

CHICAGO-KENT COLLEGE OF LAW
Illinois Institute of Technology
565 West Adams Street
Chicago, Illinois 60661

Evelyn Brody
Professor of Law
Tel 312 906 5276
Fax 312 906 5280
ebrody@kentlaw.edu

By email to charities@finance-rep.senate.gov

July 15, 2004

The Honorable Charles E. Grassley
Chairman
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Max Baucus
Ranking Member
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

RE: White Paper for Roundtable on Exempt-Organization Reforms

Gentlemen:

I very much appreciate the invitation of Mr. Dean Zerbe to submit comments on the draft proposals issued by the Senate Finance Committee staff for the hearing on June 22, 2004 relating to tax-exempt organizations, and to participate in the July 22 roundtable.

While all of the staff's proposals deserve serious consideration, the attached submission focuses on those proposals to increase the role of the Internal Revenue Service and the U.S. Tax Court in the enforcement of fiduciary duties of directors and officers of exempt organizations. As described in my statement, the Committee's valuable undertaking coincides with several important legal reform projects to clarify and improve State laws relating to charity governance. I do not favor importing additional substantive fiduciary law into the Internal Revenue Code, or granting private parties standing to enforce tax-exemption requirements. Rather, I support those proposals in the discussion draft that would improve charity operations in three ways: (1) by freeing the Service to share information with State regulators; (2) by expanding the information relating to good governance practices to be reported on the Form 990, both to educate the charity and to inform the public; and (3) by increasing funding to the Service for increased enforcement of and education about existing Federal tax laws, and by providing revenue to the States for enforcement and education.

I look forward to participating in the roundtable, and to assisting the Committee on this project in any way I can.

Sincerely,

Encl.

Evelyn Brody

July 15, 2004

**SUBMISSION IN RESPONSE TO JUNE 2004 DISCUSSION DRAFT
OF THE SENATE FINANCE COMMITTEE STAFF
REGARDING PROPOSED REFORMS AFFECTING TAX-EXEMPT ORGANIZATIONS
FOR JULY 22, 2004 SENATE FINANCE COMMITTEE ROUNDTABLE**

**Evelyn Brody¹
Professor, Chicago-Kent College of Law
Illinois Institute of Technology
565 West Adams Street, Chicago, IL 60661
ebrody@kentlaw.edu
312-906-5276**

I. INTRODUCTION

II. RECENT AND CURRENT LEGAL REFORM PROJECTS RELATING TO GOVERNANCE OF NONPROFIT ORGANIZATIONS

III. WHAT IS THE APPROPRIATE FEDERAL ROLE?

A. Federalism: State Substantive Law and Federal Tax Law

B. Enforcement Mechanisms

1. Role of the Internal Revenue Service
2. Disclosure
3. The IRS as Enforcement Agency, and Federal-State Coordination
4. The Issue of Private Standing
5. Peer "Regulation" and Certification

IV. CONCLUSION

¹ Also associate scholar with The Urban Institute's Center on Nonprofits and Philanthropy; previously attorney/advisor in the Office of Tax Policy of the U.S. Treasury Department (1988-1992) and associate in private practice (Arnold & Porter, Washington, DC, 1981-85, and Michael, Best & Friedrich, Madison, Wisconsin, 1985-88). Note that while this submission draws, in part, from work that I have done as Reporter of the American Law Institute's Project on Principles of the Law of Nonprofit Organizations, the opinions expressed reflect my views only and do not represent the position of the ALI or of any other institution with which I am affiliated.

I. INTRODUCTION

Unfortunately, it is impossible to determine how big a problem misfeasance and malfeasance by charity fiduciaries is, and how well government is doing to address it. Charity regulators themselves generally operate in secrecy (to the extent they act at all). Whether you regard the press as watchdog, sensationalist, or members of the prevailing social network, we know essentially the negative anecdotes we read in the newspaper. (See Fremont-Smith and Kosaras 2003; Boston Globe Staff 2003.) As charity operations gone wrong constantly make front-page news, however, we need to ask ourselves whether the proper response is a change in the law – or, instead, whether regulators need better funding and increased resources to enforce the laws that already exist.

Nonprofit organizations and their fiduciaries are subject to multiple levels of governmental supervision and scrutiny. State attorneys general have achieved important successes in educating the public about fraudulent fundraising and challenging wrongdoing; educating fiduciaries and staffs in meeting their legal obligations and improving charity governance; rectifying self-dealing and other breaches of fiduciary duty by charity insiders; and assisting charities that have lost their way to restructure or dissolve. The “biggest problem” of top State charity officials (according to a survey in which 38 States responded) relates to charitable solicitations, and whether charities spend their money as represented to donors. (See Mehegan, et al., 1994.) The Internal Revenue Service also functions as a regulator – often the only effective regulator – and as an important educator of the charitable sector.

The IRS has never had adequate resources to administer the tax-exemption regime. Just a few States fund and actively engage in charity enforcement. (See Fremont-Smith 2004.) However, the effective coverage is greater than it sounds: A disproportionate percentage of charitable assets is concentrated in a few States with active charity regulation, and, for the many charities operating across State borders, the inactive States can free-ride on the enforcement efforts of the few. To a large degree, legislatures are coming to view sunshine as the best disinfectant, and Congress and the States are increasing nonprofit or tax-exempt disclosure requirements to allow a better-informed public to provide oversight – although private parties cannot generally enforce nonprofit laws in court.

