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Cover Page Footnote

Professor, Pace University School of Law.

WRONG WAY CORRIGAN AND RECENT DEVELOPMENTS IN THE NONPROFIT LANDSCAPE: A NEED FOR NEW LEGAL APPROACHES

*James J. Fishman**

You see things; and you say "Why?"
But I dream things that never were;
and I say "Why not?"¹

INTRODUCTION

In July 1938, an aviator, Douglas Corrigan, flew from Long Beach California to New York's Floyd Bennett Field in Brooklyn. His flight plan called for him to return to California. On July 17, Corrigan took off in thick fog, and headed east because airport officials had told him to lift off in any direction save west, as there were some buildings at the western edge of the field. He continued flying east, claiming his compass indicated he was heading west. After a twenty-eight hour, thirteen-minute flight, Corrigan landed in Dublin, Ireland. He became a national hero, and his nickname, "Wrong Way Corrigan," became a colloquialism describing anyone who blunders and goes the wrong way.²

This essay argues that some of the assumptions by which we view and regulate the nonprofit sector are traveling, as did Wrong Way Corrigan, in the wrong direction. This is due to faulty assumptions about the nonprofit universe, overreactions to perceived problems, and a reluctance to consider innovative approaches to existing problems. This essay examines some of the erroneous assumptions, discusses recent legislative initiatives, and suggests that there is a need for more than incremental approaches when considering the nonprofit landscape. It argues that regulation of fiduciary behavior should be at the local level, or a combination of local and state regulation, in contrast to federal enforcement. Federal tax law issues are

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1. Bernard Shaw, *Back to Methuselah* act 1, in *Bernard Shaw Selected Plays with Prefaces* 7 (1949).

2. See *'Just Dumb Luck,' Corrigan Asserts*, N.Y. Times, July 19, 1938, at 3; *Pilot of Old Plane Wings Toward Sea: Flier Who Came Non-Stop from Coast Vanishes Eastward on His 'Return' Trip*, N.Y. Times, July 18, 1938, at 1; Hugh Smith, *Lost Way, He Says: Set Out for California but Compass 'Got Stuck,' He Asserts*, N.Y. Times, July 19, 1938, at 1.

appropriately left to the Internal Revenue Service (IRS). This essay also will discuss the recent interest in for-profit social enterprise organizations.

The nonprofit sector has been under critical scrutiny from regulators, legislators, the public, and the press. Scandals involving charities and their fiduciaries appear regularly in the media. In recent years, this has led to increased regulation of charities by the primary federal regulator, the IRS. Whether regulation increases probity is problematic. For many organizations, particularly smaller ones, additional regulation merely increases the burdens of nonprofit status, or in economic jargon, transaction costs, at the expense of focusing on mission.

I. ERRONEOUS ASSUMPTIONS

A. *There Is a Single Nonprofit Sector*

The idea of a singular “nonprofit sector” that exists between business and the government is a myth, and harmful when it comes to attitudes and approaches to regulation. There are really many sectors, or types of organizations, that are called nonprofit or even charities. Under the Internal Revenue Code (IRC), there are at least twenty-eight types of organizations entitled to be tax exempt.³ The most important are the charitable nonprofits, those exempt under § 501(c)(3) of the IRC. The 501(c)(3) organizations have become so differentiated that it may be time to reconsider the scope and definition of those organizations that fit within this tax category.

The 1,064,191 § 501(c)(3) organizations registered with the IRS in 2006⁴ have been divided into two categories: private foundations and public charities. Private foundations are essentially organizations that have failed certain tests of public support.⁵ The other 501(c)(3) organizations are public charities, organizations to which contributions⁶ are deductible for federal tax purposes.⁷ Over half of all organizations recognized as exempt by the IRS are in this group.⁸

3. I.R.C. §§ 501(c)(1)–(28), 501(d), 501(e), 501(f), 501(k) (2000); *see also* I.R.C. § 521(a) (farmers’ cooperative organizations).

4. Dep’t of the Treasury, Internal Revenue Service Data Book Publication 55B, at 56 tbl.25 (2006), *available at* www.irs.gov/pub/irs-soi/06databk.pdf.

5. More specifically, private foundations are organizations that have failed the public support tests of I.R.C. § 509.

6. With the exception of organizations testing for public safety, contributions to private foundations are also deductible, but the maximum amount of one’s adjusted gross income that can be deducted is less than for public charities.

7. I.R.C. §§ 170(c)(2) (income tax), 2055(a)(2) (estate tax), 2522(a)(2) (gift tax). However, contributions are not deductible to organizations testing for public safety, even though they are 501(c)(3) charities.

8. Section 501(c)(3) of the Internal Revenue Code exempts

[c]orporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur

Within the 501(c)(3) group, vastly different organizations are treated alike. Today, the 501(c)(3) category encompasses a diverse range of organizations, from those with assets of billions of dollars, such as Harvard University and various hospital systems, to those with no resources, such as a three-member dance company. The sources of support for 501(c)(3) organizations come from government at all levels, foundations, and corporate and private donations. Fees for services have become a prominent part of the financial structure.⁹

The scale of activity of some charitable nonprofits is immense. At some point quantitative differences in size become qualitative ones. One of the justifications for nonprofit organizations is that they emerge where there is market failure, that is, where the commercial market does not provide a particular kind of service or good.¹⁰ Despite the market failure rationale, many nonprofits compete with and resemble their for-profit counterparts.

As government support declined as a result of the Reagan revolution, there was a convergence of the for-profit and nonprofit sectors.¹¹ In the latter decades of the twentieth century, nonprofits moved into activities providing them with sources of revenue that were not normally considered charitable and did not minister to the poor. Charities became commercial entities, often indistinguishable from their for-profit counterparts.¹² No sector represents this change more than the health-care industry. Hospitals originated as institutions where the poor could come to die. By the end of the twentieth century, nonprofit hospitals were largely indistinguishable from their for-profit counterparts, both of which received the bulk of their revenue from third-party payers—government and insurance—and often provided minimal charity care. Should such forms of organization be allowed to remain under the 501(c)(3) umbrella without the organization demonstrating a tangible community benefit?¹³ Recent developments suggest not.¹⁴

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, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation [including the publishing or distributing of statements] and which does not participate in, or intervene in [or oppose] any political campaign on behalf of any candidate for public office.

9. According to the National Center for Charitable Statistics, the primary sources of revenue for charities with \$25,000 or more in assets were fees for services (70.9% of the total); private contributions (12.5%); government grants (9%); investment income (3.9%); and other income (3.7%). Urban Inst., *The Nonprofit Sector in Brief 4* (2006), available at http://www.urban.org/UploadedPDF/311373_nonprofit_sector.pdf.

10. See Lester Salamon, *America's Nonprofit Sector: A Primer* 12–13 (2d ed. 1999).

11. See generally Burton A. Weisbrod, *Conclusions and Public-Policy Issues: Commercialism and the Road Ahead*, in *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector* 287, 287–305 (Burton A. Weisbrod ed., 1998).

12. See Stephanie Strom, *Make Money, Save the World: Businesses and Nonprofits Are Spawning Corporate Hybrids*, N.Y. Times, May 6, 2007, § 3, at 1.

13. The affirmative test of exemption for hospitals changed from a “relief of poverty” rationale, which required hospitals to treat indigent patients without regard to their ability to pay, Rev. Rul. 56-185, 1956-1 C.B. 202, to a community benefit standard, where charity care

The "charitable" category needs to be redefined and perhaps narrowed.¹⁵ In the past, public benefit and relief of the poor were the central purposes of public charities.¹⁶ Clearly, charities have drifted from this core, albeit narrow, function. Frances R. Hill has recommended that the public charity focus return to its roots.¹⁷ Mark A. Hall and John D. Colombo have suggested that public charities be limited to organizations that receive a certain amount of their budgets from private donations.¹⁸

We should also ask questions about the scope of the 501(c)(3) universe, an issue which has regulatory implications: What should be the role of nonprofits in a modern economy? What should be the scope of nonprofit business? Should charities be allowed to compete with for-profit organizations and under what circumstances? What should be the role of government in financing charitable activities and organizations, and what sort of control should the government have over these activities? When should state action force private organizations to open their operations to scrutiny? How much community benefit should an organization provide before it is eligible for 501(c)(3) status? Should we require charitable nonprofits to help the poor and provide tangible public benefits, or is that too constraining?

Redefinition of the charitable sector will not be an easy task. What does community benefit mean, and do we really expect many charities besides those that obtain their revenues by charging for goods and services, who could give those goods and services away, to be able to show a tangible community benefit?¹⁹ And should the IRS make that determination? It may be easy to justify stripping nonprofit hospitals of their tax-exempt

was not a requirement, Rev. Rul. 69-545, 1969-2 C.B. 117. See James J. Fishman & Stephen Schwarz, *Nonprofit Organizations: Cases and Materials* 353-77 (3d ed. 2006).

14. See John D. Colombo, *The Failure of Community Benefit*, 15 Health Matrix 29 (2005). For a review of the literature on whether the nonprofit form results in different financial behavior or results in charity care for the poor, see John D. Colombo, *The Role of Tax Exemption in a Competitive Health Care Market*, 31 J. Health Pol. Pol'y & L. 623 (2006).

15. A winnowing of the category has occurred in the past. For example, in 1986 Blue Cross insurance plans lost their status as 501(c)(3) organizations when Congress enacted I.R.C. § 501(m) (2000), which disqualifies an organization from exemption under §§ 501(c)(3) or 501(c)(4) if a substantial part of its activities are providing commercial-type insurance.

16. This originated with the Statute of Charitable Uses, 1601, 43 Eliz., c. 4 (Eng.).

17. See *Overview of the Tax-Exempt Sector: Hearing Before the Comm. on Ways & Means*, 109th Cong. 61-68 (2005) (statement of Frances R. Hill, Professor, University of Miami School of Law); see also Stephanie Strom, *What Is Charity?* N.Y. Times, Nov. 14, 2005, at F1.

18. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St. L.J. 1379 (1991). Professor Colombo recently testified before the House Ways and Means Committee to that effect. See *Overview of the Tax-Exempt Sector: Hearing Before the Comm. On Ways & Means*, 109th Cong. 57-61 (2005) (statement of John Colombo, Professor, University of Illinois College of Law).

19. This was the concern of Justice Lewis Powell in his concurrence in *Bob Jones University v. United States*, 461 U.S. 574, 608-11 (1983) (Powell, J., concurring).

status if they provide no charity care, but what about nonprofit day care centers or assisted living homes that give nothing away?²⁰

*B. Nonprofits Inhabit a Sector of Society
Between the Private and Public Sectors*

Another misassumption is the belief that the nonprofit sector stands between government and the private sector, as a third or independent sector. The leading trade association for charitable nonprofits is the Independent Sector. The name is an oxymoron, perhaps wishful thinking, for nonprofits are neither independent of private enterprise nor government. They are intertwined at a number of levels and always have been.²¹ Nonprofits mimic for-profit firms, and the private sector plays a substantial and growing role in the nonprofit sector through joint ventures, corporate sponsorships, purchases of mailing lists, exclusive licensing agreements, and other forms of financial collaboration.²² This interlocking relationship between nonprofit, government, and the private sectors dates back to the earliest years of European settlement.²³

Today, many nonprofits engage substantially, if not excessively, in regular business activity. Some museum shops resemble department stores. Universities profit from the commercialization of higher education, through lucrative research and licensing transactions, forays into dot-com businesses, and endorsement and outsourcing of functions. Many charitable nonprofits remain reliant on government financing.

20. For a powerful argument that relying on the amount of charity care is an insufficient justification alone for preserving the exemption of nonprofit hospitals, see Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 Yale J. on Reg. 139 (2007). Professor Horwitz presents evidence that hospital ownership, whether for-profit, nonprofit, or government-owned, has a significant effect on the mix of medical services offered. Nonprofit hospitals provide medical services that are unlikely to be provided by other hospital types, and removal of the exemption would lead to other costs to society. *See id.*

21. *See* Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector*, *supra* note 11, at 1, 1–4.

22. Strom, *supra* note 12. The Internal Revenue Service (IRS) has become concerned about the enormous increase in joint ventures and other relationships between for-profits and nonprofits. In a number of rulings and cases, the IRS has established parameters for joint ventures between nonprofits and for-profits. *See* St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003); Redlands Surgical Serv., 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 2004-51, 2004-1 C.B. 974; Rev. Rul. 98-15, 1998-1 C.B. 718.

23. The establishment of Harvard in 1629 demonstrates the early fusion of the public and private spheres. The college, chartered as a corporation, was governed by ministers of the tax-supported Congregational Church and by government officials sitting *ex officio*. Harvard possessed a small endowment received from private donors. Most of its revenues, however, came from legislative grants and tuition and fees. The institution was considered public. *See* Peter Dobkin Hall, *Inventing the Nonprofit Sector and Other Essays on Philanthropy, Volunteerism and Nonprofit Organizations* 16–17 (1992). It was not until the mid-nineteenth century that Harvard could be considered private in the modern sense.

Business structures have influenced nonprofit approaches. Many nonprofits have spawned for-profit subsidiaries.²⁴ At the same time, for-profit firms are encroaching upon traditional nonprofit turf in such areas as health care and education. Government (the public sector) and the private nonprofit sector are extensively interconnected and influence one another. Congress routinely authorizes, and federal agencies administer, many domestic policy programs through nonprofit organizations.²⁵ Private nonprofit agencies may receive all, or nearly all, of their revenue from the government. Such institutions range from social services organizations to the Los Alamos Nuclear Laboratory, which until recently was administered by a university. How independent are organizations that are primarily or exclusively funded by the government? Should these organizations be treated as government agencies?

