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Charity Begins at Home: Alternatives in Nonprofit Regulation

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TO THE READER

The Western State University Consumer Law Journal's purpose is to provide a comprehensive resource, focused on commerce, for attorneys and the general public. It was conceived to serve as an aid in the analysis, evaluation and advocacy of issues that confront everyone as they act as, or on behalf of, consumers of products, services and their interrelated concerns; the marketing, merchandising, advertising, financial, charitable and legal components of commerce.

The Consumer Law Journal has, therefore a broad reach, but a singular goal; to serve as a conduit of information from those who have knowledge of a particular part of the universe of commerce to those who have need of it.

In this, the second volume of the Western State University Consumer Law Journal, the conscience of our economy is examined in *Charity Begins at Home: Alternatives in Nonprofit Regulation* and in *Diagnosing and Treating the Slumlord Syndrome*. The unanticipated side effects of the revolution in productivity through chemicals and its attendant risks to society has resulted in the need to monitor our exposure to them. The question of who should bear the burden of tracking these risks is discussed in *Medical Monitoring: A New Cause of Action in California*. One of the largest groups of consumers provided specific protections in their transactions are the buyers of automobiles. An updated understanding of these rules is provided in *The California Lemon Law: A Misunderstood Statute*.

We are pleased to be able to continue to distribute the *Journal* to law offices in Orange County on a complimentary basis because the *Journal* has found support amongst the members of our legal community. We solicit your support through the submission of articles or initiation of a yearly subscription to guarantee receipt of subsequent issues. Questions or manuscripts should be addressed to the editorial staff c/o Western State University Law Review Association, 16485 Laguna Canyon Road, Irvine, California 92718.

WILLIAM R. FOWLER
Editor-in-Chief, 1993

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Charity Begins at Home: Alternatives in Nonprofit Regulation

*Jon Garon**

INTRODUCTION

We are not unaware that the giving of alms has long been considered virtuous in our Western tradition. In antiquity the humanist and jurist, Cicero, said of Caesar: "Of all thy virtues none is more marvelous and graceful than charity." Some centuries later the Christian thinker, Augustine of Hippo, observed that it is essential to the virtue that "charity obeys reason, so that charity is vouchsafed in such a way that justice is safeguarded, when we give to the needy." In Medieval times the Jewish philosopher, Moses Maimonides, espoused a charity such that no contribution should be made without the donor feeling confident that the administration is honest, prudent and capable of management.¹

Throughout the last decade, public perception towards charity has changed as church leaders were sentenced to jail for robbing their own congregants,² controversies plagued art and cultural institutions,³

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The author wishes to thank Stacy Blumberg Garon, Esq. for her invaluable assistance, suggestions and support in the preparation of this article.

1. *Young v. N.Y. City Transit Auth.*, 903 F.2d 146, 156 (2d. Cir.), Cert. denied, 498 U.S. 984 (1990).

2. The PTL Club founded by Jim Bakker had grown to over 2,000 employees and included PTL Lodgings, a condominium resort complex which raised the religious charity over \$158 million dollars between 1984 and 1987. As a result of a sexual scandal with Bakker's secretary, Jessica Hahn, the payment of hundreds of thousands of dollars in "hush money," and the resulting disclosure regarding the PTL operations, Bakker was convicted on twenty-four counts of fraud and conspiracy. His forty-five year prison sentence was ultimately set aside, and the term

and the head of United Way, America's largest umbrella funding agency, was forced to resign amid scandal of excessive salary and possible improprieties.⁴ Adverse changes to charitable giving deductions under the Federal Income Tax reflected the decreased faith in the nonprofit sector and added to the difficulties of charitable fundraising.⁵

Despite this crisis in confidence, reduced Federal funding and the economic downturn have combined to reinvigorate the role of the nonprofit agency. Crisis intervention for victims of Hurricane Andrew in Florida, the flooding of the Mississippi in the Midwest, and the personal crises of thousands of individuals facing unemployment, have once again propelled charities into the forefront of public need and public good.

Despite these more positive trends, the public view of charities continues to decline. A poll conducted by the Gallup Organization in September 1993, revealed that eighty-one percent of those surveyed were either "very" or "somewhat" concerned about nonprofit expend-

reduced to eighteen years. George James, *Bakker's 45-Year Prison Term Set Aside*, THE N.Y. TIMES, Feb. 13, 1991 at B6; *Bakker Eligible for Parole in '85*, THE ATLANTIC CONST., Aug. 23, 1991 at A1.