II. RECENT AND CURRENT LEGAL REFORM PROJECTS AFFECTING THE GOVERNANCE OF NONPROFIT ORGANIZATIONS

There is no single “law of nonprofit organizations.” Much of the common law of charity, property, and wills and trusts has found its way into State statutes. We find State laws on nonprofit corporations; Federal and State tax laws; and State (and sometimes local) laws on charitable solicitations. Like businesses, many nonprofits worry about laws (sometimes with

special rules for nonprofits) on contracting, labor and employment, torts and insurance, employee benefits, antitrust, bankruptcy, and political activity, as well as laws that govern specific industries such as hospitals and day care. Of additional importance are several sources which are not themselves law but which influence legal development, including uniform laws adopted by the National Conference of Commissioners on Uniform State Laws; model acts adopted by the American Bar Association; and restatements and principles of the law issued by the American Law Institute. Finally, an increasing amount of secondary legal guidance and scholarship is being produced.

The Committee issued its June 2004 discussion draft in a climate of intense interest to improve the legal regime that applies to the governance of nonprofit organizations, notably charities. Even prior to the scandals that led to the Sarbanes-Oxley Act of 2002, legal reform projects were proceeding in a variety of contexts:

- Trust Law. The National Conference of Commissioners on Uniform State Laws adopted the Uniform Trust Code in 2000 (and amended it in 2001 and 2003). This uniform act has been enacted in the District of Columbia, Kansas, Maine, Nebraska, New Hampshire, New Mexico, Tennessee, Utah, and Wyoming.

Separately, the American Law Institute's Restatement (Third) of Trusts has been underway for more than a decade, and is being issued as topics are completed. Volume I, "The Prudent Investor Rule," was issued in 1992. Volume II, addressing (among other topics) the definition of charity and *cy pres* modification, was issued in 2003. Current work focuses on fiduciary duties, including administration and enforcement.

Except where explicitly provided, both the Uniform Trust Code and the Restatement (Third) of Trusts cover private trusts as well as charitable trusts.

- Prudent Investing. For the last thirty years, the Uniform Management of Institutional Funds Act (1972), adopted in 47 jurisdictions, provides statutory rules governing the prudent investment of endowments that are "institutional funds." Generally, an "institution" is an organization formed and operated exclusively for educational, religious, charitable, or other eleemosynary purposes. The National Conference of Commissioners on Uniform State Laws is revising UMIFA. A draft received its first reading at NCCUSL's 2003 annual meeting. A revised draft for the 2004 annual meeting can be found at <http://www.law.upenn.edu/bll/ulc/umoifa/UMIFA2004AnnualMtgDraft.htm>.
- Nonprofit Corporation Acts. The American Bar Association's 1988 Revised Model Nonprofit Corporation Act has been enacted (sometimes with variation) in over a dozen States; the ABA's prior version was adopted in 39 States. A working group of the Business Law Section of the American Bar Association is drafting revisions to the

Revised Model Act. Meanwhile, some State legislatures and legal reform groups – including those in California, Massachusetts, New York and Pennsylvania – are considering statutory reforms, some modeled after provisions of Sarbanes-Oxley.

- Principles of the Law of Nonprofit Organizations. In 1992 the American Law Institute issued the Principles of Corporate Governance, relating to business corporations, and in 2001 opened a project on Principles of the Law of Nonprofit Organizations, for which I am Reporter. Work on the nonprofit project has produced two discussion drafts, but no material has yet been presented to the Institute for adoption. See Council Draft No. 1 (October 2, 2003) (relating to choice of entity; the legal issues raised by donations and donor control – including reforming restrictions that can no longer be carried out (equitable deviation and cy pres); and amendments to charitable purposes); Preliminary Draft No. 2 (May 26, 2004) (relating to governance – including the imposition and enforcement of fiduciary duties, and recommended practices beyond those legally mandated).

I recite all of these regimes and projects for two reasons: not only to describe the broad interest in and expertise being brought to bear on improving charity governance, but also to demonstrate the overlapping and potentially conflicting types and levels of law that any charity must take into account. There has been a welcome trend in recent reforms to converge on the same legal standards and remedies – notably, to produce the same results for trustees of charitable trusts and directors of nonprofit corporations – and I hope to further this trend as much as possible in the ALI project.

Moreover, as I work on the ALI project, I am ever mindful of the distinction between legal dictates and “best” practices. Good corporate governance often requires more than satisfying the legal threshold. The admitted gaps between the legal requirements and sound business practices do not, however, necessarily mean that formal laws should be expanded or reformed to mandate those practices. Charity management is located in the private sector precisely because society prefers reasonable discretion exercised by different participants under different conditions to the uniformity of government-directed action.

Accordingly, I hope that any new Federal tax requirements and remedies would be enacted only if designed to further the administration of the tax-exemption system, and appropriate to the institutional competence of the Internal Revenue Service. To this subject I turn next.

III. WHAT IS THE APPROPRIATE FEDERAL ROLE?

A. Federalism: State Substantive Law and Federal Tax Law

Under the decentralized U.S. federal system, substantive nonprofit law is a State concern, with differences occurring across States. Generally, the common law of charity develops on those rare occasions when a testator leaves property to a purported charity, and the disappointed heirs seek to defeat the will; or when a State attorney general is faced with a charity scandal that cannot be ignored. Issues implicating the Federal constitution rarely arise: Two of the most important U.S. Supreme Court decisions dealing with nonprofit organizations appeared 180 years apart, *Dartmouth College v. Woodward* in 1819 and *Boy Scouts of America v. Dale* in 2000, augmented in the last 25 years by a series of cases affirming the free-speech limits on state regulation of charitable solicitations.