*C. Fraud, Misappropriation, and Breaches of Fiduciary Duty
Are Extensive in the Sector*

"Charity," Paul told the Corinthians, "beareth all things, believeth all things, hopeth all things, endureth all things. Charity never faileth."²⁶ Though charity may never faileth, those who administer charities do so with regularity. Or, in the words of a very different voice, Oscar Wilde, "Charity creates a multitude of sins."²⁷ The contemporary nonprofit sector has been criticized for permitting defalcations of charitable assets to occur, for a lack of fiscal controls, and for an absence of accountability to the public and to the government.

In recent years we have become aware of the seeming proliferation of scandal in the nonprofit sector. No organization, it seems, is too elevated to be touched. The misdeeds typically involve corporate governance lapses, conflicts of interest, defalcation of funds, and excessive compensation. It seems several times each week that *Philanthropy Today*, a daily chronicle of events in the philanthropic community, publishes an item involving charity fraud. The nonprofit sector has become of interest to the general press.²⁸ For example, after a two-year investigation the *Los Angeles Times* uncovered serious corporate governance lapses, conflicts of interest, and excessive compensation at the Getty Museum.²⁹ *The Washington Post* and

24. Reed Abelson, *Charities Use For-Profit Units to Avoid Disclosing Finances*, N.Y. Times, Feb. 9, 1998, at A1; Mark Maremont, *Doing Well: Kennedy Nonprofit Has Benefited the Poor and Its Officials, Too*, Wall. St. J., Mar. 25, 1998, at A1.

25. See Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. Rev. 543, 595 (2000).

26. 1 Corinthians 13:6-7.

27. Oscar Wilde, *The Soul of Man Under Socialism and Selected Critical Prose* 128 (Linda Dowling ed., Penguin 2001) (1891).

28. This interest is episodic, as no paper assigns reporters to the "charity beat" on a full-time basis.

29. See Jason Felch, Ralph Frammolino & Robin Fields, *Munitz Steps Down as Head of Getty Trust*, L.A. Times, Feb. 10, 2006, at A1.

The Boston Globe have engaged in important investigative exposés.³⁰ Cumulatively, such journalistic efforts and the resulting drumbeat of bad publicity have awakened Congress and the public and have tarnished the nonprofit halo. The increased focus on the sector seems to indicate there is extensive fraud throughout.

A study of wrongdoing by charitable fiduciaries conducted by Marion Fremont-Smith and Andras Kosaras found 152 organizations over seven years whose fiduciaries were accused of criminal or civil wrongdoing.³¹ Of the 152 incidents, 98 detailed criminal activity. Another 54 involved breaches of the duty of loyalty and prudence—self-dealing, failing to carry out the charity's mission, and negligent management of assets. A further 6 involved both civil and criminal activity. The authors conclude there is serious underreporting of such incidents and that a root cause of wrongdoing is a failure of governance.³²

Is the charity scandal glass half full or half empty? Even though there may be serious underreporting of charity fraud, there are a large number of nonprofit organizations, over one million in the 501(c)(3) category alone³³ out of a total of 1,045,979 tax-exempt organizations on the IRS's master file in 2005,³⁴ would seem to indicate that misfeasance is not such a problem. No one knows the extent of wrongdoing. Certainly the misdeeds do not necessitate the increased burdens on nonprofits that have been adopted, or the Sarbanes-Oxley³⁵ type reforms that have been proposed.³⁶

Has wrongdoing increased or has the added scrutiny merely uncovered more misdealing? Many fiduciaries in almost all contexts and periods have

30. See Joe Stephens & David B. Ottaway, *Nonprofit Sells Scenic Acreage to Allies at a Loss*, Wash. Post, May 6, 2003, at A1 (reporting that the Nature Conservancy resold donated land with development restrictions at a loss to a trustee or supporter, followed by a charitable contribution to make up the difference in value, allowing the buyer to take charitable deduction). *The Washington Post's* coverage triggered an IRS audit, an investigation and report by the Senate Finance Committee staff, and a one-day hearing on June 8, 2005. See Francie Latour & Walter V. Robinson, *Trustees Reimburse Charitable Foundation*, Boston Globe, Apr. 14, 2006, at B1; Walter V. Robinson & Michael Rezendes, *Foundation Chief Agrees to Repay over \$4m*, Boston Globe, Dec. 16, 2004, at A1. An executive summary of the staff report, *The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform*, is available at <http://finance.senate.gov/hearings/other/tnccontents.pdf>.

31. Marion Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002*, 42 Exempt Org. Tax Rev. 25, 25 (2003). The study reviewed newspaper reports of charity scandals published between 1995 and 2002 by Lexis/Nexis, a service that retains online 13,111 English-language news sources, including daily newspapers from all the major American cities.

32. *Id.*

33. See Dep't of Treasury, *supra* note 4.

34. Dep't of the Treasury, Internal Revenue Service Data Book Publication 55B, at 39 tbl.22 (2004), available at www.irs.gov/pub/irs-soi/04databk.pdf.

35. See Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

36. See Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. Davis L. Rev. 205 (2004). California is the only state to have adopted legislation based on Sarbanes-Oxley. See Cal. Nonprofit Integrity Act, Cal. Gov't Code §§ 12585–12599 (West 2005).

breached their trust; and the attempt to regulate charities and fiduciaries has largely been ineffective.³⁷ With the advent of the Internet and electronic availability of data, the sector is more transparent than ever before, and the constraints imposed by the fear of negative publicity have encouraged many organizations in the sector to become more sensitive to and improve their governance practices on their own. The outliers exist and always will, but behavior at the margins in any endeavor differs from norms at the center.

Misassumptions about the charitable nonprofit sector have led to regulatory initiatives. Congress has enacted and proposed numerous changes for the sector, ostensibly to increase transparency and diminish fraud, but many of the efforts have increased the regulatory burden with little added benefit. Others have tilted the regulatory fulcrum toward the federal government and away from its historical state and local locus. The diversity of the charitable nonprofits has not been fully recognized. The most significant development of the last half century has been the emergence of the federal government through the IRS as the primary regulator of charitable nonprofits.

II. THE FEDERAL INTEREST IN CHARITABLE ACCOUNTABILITY

A. *Local Enforcement*³⁸

Until the last quarter of the nineteenth century, most charities were local, particularly those engaged in poverty relief. In the cities, many overlapping social service agencies provided assistance to the “worthy” poor. These charities often received local and state funding. There were charity boards at all levels of government that oversaw the distribution of such funds. Questions of ineffective governance by the offending organization or a lack of accountability were not the significant issues they are today. Charity fraud occurred and was thwarted. Local district attorneys treated these matters as run-of-the-mill criminal cases. Misappropriation of charitable funds was no different than embezzlement from a bank. The organization would be dissolved, and the individual charged, convicted, and sentenced to prison. Issues of corporate governance did not arise until much later. Eventually, self-regulatory efforts emerged.

In the 1870s charity organization societies emerged in the eastern United States and later spread to cities in the West. The Charity Organization Society (COS) was a coalition of agencies that sponsored relief for the poor.³⁹ COS heads were leading citizens, a city’s establishment. These organizations attempted to coordinate social relief, monitor the accountability of charities, assure that only the worthy poor received relief,

37. See generally James J. Fishman, *The Faithless Fiduciary and the Quest for Charitable Accountability 1200–2005* (2007) (tracing charity fraud from 1200 through the present).

38. See *id.* at 269–70.

39. Hall, *supra* note 23, at 39.

and root out fraud.⁴⁰ COS leaders were self-appointed sentries against fraud by individuals seeking relief or by social service charities spending money improperly. They reflected hostility to the poor and tended to find a substantial amount of fraud in poverty relief, a conclusion that was often contradicted by individual social service agencies.⁴¹ The COS officials had powers of arrest and often brought criminal complaints against individuals accused of charity fraud.⁴² Additionally, these COSs began to rate charities and found that some were fronts for fraud, often vehicles where public money could be tapped for private gain.⁴³ This approach is attempted today by a few organizations such as the Better Business Bureau's Wise Giving Alliance and Charity Navigator.

Even though the state attorney general had the common law authority to monitor charities, the primary official enforcing charities' accountability was the local district attorney or similar law-enforcement official, who treated charitable misdealing or fiduciary breaches as bread-and-butter criminal activities. Not until the 1940s did decisions attribute fiduciary breaches as violations of nonprofit corporate law.⁴⁴ There were more cases

40. The objectives of the Charity Organization Society (COS) were

1. To be a centre of intercommunication among the various churches and charitable agencies in the City. To foster harmonious co-operation among them and to check the evils of the overlapping of relief.
2. To investigate thoroughly, and without charge, the cases of all applicants for relief which are referred to the society for inquiry, and to send the persons having a legitimate interest in such cases full reports of the results of investigation. To provide visitors, who shall personally attend cases needing counsel and advice.
3. To obtain from the proper charities and charitable individuals suitable and adequate relief for deserving cases.
4. To procure work for poor persons who are capable of being wholly or partially self-supporting.
5. To suppress mendicity by the above means and by the prosecution of impostors.
6. To promote the general welfare of the poor by social and sanitary reforms and by the inculcation of habits of providence and self-dependence.

Charity in New-York, N.Y. Times, July 15, 1883, at 9. The COS merged into the Community Service Society in 1938. Community Service Society, <http://www.cssny.org/about/history.html> (last visited Oct. 4, 2007).

41. *Id.* Charles D. Kellogg, from the COS central bureau, says 65% of a sample from 40,000 cases of public charity were misdirected. *Id.* The United Hebrew Charities and the Association for Improving the Condition of the Poor each found that only 1.5% were unworthy of relief. *Id.*

42. To counteract fraud against charity, the New York City COS created a "Central Bureau" to which social service charities would make reports of their cases to eliminate frauds or to avoid duplication of relief. *See Charged with False Pretenses*, N.Y. Times, Feb. 11, 1883, at 5.

43. For example the New York Juvenile Guardian Society received \$10,000 annually from the legislature and \$13,000 from other sources, ostensibly to run schools for poor children. However, none of its schools were maintained for any length of time. The organization was a front for Tammany Hall. *A Questionable Charity*, N.Y. Times, Jan. 27, 1872, at 2; *The Bureau of Charities*, N.Y. Times, Mar. 6, 1874, at 5.

44. *Cf. People v. Volunteer Rescue Army*, 28 N.Y.S.2d 994 (1941).

relating to breaches of trust, perhaps because charitable trustees were more circumscribed in their actions.

B. *State Regulation: The Attorney General*

Traditionally, in common law jurisdictions the attorney general, a state official, was responsible for the oversight of charitable activities.⁴⁵ The earliest American cases involving charities where the attorney general participated concerned the validity of charitable gifts and issues of cy pres.⁴⁶ Fremont-Smith notes that the power to correct wrongdoing was rarely invoked before the Second World War.⁴⁷ This is surely correct as it applies to the monitoring of charities by attorneys general.

There were other officials at the state level that regulated certain types of charities, though most enforcement until the mid-twentieth century was at the local level. Social service agencies that received state and local funding were accountable to state boards. Sometimes there were state boards of charity. In other states the same board that regulated prisons was responsible for social service organizations. There were a variety of approaches.⁴⁸ Charitable organizations, such as educational or health-care institutions or museums, were regulated by state officials charged with overseeing that particular field. Neither those officials nor the attorney general were general watchdogs of charitable accountability.

Under modern nonprofit statutes and judicial decisions, the attorney general has the responsibility of supervision and oversight of charitable trusts and corporations and may maintain such actions as appropriate to protect the public interest.⁴⁹ Attorney general effectiveness overall in enforcing charitable accountability is problematic. Fraud cases are resource intensive, and, as a result, enforcement is necessarily selective. Adding to the state burden was that, until recently, there was little coordination of information between the IRS and state attorneys general. One promising

45. 4 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 348.2 (4th ed. 1989); Gareth Jones, *History of the Law of Charity, 1532–1827*, at 160 (1969).

46. Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation* 54 (2004).

47. *Id.*

48. By the beginning of the twentieth century, state supervision of charities and corrections was the norm in forty-two states. States differed as to whether there were one, two, or three boards overseeing state charities, social service agencies, and penal institutions. Twenty-two states had a single board for all three fields. Massachusetts and New York had a separate board for each of the three fields. California had separate boards for each field, with an additional fiscal board over the other three. See Frederick H. Guild, *Administration and Supervision of State Charities and Corrections*, 10 Am. Pol. Sci. Rev. 327, 327–28 (1916).

49. Cal. Corp. Code §§ 5142, 5250, 6511, 9230 (West 2006); N.Y. Not-for-Profit Corp. Law § 112 (Consol. 2002); Rev. Model Nonprofit Corp. Act §§ 1.7, 3.04, 8.10, 14.03–.04. See Fremont-Smith, *supra* note 46, app. I, at 476, for a state-by-state guide. In a few jurisdictions, this role is performed by the district or county attorney.

development in leveraging limited state resources is that Congress has broadened the information that the IRS can share with state officials.⁵⁰

One should not forget that attorneys general are political creatures. In many states, the acronym "AG" stands for "aspiring governor," and the selection of which issues to focus upon and which individuals and organizations to prosecute has a political tinge. This has led, in Evelyn Brody's phrase, to "parochialism," where the attorney general forces a local option to benefit the people of a particular state where the charity is incorporated at the expense of the interests of the organization and its beneficiaries.⁵¹ Despite a recent flurry of high-profile cases in a few states, regulation at the state level has been neither efficient nor effective. The lack of resources, a lack of will, and other, more pressing responsibilities have made state regulation of charities more theoretical than real. In the words of Professor Harvey Dale, a longtime observer of the nonprofit sector,

[G]overnment regulators (and most particularly attorneys general, to whom the law confides the principal role in policing charities) tend to allocate their scarce regulatory resources to other more politically potent portions of their domains. In most states, the Charity Bureau of the Attorney General is inactive, ineffective, overwhelmed, or some combination of these.⁵²

Though state attorneys general historically were responsible for charities' accountability, their lack of resources and other priorities resulted in the IRS becoming the primary regulator of nonprofit behavior.

50. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1224, 120 Stat. 780, 1091-93 (codified in scattered sections of the I.R.C.). Upon written request by an appropriate state officer, the IRS may disclose a notice of proposed refusal to recognize an organization as a § 501(c)(3) organization; a notice of proposed revocation of tax exemption of a § 501(c)(3) organization; the issuance of a proposed deficiency of tax imposed under I.R.C. § 507; the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as § 501(c)(3) organizations; and returns and return information of organizations with respect to which information has been disclosed concerning the above informational matters. In addition, the IRS can disclose or open to inspection the returns and return information of an organization that is recognized as a valid § 501(c)(3) organization, or has applied for such status if the IRS believes there has been noncompliance with state law in the jurisdiction of the appropriate state officer.

51. See Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 Ind. L.J. 937 (2004). One example is that the attorney general of Pennsylvania opposed the sale of Hershey Chocolate Co. to a foreign buyer because it would harm the people who worked for the company, though it would have benefited the Hershey Trust and its beneficiaries. *Id.* at 985-99. A second example: Eliot Spitzer, who was hardly a passive attorney general of New York, was silent about the conversion of Empire Blue Cross and the use of nonprofit assets to increase hospital workers' wages instead of creating a private foundation devoted to health care. Silence was politically sensible. Mr. Spitzer made no secret he intended to run for governor, and in New York, union support is crucial for a Democratic candidate.

52. Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, 25 Exempt Org. Tax Rev. 413, 413 (1999).

C. *The Federal Interest in Charitable Accountability*

Until the twentieth century, the federal government had no interest in the regulation of charities. The introduction of federal taxation was to change all that, as it has in so many other areas of modern life. The automatic nature of obtaining tax exemption and deductibility of contributions initially encouraged this lack of federal oversight.⁵³ Charities have been granted preferential federal tax status since the first income tax was created in 1894.⁵⁴ Federal tax law relating to nonprofits has not consistently evolved but has resulted from politics, policies, and reactions to perceived abuses of the nonprofit structure.

Professors John Simon, Harvey Dale, and Laura Chisolm have recognized four essential functions of federal tax policies that shape the treatment of nonprofits. They are the support, equity, border patrol, and regulatory functions.⁵⁵ The police function, which this essay addresses, regulates the fiduciary behavior of trustees, directors, managers, and donors. Traditionally, this was the role of state law since nonprofits were creatures of state corporate law and state fiduciary standards. The purpose of the federal tax system is to raise revenue. Beginning in 1969 with private foundations, Congress, through its primary regulatory agency of the

53. A report in the Commission on Private Philanthropy and Public Needs, known as the Filer Commission for its chair, stated,

The essence of the advantage of [the coordinate privileges of tax exemption and deductibility] is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and the choices of private givers. The donors determine the direction of their own funds, and the distribution of "tax savings" as well. The income of each individual organization is a product of donations it receives and the investment wisdom of its managers. Since all of these operations are out of the hands of government under the exemption and deduction statutes, the beneficiary organizations receive their governmental aid without having to petition for it.

Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in 4 Research Papers Sponsored by the [Filer] Commission on Private Philanthropy and Public Needs 2025, 2039 (1977).

54. Internal Revenue Act of 1894, ch. 349, 28 Stat. 509 (repealed 1895). This statute was declared unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). The Corporation Excise Tax of 1909 contained an exemption for charities in language that parrots most of the modern § 501(c)(3). Corporation Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 113.

55. See John Simon, Harvey Dale & Laura Chisolm, *The Federal Tax Treatment of Charitable Organizations*, in *The Nonprofit Sector: A Research Handbook* 267, 267 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006). The support function encourages the continuation and expansion of the nonprofit sector through relief from taxation. The equity function, with its goal of redistributing resources, has roots in the history of charity and in Anglo-American law in the Statute of Charitable Uses, 1601, 43 Eliz., c. 4 (Eng.). The issues here relate to questions as to whether exempt status should be conditioned on service to the poor and how much private benefit donors should receive for their contributions. The border patrol function deals with the limits of activity in which nonprofits may engage. There are absolute prohibitions on participation in political campaigns, constraints on the amount and types of lobbying by nonprofits, and restrictions on commercial and unrelated business activity. These limits patrol the nonprofit-business border.

nonprofit sector, the IRS, a subdivision of the Treasury Department, has played an increasing role.⁵⁶

Fremont-Smith has identified three stages in the federal development of charity regulation.⁵⁷ In the first, which lasted roughly until the 1940s, broad definitional parameters were established as to the boundaries of charity status.⁵⁸ In the second stage, a border between exempt and nonexempt organizations was drawn when Congress enacted the unrelated-business income tax in 1950. In the third phase, there was an expansion in the IRS's regulatory functions: first with the 1969 adoption of severe limitations on private foundations and their managers; second with the 1996 enactment of the intermediate sanctions legislation.⁵⁹ A fourth phase seems to be emerging, where federal fiduciary norms of behavior may be applied to all § 501(c)(3) charities, replacing the primacy of state law.⁶⁰

D. Federal Efforts to Monitor Charitable Accountability

Prior to the 1950s, the IRS's initial focus on charities was at the front end—i.e., assessing whether the organization met the requirements for tax-exempt status.⁶¹ Not until 1954 did a purportedly exempt organization have to obtain a determination from the IRS that it was entitled to that status, though with the exception of churches, almost all organizations that relied

56. There are other federal agencies that oversee nonprofit activity. They include the Federal Bureau of Investigation, through its economic crimes unit; the Federal Emergency Management Agency; the Federal Trade Commission; the United States Postal Inspection Service; and the Office of Personnel Management. See U.S. Gen. Accounting Office, GAO-02-526, *Tax-Exempt Organizations: Improvements Possible in Public, IRS and State Oversight of Charities 69–71* (2002) [hereinafter GAO Report]. These agencies play a very minor role compared to that of the IRS.

57. Fremont-Smith, *supra* note 46, at 300.

58. *Id.* This enabled donors to deduct from their own tax liability charitable contributions to certain nonprofits. This stage, which lasted roughly until the Second World War, relied upon self-policing to assure accountability.

59. I.R.C. § 4958 (2000). This enabled the IRS to impose an excise tax on managers and organizations that provided insiders with excess benefit transactions, such as excessive compensation. Previously, all the IRS could do was revoke the exemption of the organization. The remedy was usually more draconian than the offense and was rarely employed.

60. Congress has considered extending federal fiduciary standards beyond the private foundation category and into the territory of all § 501(c)(3) charities, though as of yet has not acted.

61. For example, the insular collector of taxes of the Philippine Islands, then under U.S. control, challenged the right of a Philippine religious order, *Sagrada Orden de Predicadores*, to qualify for exemption. The insular collector argued that though the order was religious, it was not operated exclusively for such purposes because it derived significant revenue from real estate and securities holdings and more modest revenues from the sale of wine, chocolates, and other items for use within its religious missions. The U.S. Supreme Court held that as long as the profits were dedicated to charitable or exempt purposes, the organization would not lose its exemption. *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924). The Internal Revenue Code of 1954 denied exemption to feeder corporations. Pub L. No. 91-172, § 502, 68A Stat. 1, 166 (codified at I.R.C. § 502 (2000)). A tax on unrelated business income was imposed on some tax-exempt organizations and later imposed on all.

on contributions did obtain such a ruling from the IRS.⁶² The sheer number of organizations seeking exemption, the complexity of the tax laws relating to the tax-exempt sector, and the limited resources of the IRS make the gatekeeping approach chimerical in terms of assuring that recognized exempt organizations will be accountable.

The IRS's Division of Tax Exempt and Government Entities is responsible for regulatory oversight. Initially, it can screen nonprofit organizations when they apply for recognition of tax-exempt status. Thereafter, a small percentage of Form 990 annual returns are examined. In the past decade, the number of applicants has doubled.⁶³ In 2001, 58,938 applications were received requesting recognition of 501(c)(3) status. Of those, 10,548 were disposed of because the applicant did not submit a fee or did not submit all documents or because the application was withdrawn. Of the 42,366 completed applications submitted, only 58 were denied.⁶⁴ This means that organizations that fill out the application in boilerplate fashion will almost automatically obtain recognition of exemption. Ultimately, the IRS's lack of scrutiny may affect grants and contributions available to new organizations. Traditionally, the recognition-of-exemption letter has been a seal of approval for foundations and other donors. If the perception spreads that the IRS's scrutiny is pro forma, donor confidence could be affected.⁶⁵

The Treasury Department first required all tax-exempt organizations to file an annual-information return in 1942. The two-page form covered the 1941 tax year and consisted of three questions, an income statement, and a balance sheet. The Treasury's authority to impose this requirement was challenged and compliance was poor.⁶⁶ Neither the IRS nor anyone else imagined that Form 990, the annual report, would exponentially expand in

62. Fremont-Smith, *supra* note 46, at 61. In 1954, the Treasury made filing an exemption mandatory, upon which the organization received a determination letter that recognized its exemption. Treas. Reg. § 1.501(c)(3)-1(b)(6) (as amended in 1990).

63. Elizabeth Schwinn & Grant Williams, *A Challenge for the IRS: Lack of Funds and Manpower Taxes Agency's Ability to Regulate Charities*, Chron. of Philanthropy, Aug. 23, 2001, at 1. The figures cited by Schwinn and Williams were provided by the IRS but differ slightly from those reported in the GAO Report, *supra* note 56, at 21. The GAO stated that the IRS did not have data for fiscal years 1996 and 1997.

64. GAO Report, *supra* note 56, at 21 tbl.2.

65. See Schwinn & Williams, *supra* note 63, at 28-29.

66. Fremont-Smith, *supra* note 46, at 65. In 1943, the Treasury sought statutory authority from Congress, which had become concerned with reports of abuse of charitable status. *Id.* at 59, 65. Congress required certain exempt organizations, principally foundations, to file returns that would disclose their financial affairs. Revenue Act of 1943, ch. 63, § 117, 58 Stat. 21, 36-37. Excluded from this filing requirement were churches and other religious organizations, certain educational institutions, and certain publicly supported organizations. One purpose of the 1943 legislation was to provide Congress with sufficient information to determine if further legislative restrictions were needed. See generally Laurens Williams & Donald V. Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations* (1975), reprinted in 4 Research Papers Sponsored by the [Filer] Commission on Private Philanthropy and Public Needs 2099 (1977).

pages and importance to become the principal disclosure tool for government oversight of exempt organizations.⁶⁷

Though it contains a substantial amount of financial information, Form 990 does not provide a way to analyze the effectiveness of the organization's attainment of its mission. Nor does the IRS have the resources to examine more than a very small number of returns filed.⁶⁸ It is now targeting for audits selected areas where abuses have been discovered.⁶⁹ The complex system of federal charity regulation has not developed with a particular logic or plan, but largely in response to perceived abuses of charitable status. A primary catalyst for imposing accountability under the tax system has been the private foundation.

E. *The Private Foundation Restrictions*

As mentioned, private foundations are § 501(c)(3) organizations but are not "public charities."⁷⁰ Private foundations have been more strictly regulated and circumscribed in their activities than other charities.⁷¹ The distinction between public charities and private foundations seemed to be based on Congress's view that public charities satisfy more pressing social needs or have been endorsed by a kind of public referendum—that is, people have voted with their charitable donations to support them. Churches, schools, and hospitals fall into the charmed public-charities circle because they are the most venerable and influential members of the charitable sector.⁷² Another reason for the distinction between public charities and private foundations is the belief that the former are more likely to use their resources for the public benefit more quickly than private

67. The form has continually been revised to contain more information. All private foundations and most other 501(c)(3) charities' annual reports are online with GuideStar. Fremont-Smith, *supra* note 46, at 65–67, tracks the changes in the form.

68. From 1995 to 2003, the number of Form 990 annual returns filed with the IRS increased by 51% (274,129) while the number examined declined from 2% to .7% (10,450 to 5754). Staff of the Joint Comm. on Taxation, Description of Present Law Relating to Charitable and Other Exempt Organizations and Statistical Information Regarding Growth and Oversight of the Tax-Exempt Sector 38 tbl.5 (2004), *available at* <http://www.house.gov/jct/x-44-04.pdf>. Beginning in 2003, the IRS has reversed the rate of decline in examinations and staff, though not in sufficient numbers to make a substantial difference. See *IRS Comm'r Testimony: Charitable Giving Problems and Best Practices Before the S. Comm. on Finance*, 108th Cong. 13 (2004) (statement of Mark W. Everson, Comm'r of Internal Revenue) [hereinafter *Statement of Mark W. Everson*], *available at* <http://www.irs.gov/pub/irs-news/ir-04-081.pdf>.

69. *Statement of Mark W. Everson*, *supra* note 68, at 14.

70. *Id.* at 3.

71. There is a fundamental distinction in the Internal Revenue Code between public charities and private foundations. The former category, which includes schools and hospitals, is tax favored, because these charities have passed extremely complicated tests of public support. The second category, private foundations, is generally funded by fewer people and lacks the broad base of public support. Simon, Dale & Chisolm, *supra* note 55, at 268–69, 283–84.

72. See Boris I. Bittker, *Should Foundations Be Third-Class Charities?*, in *The Future of Foundations* 132, 142–43 (Fritz F. Heimann ed., 1973).

foundations, which keep the great corpus of their wealth in a permanent endowment.