3. Contemporary Arts Center in Cincinnati and its director, Dennis Barrie, were charged with violating local obscenity laws as the result of an exhibition of the work of artist Robert Mapplethorpe. Mapplethorpe's exhibit of 175 photographs included seven homoerotic or sado-masochistic photographs. Barrie and the museum were ultimately acquitted at jury trial of all charges. Mary Schmuch, *Art Gallery, Director Not Guilty, Cincinnati Jurors Clear Both of Obscenity Charges*, CHI. TRIB., Oct. 6, 1990 at 1.

A result of the charges and the surrounding public debate was an amendment to the National Foundation of the Arts and Humanities Act of 1965, 20 U.S.C. § 954-955, to include standards of "decency." 20 U.S.C. § 954(d)(1) (1990). In 1992, this amendment was ruled unconstitutional as a violation of the First Amendment for overbreadth. *Finley v. National Endowment for the Arts*, 795 F. Supp. 1457 (C.D. Cal. 1992). The Court found the restrictions covered more than the government merely choosing not to subsidize a type of speech. Instead, the obscenity restriction was found to be an impermissible restriction on First Amendment rights, analogous to the recognized rights of academic freedom.

"Our Nation is deeply committed to safeguarding academic freedom, which is of transcendent value to all of us and not merely to the teachers concerned. . . . Artistic expression, no less than academic speech or journalism, is at the core of a democratic society's cultural and political vitality. Congress recognized as much in establishing the NEA." *Id.* at 1473.

4. Felicity Barringer, *United Way Head Is Forced Out In Furor Over His Lavish Style*, N.Y. TIMES, Feb. 28, 1992 at A1. As events unfolded, William Aramony recognized no improprieties, but did acknowledge the effect of the scandal and his forced resignation. "I do apologize for any problems my lack of sensitivity to perceptions has caused [United Way]," Aramony said in response to a demand for an apology from the head of the United Way of Georgia. *Id.*

5. The 1984 Tax Reform Act imposed strict regulations regarding the appraisal of charitable contributions other than cash or publicly traded securities. 26 C.F.R. § 602 (1988). Rules under the 1984 Tax Reform Act required detailed substantiation of the gift's appraisal value. 53 Fed. Reg. 16076 (1988), 26 C.F.R. Parts 1 and 602. The changes also disallowed the deduction of the appreciation of certain property, such as art, unless the use of such property was directly related to the charitable purpose of the organization. I.R.C. § 170(e)(1) (1988). In Congress, the 1984 Tax Reform Act restrictions on deductions for donated art have been repealed. I.R.C. § 170(e)(1)(B)(i) (1992).

itures "not directly related to their stated mission."⁶ Two out of three of the persons surveyed believe that charities do not provide enough information for contributors to make informed decisions, and seventy-five percent believe that "mandatory regulation" is required.⁷ The survey indicates that most respondents do not intend this mandatory regulation to be government involvement, but rather a new form of watchdog agency or other solution.⁸ The public does not want direct government intervention, but it wants credibility and integrity restored.

What is necessary for the next decade is a new model of nonprofit support and regulation which serves to encourage agency responsibility; to increase donor participation in policing the agency's activities; and to promote charitable giving to those agencies which are efficiently run and support worthwhile causes. Such a model must also address concerns of the State and Federal governments' fears of increased fraud, as well as respond to those who criticize the role of the nonprofit sector. Such a model may be difficult to implement, but it can be developed.

I. THE PERCEIVED NEED FOR REFORM

The push to change the nonprofit sector's self-regulation stems from a number of discrete areas. Because of the excess of the 1980s, the image of major charities has been badly tarnished. In sentencing Jim Bakker for the PTL scandal, Federal District Judge Robert Potter said "[t]hose of us who do have a religion are sick of being saps for money-grubbing preachers and priests." Judge Potter aptly summarized the public sentiment towards the televangelist industry.⁹

In one of the most embarrassing of the charitable scandals, William Aramony, president of United Way of America, was forced to resign amid charges of excessive salary, inappropriate fringe benefits and questionable management practices.¹⁰ Press reports described

6. Sean Mehegan, *Gallup Poll: Most Favor More Oversight of Charities*, *NONPROFIT TIMES*, Oct. 1993 at 6.

7. *Id.*

8. *Id.*

9. James, *supra*, note 2, at B6. Judge Potter's comments also led to a reduction in the sentence to 18 years. In setting aside the verdict, the 4th Circuit Court of Appeals panel held that Potter allowed his own religious sense to be reflected in the harsh sentence, commenting that the court "cannot sanction sentencing procedures that create the perception of the bench as a pulpit from which judges announce their personal sense of religiosity and simultaneously punish defendants for offending it." *Id.*

10. Barringer, *supra*, note 4, at A1. See also, Robert Kardon, *Nonprofit Sector Falling from Grace . . . United Way Controversy Impacts All Charities*, *Cal. Ass'n Nonprofits Alert*, April/May 1992, at 1.