One important caveat: It can be difficult to say what “the law” is. Even where enforcement action might be occurring, few cases involving nonprofit fiduciary issues have reached the courts. Generally, the charity regulator (State or IRS) prefers reform to punishment, in order to improve charity performance and to avoid embarrassment to well-intentioned charity managers. Settlements can be quite detailed – often spelling out changes in governance and future operations – but settlements remain secret except when regulators demand disclosure, typically where the transgression reflects more than a minor infraction by a single bad actor. (By contrast, prosecutions for embezzlement and other crimes are very public affairs.) This invisibility at the informal end of the regulatory spectrum makes it hard to judge the level and the effectiveness of regulators in influencing charity behavior.

While the most developed legal treatment can often be found under Federal tax law, it would be a mistake to assume that only the tax law is relevant or available to remedy wrongdoing. Of course the administration of the Federal tax-exemption scheme is not preempted by State law. That is, the Internal Revenue Service is free to enforce the requirements of the Code independently of the operations of State nonprofit laws. At the same time, though, Congress has generally intended that the regulation of charity fiduciary behavior be a State, not a Federal, case. Sarbanes-Oxley did not even federalize the law of business corporations. Rather, it set forth limited minimum governance requirements for those few thousand corporations that are publicly traded.

Thus, for example, I do not endorse the proposal in the discussion draft to impose self-dealing prohibitions on charities that are more stringent than allowed under State law. I appreciate that such a situation already exists for private foundations (although I might question the wisdom of a per se bar in that context as well). For operating charities, however, transactions with insiders under arrangements favorable to the charity should be permitted, under the State standard of “best interests of the charity.”

Moreover, the mandated good-governance practices that appear in Sarbanes-Oxley fall far short of the detailed good-governance standards promulgated by the Better Business Bureau’s Wise Giving Alliance and other charity watchdogs and associations. I note that several of the proposals in the discussion draft cite these “best practices”: These include requiring boards to

comprise at least three but no more than 15 directors, requiring the board to approve budgets, requiring that compensation consultants only be retained by the board, and requiring the board to define a mission and objectives. However, as much as I might recommend these practices in the ordinary case (see discussion below of peer-group and private regulation), I do not believe the case has been made for imposing as a condition of Federal tax exemption more prescriptive rules of governance than are imposed by State law.

The rules of Federal tax exemption essentially create a uniform floor for charity fiduciaries, and so I worry that raising the floor to the degree sketched out in the discussion draft will create an intolerable and inappropriate Procrustean bed for nearly a million organizations of great variety. Of course, the Internal Revenue Service can use the absence of these good practices to inquire into whether an organization deserves initial or continued tax exemption. (I note, though, that the IRS already has trouble administering current requirements with the limited resources Congress has provided to it.) Because I view the proper solution instead as increased enforcement, I turn next to an examination of how the law should be enforced – and by whom.

B. Enforcement Mechanisms

A State official, usually the attorney general, can investigate charges of improper charitable activities, view books and records, and subpoena witnesses. The courts, on motion of the attorney general or on their own, can “enjoin[] wrongful conduct, rescind[] or cancel[] a transfer of property, appointment of a receiver, replacement of a fiduciary, compel[] an accounting, redress of a breach or performance of fiduciary duties” (Fisch, et al. 1974, § 712: 549-50), dissolve a corporation, enforce restrictions in gifts, supervise indemnification awards, and surcharge fiduciaries for improperly received benefits (see Fishman and Schwarz 2000, at 255-56). The other primary focus of State enforcement interest relates to statutes governing charitable solicitations, to prevent fraud on donors and the diversion or waste of donated funds.

Federal enforcement over nonprofit activity is primarily confined to the Internal Revenue Service. In general, the Federal Trade Commission has jurisdiction over interstate charitable solicitations only if engaged in by for-profit solicitors, although the FTC does have jurisdiction over a nonprofit used as a shell for the direct private gain of its members. Some Federal enforcement activity against fraud can be credited to the U.S. Postal Service. The Treasury Department has begun to focus on the use of charities to further international terrorist activities. Of course, Federal regulation, like State regulation of charitable solicitation, is bound by charities’ constitutional rights.

1. Role of the Internal Revenue Service

The staff’s discussion draft proposes to alter the current statutory regime under which the Service lacks plenary equity powers over charity fiduciaries. Compare the 1969 Treasury Department recommendations to the Ways and Means Committee that the IRS have the power to

obtain equitable sanctions in district court to enforce exempt-organization fiduciary duties. See Treasury Proposals to Improve Private Philanthropy (Treas. Dept. News Release Jan. 18, 1977), [1977] 9 Standard Fed. Tax Rep. (CCH) & 6156, at ¶ 70,850-57 (Jan. 26, 1977). The Treasury Department introduced this proposal with the following general description:

United States District Courts would be invested with (1) equity powers (including, but not limited to, power to rescind transactions, surcharge trustees and order accountings) to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and (2) equity powers (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers) to ensure that the organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future.

Id. at Technical Explanation, part 1.C.1.b.(2)(a), at ¶ 70,855 (Improving the Philanthropic Process, Enforcement Procedures, Alternative Sanctions, Treasury Proposal, Detailed Description, Equity Powers). This proposal specified that the Federal courts would defer to any State equitable proceedings:

In the event that appropriate State authorities institute action against a philanthropic organization or individuals based upon acts which constitute a violation of substantive rules of law applicable to such organization, the United States District Court before whom the Federal civil action is instituted or was pending would be required to defer action on any equitable relief for protection of the organization or preservation of its assets for its philanthropic purposes until conclusion of the State court action. At the conclusion of the State court action, the District Court could consider the State action adequate or provide further equitable relief, consistent with the State action, as the case warrants. However, no action by a State court would defer or abate the imposition of the initial Federal excise taxes for the violations.

Id. at part 1.C.1.b.(2)(c), at ¶ 70,856. Congress did not enact these 1977 proposals.