Because of their wealth, and the influence that wealth brings, it should be of no surprise that foundations have come under ongoing criticism. At one time, the criticism was justified. A 1965 Treasury report identified a number of problems in the private-foundation sector that needed legislative attention: (1) the use of the foundation form produced an undue lag between the charitable gift generating the tax benefit and the use of the funds for charitable purposes; (2) foundations were becoming a disproportionate segment of the national economy; and (3) foundations represented a dangerous concentration of economic and social power.⁷³ The result of Congress's concern was a complicated enforcement regime by which private foundations were regulated more strictly than public charities.⁷⁴ Sections 4940 to 4945 were added to the IRC and imposed a sliding scale of excise taxes (depending upon the offending foundation's willingness to correct its wrong) for abuses in which Congress felt private foundations were most likely to engage. These excise taxes were imposed on private foundations, their managers, sometimes their principal donors, and in some cases even government officials.⁷⁵ The 1969 reforms also

73. Staff of S. Comm. on Fin., 89th Cong., Treasury Department Report on Private Foundations 6–7 (Comm. Print 1965).

74. This is a dauntingly complex area of the law. The description here does not do it justice. See generally Fishman & Schwarz, *supra* note 13, at 781–90; Fremont-Smith, *supra* note 46, at 264–85. For a more technical analysis, see generally Bruce Hopkins & Jody Blazek, *Private Foundations: Tax Law and Compliance* (2d ed. 2003).

75. Private foundations are subject to an excise tax of two percent on their net-investment income. I.R.C. § 4940 (2000). This fee was originally four percent. It can be reduced to one percent if the foundation increases its charitable distributions by a specified amount. I.R.C. § 4940(e). This is less a tax than an audit fee, the purpose of which is to raise funds to monitor foundations. Private foundations are also subject to excise-tax sanctions if they engage in proscribed activities such as self-dealing, I.R.C. § 4941; if they do not meet certain minimal annual distributions for charitable purposes in relation to their investment assets, I.R.C. § 4942; if they have excess business holdings in the principal donor's family business, I.R.C. § 4943; if they make investments that may jeopardize the carrying out of the foundation's exempt purposes, I.R.C. § 4944; and if they make taxable expenditures inconsistent with a private foundation's mission, such as expenditures for lobbying, electioneering, voter registration, grants to organizations that are not classified as public charities, or other non-charitable purposes, I.R.C. § 4945. The self-dealing provisions prohibit transactions between a private foundation and individuals termed "disqualified persons," who are major donors, trustees, officers of the foundation, members of their families, business associates, and related business entities. I.R.C. § 4946.

Types of prohibited self-dealing transactions between a disqualified person and a private foundation—though each has exceptions—are sales, exchanges, and leases; loans; furnishing of goods, services, or facilities; payment of excessive compensation; transfer of foundation assets or income; and payments to government officials.

The excise taxes for violation of these prohibitions are graduated. If a foundation, a disqualified person, or a foundation manager violates a proscription, the person or entity will be subject to an initial tax. The wrongdoers will probably seek to correct the violation. In some situations the excise taxes may be abated. If the violators do not correct and unwind the transaction, a much higher second-tier tax will be imposed. Only the most flagrant violations risk loss of tax exemption for the foundation.

assured that private foundations would not sneak through the exemption process as public charities. There is a presumption that organizations seeking recognition of their tax exemption are private foundations unless they can prove they are public charities by fitting into one or more of the four categories in the code of non-private foundations.⁷⁶

The private foundation rules have served their purpose. They have curtailed extensive fiduciary misbehavior without overly restricting the sector. At the time they were enacted, some thought that the use of the foundation as an organizational form would end. There was a decline in the creation of new foundations after the Tax Reform Act of 1969, a decline which was reversed in the 1990s.⁷⁷ Fremont-Smith has shown that, with the exception of the tax for failure to make minimum distributions, very little revenue has been raised.⁷⁸ Recently, she has argued that the restrictions on private foundations should be eliminated, placing them on equal footing with public charities.⁷⁹ This is a sensible proposal for larger foundations, those with over \$30 million in assets, but most of the abuses lie with smaller foundations, which are more likely to run afoul of the rules.

Of course, there are still misdeeds by foundations or their managers, but these typically involve family foundations with unsophisticated managers.⁸⁰ Whether or not one feels the private foundation rules are necessary, they have worked well. Why? A primary reason may be that the foundation sector has the resources to hire the lawyers, bankers, and managers who can navigate through these complicated statutes and Treasury Regulations. In addition, the 103,880 private foundations are easier for the IRS to monitor than the 1,010,365 § 501(c)(3) charities on the IRS master files in 2004.⁸¹ But the most significant difference between the private-foundation and public-charity worlds is that in the latter, most nonprofits have neither the expertise in-house nor the resources to access the expensive legal talent

76. I.R.C. § 509(a) (2000).

77. Fishman, *supra* note 37, at 298.

78. See Fremont-Smith, *supra* note 46, at 283–84.

79. Marion Fremont-Smith, *Is It Time to Treat Private Foundations and Public Charities Alike?*, 52 Exempt Org. Tax Rev. 257 (2006). Congress has not agreed with her proposal, doubling the excise tax penalties in the Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212, 120 Stat. 780, 1074–75 (codified at I.R.C. §§ 4941–4945, 4958 (West 2007)).

80. The Massachusetts attorney general forced the scion of one of New England's oldest families, Paul Cabot, to repay a family foundation more than \$4 million that he had used for personal expenses and compensation. See Robinson & Rezendes, *supra* note 30. Tom D'Alessio, a New Jersey county executive, was convicted of extortion, money laundering, and accepting a \$59,000 bribe; he was sentenced to a forty-six-month federal prison term. Two months after his release, he established the Evergreen Fund, a private foundation, and endowed it with more than \$1.8 million remaining from his campaign fund. In 2004, the foundation gave \$37,750 in \$500 grants. It paid D'Alessio \$81,708 as executive director, leased a \$45,665 Mercedes for him, and purchased a \$432,000 luxury condominium on Marco Island, Florida. See Ted Sherman, *Loophole Lets Ex-con Fund His Retirement*, Newark Star-Ledger, June 12, 2005, § 1, at 1.

81. See Dep't of Treasury, *supra* note 34. The private foundation figure is from the Nonprofit Sector in Brief 2007. Urban Inst., *supra* note 9, at 2 tbl.1.

necessary to assure compliance with a complicated enforcement regime such as the private-foundation rules. The most significant implication of the private-foundation rules was to make the IRS the primary regulator of charitable fiduciary behavior.

F. *Intermediate Sanctions*

The use of excise taxes in place of the more draconian remedy of revocation of tax-exempt status first migrated to the public charity world as initial penalties for violations of the lobbying limitations and transgressions of the political proscription.⁸² And then later such use developed with the enactment of the intermediate sanctions legislation that imposes a tax on “excessive benefit transactions” by “disqualified persons,” insiders who receive excessive compensation.⁸³

The fundamental tax rule against opportunistic fiduciary behavior is the prohibition against private inurement. In order to obtain exemption under § 501(c)(3), “no part of the net earnings may inure to the benefit of any private shareholder or individual” (insiders such as founders, directors or officers).⁸⁴ The private-inurement prohibition is “the primary distinction between taxable and tax-exempt entities.”⁸⁵ This rule, though first adopted in 1909,⁸⁶ remains “elusive, elastic,” vague, and inconsistently applied.⁸⁷

82. In 1976, Congress added § 501(h) to the Internal Revenue Code, which enabled charities to avoid the vague and subjective standard in § 501(c)(3), namely that “no substantial part of [a charity’s] activities . . . [can involve disseminating] propaganda, or otherwise attempting, to influence legislation.” This section also permits charities to elect to be governed by a more objective and mechanical expenditure test. Organizations that exceeded the mechanical dollar lobbying limits triggered a twenty-five percent excise tax on excessive lobbying expenditures. More frequent excesses could trigger a revocation of exemption. In 1987, Congress concluded, in some circumstances revocation of exemption under the original “no substantial lobbying” test might be irrelevant if the organization had no taxable income or had accomplished its political objectives. Congress imposed an excise tax on the charity equal to five percent of the excess lobbying expenditures. An additional five percent tax was imposed on the managers, who made expenditures knowing they were likely to cause revocation. There is no equivalent tax on an organization’s managers that has elected § 501(h). Taxes may be imposed on charities and their managers if they engage in proscribed political campaign expenditures. I.R.C. § 4955 (2000).

83. I.R.C. § 4958.

84. I.R.C. § 501(c)(3). A related “private benefit” doctrine prohibits § 501(c)(3) organizations from providing a substantial economic benefit to individuals who do not exercise control over the organization. As interpreted by the IRS, “private benefit” must be more than incidental to disqualify an organization; in contrast to the absolute ban on private inurement.

85. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 Va. Tax Rev. 575, 577 (2000).

86. Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 11, 112.

87. Jones, *supra* note 85, at 581. “[T]he courts and the Service are content to proceed as though private inurement is as incapable of definition, but as easily recognizable, as pornography. The result is a chameleon-like doctrine that seemingly defies precise identification or prediction.” *Id.* at 590. The absence of guidance, the generality of the phrase, and the infrequency of the use of the sanction revocation of tax-exempt status became a practical problem. The generality and ambiguity of the rule was insufficient to signal normative behavior.

Beyond the vague inurement proscription, federal law only dealt specifically with fiduciary behavior of private foundations, where Congress documented abuses by donors and insiders.⁸⁸ State legal principles were applicable in curbing excessive compensation, which was sometimes seen as a less venal form of interested transaction.⁸⁹ Congressional hearings in 1993 produced several outrageous instances of excessive compensation.⁹⁰ Though the existing federal law could penalize an organization by removing recognition of its tax-exempt status, the IRS rarely, if ever, imposed such a penalty, for the removal of exemption was like hanging someone for stealing a loaf of bread. It was too draconian for the wrong, and it hurt the organization rather than the individuals who engaged in the private inurement. In response to this problem, Congress adopted the approach of the private-foundation rules, imposing a graduated excise tax on "excess benefit transactions" involving §§ 501(c)(3) and 501(c)(4) organizations other than private foundations,⁹¹ a so-called intermediate sanction that replaced the ultimate penalty of revocation of tax exemption.

The legislation itself did not define an excess benefit transaction, but it placed a tax upon individual insiders who exercised substantial influence on nonprofit organizations.⁹² The regulations suggest a procedure whereby the organization can rely on a rebuttable presumption that the transaction is not an excess benefit transaction: (1) if its terms were approved by a board or board committee composed of individuals who have no conflict of interest; (2) if disinterested board members relied upon comparable data; and (3) if the board adequately documented the basis for its determination.⁹³

The regulations create guidelines for fiduciary behavior: those who are interested in a transaction should not participate in the decision; comparability requires the nonprofit board to examine whether the transaction is fair; and adequate documentation is required. The intermediate-sanctions approach is expensive for any organization of size because it needs to be guided by experts, lawyers, and compensation consultants, in setting salaries and creating paper trails indicating a rebuttable presumption.⁹⁴

88. I.R.C. §§ 4941–4945.

89. N.Y. Not-for-Profit Corp. Law § 715(e) (Consol. 2002) gives authority for fixing of board compensation without any of the procedures applying to other interested transactions.

90. Subcomm. on Oversight of H. Comm. on Ways and Means, 103d Cong., Report on Reforms to Improve the Tax Rules Governing Public Charities 14–15 (Comm. Print 1994).

91. Section 501(c)(4) organizations are civic leagues or organizations "not organized for profit but operated exclusively for the promotion of social welfare." Contributions to such organizations are not deductible.

92. For a description of the intermediate-sanctions regime, see Fishman & Schwarz, *supra* note 13, at 488–96.

93. Treas. Reg. § 53.4958-6(c) (2002).

94. The regulations allow smaller organizations to obtain salary comparisons with similarly sized organizations to gain use of the presumption that the benefit is not excessive. Treas. Reg. § 53.4958-6(c)(2)(ii).

In the first few years after the intermediate-sanctions regime became effective, the IRS imposed excise taxes for excessive benefit transactions in only two cases that reached court, both particularly egregious violations.⁹⁵ The problem of excessive compensation remains, and the issue still raises Congress's hackles. The Senate Finance Committee hearings in June 2004 offered several notorious examples of excessive compensation, and the Pension Protection Act of 2006 doubled the dollar limit of the excise tax to \$20,000 on managers of public charities and social welfare organizations that participated in an excess benefit transaction.⁹⁶ The IRS responded by announcing a major initiative of a compensation review, which would examine the salaries of executives of nonprofits that earned over \$1 million, typically health-care or investment managers.⁹⁷

The threat of such examinations and continued embarrassing disclosures in the press⁹⁸ will force all nonprofits to become aware of this issue. Though the IRS's audit capability has declined in recent years, its reputation and the fear the IRS engenders may improve fiduciary behavior. Over time the intermediate-sanctions legislation, and the IRS's recent announcement of continued enforcement efforts, should strengthen the nonprofit community's reluctance to engage in excessive benefit transactions and result in more generally acceptable levels of compensation.

95. One involved the Bishop Estate. See Fishman & Schwarz, *supra* note 13, at 204. The other case involved a group of health-care organizations acquired by a family in a conversion transaction. *Caracci v. Comm'r*, 118 T.C. 379 (2002). There have also been several technical advice memoranda where the IRS has ruled that excise taxes should be imposed under § 4958. See I.R.S. Tech. Adv. Mem. 2004-35-020 (May 5, 2004); I.R.S. Tech. Adv. Mem. 2004-35-019 (May 5, 2004); I.R.S. Tech. Adv. Mem. 04-35-021 (May 5, 2004); I.R.S. Tech. Adv. Mem. 2004-35-018 (May 5, 2004); I.R.S. Tech. Adv. Mem. 2002-43-057 (July 2, 2002). The memoranda issued on May 5, 2004, all involved the same organization.

96. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212, 120 Stat. 780, 1074-75 (codified at I.R.C. §§ 4941-4945, 4958 (West 2007)).