Aramony's use of first class travel, a \$463,000 income package, a questionable relationship with an affiliated agency run by Aramony's son and the use of a chauffeured limousine service as instances of non-profit abuse.¹¹ These accusations shook the foundations of United Way. Some local United Way chapters withdrew from the national organization while many others reduced or eliminated donations to the national organization.¹²

In response, Robert Kardon, the executive director of the California Association of Nonprofits, wrote

"[t]he charges against Aramony and the United Way of America's arrogant reaction to demands for answers from local United Ways, the public, and press are terrible violations of the nonprofit mission. The long-term effect of this controversy, I believe, will be a loss of public trust in all charitable organizations."¹³

Kardon called for charities to voluntarily and aggressively disclose information, to help rebuild the public trust, and to show that the employees in the nonprofit sector are "motivated by caring and giving."¹⁴ According to Kardon, "[t]hese are the people working unselfishly for a just and equitable society."¹⁵ Kardon is not alone. Gerald Kaufman, co-chairman of the National Council of Nonprofit Associations believes that nonprofits are actually encouraging additional regulation.¹⁶ "It's more than Tammy Faye Bakker and the United Way," Kaufman believes. "The media is coming after [the nonprofit sector], and we'd better be forthcoming. Otherwise, there will be more regulation."¹⁷

For Kardon and many people involved in charitable activities, better disclosure is simply another tool to encourage charitable agencies to show how honest, proper and positive these agencies actually are. A second, unspoken benefit of greater disclosure laws is to force the few rotten apples out of the barrel.

11. Kardon, *supra*, note 10, at 4.

12. In Milwaukee, for example, the local chapter voted to rejoin the national organization after a one-year absence brought on by the Aramony revelations and resignation. *Milwaukee United Way Rejoins National Group*, CHI. TRIB., Apr. 15, 1993, at 3.

Press reports in Spring of 1993 showed only half of the 1,400 local United Way chapters had continued to contribute to United Way of America. See, Charles Shepard, *A Year Later, United Way Still Faces Investigations, Morale Problems*, WASH. POST, Mar. 10, 1993 at A4. Even according to the new President, Elaine Chao, only 967 local chapters had pledged as of Apr. 1993. Valerie Finholm, *Lender Vows Better United Way*, HARTFORD COURANT, Apr. 17, 1993 at B5.

13. Kardon, *supra*, note 10, at 1.

14. *Id.* at 4.

15. *Id.*

16. Mehegan, *supra*, note 6, at 6.

17. *Id.*

At the June 1993 hearings before the House Ways and Means Oversight Subcommittee, new legislative suggestions were being developed to address the growing "problem." Despite the hearings and the call for action by Jake Pickle, the Democratic chairman of the subcommittee, witnesses from the Internal Revenue Service and the Better Business Bureau were reluctant to agree with Congressman Pickle's assessment regarding the existence or scope of the problem.¹⁸ Among Pickle's concerns were the salaries paid to top executives at the nation's largest charitable agencies, including some of the largest hospitals. Pickle said excessive salaries "raise serious questions about what he described as 'the fastest-growing section in the U.S. economy,' the 1.2 million nonprofit organizations that the IRS has declared exempt from paying federal income taxes."¹⁹

In response, Bennett M. Weiner of the Better Business Bureau tried to paint a different picture of the salaries paid in the nonprofit sector. Weiner said that his survey of 203 of the largest charities, excluding hospitals and universities, "does not suggest widespread abuses," and only nine pay a top salary in excess of \$250,000.²⁰ The perception problem remains, however, since the top salary in 1991 went to Aramony before he was forced to resign.

A second voice in the call for reform is that of the state attorneys general. Like the House Ways and Means Committee, many state attorneys general see a need for greater regulation and stricter control. Richard Blumenthal, chairman of a charitable solicitation committee for the National Association of Attorneys General, and the Attorney General of Connecticut, was recently quoted in *Time Magazine* as saying that "[t]here has been a dramatic increase in abuses and complaints in every state that actively monitors nonprofits and charities over the past five years."²¹ As the *Time* article illustrates, the number of criminal enterprises perpetrating fraud under the cloak of charitable respectability appears to have increased dramatically. It remains uncertain and undocumented whether such appearances reflect an actual increase in criminal activity, an increase in enforcement in the nonprofit sector, or an increase in the negative perception the public holds for charitable fundraisers. Statistical evidence on increased criminal or fraudulent activity by tax exempt agencies has not been forthcoming. The anecdotal evidence cited in Congress, the Aramony

18. See, Bill McAllister, *Charities Scored on Hill for CEO Pay, Perks*, WASH. POST, June 16, 1993 at A4.

19. *Id.*

20. *Id.*

21. Adam Zagorin, *Remember the Greedy*, TIME, Aug. 16, 1993 at 36.

resignation and an increased cynicism have left the states in a no-win situation. To regulate the charitable agencies more tightly is to make fundraising for churches, civic groups and the police booster agencies more difficult and expensive.²² The failure to regulate opens the state to charges that the most vulnerable of individuals, the naive, public-spirited donors, are being thrown to the wolves. The victims in this debate are the needy: those people helped by the good work of the charities who find donations drying up as a result of the bad press, while money that should have gone to provide services is being re-routed to line criminals' pockets or support the lifestyles of pampered senior executives.