Revocation of exemption, however, was never the IRS's only weapon: The agency can use and has used the threat of the ultimate sanction of revocation to exact specific management changes in the course of negotiating "closing agreements" that ensure future compliance – including reduced compensation, repayment of amounts improperly obtained or expended, and the adoption of a compensation committee structure or other governance changes.² But

² See the Kamehameha Schools/Bishop Estate closing agreement, which the IRS insisted be placed on the Web (go to <<http://www.ksbe.edu/newsroom/filings/toc.html#closing>>). This agreement required, in addition to a payment from KSBE to the IRS of \$9 million plus interest (for a total of about \$14 million), the permanent removal of the incumbent trustees; the reorganization of KSBE around a chief executive officer to carry out the policy decisions of the board of trustees; the adoption of an investment policy and a spending policy focused on education;

particularly where the State enforcement process is operating, the Service should recognize its institutional limitations and defer its own similar process. Moreover, by staying its hand, the IRS avoids imposing requirements inconsistent with later State-ordered reforms.

Moreover, since 1996 revocation has not even been the IRS's only statutory weapon. That year Congress finally granted the Service "intermediate sanctions" authority to sue charity insiders in cases of private inurement. By requiring that wrongdoers repay excess benefits to the charity, new Code section 4958 allows the Service to punish the responsible individuals without necessarily jeopardizing the exemption of the charity. Thus, the Federal regime converges with the State law aim of making the charity whole in cases of insider financial benefit. Indeed, the Service long petitioned Congress for such an intermediate remedy precisely to avoid compounding the harm to the innocent beneficiaries of charity. Significantly, the legislative history to this new Code section 4958 declares Congress's intent that intermediate sanctions should be the only remedy where the continued operations of the charity are not inconsistent with tax exemption.

No intermediate sanctions laws, however, apply to fiduciaries of "public charities" who breach duties other than that of financial loyalty. Thus, for such inadequacies of governance as running an indifferent charitable program, accumulating excess income, or paying undue attention to investment returns, the IRS is as helpless (or powerful) now as it was before new Code section 4958. By contrast, for those charities designated as "private foundations," Congress in 1969 adopted a panoply of intermediate sanctions.

Finally, I note that the discussion draft proposes to give the U.S. Tax Court jurisdiction over board governance. Even should Federal jurisdiction be appropriate, the district courts (as in the 1977 proposal) would seem more appropriate: The Tax Court is a court of special jurisdiction due in large part to the specialized knowledge required to apply the tax laws. That specialized knowledge does not extend to corporate governance or related management issues. Most important, though, it is the State courts that have the greatest experience and expertise in matters involving corporate governance and disputes.

2. Disclosure

Helping the public understand charity operations, as well as reducing the potential for fraud and abuse in fund raising, has led to a broad movement for increased public disclosure of charity operations. At the State level, government regulators have come to rely on public vigilance to prevent individual struggling charities from engaging in desperate fund raising

adoption of a conflicts-of-interest policy and adherence to the probate court's directive for setting trustee compensation; a ban on hiring any governmental employee or official until three years after termination of governmental service; and the Internet posting of the final closing agreement and of KSBE financial statements for the next five years.

efforts at the cost of the overall reputation of the charitable sector. Hoping that better-informed donors will make wiser gifts, State regulation now focuses on requiring charities to make increased public disclosure on standardized forms.

At the Federal level, Congress, too, views sunshine as an important disinfectant. Recent tax legislation obligates a charity to produce any of its last three tax returns upon request. (Evidently, of greatest interest to the press, the public, competitors, and even other workers in the organization is the listing of compensation paid to the top executives and independent contractors.) One private effort – by the nonprofit GuideStar and The Urban Institute’s National Center on Charitable Statistics – maintains a database on the Web of all filed IRS Forms 990. Hopefully, compliance and accuracy will improve as charities realize that the public can easily access these filings, prompting boards to take their Forms 990 more seriously.

Similar reasons support the discussion draft’s proposal to require, once every five years, that each exempt organization file “such information as would enable the IRS to determine whether the organization continues to be organized and operated exclusively for an exempt purposes (i.e. whether the original determination letter should remain in effect)” – such information becoming publicly available. Regardless of whether the Service examines the submitted material in a particular case, assembling this information will be a salutary exercise for the governing board and management of the organization. Perhaps most important, a new organization assessing its first five years of existence will be compelled to face the question of whether it is even viable to continue.³ It might be appropriate, however, to limit this requirement only to start-up organizations and, perhaps, small organizations. (Such a procedure would have the added benefit of clarifying which organizations should continue in the IRS database of exempt organizations.) Established organizations – particularly those that are accredited and regularly reviewed by another body (as described elsewhere in the draft) – might find such an exercise duplicative and resource-wasting.

A few years ago the staff of the Joint Committee on Taxation released a congressionally-mandated study of the disclosure rules that apply to exemption organizations under the Internal Revenue Code. (Joint Committee 2000.) The Joint Committee staff recommended expanding disclose to: private letter rulings and audit memoranda without “redaction” of identifying information; business tax returns of exempt organizations and their taxable affiliates; and a description of lobbying activities, including amounts spent on self-defense lobbying and on nonpartisan research and analysis that includes a limited “call to action.” The Joint Committee staff asserted that such disclosure allows not only increased public oversight, but “also allows the public to determine whether the organizations should be supported – either through continued tax benefits or contributions of donors – and whether changes in the laws regarding such

³ One commentator, Jack Siegel, favorably calls such a proposal for new organizations “training wheels.” See <<http://charitygovernance.blogs.com>>.

organizations are needed.”