97. Press Release, IRS, IRS Initiative Will Scrutinize EO Compensation Practices (Aug. 10, 2004). In March 2007, the IRS issued a report on its Exempt Organization Executive Compensation Compliance Project. IRS, Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II (2007), available at http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf. The IRS sent compliance check letters to 1826 exempt organizations—1428 public charities and 398 private foundations. *Id.* A second part of the project examined 782 organizations, of which 179 resulted from the compliance checks, regarding reasonableness of executive compensation. *Id.* at 3. Over one-third of the organizations had to file amended returns, but that reflected more the difficulty in filling out the forms than subterfuges. *Id.* The examinations led to proposed excise taxes of \$21 million. *Id.* The issues giving rise to the assessments included excessive salaries and incentive compensation, perks, and expense account payments. *Id.* at 7. Of the \$21 million, over \$4 million involved individuals associated with public charities and the remaining \$16 million involved persons with private foundations, but there was no breakdown between disqualified individuals and an organization's managers. *Id.* at 5. The names of the organizations were not released. Because the organizations selected were not a part of a statistical sampling, the findings cannot be extrapolated.

98. See Stephanie Strom, *IRS Finds Tax Errors in Reports of Nonprofits*, N.Y. Times, Mar. 1, 2007 at A15 (noting that Yale University was criticized for incomplete reporting on Form 990).

The revenue generated by the excise tax imposed for violations of the statute will be nowhere near the transaction costs to all nonprofit organizations as they try to ensure that their compensation structures will not be perceived as excessive benefit transactions. The intermediate-sanctions approach is an inefficient way to obtain reform of fiduciary behavior. A more efficient approach to changing normative behavior might be to create comparative standards based upon the size of the nonprofit and its mission or concentration in the charitable sector or upon standards set by private associations.

*G. Contemporary Congressional Concerns and Proposals
to Improve Nonprofit Accountability and Governance*

Media discoveries of conflicts of interest, excessive compensation, diversion of charitable assets, inflated deductions for gifts of appreciated property, and outright fraud attracted the attention of Congress, which held a series of hearings that resulted in the most significant legislation affecting nonprofits since 1969.⁹⁹ Title XII, subtitle B of the Pension Protection Act of 2006¹⁰⁰ dealt with some of the most pressing problems in the sector—donor-advised funds,¹⁰¹ supporting organizations,¹⁰² conservation easements,¹⁰³ tax-exempt credit counseling agencies,¹⁰⁴ donations of used clothing and household items,¹⁰⁵ and some other abuses. The legislation

99. See S. Fin. Comm., Staff Discussion Draft (2004), available at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>. A background document prepared by the Joint Committee on Taxation in conjunction with the June 2004 hearings summarizes the law and includes extensive statistical data on tax-exempt organizations. See J. Comm. on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures (2005), available at <http://www.house.gov/jct/s-2-05.pdf>; see also Staff of the Joint Comm. on Taxation, *supra* note 68; S. Comm. on Fin., Charities and Charitable Giving: Proposals for Reform (Apr. 5, 2005), <http://finance.senate.gov/sitepages/hearing030505.htm> (listing witness statements for the 2005 Senate hearings); S. Comm. on Fin., Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities (June 22, 2004), <http://finance.senate.gov/sitepages/hearing062204.htm> (listing witness statements for the 2004 Senate hearings). The House hearings were informed by a comprehensive document describing the history and present law of tax exemption. See J. Comm. on Taxation, Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations (2005), available at <http://www.house.gov/jct/x-29-05.pdf>; see also H. Comm. on Ways and Means, Hearing Archives, <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=400> (listing witness statements for the House hearings). For an overview of the parameters of congressional concern and proposals for reform, not all of which were enacted, see Fishman & Schwarz, *supra* note 13, at 13–17.

100. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified in scattered sections of the I.R.C. and 29 U.S.C.).

101. *Id.* §§ 1231–1235, Pub. L. No. 109-280, 120 Stat. 780, 1094–1102 (codified in scattered sections of the I.R.C.).

102. *Id.* §§ 1241–1245, Pub. L. No. 109-280, 120 Stat. 780, 1102–08 (codified in scattered sections of the I.R.C.).

103. *Id.* § 1213, I.R.C. § 170 (West 2007).

104. *Id.* § 1220, I.R.C. §§ 501, 513.

105. *Id.* § 1216, I.R.C. § 170.

increased some penalties, though there seemed to be little need to do so because there were so few violations. Thus, penalties were increased on charitable organizations, particularly private foundations, for self-dealing and excess benefit transactions; failure to distribute income; excess business holdings; investments which jeopardize charitable purpose; and taxable expenditures. There were also increases in penalties on managers of such organizations for prohibited liabilities.¹⁰⁶

However, the legislation also included mandates that increased the costs of compliance for some charities—small unsophisticated ones that cannot afford compliance—and could have used the resources expended to better achieve their mission. Exempt organizations with gross receipts, which in each taxable year are not more than \$25,000, are exempted from filing Form 990 or Form 990-EZ, the annual information return.¹⁰⁷ Section 1223 requires organizations excused from filing an information return to annually file electronically with the IRS certain information about the organization.¹⁰⁸ Failure to file the required notice for three consecutive years will result in revocation of tax-exempt status.¹⁰⁹ The organization will have to reapply to have tax-exempt status reinstated. Though the information required is basic, many organizations are not Internet-ready or sophisticated enough to file electronically. These very small organizations may not have accountants or lawyers or might not hear about the new requirement. The end result will be the removal from the IRS master list of many worthwhile organizations. For those that manage to comply there will be an increased cost. How much fraud will be deterred by such a requirement?

It is doubtful that the IRS will be given sufficient resources to substantially improve its oversight capability. Funding for enhanced IRS enforcement could come from earmarking excise taxes imposed on private foundations and public charities or from earmarking fees based on asset size that would be imposed on exempt organizations that file Form 990

106. *Id.* § 1212, I.R.C. §§ 4941–4945, 4958.

107. I.R.C. § 6033(a) (2000); Treas. Reg. § 1.6033-2(g)(1) (as amended in 1995). Section 6033(a)(A)(ii) specifies a \$5000 annual gross receipts exemption, but in I.R.S. Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority to increase the exemption to \$25,000.

108. Pension Protection Act § 1223, I.R.C. §§ 6033, 6652, 7428. These organizations will have to file annually an electronic Form 990-N, known as the electronic postcard. “Exceptions to this requirement include organizations who are included in a group return, private foundations required to file Form 990-PF, and section 509(a)(3) supporting organizations required to file Form 990 or Form 990EZ.” IRS, Frequently Asked Questions New Annual Electronic Notice-e-Postcard (Form 990-N) (2007), *available at* http://www.irs.gov/pub/irs-tege/epostcard_faqs_final.pdf. The organization must furnish its legal name, any other name under which it operates or does business; its mailing address; the taxpayer identification number; the name and address of a principal office; and evidence of the organization’s continuing basis for its exemption from the generally applicable information return requirements. If the IRS has an incorrect address, the burden is on the organization to provide the correct one. This will result in many organizations not even receiving notification that they have to file the electronic postcard. *See id.*

109. IRS, *supra* note 108.

information returns. Such earmarking has not occurred in the past. The legislative proposals do not adequately consider the costs, needs, and lack of sophistication of much of the nonprofit sector. There will still be a need for an effective and efficient way to improve accountability, particularly among smaller nonprofits below the radar of state attorneys general or the IRS.

Discovering an efficient and effective enforcement procedure that will hold fiduciaries accountable has been an age-old problem. Countering fraud and misdealing and improving accountability can be dealt with in several ways. One is new legislation and regulation, which was partially achieved in 2006. However, many of the evils that Congress and other critics identified were already illegal under existing rules. Additional regulation imposes costs on all nonprofits, but cost-benefit analyses of this approach are rarely conducted.

Vigorous enforcement of existing laws and regulations will reduce the amount of fraud and scare organizations into being more accountable. Enforcement, however, is expensive and time-consuming. At the state and federal levels, agencies responsible for overseeing charities have many other responsibilities, some of which, quite frankly, are more important than monitoring nonprofit behavior.

Increased educational efforts can be helpful. Many state attorneys general have improved the educational component of their web sites.¹¹⁰ Perhaps the most important educational tool is the IRS's publication of revenue rulings, revenue procedures, general counsel memoranda, technical advisory memoranda, and private letter rulings. These provide guidance to attorneys who represent nonprofits. However, the IRS has drastically cut back on its formal pronouncements, diminishing its educational role.¹¹¹ Related to educational efforts is self-regulation by sector associations, which typically create norms, guidelines, and rules for organizations to follow.

110. See Cal. Office of the Att'y Gen., Charitable Trusts, <http://caag.state.ca.us/charities/index.htm> (last visited Sept. 28, 2007); Office of the Mass. Att'y Gen., Non-Profits & Charities, <http://www.mass.gov/?pageID=cagotopic&L=2&L0=Home&L1=Non-Profits+%26+Charities&sid=Cago> (last visited Sept. 28, 2007); Office of the N.Y. Att'y Gen., Charities, <http://www.oag.state.ny.us/charities/charities.html> (last visited Sept. 28, 2007).

111. See Thomas F. Field, Eleanor J. Lewis & Marion B. Marshall, *The Guidance Deficit: A Statistical Study*, 13 Exempt Org. Tax Rev. 57 (1996) (noting that the number of guidance documents released to the public by the IRS has been steadily declining); Fred Stokeld & Christopher Quay, *Compliance, Reforms Dominate Talk at EO Conference*, 48 Exempt Org. Tax Rev. 9 (2005) (explaining that because of a shortage of resources, the technical division might not issue private-letter rulings in subject areas covered by other guidance and that it will publish only continuing professional education articles when there is need).

H. *Suggestions to Improve Accountability*

Leading commentators on the nonprofit sector have offered suggestions to improve nonprofit accountability. Fremont-Smith recommends removing the almost complete immunity from liability given to fiduciaries in the last half of the twentieth century.¹¹² The problem with this proposal is that for many nonprofits it is extremely hard to recruit knowledgeable directors. If the position carries the dangers of lawsuits and liabilities, recruiting will become even more difficult. Her second proposal is to provide greater funding to regulatory agencies to improve enforcement.¹¹³ That is surely a good idea, but the reality is that despite recent budget increases for the IRS, the amounts do not keep pace with the increase in new organizations. It is unlikely that Congress will devote sufficient additional resources to qualitatively improve enforcement or to give the IRS the right to retain fees it imposes.

Joel Fleishman, a former Duke University law professor and a foundation president, once urged the creation of a new federal regulatory agency for policing the nonprofit sector.¹¹⁴ This is not a new recommendation. Over forty-five years ago, Professor Kenneth Karst suggested the creation of a new agency at the state level, a state board of private charities that would have primary responsibility for supervising private charities and for administering the various state controls over their operation.¹¹⁵ Whether on a state or federal level, is a new agency any more likely to gain sufficient funding to make it an effective monitor of charities? Is the creation of another government agency without the clout of the attorney general or the IRS likely to improve accountability? It is doubtful.

I. *Using the Form 990 Annual Report as an Accountability Tool*

Peter Swords, former chairman of the Nonprofit Coordinating Committee, an advocacy organization for charitable organizations, suggested that the sector advocate for stronger generic oversight and for stronger governmental regulatory agencies.¹¹⁶ He recommends that private nonprofit accountability groups work with state attorneys general to provide direct assistance in meeting their goals, which does happen in several states.¹¹⁷ Nonprofit groups should make the Form 990 more effective as an

112. Fremont-Smith, *supra* note 46, at 471.

113. *Id.*

114. *Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform*, in *Philanthropy and the Nonprofit Sector in a Changing America* 172 (Charles T. Clotfelder & Thomas Ehrlich eds., 1999). Marcus Owens, former head of the IRS's Exempt Organizations Division, also reiterated that view with the caveat that, unless Congress was willing to devote substantial new money and numbers of staff, it is unlikely there would be any significant improvement. Schwinn & Williams, *supra* note 63.

115. Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 Harv. L. Rev. 433, 476-83 (1960).

116. Swords, *supra* note 52.

117. *Id.* at 416 & n.10.

accountability tool and should help with advocacy campaigns aimed at providing more support for these agencies.¹¹⁸ These sorts of initiatives are currently taking place. The Panel on the Nonprofit Sector, formed in response to the Senate Finance Committee hearings in 2004, recommended several changes to the Form 990 annual-information return to improve transparency, including electronic filing, more inclusive filing by all nonprofits, and the use of consistent accounting methods in audited financial statements and information returns.¹¹⁹

J. Self-Regulatory Initiatives

Recently, Fleishman has reconsidered his earlier view, and now feels that a governmental agency as he proposed “is so at odds with the history, culture, and need for independence of America’s nonprofit sector that it would be unworkable and, in any event, is unlikely ever to be established.”¹²⁰ Instead, he favors a proposal by Marcus Owens, former director of the IRS Exempt Organizations Division and a leading exempt organizations tax practitioner, which calls for the creation of a new congressionally chartered, private not-for-profit organization that would be related to but independent of the IRS to discharge its functions. Owens does not believe that the IRS, as currently structured, is the best home for charities supervision.¹²¹ 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.¹²² The migration of fiduciary oversight to the federal level would be formalized.

Owens’s proposed new agency would be modeled on the National Association of Securities Dealers and other self-regulating organizations (SROs), such as the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board, which assist the Securities and Exchange Commission (SEC) in carrying out its responsibilities.¹²³ All the SROs exercise oversight authority by virtue of their relationship with the SEC. This new charity oversight agency would be related to but independent of the IRS in much the same way that the National Association of Securities Dealers is related to, but independent of, the SEC.¹²⁴ It

118. *Id.* at 417–22.

119. Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations* 26–32 (2005), available at <http://www.nonprofitpanel.org/final>.

120. Joel L. Fleishman, *The Foundation* 257 (2007).

121. Marcus S. Owens, *Charity Oversight: An Alternative Approach* (Hauser Ctr. for Nonprofit Org., Harvard Univ., Working Paper No. 33.4, 2006).