The difficult financial position of the Federal government and many state governments has also created a momentum for change. The need to balance the state and federal budgets has focused a strong spotlight on any potential source of new revenue. If the government has found itself forced to cut assistance programs to save money, there are few moral prohibitions about eliminating tax exemptions for those same programs, which thereby generates new sources of income as a result. This is not a motivation which has been officially endorsed by any of the state or federal regulators, but Representative Pickle and other House Ways and Means Oversight Subcommittee members continue to address the increasingly large role the nonprofit sector plays in the U.S. economy, while eyeing those tax sources wistfully. In government hearings, there is a sense that the money should not be left in the hands of self-appointed committees and organizations. Since money is very short, the argument goes, the money should return to the government, which can best decide what are the nation's priorities.

Revenue can be seen as a large factor in the discussion of the Unrelated Business Income Tax ("UBI Tax"), a separate tax placed on tax exempt organizations for income which is not received through the organization's tax exempt activities.²³ Internal Revenue Code § 513 requires that income derived from business which is regularly carried on and that is not substantially related to the organization's exempt purpose is subject to income tax.²⁴ Prior to the enactment of

22. For example, in *Riley v. National Federation of the Blind of North Carolina*, 487 U.S. 781 (1988), Amici briefs were filed to protect the right to solicit without such disclosure by over thirty fraternal police associations as well as an equally large number of national charities. See *infra* note 100 for listing.

23. I.R.C. § 512(a)(1) (1969) defines the UBI Tax as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the [allowed] deductions."

24. I.R.C. § 513(a) (1969).

§ 513, such income was tax free as part of the organization's exempt purpose so long as the income was used for the charitable purposes of the organization. Under § 513, however, not only does the use of the income have to meet the operational test of the organization, but so does the source of the income.²⁵ This section of the tax code has spawned a tremendous amount of litigation and regulation governing what types of activities are regularly carried on and which are substantially related.

The effect of the UBI Tax is to further limit the available sources of funds for tax exempt agencies which are free from tax. One rationale behind the tax is to provide a level playing field for commercial businesses which compete with the nonprofits in the sales of similar merchandise or services. The other reason to continue expanding the scope of the UBI Tax is to increase state and federal revenue without directly increasing taxes on the public. In a 1989 speech before the Business Coalition for Fair Competition, representative Richard Schulze of the House Ways and Means Oversight Subcommittee urged a continued push to increase the scope and enforcement of the UBI Tax. Schulze pointed out that the revenues had "tripled since the matter [gained] attention."²⁶ After focusing his remarks on the revenue impact of the tax, however, he retreated from the UBI Tax as a simple revenue tool. "Fight for it because it is right, not because it raises more money," Schulze told the Business Coalition for Fair Competition.²⁷

With the increased need to find new sources of taxable income, the need to protect the public from increasingly clever fraud schemes, the heightened visibility of notorious excesses at the nation's top fundraising organization, and the need to fulfill the public perception that something must be done, new federal and state regulatory schemes are in the works. Unfortunately, few of these needs for new regulation are based on the need of the public to increase the efficiency and safety of the nonprofit sector. Increased efficiency and reduced risks of fraud should be the goal of any new regulation.

25. I.R.C. § 513(a) includes the disclaimer that "the need of such organization for income or funds or the use it makes of the profits derived" is not income which is substantially related to the exempt purpose and therefore treated as taxable income.

26. Richard Schulze, *No Major Changes in UBIT Law This Year, Rep. Schulze Predicts*, reprinted in BNA WASHINGTON INSIDER, March 16, 1989, at 1.

27. *Id.*

II. EXISTING REGULATION: WHAT HAS BEEN TRIED

The typical nonprofit agency is a corporation²⁸ formed under State law in the same fashion as the traditional "for-profit" corporation. The nonprofit corporation is distinct from the for-profit corporation in that the purpose clause of the articles of incorporation must state a charitable corporate purpose,²⁹ and all assets are dedicated to this charitable purpose. If a nonprofit corporation dissolves, the assets must be pledged to another recognized charity.³⁰ Regulation of nonprofit agencies is provided at both the state and federal level, although federal regulation is limited to the role of the Internal Revenue Service.