The discussion draft endorses some of the Joint Committee staff’s proposals, many of which I support. However, requiring the disclosure of Forms 990-T and returns of taxable affiliates would afford less privacy to exempt organizations than to those of individuals and even publicly traded corporations. Moreover, this proposal raises compliance issues: How would such a requirement apply when the taxable business is partly owned by an exempt organization and partly by individuals or unaffiliated businesses?

The proposals in the discussion draft additionally would require reporting and disclosure of, among other things, “the organization’s annual performance goals and measurements for meeting those goals (to be established by the Board of Directors) for the past year and goals for the coming year. The purpose of this requirement would be to assist donors to better determine an organization’s accomplishments and goals in deciding whether to donate, and not as a point of review by the IRS.” There are many pressures on Congress and the IRS to expand the Form 990 to accomplish a myriad of goals. I urge policy makers to restrict the Federal filing requirements to that information necessary to administer the tax-exemption regime. Other forces – some imposed by State law and others imposed by “the market” for grants, donors, and recognition by private bodies (e.g., the Combined Federal Campaign or the United Way) – operate on charities to compel them to make additional disclosures in the appropriate context.⁴

3. The IRS as Enforcement Agency, and Federal-State Coordination

A charity that violates the private-inurement (and excess-benefits) proscription also violates the duty-of-loyalty requirements of State nonprofit law. Depending on the resources and inclinations of the State attorney general’s office, the charity might be facing investigations on two fronts. Under current privacy law applying to exempt organizations, the State can share information with the IRS, but the IRS cannot share information about its investigation short of notifying the State of revocation of exemption. However, because this final determination might “not be made for a number of years, a tax-exempt organization may have exhausted its assets through illicit transactions or disposed of its assets or changed its operations in a way which can no longer be corrected by the time the IRS is permitted” to inform the State. (Joint Committee 2000, at 103, citing to Lyon 1996, at § 5.04.)

To address these concerns, the Joint Committee staff’s 2000 disclosure study contained one particularly well-received suggestion: that Congress would require the IRS to inform the appropriate State of the progress of an exempt-organization investigation. To prevent over-reliance by States on the IRS, the recommendation would allow such disclosure in only two

⁴ It is not clear to me why the discussion draft views the IRS as the appropriate agency to determine whether exempt organizations seeking government grants or participation in the CFC follow these good practices.

situations: (1) When the State has made a specific referral of an organization to the IRS before a denial or revocation of tax exemption; or (2) with State officials who regularly share information with the IRS, when the IRS determines that such disclosure may facilitate the resolution of cases. The CARE Act of 2003, passed by the Senate as S. 476 on April 9, 2003, contains a provision that, in general, would permit the IRS to inform the appropriate State official of a proposed denial of exemption or a proposed revocation of exemption. (See Joint Committee 2003, at 44-47.) In any case when both Federal and State investigations are proceeding, principles of federalism suggest that the IRS should have to defer to the State, or at least stay its hand until the proceedings conclude, to protect the charity from inconsistent mandated governance changes.

4. The Issue of Private Standing

The discussion draft proposes that any individual could submit a governance or tax complaint to the IRS for a \$250 filing fee. While increasing the number of eyes policing the nonprofit sector sounds appealing, the issue of who has standing to complain about the performance of charity fiduciaries is an area that is hotly debated in the recent and current legal projects to reform State laws.

Traditionally, private parties – including donors – have no legal authority to sue to enforce charitable duties. Nor, except in rare cases, do individual beneficiaries have standing to sue charity trustees or directors, either directly or derivatively on behalf of the charity, because “the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public.” (Bogert 1954, at 663; see generally, Blasko, et al, 1993.) Courts will grant standing to a director or trustee who is charging the others with breach of fiduciary duty, although this practice is more appropriately limited to breaches of the duty of loyalty or lack of good faith; in an ordinary suit for breach of the duty of care, outvoted fiduciaries should not be able to reargue the board’s business decision in court.

To minimize the risk of vexatious and multiple lawsuits but to take advantage of the oversight provided by appropriate private parties, a few modern statutes grant standing to an expanded class of private persons to sue fiduciaries, with any monetary recovery going to the nonprofit. Even without statutory authorization, courts will, on rare occasion, grant standing to those with a “special interest.” (See Fremont-Smith 1997; 2004.) In the case of trusts, section 405(c) of the new Uniform Trust Code allows the settlor of a charitable trust to maintain a proceeding to enforce the trust. However, the current project to reform UMIFA initially drafted, but then eliminated, a provision providing (under certain circumstances) for donor standing to enforce a restricted gift. My draft treatment of this subject for the American Law Institute generally denies donor standing to enforce a gift restriction in the absence of an enabling provision in the gift instrument. (American Law Institute 2003b.)

Because good governance is often a matter of judgement and opinion, if the proposal in the discussion draft becomes law, any charitable organization addressing controversial issues

could be forced to spend a large portion of its resources dealing with complaints, despite the proposed \$10,000 penalty for frivolous filings. Imagine what this grant of standing would have on Planned Parenthood or the National Rifle Association (assuming it were subject to this rule).

The discussion draft refers to the possible use of “relator” status. In a statutory form of this venerable common law practice, California permits suit by anyone granted relator status by the attorney general. While the relator generally pursues the matter, and is responsible for costs, the attorney general may take over, withdraw, or compromise the action at any time. (See also Fishman 1985, at 674 (urging that successful relators be granted costs and attorneys fees).) In the discussion draft’s proposal, “At all times the IRS will retain control of the suit. In addition, the IRS must refer the suit to the relevant state official prior to taking action. The state official has up to thirty days to stay the suit.”