122. Fleishman, *supra* note 120, at 258.

123. Owens, *supra* note 121, at 11.

124. Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78o-3 (2000) (registered securities associations); *id.* § 15B, 15 U.S.C. § 78o-4 (regulation of municipal securities dealers); Sarbanes-Oxley Act of 2002, tit. 1, 15 U.S.C.A. § 7211 (West Supp. 2007) (public company accounting oversight board).

"would be financed by allowing foundations to obtain a tax credit against their federal foundation tax obligations for payments to support the new agency's operations."¹²⁵

The history of self-regulation of the financial services sector in both the United Kingdom and the United States provides a cautionary tale and demonstrates that self-regulation by an industry group is basically self-protection.¹²⁶ The success of the self-regulatory bodies in the securities industry has been due to the ongoing threat both implicit and explicit that failure to regulate will bring harsher governmental sanction and intervention. In fact, over the years in the United Kingdom and the United States, the securities statutory bodies have had to increase their authority over self-regulating organizations.

It is doubtful that the IRS will play the same role as the SEC. For one thing, it is not an independent agency. Secondly, the IRS has many other responsibilities, which, if recent history is a guide, take priority over the tax-exempt sector. Much of the IRS's recent interest in abuses has been the result of congressional pressure. If the IRS is starved for resources, will Congress allow, and would the IRS want, money allocated to the supervision of exempt organizations to be used for fiduciary oversight?

The Panel on the Nonprofit Sector has also proposed a viable system of self-regulation and education.¹²⁷ Private groups can test, change, and improve norms. The testing of current norms and their meanings and roles is an important function of such organizations that lie between the citizen and the state.¹²⁸ In the nonprofit sector there are many such associations, including the Independent Sector, the Nonprofit Coordinating Committee of New York, and the Council on Foundations, to name a few. However, the nonprofit sector is so large and diverse that professional associations and other private organizations cannot provide sector-wide normative change on their own.

A report examining self-regulatory bodies in the nonprofit sector prepared by Professors Harvey Dale and Jill Manny, concludes,

125. According to Fleishman, foundations have paid between \$300 million to \$700 million, of which only \$50 million has been allocated to the Exempt Organizations Division's budget. See Fleishman, *supra* note 120, at 258.

126. James J. Fishman, *The Transformation of Threadneedle Street: The Deregulation and Reregulation of Britain's Financial Services* 55, 298-99 (1993). Over the last sixty-five years, the Securities and Exchange Commission (SEC) has exerted increasing authority over self-regulatory organizations. See David A. Lipton, *The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets*, 16 U.C. Davis L. Rev. 527, 528-30 (1983); see also Karen Talley, *Levitt Expects Wall Street to Fall Short*, Wall St. J., July 24, 2001, at C13 (explaining that the former head of the SEC expects little from Wall Street's efforts to police self-concerned analysts who recommend companies that the analysts' firms seek to represent).

127. Panel on the Nonprofit Sector, *supra* note 119, at 21.

128. Cass Sunstein, *Social Norms and Social Roles*, 96 Colum. L. Rev. 903, 947 (1996).

Self-regulatory structures are frequently important contributors to the integrity, efficiency, and overall health of various economic sectors in our country. . . .

In the resulting partial vacuum of governmental oversight, self-regulation is an indispensable tool for setting standards identifying malfeasance and misfeasance, and improving the integrity and efficiency of the nation's charities and social welfare organizations. . . .

. . . .

Expectations, however, should remain nuanced. In a free society, no amount of governmental regulation and oversight, even coupled with vibrant and vigorous self-regulatory initiatives, will prevent all nonprofit fraud, misfeasance, or ineffectiveness. If the virtues of self-regulation are trumpeted with too much enthusiasm, disappointment is inevitable when scandals eventually occur. . . .

Probably the single most significant factor contributing to the effectiveness of any self-regulatory model is legal enforceability of its standards.¹²⁹

For self-regulation to work, there would have to be a significant change in the structure of oversight. The size of the tax-exempt sector makes such a task seem impossible.¹³⁰ Self-regulation exists in certain parts of the nonprofit sector—education and museums come to mind. This approach is most effective for larger charities, which have the resources, experience, or normative values to follow the accrediting organization's rules. Smaller or recently formed organizations may be unaware of or financially incapable of adhering to certain self-regulatory mandates, such as a requirement of a certified audit. Organizations at the margins may have little desire to join or may not be able to meet the standards of accrediting bodies.

129. Nat'l Ctr. on Philanthropy & the Law, Draft Study on Models of Self-Regulation in the Nonprofit Sector (2005), *available at* www.law.nyu.edu/ncpl/library/Self_Regulation_Final_Report-040307updates.pdf.

130. In fiscal year 2003, there were 12,830 reporting firms registered under §§ 12b and 12g of the Securities Exchange Act of 1934, which requires an ongoing disclosure system to the SEC. SEC, Annual Report 2003, <http://www.sec.gov/about/annrep03.shtml>. There are 2764 companies listed on the New York Stock Exchange and 3153 companies listed on NASDAQ, two self-regulating organizations. This compares with a total of 1,680,061 exempt organizations on the IRS's master list. The nonprofit sector is an exponentially larger universe. See NYSE Euronext, Listed Securities, <http://www.nyse.com/about/listed/1170350259411.html> (last visited Oct. 1, 2007); NASDAQ, NASDAQ Performance Report, http://www.nasdaq.com/newsroom/stats/Performance_Report.stm (last visited Oct. 1, 2007).

III. NEW APPROACHES

A. *Advisory Charity Commissions Under the Aegis of the Attorney General*

It is doubtful that there will be a substantial increase in funding for enforcement activity at either the federal or state levels sufficient to improve charities' accountability. The only realistic way to increase nonprofit accountability and to create new norms of fiduciary behavior is by leveraging existing regulators' efforts within the nonprofit sector and making them more efficient and in a variant of sector-wide self-regulation by using private citizens in the service of state attorneys general.

It is better for the nonprofit sector and for the efficiency of regulation for its locus to be at the state rather than federal level. Almost all charities are incorporated at the state level. 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 play the legal mechanisms that institute accountability. Professor Cass Sunstein has suggested that it is probably best to have a presumption in favor of the lowest possible level of government, because it is closest to the people and therefore most responsive to the people and most likely to be trusted.¹³¹ Local efforts are more responsive to our constitutional structure of federalism, which increasing federal regulation of state responsibilities undermines.

This proposal recommends the creation of advisory charity commissions under the ultimate supervision of state attorneys general. The advisory charity commission structure and procedure, set forth below, has some similarity to the commission procedure established under the seminal Statute of Charitable Uses of 1601,¹³² as well as to contemporary lawyer and judicial disciplinary bodies.

B. *Proposed Charity Commission Procedures*

Local charity commissions would be the initial filter for citizen complaints about fiduciary or organizational improprieties by charities. The commissions would serve under the aegis of the state attorney general. In states with a substantial number of charities, such as New York or California, charity commissions could be established on the basis of state judicial divisions. Thus, New York has four appellate divisions and would have four charity commissions. The charity commissions would be public-private partnerships, which would imbue them with both a legal and moral authority that a wholly private body or state agency could not engender. They could also serve an educational or remedial function more easily than a governmental enforcement agency alone.

131. Sunstein, *supra* note 128, at 952.

132. 43 Eliz., c. 4 (Eng.).

Each charity commission would consist of fifteen unpaid citizens, eight appointed by the governor and seven by the attorney general.¹³³ Some members would be individuals experienced in the nonprofit sector or beneficiaries of nonprofit organizations' activities. Others would be recruited from the general public. The chief administrator of each commission would be an assistant attorney general.¹³⁴ Commissioners would be appointed for three-year terms, which would be renewable once.¹³⁵

A citizen could complain about a charity or an official of a nonprofit. She would provide to the commission or its staff information to validate the allegations. The commission would have the powers to investigate, hold hearings, and subpoena witnesses and uncover evidence. Thereafter, it could exonerate the charity or individual, resolve the problem by working with the charity, recommend it to a service organization that might provide assistance, or turn the matter over to the attorney general for routine prosecution. This remedial function could be the most important effect of the charity-commission process, for cumulatively it could inculcate new sector-wide norms of behavior.

When a complaint comes before the charity commission, a panel of three commissioners, randomly selected, would review the allegations and the evidence. If the charges were in any way colorable, the allegations and evidence would be turned over to the assistant attorney general who would promptly serve a copy of the complaint on the accused organization or individual or any other necessary parties and make a preliminary investigation. The assistant attorney general would determine whether the charity commission or the attorney general should have jurisdiction over the allegations. If she has probable cause to believe the allegations are true, the assistant attorney general would be responsible for initially subpoenaing witnesses and gathering evidence that would be presented to the three-person commission. Allegations of wrongdoing would be heard by the three commissioners, who could dismiss the charge, seek additional information, or place the matter before the full commission.

In the words of Judge Learned Hand, "[I]ndictments are calamities to honest men."¹³⁶ The same applies to charities. Public investigations are a disaster for a charity's reputation. Therefore, commission investigations and hearings should be confidential, and a prime role of the charity commissions should be to engage in settlement, conciliation, and remediation if necessary to remove the force of the allegations. It is

133. There is precedent for such cooperation. In New York, the governor and attorney general can appoint a deputy attorney general in charge of the Organized Crime Task Force. N.Y. Exec. Law § 70a(2) (McKinney 2002).

134. The attorney general and other agencies could loan officials, but the legislature should appropriate a sum for the maintenance of offices.

135. Initially, five commissioners would be appointed for three years, five for two years, and five for one year, thereby creating a board with staggered terms.

136. *United States v. Garsson*, 291 F. 646, 649 (S.D.N.Y. 1923).

assumed that many wrongdoings of charities flow out of nonfeasance or ignorance. The three-member commissions could provide direction and assistance in bringing the charity into line with procedures, mandates, or law. Under the resolution process, the charity and the commission would sign a settlement agreement whereby the charity would admit any wrongs, might indicate changes it will make to bring itself into compliance, and would agree to present a report within twelve months of the agreement date, outlining the implementation of the suggested changes. These proceedings and settlement would not be made public.

If a settlement could not be reached or there was probable cause for the allegations, the three-member commissions would decide by majority vote to turn the matter to the full commission for a hearing. The hearing before the full commission should also be held *in camera*. The organization or individual (the respondent) might file a written answer and appear with or without counsel. If the respondent failed to appear, a default judgment should be entered and the matter turned over to the attorney general for enforcement.

Upon the conclusion of the hearing by the full commission, the matter could be dismissed or settled, or an order could be issued requiring the respondent to take certain steps to implement compliance, to pay the costs of the investigation, and to provide a report in the manner of compliance. If the commission found the respondent innocent of such charges, it should issue an order dismissing those charges, which should also be transmitted to the attorney general. The commission's report should not be made public. If the commission found that the allegations were correct and no settlement had been reached or order complied with, the matter should be turned over to the attorney general who would handle it as part of his normal oversight of charities.

When an individual or an organization has been summoned before a three-member panel or the full commission, the individual or organization might challenge any of the commissioners as having a conflict of interest. If such conflict was found by the other members of the commission, the particular commissioner must recuse herself from hearing the matter. Annually, the charities commissions should issue a report summarizing the number of matters brought to it and their method of disposition. An underlying assumption of these advisory charity commissions is that local enforcement by citizens in the community is the most efficient and effective method of providing accountability and for providing support and encouragement of the charitable sector.

One of the few interludes in history when there was an effective system of oversight of charities was in the first quarter of the seventeenth century. The charity commission procedure created under the Statute of Charitable Uses of 1601¹³⁷ provided that, upon complaints by local citizens of fiduciary wrongdoing by trustees of charitable trusts, charity commissions

137. 43 Eliz., c. 4 (Eng.).

would be empanelled at the parish level to examine the charges. The procedure was developed because of the inadequacies of the chancery court in monitoring charitable abuses. Over 1000 decrees were issued by these charity commissions in the period 1597 to 1625, compared to one or two annually by chancery.¹³⁸

Attorney and judicial disciplinary committees offer useful current analogies in terms of procedure and the use of private citizens backed by the authority of the state. They invoke a public-private citizen partnership. The public agency in the case of attorney and judicial disciplinary proceedings is the court system. The purposes are similar to the charity commissions: protection of the public, punishing wrongdoing where appropriate, serving an educational or warning function if necessary, and improving the reputation of the professional area. These disciplinary committees also protect attorneys and judges against unmerited charges. The hearings are civil in nature, but provide a modicum of due process.¹³⁹

The disciplinary panels are composed of private citizens as well as attorneys or judges under the legal authority of a public official, who, in appropriate situations, can subpoena, investigate, and commence disciplinary proceedings. Attorney and judicial disciplinary bodies have a broad range of remedial powers ranging from dismissal of complaints to the filing of formal charges. Because of the damage to reputation that even an unmerited complaint can bring, the hearings are confidential until probable cause is found. They also serve an educational function for those accused of acts that do not rise to the level of a formal investigation.

C. Charity Commissions as Catalysts of Changes in Fiduciary Behavior

This proposal will bring an improvement in fiduciary behavior through education, publicity, and the threat of investigation and prosecution. The charity commissions could reach many organizations and their fiduciaries. The educational functions and the fear of sanction by the attorney general will force many organizations on the behavioral margin, that have been brought to the attention of the commissions, to change their behavior and governance patterns. Most of these fiduciaries will understand their obligations and internalize them.¹⁴⁰ In due course, new social norms will emerge, expressing higher fiduciary expectations. The charity commissions will encourage adherence to the social norm of following fiduciary rules by increasing the possibility of enforcement and extending the reach, though indirectly, of government investigation.

138. See Jones, *supra* note 45, at 47–56.

139. For a more detailed description of how attorney and judicial disciplinary committees work, see James J. Fishman, *Improving Charitable Accountability*, 62 Md. L. Rev. 218, 279–86 (2003).