A. Federal Regulation and the IRS

Being a nonprofit corporation is distinct from having tax exempt status. The privilege of operating without paying certain State and Federal taxes is limited to select organizations, including those which provide the educational, charitable or religious services enumerated in Section 501(c)(3) of the Internal Revenue Code³¹ as well other cate-

28. The agencies may also be trusts, partnerships or unincorporated associations. *E.g.*, CAL. CORP. CODE § 5130 et. seq. (Deering 1993); ILL. REV. STAT. ch. 32, para. 125 § 2 (1993); TEX. REV. CIV. STAT. ANN. § 1396-50.01 (West 1993).

29. Often the state nonprofit regulations will recite the definition of I.R.C. § 501(c)(3) regarding the organization's charitable, educational, scientific or literary purposes. Some states, such as California, simply require "charitable purposes" and govern the different types of charitable purposes separately, including public benefit organizations, CAL. CORP. CODE. § 5111 (Deering 1993), mutual benefit corporations, CAL. CORP. CODE § 7111 (Deering 1993), and religious organizations, CAL. CORP. CODE § 9111 (Deering 1993). New York has four types of nonprofits, but classifies religious and other § 501(c)(3) organizations together as "Type B," which includes "charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals." N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) Type B (McKinney 1993). Other states separate charitable from religious (MINN. STAT. § 315 et. seq. (1993)) and still others treat all charities, including religious organizations, the same for state law purposes. *See further* ILL. REV. STAT. ch. 32, para. 103.05 (1993) (listing thirty types of nonprofit corporations under the same statute); PA. CONS. STAT. § 5301 (1993).

30. I.R.C. § 501(c)(3) (1993). Some state laws require a similar provision for all assets or for assets dedicated to a specific purpose, such as those "legally required to be used for a particular purpose ('cy-pres'-type assets)." N.Y. NOT-FOR-PROFIT CORP. LAW § 1005 (Revisor's Notes, Comment (a)) (McKinney 1993); ILL. REV. STATE. ch. 32, para. 112.16 (1993); MINN. STAT. § 317A.735 (1992); PA. CONS. STAT. § 5976 (1993).

31. Corporations, 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 sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), 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 (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. I.R.C. § 501(c)(3).

gories of more narrowly defined tax exempt organizations.³² Many types of organizations may be nonprofit and still not qualify for tax exempt status.³³ Federal regulation for the nonprofit sector is based on this tax exemption and limited to the corporation's taxable and non-taxable activities. An organization may lose its tax exempt status, but will not be forced into automatic dissolution as a result.³⁴

To achieve tax exempt status, an exemption application must be filed with the Internal Revenue Service and similar forms must be filed with the appropriate State tax authorities. The Form 990 tax return must be filed annually and must be available to the public at the office of the charitable agency.³⁵ A key element of the tax return is the detailed salary paid to each of the agency's top five employees.³⁶ Because such information is considered very sensitive, agencies are often less than forthright in disclosing the information included in the Form 990 or making the form available to the public. In "Warehouses of Wealth,"³⁷ a survey of 6,000 nonprofit agencies showed that many

32. The other organizations must meet certain criteria, including that the institution is not organized for profit and no part of the net earnings inures to the benefit of any private individual, and any benefits to individuals in such organizations are limited to the charitable purpose of the organization. Specific exemptions are available for the following: Civic leagues or local employee associations. § 501(c)(4); Labor, agricultural, or horticultural organizations. § 501(c)(5); Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues. § 501(c)(6); Clubs organized for pleasure, recreation, and other non-profitable purposes. §§ 501(c)(7), 501(c)(10); Certain fraternal beneficiary societies, orders, or associations. § 501(c)(8); Voluntary employees' beneficiary associations. § 501(c)(9); Teachers' retirement fund associations. § 501(c)(11); Certain benevolent life insurance associations. § 501(c)(12); Nonprofit cemetery companies. § 501(c)(13); Nonprofit credit unions. § 501(c)(14); Insurance companies other than life if the net written premiums for the taxable year do not exceed \$350,000. § 501(c)(15); Regulated crop financing corporations. § 501(c)(16); Selected trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits. §§ 501(c)(17), 501(c)(18); Military auxiliary units or societies. § 501(c)(19); Qualified legal services plan. § 501(c)(20); Qualified Black Lung Acts trusts. § 501(c)(21); Qualified multi-employer plans. § 501(c)(22); Certain veterans benefits association organized before 1880. § 501(c)(23); Qualified trusts under the Employee Retirement Income Security Act of 1974. § 501(c)(24); and certain corporations organized to acquire and hold real property for another § 501(c) organization. § 501(c)(25).