I do not support this proposal in the discussion draft. Any person is always free to bring a complaint to the Internal Revenue Service or State charity official. Indeed, private complaints, despite our elaborate filing requirements, are a valuable source of new cases for government enforcers. However, it seems logical that enhancing the ability of private parties to bring suits under Federal tax law, as described by the proposal, would actually increase the workload of Federal and State regulators in assessing the merits of these cases.

Overlaid on these policy concerns is the general lack of standing on the part of Federal taxpayers – including their lack of standing to complain about how the Service administers the Internal Revenue Code. See *Eastern Kentucky Welfare Rights Organization v. Simon*, 426 U.S. (1976) (holding that plaintiffs lacked standing to challenge a revenue ruling defining the exemption standards for hospitals); *In re U.S. Catholic Conference*, 885 F.2d 1020 (2d Cir. 1989) (denying standing to the Abortion Rights Mobilization, Inc., and others to challenge the IRS’s failure to revoke the exemption of the Catholic Church for lobbying and political activity), *cert. denied* 495 U.S. 918.

5. Peer “Regulation” and Certification

Private regulation takes many forms, which vary in their degree of voluntariness or compulsion, and attendant sanction: at the individual organization level, the demands of funders or of government contracts; at the industry or professional level, the requirements of accreditation bodies; and at the sector level, trade association best-practices guides and even certification. (See generally Brody 2002b.)

For example, “United Way of America now requires all 1,400 local United Ways to provide national headquarters with annual financial-data reports, to pay for independent financial audits, to write and adhere to a code of ethics, and to have an independent company perform a detailed organizational assessment of the group every three years.” (Wolverton 2003; see also United Way of America, Press Release, “United Way Adopts Upgraded Accountability and

Financial Standards: New Practices to Be Required for Membership” (Jan. 23, 2003), available at <<http://www.unitedway.org>>; Williams 2002.)

One long-time charity watchdog cited by the discussion draft – the donor-focused BBB Wise Giving Alliance – published the standards it uses in responding to public requests about specific charities. (See <<http://www.give.org/standards/>>.) These standards cover board membership, activity and policies, accuracy of public information such as solicitations and websites, openness about relationships with commercial entities, use of funds, annual report, and budget, and, for established charities, whether the organization spends more than a certain percent on fundraising and other administrative costs. Rating systems that employ formulas or grades are the most controversial. Moreover, the private watchdogs have differing philosophies – sometimes even opposite views of the same metric. Notably, a high endowment earns an A (for fiscal prudence) from one rater but an F (for lack of dependence on the donating public) from another.

More systematically, State nonprofit associations have begun to design variously named “accountability codes” and “standards of practice.” Two of the most thorough – adopted by the Maryland Association of Nonprofit Organizations and by the Minnesota Council of Nonprofits in substantially similar form – cover mission and program evaluation, governance, human resources, financial management, fundraising, public accountability and communications, and public policy and advocacy. (Indeed, these “best practices” might be too prescriptive for some.) The intermediate-sanctions tax law is inducing more charities to adopt conflict-of-interest policies, and these private guidelines explain what the documents should require. Finally, the Maryland association offers peer-review certification for nonprofits seeking to demonstrate that they abide by its principles.

Private regulation has advantages and disadvantages compared with the compulsory, but minimal, public regulation. A charity has some discretion in orienting itself towards particular validating private authorities having varying requirements. For example, a member-funded private body generally relies on voluntarily-supplied and unverified information. On the other hand, standards could be inappropriate in a given case, and a proliferation of tests could either unnecessarily burden compliant charities, or cause small charities lacking the sophistication or resources to conform to appear unworthy of donor support. The relationship between the private regulator and regulated can become just as complicated as in the public sector, with concerns of “capture” and protection of elite, vested interests. (Meek 1977, at 2842-44.)

The real test of the effectiveness of private regulation comes when the nonprofit body is faced with having to expel a nonconforming nonprofit, or impose other sanctions. In sum, regulation can merely move the “who guards the guardians” question one step up: How can the process send not just a signal of trustworthiness, but also a credible and legitimate signal? And perhaps of most immediate practical consideration, it will not be possible to select a single private group to promulgate standards for the entire exempt sector – without simply privatizing

the Internal Revenue Service.

IV. CONCLUSION

While all of the discussion draft's proposals deserve serious consideration, this submission focused on those proposals to increase the role of the Internal Revenue Service and the U.S. Tax Court in the enforcement of fiduciary duties of directors and officers of exempt organizations. As described above, the Committee's valuable undertaking coincides with several important legal reform projects to clarify and improve State laws relating to charity governance. I do not favor importing additional substantive fiduciary law into the Internal Revenue Code, or granting private parties standing to enforce tax-exemption requirements. Rather, I support those proposals in the discussion draft that would improve charity operations in three ways: (1) by freeing the Service to share information with State regulators; (2) by expanding the information relating to good governance practices to be reported on the Form 990, both to educate the charity and to inform the public; and (3) by increasing funding to the Service for increased enforcement of and education about existing Federal tax laws, and by providing revenue to the States for enforcement and education.

SELECTED BIBLIOGRAPHY:

Note: Peer- or self-regulatory ethical guides are also emerging. See, e.g., BBB Wise Giving Alliance, "Standards for Charity Accountability," available at <http://www.give.org/standards/spring03standards.PDF>; Independent Sector, "Compendium of Standards, Codes, and Principles of Nonprofit and Philanthropic Organizations," available at <http://www.independentsector.org/issues/accountability/standards.html>; BoardSource, "Ten Basic Responsibilities of Nonprofit Boards" (Pub. 301) and other publications available at <http://www.boardsource.org/>; Evangelical Council for Financial Accountability, *Seven Standards of Responsible Stewardship*, at www.ecfa.org; Maryland Association of Nonprofit Organizations, *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector, II.B.6* (Baltimore: Maryland Association of Nonprofit Organizations, 1998), available at www.mdnonprofit.org/ethicbook.htm; Minnesota Council of Nonprofits, *Principles and Practices for Nonprofit Excellence* (Minnesota Council of Nonprofits, 1998), available at www.mncn.org/pnp_doc.htm#intro; and the Association of Fundraising Professionals (formerly the National Society of Fund Raising Executives), which requires those applying for certification to adhere to its Code of Ethics and Standards of Professional Practice in addition to its Donor Bill of Rights, available at www.nsfre.org/about/certification/about_certification.html. For other resources, see, e.g., *The Nonprofit Good Practice Guide* (The Dorothy A. Johnson Center for Philanthropy & Nonprofit Leadership, Grand Valley University), at www.nonprofitbasics.org.