140. Cf. Robert Cooter, *Expressive Law & Economics*, 27 J. Legal Stud. 585, 585–86 (1998).

One area where the charity commissions could encourage new patterns of behavior is conflicts of interest. The commissions could encourage fiduciaries to establish conflict-of-interest policies and to sanitize interested transactions by requiring full, not material, disclosure and by encouraging nonprofits not to include the interested directors or officers for voting or quorum purposes. This could be achieved in a simpler, less expensive, and more effective way than the use of traditional federal or state resources, which are in such short supply. First, the organizations brought before the commissions would be taught, encouraged, or sanctioned to obey these rules. Second, cumulative reporting of the commissions' actions would give publicity to the need to deal with conflicts of interest. Most fiduciaries desire to live up to the norms of society, but they have to know what these norms are. Publicity generated by the charity commissions would signify the seriousness of types of fiduciary breaches.

The proposed charities commissions offer an effective and efficient method of increasing resources of state regulators at a minimum cost and complement federal initiatives. If successful, the charity commissions will signal that they are not principally enforcement arms but remedial bodies that will build trust and encourage people to report serious problems. They will provide a channel for citizen action resulting from increased transparency provided by the Internet. They will leverage the enforcement capacity of the attorney general and return the focus of regulation to a more local level by involving interested citizens. Because of their breadth of remedial powers, charity commissions can educate charities and resolve minor problems. They can offer a partnership between the nonprofit community and regulators, which avoids the problems of industry self-regulation that so often turns into self-protection. They will return the focus of fiduciary regulation to the state or local level, where it belongs, and should be more effective at less cost to regulators and to charities. Moreover, they will allow the IRS to do what it does best: ensuring adherence to the federal tax laws.

D. *New Structures for Charitable Activity:
Social Enterprise Organizations*

Thus far, this essay has criticized some assumptions and recent regulatory developments in the nonprofit world. There has been one encouraging development: the emergence of social enterprise organizations, specifically for-profit vehicles committed to philanthropic activity. This section raises some questions and reservations about social enterprise organizations.

Social enterprise firms have been characterized as for-benefit corporations that inhabit a "fourth sector" of society composed of organizations driven by social purposes and financial promise that fall

between traditional businesses and charities.¹⁴¹ The social enterprise movement is based upon the belief that market forces offer a more flexible, efficient, and effective approach to promoting the public good than traditional charitable nonprofits, such as private foundations, which are subject to a restrictive regulatory regime.¹⁴² These organizations would not be concerned with the tax issues that envelope traditional charitable activity. They would be fully taxable, and could issue shares of stock and return profits for investors, who would be shielded from shareholder attacks for failing to maximize profits.¹⁴³ The private sector will be encouraged to invest in social enterprises because they will derive a financial return while providing a public benefit.

The most recent American catalyst for social enterprise investment was the announcement that Google Inc. would pledge one percent of the company's stock, worth \$1 billion, and one percent of its annual profits over the next twenty years to invest in businesses with a social purpose.¹⁴⁴ Initially, Google Inc. established a traditional private foundation to which has been committed \$90 million. The second charitable vehicle, Google.org, to which most of the support would be given, is a for-profit corporation. There are two important differences between these philanthropic vehicles. The assets of the Google Foundation must remain permanently in the charitable stream. If the foundation decides to dissolve, its assets remaining after liabilities have been paid must be distributed to another 501(c)(3) organization.¹⁴⁵ If Google.org dissolves, its remaining assets can be refunded to donor-investors. A second difference is that the Google Foundation cannot return profits or dividends to its donors, whereas Google.org may declare dividends to investors.¹⁴⁶ Other businesses and entrepreneurs, such as private equity funds, have also formed large pools of capital for social purposes outside of charitable tax-exempt structures.¹⁴⁷ These "social enterprise organizations," as they are called, have appeared both in the United States and the United Kingdom.

For-profit public benefit ventures raise several questions. Are they charities? Are they a new phenomenon? Are they more efficient and effective than traditional charities? Are social enterprises permanent entities or merely reflections of transitory stock market success or rising

141. Strom, *supra* note 12 (explaining that government, private, and nonprofit sectors are the other three).

142. *See id.*

143. *See* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

144. Nicole Wallace, *Blending Business and Charity*, Chron. of Philanthropy, Sept. 28, 2006, at 14; Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. Times, Sept. 14, 2006, at A1.

145. Treas. Reg. § 1.501(c)(3)-1(b)(4) (as amended in 1990).

146. I.R.C. § 501(c)(3) (2000) requires in part that no part of the net earnings of an exempt organization can inure to the benefit of any private shareholder or individual. Charities can pay interest on tax-exempt bonds they have issued.

147. *See* Jenny Anderson, *A Hedge Fund with High Returns and High Reaching Goals*, N.Y. Times, Nov. 13, 2006, at F14; Stephanie Strom, *What's Wrong with Profit*, N.Y. Times, Nov. 13, 2006, at F1.

earnings? Should they receive tax benefits? If so, under what circumstances?¹⁴⁸ Do social enterprise organizations live up to their hype?

“Social entrepreneurship” or “social enterprises” are phrases with many meanings, some with almost religious overtones.¹⁴⁹ One definition is that they are organizations for “people who use the techniques of business to achieve positive social change.”¹⁵⁰ The United Kingdom’s new Office of the Third Sector, a cabinet level office that has promoted a social enterprise initiative, defines social enterprises as “business[es] with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximize profit for shareholders and owners.”¹⁵¹ There are programs in social entrepreneurship at leading business schools.¹⁵²

An assumption underlying the use of the social enterprise structure is that because they are for-profit, they will utilize modern business techniques, and therefore will be more efficient and effective than their charitable

148. For an argument that for-profit entities should receive the same tax advantages as nonprofits, see Eric Posner & Anup Malani, *The Case for For-Profit Charities* (Univ. of Chicago Law & Econ., Olin Working Paper No. 304, 2006), available at <http://ssrn.com/abstract=928976>. There is no good argument for making those tax subsidies available only to charities that adopt the nonprofit form.

149. One definition of social enterprise states,

Social entrepreneurs play the role of change agents in the social sector by:

- Adopting a mission to create and sustain social value (not just private value),
- Recognizing and relentlessly pursuing new opportunities to serve that mission,
- Engaging in a process of continuous innovation, adaptation and learning,
- Acting boldly without being limited by resources currently in hand, and
- Exhibiting heightened accountability to the constituencies served and for the outcomes created.

J.G. Dees, *The Meaning of Social Entrepreneurship* (2001), available at www.fuqua.duke.edu/centers/case/documents/dees_SE.pdf; see also Gordon M. Bloom, *The Social Entrepreneurship Collaboratory (SE Lab): A University Incubator for a Rising Generation of Leading Social Entrepreneurs* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 31, 2006).

150. Jung E. Chio & William F. Meehan, Stanford Graduate Sch. of Bus., *Ashoka: Innovators for the Public* (North American Program) (2006).

151. Office of the Third Sector, *Social Enterprise Action Plan: Scaling New Heights 11* (2006), http://www.cabinetoffice.gov.uk/third_sector/documents/social_enterprise/se_action_plan_%202006.pdf.

152. See, e.g., Columbia Bus. Sch., *The Social Enterprise Program*, <http://www.gsb.columbia.edu/socialenterprise> (last visited Sept. 28, 2007); Duke Fuqua Sch. of Bus., *Center for the Advancement of Social Entrepreneurship*, <http://www.fuqua.duke.edu/centers/case> (last visited Sept. 28, 2007); Harvard Bus. Sch., *Social Enterprise Initiative*, <http://www.hbs.edu/socialenterprise/> (last visited Sept. 28, 2007); N.Y. Univ., *Berkley Center for Entrepreneurial Studies*, http://w4.stern.nyu.edu/berkley/social.cfm?doc_id=1868 (last visited Sept. 28, 2007); Oxford Said Bus. Sch., *Skoll Centre for Social Entrepreneurship*, <http://www.sbs.ox.ac.uk/skoll/> (last visited Sept. 28, 2007); Stanford Graduate Sch. of Bus., *Center for Social Innovation*, <http://www.gsb.stanford.edu/csi/> (last visited Sept. 28, 2007); Yale Sch. of Mgmt., *Program on Social Enterprise*, <http://pse.som.yale.edu> (last visited Sept. 28, 2007).

counterparts. This attitude ignores the fact that many nonprofit organizations use modern business principles to achieve their goals and, by any standard, are efficient. Correspondingly, many for-profit firms are inefficient. The recognition that philanthropy should not necessarily be attached to a tax-exempt vehicle is a salutary development. There is so much that needs to be done. In certain areas, such as cross-border giving, a for-profit vehicle may have more flexibility and fewer transaction costs than a private foundation.¹⁵³

E. *The United Kingdom Approach to Social Enterprise:
The Community Interest Company*

According to the British government there are an estimated 55,000 social enterprise-type organizations in the United Kingdom.¹⁵⁴ Social enterprises are businesses with social objectives whose surpluses are primarily reinvested for that purpose in the business or in the community, rather than being driven by the need to maximize profits for investors. Since July 2005, social enterprise firms have had statutory backing and can register as a specific type of corporation, a community interest company (CIC).¹⁵⁵ As of April 2007, nearly 900 such organizations have been formed.¹⁵⁶ What distinguishes the CIC from Google.org is the permanence of assets devoted to community interest or social enterprise use. There is a statutory lock on a CIC's assets, a partial non-distribution constraint.¹⁵⁷ The asset lock means that, if upon dissolution there are residual assets remaining after the payment of liabilities, the assets can be distributed to members or

153. The advantages of social enterprise firms compared to traditional charities are discussed in Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 Exempt Org. Tax Rev. 233 (2006); see also Rosie Parr, *Charities: Showing Interest*, 157 Solic. J. 226 (2007). For a criticism of the social enterprise approach for nonprofits, see Ben Casselman, *Why 'Social Enterprise' Rarely Works*, Wall St. J., June 1, 2007, at W3.

154. Office of the Third Sector, Social Enterprise Plan, http://www.cabinetoffice.gov.uk/third_sector/social_enterprise/action_plan/ (last visited Oct. 28, 2007). The author wishes to thank Betsy Buchalder Adler for introducing him to community interest companies (CIC).

155. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 26 (Eng.).

156. Cmty. Interest Regulator, List of Community Interest Companies (April 2007), www.cicregulator.gov.uk/coSearch/companyList.shtml. Previously, social enterprise organizations have existed in a variety of structural formats: companies limited by share or by guarantee without share capital, partnerships, limited partnerships, cooperatives, or societies for the benefit of the community. Parr, *supra* note 153, at 226. Companies limited by shares are traditional corporations. A company limited by guarantee is an alternative type of incorporation used primarily for nonprofit organizations that require corporate status. It does not have shares but has members, who are guarantors instead of shareholders. The guarantors give an undertaking, as little as £1, which is the limitation of liability of the guarantors if the company is dissolved. Until the Charities Act of 2006, companies limited by guarantee were the only incorporated forms available as charities.

157. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 31 (Eng.); Community Interest Company Regulations, 2005, S.I. 2005/1788, art. 23 (U.K.).

shareholders but only up to the paid-in-value of the shares held.¹⁵⁸ If there are residual assets after distribution to members, the remaining assets must remain in the community interest stream and be distributed to another CIC named in the articles of the company or distributed as the regulator of CICs directs.¹⁵⁹

On a continuum, CICs are somewhere between for-profit firms and traditional charities. The justification for statutory backing was that until 2006, the purposes for which charities could be formed were more limited than in the United States. CICs can be formed for any lawful purpose, but must provide benefit to the community. Their formation is governed by an expansive community benefit test, which is broader than the public benefit test that must be met to be classified as a charity.¹⁶⁰ A CIC will satisfy the community benefit test if “a reasonable person might consider that its activities are being carried on for the benefit of the community.”¹⁶¹ As yet, there are no tax benefits from adopting CIC status.

A major difference between a charity and a for-profit firm is that the latter has the ability to issue shares and declare dividends.¹⁶² CICs can have shareholding investors and pay dividends, which are limited by regulation.¹⁶³ Another distinction is that English charities cannot reimburse board members and managing directors, but CICs can.¹⁶⁴

CICs offer the advantages of limited liability. They can engage in more commercial activity than a charity but are less regulated. A CIC must file an annual report describing how its activities benefited the community and provide financial information as to dividends, interest paid, and compensation of directors, but the reporting is less extensive than that

158. Community Interest Company Regulations, 2005, S.I. 2005/1788, art. 23, ¶¶ 1–3 (U.K.).

159. *Id.* § 23(4)–(11). A CIC cannot distribute assets to members by way of redemption, purchase of shares, or reduction of share capital. *Id.* §§ 24, 25.

160. *See* Charities Act, 2006, c. 50, §§ 1–5 (Eng.).

161. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 35(2) (Eng.). “Community” includes a section of the community, whether in Great Britain or elsewhere. *Id.* § 35(5). The regulations add that for the purposes of the community interest test, any group of individuals may constitute a section of the community if it shares a readily identifiable characteristic and other members of that community do not share that characteristic. Community Interest Company Regulations, 2005, S.I. 2005/1788, art. 5 (U.K.).

162. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 30 (Eng.).

163. Community Interest Company Regulations, 2005, S.I. 2005/1788, arts. 17–22 (U.K.). The dividend cap regulations are complicated. Basically, the share dividend cap, a maximum rate for determining dividends per share, is a percentage of the paid-up value of a CIC share which can be five basis points higher than the Bank of England’s base lending rate. The aggregate dividend cap, a cap for determining the maximum aggregate dividends that can be declared, is set at thirty-five percent of a company’s distributable profits. There is also a cap on the interest that can be paid on debt. The regulator of CICs can adjust the caps. The members or shareholders cannot vote to amend or remove the asset lock. Tangible assets can be sold, but the proceeds must remain asset locked.