33. For example, social clubs which maintain written discrimination policies. I.R.C. § 501(i). Other general categories of companies which are not organized for private gain and are still ineligible for tax exempt status include political organizations and fraternal organizations which provide life or health insurance benefits.

34. See, e.g., *Incorporated Trustees of Gospel Workers Soc'y v. United States*, 510 F. Supp. 374 (D.C. Cir. 1981) *aff'd mem.*, 672 F.2d 894, *cert. denied*, 456 U.S. 944 (1982) (publisher lost tax exempt status for publishing religious literature after it stopped missionary work and limited its operation to publication of commercial, though religious, literature, retained large profits, and greatly increased employee salary).

35. I.R.C. § 6104(e)(1)(A)-(B) (1987). The Form 990 is also available from the IRS for public inspection. 26 C.F.R. 601.702 (1992). Certain organizations may be exempt from the Form 990 filing requirement, and churches (including certain religiously affiliated organizations) are precluded from filing. I.R.C. § 6033(a)(2) (1987).

36. *Id.*

37. *Warehouses of Wealth* was originally printed as a series of six articles in the Philadelphia Inquirer. The series has been collected and expanded into the upcoming paperback *Warehouses of Wealth: The Tax-Free Economy* by Gilbert Gaul and Neill Borowski, which is predicted to

agencies either omitted this information or found improper ways to discourage or eliminate the availability of the Form 990 to members and contributors.³⁸ The results of this survey indicate a continuing problem in achieving disclosure of the existing requirements.

Under current law, the enforcement powers of the IRS are limited. Assuming that errors or under-reporting do not rise to the level of criminal misconduct, the IRS has only the option of terminating the nonprofit tax status of the organization. Because this is such a drastic step, essentially the death penalty for the organization, the IRS is left with few alternatives. At the urging of Representative Pickle, the IRS Commissioner Margaret Milner Richardson is developing new restrictions aimed at nonprofit agencies. One of her priorities is a set of new sanctions in the form of a five percent excise tax, which would allow the IRS to penalize an organization without having to resort to challenging its tax exempt status.³⁹ While this suggestion may assist the IRS and resolve the dilemma faced by the agency, it will not address the central concerns of increasing efficiency, eliminating fraud and restoring public confidence.

Since the primary purpose of the IRS is to collect income for the government, it is not the best policing agency for charitable activities. Unfortunately, the IRS has earned this obligation by default. Although beyond the scope of this article, the role of the IRS as a federal police force deserves greater examination. In addition, if the excise tax evolves into a revenue source like the UBI Tax, it will become a potent tool for the IRS to use to raise income and penalize charities, a result which may not have been intended.

B. Traditional Forms of Corporate Regulation

All the traditional tools available for state regulation of business activities and control of criminal conduct are available to control the affairs of nonprofit corporations just as they are for any other business practice. Despite this, there remains a need for supplemental regulation in the nonprofit business sector.

The need for greater supervision over nonprofit agencies flows from the sources of corporate control available for the for-profit sec-

have the potential to do "to the non-profit sector what Sinclair's *The Jungle* did to the meatpacking industry." Bruce D. Collins, *So You Say You Want a Revolution? It's Coming*, Corporate Legal Times, Sept. 1993 at 6.

38. Gilbert Gaul and Neill Borowski, *Warehouses of Wealth*, PHILADELPHIA INQUIRER quoted in Bruce Collins, *Don't Try to Thwart Public Demand for 990 Disclosure*, Corporate Legal Times, July 1993 at 6.

39. McAllister, *Charities Scored supra*, note 18, at A4.

tor. While a variety of factors exist to control and monitor the conduct of business managers, there are five primary sources of corporate control: "(1) the proxy contest, (2) the takeover bid, (3) the derivative action, (4) public monitoring by the SEC and (5) the appraisal remedy."⁴⁰ Of these five primary mechanisms of corporate control, neither the takeover bid nor the appraisal remedy are available. As will be discussed below, the other mechanisms may also suffer in the translation into the nonprofit sector.

1. Absence of Appraisals and Take-Overs in Nonprofits

Both takeovers and appraisals are based on the financial stake of the shareholder. Unlike a shareholder, a donor cannot have any financial interest in the corporation.⁴¹ The articles of incorporation for every charitable agency require that all income is permanently dedicated to charity and that no dividends or other income⁴² be paid for the private gain of any individual.⁴³ As a result, there is no financial self-interest to protect for the members or donors of an organization. Money spent is gone. A disgruntled donor may refuse to renew her contribution, but with few exceptions, neither appraisal nor take-over remedies apply. Since there is no financial interest, no appraisal or other method of valuation can stop existing management from their course of conduct in and of itself.