American Bar Association. 1988. REVISED MODEL NONPROFIT CORPORATION ACT. Chicago.

- ABA SECTION OF BUSINESS LAW, NONPROFIT CORPORATIONS COMMITTEE. 2002. *GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS* (George W. Overton & Jeannie Carmedelle Drey, eds., 2d ed.).
- American Law Institute. 1959. *RESTATEMENT (SECOND) OF THE LAW OF TRUSTS*. Philadelphia: American Law Institute.
- _____. 1992. *RESTATEMENT (THIRD) OF THE LAW OF TRUSTS: THE PRUDENT INVESTOR RULE*. Philadelphia: American Law Institute.
- _____. 1992. *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS*. Philadelphia: American Law Institute.
- _____. 2003a. *RESTATEMENT (THIRD) OF THE LAW OF TRUSTS (Vol. 2)*. Philadelphia: American Law Institute.
- _____. 2003b. *Principles of the Law of Nonprofit Organizations – Council Draft No. 1*. Philadelphia: American Law Institute. October 2.
- _____. 2004. *Principles of the Law of Nonprofit Organizations – Preliminary Draft No. 2*. Philadelphia: American Law Institute. May 26.
- Atkinson, Rob. 1998. *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?* *JOURNAL OF CORPORATION LAW* 23: 655-99.
- Blasko, Mary Grace, Curt S. Crossley, and David Lloyd. 1993. *Standing to Sue in the Charitable Sector*. *UNIVERSITY OF SAN FRANCISCO LAW REVIEW* 28: 37-84.
- Bograd, Harriet. 1994. *THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS*. Yale University Program on Non-Profit Organizations, Working Paper No. 206, August.
- [Boston] Globe Staff. 2003. *Spotlight: Some Officers of Charities Steer Assets to Themselves*. *BOSTON GLOBE*, Oct. 9, at 1.
- BOWEN, WILLIAM G. 1994. *INSIDE THE BOARDROOM: GOVERNANCE BY DIRECTORS AND TRUSTEES* (John Wiley & Sons).
- Brakman Reiser, Dana. 2004. *Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*. *U.C.-DAVIS LAW REVIEW*. 38: forthcoming.
- Brody, Evelyn. 1997a. *Charitable Endowments and the Democratization of Dynasty*. *ARIZONA LAW REVIEW*. 39: 873-948.
- _____. 1997b. *Hocking the Halo: Implications of the Charities' Winning Briefs in Camps Newfound/Owatonna, Inc.* *STETSON LAW REVIEW* 27(2) (Howard Oleck Memorial Nonprofit

Symposium Issue): 433-56.

- _____. 1998a. *The Limits of Charity Fiduciary Law*. MARYLAND LAW REVIEW. 57: 1400-1501.
- _____. 1998b. *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*. JOURNAL OF CORPORATION LAW 23: 585-629 (Nonprofit Symposium Issue).
- _____. 1999a. *Charities in Tax Reform: Threats to Subsidies Overt and Covert*. TENNESSEE LAW REVIEW. 66: 687-763.
- _____. 1999. *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?* UNIVERSITY OF HAWAII LAW REVIEW. 21(2) (Symposium Issue on the Bishop Estate Controversy): 537-91.
- _____. 2001. *Troubling Lessons from the Bishop Estate Settlement for Administering the New Intermediate Sanctions Regime*, 32 EXEMPT ORG. TAX REV. 431 (June); reprinted as *Administrative Troubles for the Intermediate Sanctions Regime*, 92 TAX NOTES 423 (July 16).
- _____. 2002a. *Entrance, Voice and Exit: The Constitutional Bounds of the Right of Association*. UNIVERSITY OF CALIFORNIA AT DAVIS LAW REVIEW. 35(4): 821-901
- _____. 2002b. *Accountability and Public Trust*. In THE STATE OF AMERICA'S NONPROFIT SECTOR (Lester M. Salamon, editor), 471-98. Washington, D.C.: Brookings Institution Press and The Aspen Institute.
- _____. 2004. *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937-1036.
- Chester, Ronald. 2003. *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?* REAL PROPERTY, PROBATE AND TRUST JOURNAL 37: 611-25 (2003).
- Chisolm, Laura B. 1995. *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*. NONPROFIT MANAGEMENT AND LEADERSHIP. 6 (Winter): 141-56.
- Filer Commission (Commission on Private Philanthropy and Public Needs). 1977. *Commentary on Commission Recommendations*. In FILER COMMISSION RESEARCH PAPERS 1: 38. Washington, D.C.: U.S. Treasury Department.
- Fisch, Edith L, Doris Jonas Freed, and Esther R. Schachter. 1974. CHARITIES AND CHARITABLE FOUNDATIONS. Pomona, N.Y.: Lond Publications.
- Fishman, James J. 1985. *The Development of Nonprofit Corporation Law and an Agenda for Reform*, EMORY LAW JOURNAL 34: 617-83.
- _____. 1987. *Standards of Conduct for Directors of Nonprofit Corporations*. PACE LAW REVIEW.