164. *Id.* arts. 30–33.

required for charities.¹⁶⁵ The CIC sector is overseen by the regulator of CICs, who has publicly stated that regulation will be by a “light touch.”¹⁶⁶ While many administrative agencies exercise a light touch or lax oversight, it is rare for a regulator to admit this fact so candidly. Whether light touch means no touch remains to be seen. The regulator has substantial reserve powers.¹⁶⁷

The CIC social enterprise sector is involved in all parts of the economy, including local community and business enterprises, environmental and social welfare organizations, mutual organizations such as cooperatives, day-care and recycling centers, low-cost housing, and preservation efforts.¹⁶⁸ They are particularly useful vehicles for joint projects with units of government.¹⁶⁹

F. Old Wine in New Bottles? The Uniqueness of the Social Enterprise Form

From much of the publicity, one would surmise that social enterprise organizations, like the Google phenomenon itself, are something new. In fact, involvement in social benefit activities regardless of the structure of the organization or benefits of tax exemption runs deep in Western history. Most philanthropic activity has been based not upon tax advantage but religious principle.¹⁷⁰ It is sometimes overlooked that the charitable

165. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 34 (Eng.); Community Interest Company Regulations, 2005, S.I. 2005/1788, arts. 26–28 (U.K.).

166. Dep’t Trade & Indus., Community Interest Companies: The Regulator of Community Interest Companies 11–12 (2005), available at <http://www.sel.org.uk/docs/cicfactsheet2.pdf>; see Regulator of Cmty. Interest Cos.: Report to Secretary of State for Trade & Industry: Year to 31 March 2006 (2006). The statute specifies that the “Regulator must adopt an approach which is based on the principle that those powers should be exercised only to the extent necessary to maintain confidence in community interest companies.” Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 41(1) (Eng.).

167. These include powers of investigation, audit, civil proceedings, appointment and removal of directors, winding up and dissolution of CICs, and transferring assets and shares. Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, §§ 41–51 (Eng.).

168. Political activities are not considered for the benefit of the community unless incidental to other activities if a reasonable person would consider them carried on for the benefit of the community. Community Interest Company Regulations, 2005, S.I. 2005/1788, art. 3 (U.K.). An activity is not carried on for the benefit of the community if a reasonable person might consider that the activity benefits only the members of a particular body or the employees of a particular employer. *Id.* art. 4.

169. Many local government units engaged in redevelopment or providing social services would rather work with a CIC than a charity because managing directors can be paid a market rate, which is not possible for charities—the assumption being that professional management will be more cost efficient. Parr, *supra* note 153, at 226.

170. *Deuteronomy* 15:7 (“If there is among you anyone in need, a member of your community in any of your towns within the land that the Lord your God is giving you, do not be hard-hearted or tight-fisted toward your needy neighbor.”); *Deuteronomy* 15:10–11 (“Give liberally and be ungrudging when you do so, for on this account the Lord your God will bless you in all your work and in all that you undertake.”); *Matthew* 5:42 (“Give to

deduction dates only from 1917,¹⁷¹ the estate tax from the following year,¹⁷² and the gift tax from 1924.¹⁷³ Philanthropic impulses of the more affluent today are usually driven by tax considerations; however, the nearly eighty percent of American taxpayers, those who do not itemize their deductions, give without regard to the tax consequences.¹⁷⁴

From a historical perspective, social enterprise corporations are nothing new. In England in 1841 the Metropolitan Association for Improving the Dwellings of the Industrious Classes was formed “for the purpose of providing the labouring man with an increase of the comforts and conveniences of life, with full compensation to the capitalist.”¹⁷⁵ After four years of effort the association raised shares totaling £20,000. It obtained a royal charter of incorporation to limit liability of the shareholders,

and as a feeling then existed that too large a profit should not be made out of the class of tenants intended to be benefited, the charter limited the rate of dividend to five percent; any surplus, after providing a guarantee fund not exceeding £15,000 to be applied in extension of the object [surplus profits going to expand the organization’s operations].¹⁷⁶

The association built blocks of apartments for multifamily occupancy, and was a model for other semi-philanthropic, semi-investment vehicles that were based on business principles. By the 1870s, the association had erected 6838 dwellings at a cost of £1,209,359 and claimed to have paid for

everyone who begs from you and do not refuse anyone who wants to borrow from you.”); *Qur’ān* 57:18, reprinted in *The Meaning of the Glorious Koran* 388 (Marmaduke Pickthall trans., Everyman’s Library 1992) (“Lo! those who give alms, both men and women, and lend on to Allah a goodly loan, it will be doubled for them, and theirs will be a rich reward.”) *Qur’ān* 2:177, reprinted in *The Meaning of the Glorious Koran* 48, *supra* (“It is not righteousness that ye turn your faces to the East and the West; but righteous is he who believeth in Allah and the Last Day and the angels and the Scripture and the Prophets; and giveth his wealth, for love of Him, to kinsfolk and to orphans and the needy and the wayfarer and to those who ask, and to set slaves free; and observeth proper worship and payeth the poor-due. And those who keep their treaty when they make one, and the patient in tribulation and adversity and time of stress. Such are they who are sincere. Such are the God-fearing.”); see also Robert Bremner, *Giving* 11–20 (2000).

171. War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

172. Revenue Act of 1918, ch. 18, § 403(a)(3), 40 Stat. 1057, 1098 (1919).

173. Revenue Act of 1924, ch. 234, §§ 319–324, 43 Stat. 253, 313–16; see David E. Pozen, *Remapping the Charitable Deduction*, 39 Conn. L. Rev. 531, 538 (2006).

174. In 2003, 29.6% of tax returns itemized charitable deductions. Am. Ass’n of Fundraising Counsel Trust for Philanthropy, *Giving USA 2005*, at 67 tbl.1 (2005). In dollar terms, itemizers typically account for around 80% of total individual donations. See, e.g., Cong. Budget Office, *Effects of Allowing Nonitemizers to Deduct Charitable Contributions* 6 fig.1 (2002), available at <http://www.cbo.gov/ftpdocs/40xx/doc4008/12-13-CharitableGiving.pdf>, quoted in Pozen, *supra* note 173, at 553 n.109. Those who take the standard deduction as a group are poorer but more generous in relation to percentage of income donated compared to more affluent taxpayers.

175. Charles Gatliff, *On Improved Dwellings*, 38 J. Statistical Society 33 (1875), reprinted as Charles Gatliff, *On Improved dwellings and Their Beneficial Effect on Health and Morals, and Suggestions for their Extension* 1 (Edward Stanford ed., 1875).

176. *Id.* at 2.

the five years from 1869 to 1874 a dividend of 4.5%.¹⁷⁷ Many enlightened factory owners built housing for their employees and received a below market return. There were mixed motives. Efforts to improve employee welfare through decent housing, later pejoratively termed “company towns,” tied employees to their jobs.

In 1874, Member of Parliament U.J. Kay-Shuttleworth addressed the House of Commons about the work being done in building improved habitations by various societies and companies, “some of a philanthropic character, others half philanthropic and half commercial, some of a purely commercial character, many of which were set on foot and are carried on by private individuals who have shown an example for others to follow.”¹⁷⁸ Urging private developers to invest in renovated housing, because community benefit projects could be profitable, he stated,

Some companies, it must be admitted, have been failures: others have paid very little; but when wisely managed they have set an example which private individuals and speculators may follow, for they show that dividends at the rate of 5 per cent. can be obtained.¹⁷⁹

The Office of the Third Sector traces social enterprise organizations back to the Rochdale Society of Equitable Pioneers, one of the early cooperatives, whose principles or rules were widely adopted by the cooperative movement.¹⁸⁰ One of the principles was payment of limited interest on capital.¹⁸¹ There is also a long tradition in the United Kingdom of cooperative mutual benefit societies. There are two forms of such societies: bona fide cooperatives run by their members, as was Rochdale, and community benefit societies. Recent legislation has allowed these organizations to choose to have asset locks for the benefit of the community.¹⁸²

In the United States, the phrase “public benefit corporation” is currently used as a synonym for a 501(c)(3) charity, but its original meaning was a for-profit corporation that provided a social benefit.¹⁸³ During the colonial

177. *Id.* at 2, 14.

178. 218 Parl. Deb., H.C. (3d ser.) (1874) 1960–61.

179. *Id.* at 1963–64.

180. Office of the Third Sector, *supra* note 151, at 11.

181. Another principle was that profits would be distributed to each member in proportion to the amount of money expended at the stores. The Rochdale Society of Equitable Pioneers was a group of weavers and other artisans who formed a cooperative in 1844, opening a store that sold food, and developed a series of rules and principles for cooperative organization. Though the Rochdale Pioneers were not the first cooperative, their principles were adopted internationally. See W. Henry Brown, *The Rochdale Pioneers: A Century of Co-operation in Rochdale* 22 (1944); George Douglas Howard Cole, *The Rochdale Principles: Their History and Application* 3–6 (1947).

182. Co-operatives and Community Benefit Societies Act, 2003, c.15, § 1 (Eng.).

183. Early corporate charters, particularly in the recitals of their purposes, emphasized that the corporate purposes were public in the sense of managing and ordering trade as well as the private goal of earning profit for shareholders. See Samuel Williston, *The History of the Law of Business Corporations Before 1800*, in 3 *Select Essays in Anglo-American Legal History* 195, 201 (Ass’n of Am. Law Schs. ed. 1909).

period business corporations were few and of little importance. Many of the colonial business corporations would be considered cooperatives or quasi-philanthropic entities today. They were incorporated for the purpose of erecting bridges, building or repairing roads, or promoting ends of general public utility.¹⁸⁴ They seemed to fit the current definition of social enterprises.

After independence, most states actively encouraged the incorporation of private associations that performed vital public services.¹⁸⁵ In the beginning of the nineteenth century, incorporation was by petition to the legislature. Corporate charters were given to those who were thought to be public stewards rather than private ones.¹⁸⁶ New England led the new nation in the creation of corporations, both for-profit and charitable. The early business corporations were strictly limited in purpose and were expected to serve the public good.

G. Some Reflections and Further Questions About Social Enterprise Organizations

The CIC reflects a particular need in the U.K. legal landscape because of the restrictiveness of the pre-2006 public benefit test for charities, and the lack of fit for some mutual benefit and social welfare organizations in its tax scheme. One of the advantages of the multi-category I.R.C. § 501 is it provides a tax-exempt home somewhere for most of the organizations that fit under the CIC umbrella. Two major differences between CICs and American social enterprise organizations are the asset lock and the investor's right to receive limited dividends.

In the United States, social enterprises consciously blur the line between charity and for-profit activity. At what point does an investment have philanthropic objectives and when does it become a business decision? Much will rest on whether the project is successful and if investors find the activity sufficiently profitable. Determining social benefit is no easy task, as nonprofits attempting to qualitatively measure mission success have learned. Social benefit success may take years to achieve or determine, by which time circumstances may change. Profitable companies backing such efforts may in time suffer losses. Independent companies get taken over, and firms' policies may change.

Let us assume Google Inc. is taken over by a private equity firm and becomes Blackstone Google. In an effort to cut costs and close unprofitable

184. 2 Joseph Standcliffe Davis, *Essays in the Earlier History of American Corporations* 87, 98, 103 (1917). Other early corporations would be considered mutual benefit organizations or trade associations, such as the marine societies formed for the purpose of bringing together mariners of a particular port. See generally Ronald Seavoy, *The Public Service Origins of the American Business Corporation*, 52 *Bus. Hist. Rev.* 30, 38–39 (1978).

185. Ronald Seavoy, *The Origins of the American Business Corporation, 1784–1855*, at 255 (1982).

186. Peter Dobkin Hall, *A Historical Overview of the Private Nonprofit Sector*, in *The Nonprofit Sector: A Research Handbook* 4 (Walter W. Powell ed., 1987).

operations, Blackstone Google revokes the policy of donating one percent of its profits to Google.org, and calls in outstanding loans. There is nothing to prevent this from happening. In contrast, the Google Foundation would continue to exist, its endowment intact. If it decided to go out of business, any remaining assets would be given to another charity. This is not a hypothetical situation. Ben & Jerry's, the ice cream manufacturer, had a policy of donating a certain percentage of its profits to charity. When the corporation was purchased by Unilever that largesse ended.¹⁸⁷ In contrast, a corporation whose charitable activities are channeled through a private foundation will give in good times and bad, to the annoyance of investors and employees. In 1997, when Boeing laid off thousands of employees and suffered a \$178 million loss, it still spent \$51.3 million on philanthropy.¹⁸⁸

Social enterprise or for-benefit corporations represent an interesting opportunity to expand philanthropy and good works. They are not charities and do not offer the permanence of the private foundation. A concern about social enterprise activities such as Google.org is whether they are fair-weather donors. Should there be tax incentives to assure or at least encourage that these sorts of ventures stay the course? Should for-profit companies be eligible for program-related investments from private foundations? Should there be a trade-off of providing tax benefits to such firms in exchange for an asset lock? This could draw them closer to the charity side of the continuum without harming their flexibility.

This is a period when we need to rethink the axioms that have governed nonprofit law in recent years. This essay has suggested several misconceptions that govern thinking about the nonprofit world. It has traced the federal government's intrusion into traditional state matters of nonprofit law and has presented a proposal to return the locus of fiduciary regulation and oversight back to the state and local level. There are many other initiatives that should be considered, including a need to rethink what it means to be a charity as well as the development of new structures of nonprofit activity to deliver charitable efforts.

187. Strom, *supra* note 11. The Body Shop and the And 1 Corporation, which also contributed a percentage of their profits to charity, suffered the same fate when acquired.

188. Marianne Jennings & Craig Cantoni, *Manager's Journal: An Uncharitable Look at Corporate Philanthropy*, Wall St. J., Dec. 22, 1998, at A18.

Notes & Observations