2. Derivative Actions by the Nonprofit Membership

The derivative action allows shareholders to pursue rights of the corporation when the corporate board of directors has failed to do so. In both theory and practice, this remedy is available to any charity which operates under a membership structure. Subject to limits of state law, this cause of action will be available to provide standing for members of an organization to sue on the company's behalf.⁴⁴ The

40. WILLIAM KLEIN AND JOHN COFFEE, *BUSINESS ORGANIZATION AND FINANCE*, 177, Foundation Press (5th ed. 1993). The accountability mechanisms also include other methods, including fraud, state securities regulation, and shareholders' inspections. *Id.*

41. An exception to this general rule exists for those nonprofit organizations which have financed projects with debt securities sold to their members, such as charitable bonds. While such donors do not have an interest in the dividends or profits of the corporation, they do have an interest in the repayment of principal and interest. Such rights, however, do not give rise to an ownership stake in the company that could create a corporate takeover or result in an appraisal remedy.

42. Other than reasonable salary.

43. *E.g.*, CAL. CORP. CODE § 5130(b) (Deering 1993); ILL. REV. STAT. ch. 32, para. 112.16 (1993); N.Y. NOT-FOR-PROFIT CORP. LAW § 515(a) (McKinney 1993); PA. CONS. STAT. § 5551 (1993); TEX. REV. CIV. STAT. ANN. § 1396-1.02 (West 1993).

44. Such standing is not universally available to all donors of organizations. It is generally recognized that a member of an organization has the standing to sue derivatively on the corpora-

membership can use the derivative action to force a company to pursue rights such as collection of pledges or enforcement of contracts which the board of directors had elected not to pursue.

Such power disappears, however, if the charity is organized under a law which provides for non-membership agencies. Many corporations which have wide public support do not have an actual membership. In such cases, the standing to sue is further weakened or eliminated. In *Lewis v. Anclote Manor Hospital, Inc.*,⁴⁵ an employee and contributor was found to have no standing to bring derivative action on behalf of a nonprofit hospital against the board of directors for alleged improprieties and transactions which did not support its tax exempt status. Similarly, in *Louisiana World Exposition v. Federal Insurance Company*,⁴⁶ creditors sued the bankrupt company derivatively on the theory that any recovery by the corporation from its directors would go to the creditors since there was no membership. The court acknowledged the member's right to a derivative action but would not extend the right to the creditors. "Louisiana establishes a cause of action for breach of fiduciary obligations and mismanagement by corporate officers and directors who are grossly negligent in the performance of their duties. This cause of action, however, runs solely in favor of the corporation and its shareholders — or, in the case of a nonprofit corporation, the corporation and its members, if any."⁴⁷ The creditors of the bankrupt nonprofit corporation could not sue derivatively, and because the corporation had no membership, no outside party (except perhaps the state attorney general) would have standing to sue the board of directors.⁴⁸

Membership derivative suits are not a common or popular method of nonprofit regulation, but they serve an important purpose. The specter of judicial scrutiny adds a reminder to both the organization and the organization's board of directors that no one is free to violate the rights of the charity or its members. The lack of standing

tion's behalf. *E.g.*, *Kidwell ex. rel. Penfold v Meikle*, 597 F.2d 1273, 1288 (9th Cir. 1979) ("There are several means by which these beneficiaries' interests might possibly be protected, including (1) a class action; (2) a suit by the corporation, either directly or derivatively by members; and (3) a suit by a willing attorney general." However, the court found no such right to a derivative action by the directors themselves.) *See also*, *Kirtley v. McLelland*, 562 N.E. 2d 27 (1990) (member of nonprofit condominium cooperative had standing to bring derivative action against board of directors).

Such a right may be limited by statute. For example, under N.Y. NOT-FOR-PROFIT CORP. LAW § 623, the derivative plaintiff must represent 5% of the outstanding membership. *Hoffert v. Dank*, 55 A.D. 2d 518, 389 N.Y.S.2d 101 (1976).

45. 1987 U.S. Dist. LEXIS 16109 (M.D.FI 1987).

46. 858 F.2d 233 (5th Cir. 1988), *reh den'd* 864 F.2d 1147 (5th Cir. 1989).

47. *Id.* at 239.

48. 846 F.2d at 1153.

for non-membership organizations removes this possible scrutiny and the self-regulation it encourages.

3. The Proxy Fight and the Membership Meeting

For membership organizations, the proxy fight or the fight at the annual membership meeting may be the most effective mechanism to transfer control from one segment of the organization to another. Like the for-profit counterpart, voting battles are not particularly simple or efficient, except in comparison to litigation. Nonetheless, they serve an important function to encourage involvement and remind entrenched management that there exists a mechanism for corporate reform which may be invoked at any time.