7: 389-462.

_____. 2003. *Improving Charitable Accountability*. MARYLAND LAW REVIEW. 62: 218-87.

Fishman, James J., and Stephen Schwarz. 2000. NONPROFIT ORGANIZATIONS: CASES AND MATERIALS. New York: Foundation Press. Second edition.

Fleishman, Joel L. 1999. *Philanthropy and Outcomes: Dilemmas in the Quest for Accountability*. In PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA (Charles T. Clotfelter and Thomas Ehrlich, eds.): 172-97. Bloomington: Indiana University Press.

Fremont-Smith, Marion R. 1965. FOUNDATIONS AND GOVERNMENT. New York: Russell Sage Foundation.

_____. 1966. *Duties and Powers of Charitable Fiduciaries: The Law of Trusts and the Correction of Abuses*. UCLA LAW REVIEW 14: 1041-1059.

_____. 1997. "Enforceability and Sanctions." Presented at New York University School of Law, National Center on Philanthropy and Law, Conference on Governance of Nonprofit Organizations.

_____. 2004. GOVERNING NONPROFIT ORGANIZATIONS: STATE AND FEDERAL LAW AND REGULATION. Cambridge, Mass.: Belknap Press of the Harvard University Press.

Fremont-Smith, Marion R., and Andras Kosaras. 2003. *Wrongdoing by Officers and Directors of Charities: a Survey of Press Reports 1995-2002*. EXEMPT ORGANIZATION TAX REVIEW. 42: 25-59.

Fremont-Smith, Marion R., and Jonathan A. Lever. 2000. *State Regulation of Health Care Conversions and Conversion Foundations*. B.N.A. HEALTH LAW REPORTER 9(19): 714-720. May 11.

General Accounting Office. 2002. Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, "Tax-Exempt Organization: Improvements Possible in Public, IRS, and State Oversight of Charities" (GAO-02-526, April).

Ginsburg, David, Lee R. Marks and Ronald P. Wertheim. 1977. *Federal Oversight of Private Philanthropy*. In FILER COMMISSION RESEARCH PAPERS 5: 2575-2696. Washington, D.C.: U.S. Treasury Department.

Hansmann, Henry. 1980. *The Role of Nonprofit Enterprise*. YALE LAW JOURNAL. 89: 835-901.

_____. 1981. *Reforming Nonprofit Corporation Law*. UNIVERSITY OF PENNSYLVANIA LAW REVIEW 129: 497-623.

_____. 1996. OWNERSHIP OF ENTERPRISE. Cambridge, Mass.: Belknap Press of Harvard University Press.

Joint Committee on Taxation, Staff of [U.S. Congress]. 2000. *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Exempt Organizations* (JCS-1-00, Jan. 28) (at <<http://www.house.gov/jct>>).

_____. 2003. *Technical Explanation of the Revenue Provisions of S. 476, the "CARE Act of 2003," as Passed by the Senate* (JCX-47-03, May 12) (at <<http://www.house.gov/jct/x-47-03.pdf>>).

Karst, Kenneth L. 1960. *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*. HARVARD LAW REVIEW. 73: 433-83.

Lyon, James B. Lyon. 1994. *The Supervision of Charities in the United States by the State Attorneys General (and Other State Agencies) and the Internal Revenue Service*. NEW YORK UNIVERSITY 24TH CONFERENCE ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS. Chapter 5.

Meek, Peter G. 1977. *Self-Regulation in Private Philanthropy*. In FILER COMMISSION RESEARCH PAPERS 5: 2781-2855. Washington, D.C.: U.S. Treasury Department.

Mehegan, Sean, Betsy Bush, and Sharon Nacson. 1994. *Charity Regulation Today: How the States See It*. NONPROFIT TIMES. March, at 1.

National Conference of Commissioners on Uniform State Laws. 1972. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT. Chicago. For the 2004 draft revision, go to <<http://www.law.upenn.edu/bll/ulc/umoifa/UMIFA2004AnnualMtgDraft.htm>>.

_____. 2000. UNIFORM TRUST CODE. Chicago.

Peregrine, Michael W., and James R. Schwartz. 2000a. *A General Counsel's Guide to Accessing Restricted Gifts*. EXEMPT ORGANIZATION TAX REVIEW 29(1): 27-34. July.

_____. 2000b. *The Business Judgment Rule and Other Protections for The Conduct of Not-for-Profit Directors*. JOURNAL OF HEALTH LAW. 33: 455-484.

_____. 2002. *Key Nonprofit Corporate Law Developments in 2001*. HEALTH LAW REPORTER 11: 272 (February 14).

Siegel, Jack. 2004. *Avoiding Trouble While Doing Good: A Guide for the Non-Profit Director and Officer*. Auto Didactix LLC (CD-ROM), available at <<http://www.charitygovernance.com>>.

Silber, Norman I. 2001. A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR. Boulder, Colo.: Westview Press.

U.S. Congress, Joint Committee on Taxation. See Joint Committee on Taxation.

U.S. General Accounting Office. See General Accounting Office.

Williams, Grant. 2000. *United Way Crafts New Accountability Standards*. CHRONICLE OF PHILANTHROPY. Oct. 31.

Wolverton, Brad. 2003. *What Went Wrong?*. CHRONICLE OF PHILANTHROPY. September, available at <<http://philanthropy.com/premium/articles/v15/i22/22002701.htm>>.

Yarmolinsky, Adam, and Marion R. Fremont-Smith. 1977. *Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy*. In FILER COMMISSION RESEARCH PAPERS 5: 2857-68. Washington, D.C.: U.S. Treasury Department.