fiduciary duties by charity managers.<sup>527</sup> Its self-interest lies in maintaining strong public confidence in the vitality and integrity of the charitable sector. The charitable sector representatives thus would be motivated to ensure the Oversight Board works effectively to detect and remedy wrongdoing in the sector. Also, by allowing the Oversight Board to collect the excise taxes it imposes on charity managers and charitable organizations that have violated the federal tax rules governing fiduciary behavior, the Oversight Board would have financial incentive to allocate additional resources to monitor and investigate perceived abuses in the charitable sector that would do the most harm. The excise tax revenues it collects from increased enforcement efforts may offset the expense of its increased efforts, thereby allowing the Oversight Board to realize a budgetary return on capital. Increased enforcement presence in an area of perceived abuse would also benefit the charitable sector because charity managers who might otherwise engage in such abusive transactions would be more reluctant to do so, thus, the occurrence of the targeted abusive transactions would diminish, less charitable resources would be

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<sup>525</sup> *Id.* at 636.

<sup>526</sup> See *supra* notes 170–200 and accompanying text. It is conceded that no agency can be completely free from political influence. In fact, the agency proposed herein will likely face lobbying efforts by constituent groups when the agency proposes new rules or modifications to existing rules. This type of “political influence” plagues most rule-making authorities, government agencies, and self-regulatory organizations alike. The political influence referred to here is the perception that enforcement efforts of the agency are politically motivated. See *id.*

<sup>527</sup> See *supra* notes 484–89 and accompanying text.

diverted for private gain, and public confidence in the integrity of the charitable sector would improve. The foregoing incentives would increase the self-interest of the Oversight Board in ensuring effective and efficient regulation of the charitable sector.

### CONCLUSION

Substantial reform in the regulation of charitable organizations is necessary to adequately curb reported abuses in the charitable sector. Effective regulation of the charitable sector increases public confidence in the sector.<sup>528</sup> Public confidence in the charitable sector is important to the sector's well-being; the sector is reliant on public confidence for gratuitous support.<sup>529</sup> Without effective oversight of the charitable sector, public confidence falters, and as a result the vitality of the sector suffers. Charities collectively possess a substantial amount of influence and wealth that cannot be disregarded. Due to the "halo effect" of the charitable sector, charities are particularly vulnerable to being vehicles for fraud and abuse. It is no coincidence that substantial Ponzi-type schemes have victimized the charitable sector over five times in the past fifteen years.<sup>530</sup> The charitable sector's perceived existence to "do good" makes the public less skeptical of proposals given by or to charities, resulting in an environment ripe for abuse.

Furthermore, regulatory reform is necessary to address self-policing enforcement limitations unique to the charitable sector. The directors and trustees who manage charitable organizations are primarily volunteers who do not necessarily have expertise in the laws regulating the

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<sup>528</sup> See Karst, *supra* note 82, at 434–35 ("Friends of private philanthropy will not mind our looking over their shoulders. They know the continued existence of the institutions of private charity will depend in considerable measure on public confidence in the efficiency of those institutions.").

<sup>529</sup> See Paul C. Light, *How Americans View Charities: A Report on Charitable Confidence, 2008*, THE BROOKINGS INSTITUTION ISSUES IN GOVERNANCE STUDIES, April 2008, available at [http://www.brookings.edu/papers/2008/04\\_nonprofits\\_light.aspx](http://www.brookings.edu/papers/2008/04_nonprofits_light.aspx).

<sup>530</sup> See *supra* note 11. In addition to the four Ponzi-type schemes discussed in the Fremont-Smith study, numerous charities were victimized by Bernard Madoff's \$50 billion Ponzi-type investment scheme. See Rick Cohen, *Smug Board Members Had Warm Feeling About Heat That Turned Out To Be Ponzi Fire*, THE NONPROFIT TIMES, Feb. 1, 2009, available at <http://www.nptimes.com/webex/09Feb/c1-2-1-09.html>; Terri Lynn Helge, *Other People's Money: Implications of the Bernard Madoff Scandal on a Charitable Director's Fiduciary Duties Regarding Investments*, WESLEYAN LAWYER (Spring/Summer 2010), at 26, available at [http://law.txwes.edu/Portals/0/docs/adozier/45500\\_TWLS\\_Lawyer\\_Spring09.pdf](http://law.txwes.edu/Portals/0/docs/adozier/45500_TWLS_Lawyer_Spring09.pdf); Eleanor Laise & Dennis K. Berman, *Impact on Jewish Charities is Catastrophic*, WALL ST. J., Dec. 16, 2008, at A20. Disabling conflicts of interest and the failure to properly exercise a director's duty of care have been cited as reasons why many charities invested with Bernard Madoff—and lost. See Helge, *supra* at 26; Douglas Feiden & Greg B. Smith, *State Investigation Exposes Bernie Madoff Middleman J. Ezra Merkin's Charity Conflicts of Interest*, N.Y. DAILY NEWS, Jan. 17, 2009, available at [http://www.nydailynews.com/money/2009/01/16/2009-01-16\\_state\\_investigation\\_exposes\\_bernier\\_madof.html](http://www.nydailynews.com/money/2009/01/16/2009-01-16_state_investigation_exposes_bernier_madof.html).

governance of charitable organizations. Additionally, the charitable sector lacks natural external private forces to uncover and regulate unscrupulous behavior, such as shareholder derivative actions and market constituents in the for-profit sector. There is no comparable private enforcement substitute in the charitable sector.

The policies underlying oversight of charitable organizations support maintaining primary responsibility for their regulation in a centralized authority. However, the financial, political, institutional, and agency constraints imposed on the Internal Revenue Service and state attorneys general make them unlikely to implement enough internal reform to be an ongoing, effective enforcement presence in the charitable sector.

The creation of a new federal quasi-public agency with authority to enforce federal tax laws applicable to charitable organizations would remove the financial, political, institutional, and agency handicaps that current government regulators, such as the Internal Revenue Service, face. The proposed agency would be a self-funded, independent, and proactive regulator that would serve the dual purposes of curbing abuses that have eroded public confidence in the sector and educating charity managers of their obligations to be responsible stewards of charitable resources. The agency would be primarily responsible for enforcing federal tax laws aimed at influencing fiduciary behavior of charity managers and preserving charitable assets for public benefit. Its formation, therefore, would separate the oversight of charity governance from the tax collection function, thus harmonizing the United States with other countries that have established independent charity oversight agencies.