The nonprofit battle at the ballot box will fare better than its for-profit counterpart. Shareholder democracy suffers from the ability of the shareholder to “vote with her feet” and sell rather than stay with a company to change the corporate course. A nonprofit member does not have that option. Unlike the shareholder who is primarily concerned with maximizing an investment, the donor is concerned with maximizing the impact of a contribution. While the member may elect to drop membership, there is no economic incentive to do so. The donor’s gift cannot be rescinded. The money spent on prior membership years will be lost, and a failure to remain involved has the effect of decreasing the importance or effectiveness of that membership. Therefore, the only way to maximize the gift is to become personally involved.

A second reason the nonprofit vote should be more effective than the for-profit version is that no single shareholder can control any block of votes. In the typical membership organization, every member is entitled to vote. While many charities have classes of membership, voting memberships are often granted to donors at either the lowest or at relatively low levels of support. Votes do not accrue to larger donors proportionally.⁴⁹ The largest shareholder of a for-profit corporation can dominate the board of directors, but no member can dominate the vote of the membership (at least not as directly). Since “one-person, one-vote” governs most membership organizations, an

49. This does not suggest that influence may not be increased by increasing the size of the donation. The professional staff at any charity can be expected to give the largest donors a tremendous amount of deference and respect with regard to the wishes those donors have for their funds. There is nothing implicitly improper in this. A donor may have a right to say how the charitable donation is used and is often solicited for specific purposes. Voting rights, however, are not generally granted as a function of donation size. As a result, the large donor does not carry the same amount of clout or control as the large shareholder in a for-profit corporation.

organized segment of the corporation can sway votes on those matters properly before the membership.

The question remains, however, as to what may motivate a non-profit membership to take matters into its own hands. Instead of share prices as a motivating factor, the typical membership will be roused from its complacency only when contributions are down or services are no longer being provided.

Reductions in contributions may be caused by general inefficiency, a sudden loss of credibility with the public, or the disaffection of key contributors. If credibility is suddenly eroded, the cause of the erosion may also motivate the membership to take matters into its own hands.

It must be noted that the relationship between the members, the board of directors and the officers may be different than that of for-profit shareholders with their boards of directors and officers. While most for-profit directors are "insiders," officers or shareholders with a financial stake, nonprofits are structured slightly differently. The board of directors in a well organized charity will have a majority of volunteer board members.⁵⁰ Only a minority of the board will be professional, paid staff members. At the membership meeting, the composition of the board of directors can be changed, but the employment of the professional officers will not be directly addressed. New volunteer leadership may have the desired impact of changing the nature of the professional operations, but a risk remains that no effective changes can be implemented by new volunteer leadership without completely removing the existing professional staff.

The second cause of dissatisfaction results from a lack of services coming from the charity. In no place is this more evident than in the health care industry. Throughout the country, eyebrows are being raised and legislation written to address the problem of nonprofit hospitals which continue to receive significant tax benefits while no longer providing any significant charitable health services.

In a recent editorial in the *Boston Globe*, Boston area hospitals were castigated for financial practices which grossly understated their reserves while these same hospitals cut back on services to the needy, the uninsured and inner-city communities.⁵¹ Boston is not alone.

50. Occasionally, this may be the result of state law as well. The board must be comprised of a majority of disinterested directors under the California public benefit corporations statute. CAL. CORP. CODE § 5227 (Deering 1993). This restriction applies only to public benefit corporations and does not apply to mutual benefit and religious corporations.

51. *The Wealth of Hospitals*, *Boston Globe*, May 9, 1993 at A6 (editorial). The editorial cites a study by Nancy Kane of the Harvard School of Public Health which identifies "enormous

In Texas, the battle has gone one step further. A court fight won by the local hospital was lost to new state law. The Methodist Hospital in Houston won a court victory, after the Texas Attorney General brought an action to have the hospital's tax exempt status revoked.⁵² The trial court held that the use of the charity's reserves were not at issue and the hospital was within the applicable charitable guidelines.⁵³ Methodist Hospital lost the war, however, and on September 1, 1993 a new revenue statute went into effect which requires that nonprofit hospitals donate a proportion of their income to indigent care or other community benefits.⁵⁴ According to Texas Attorney General Dan Morales, the statute "holds nonprofit hospitals accountable to the public for the millions of dollars in tax-exemptions they receive."⁵⁵ Morales agreed not to appeal the Methodist Hospital decision after the hospital obligated itself to begin making payments to the indigent care fund immediately.⁵⁶

Hospitals and other charities are fighting similar battles throughout the country. In *School District of the City of Erie v. Hamot Medical Center*,⁵⁷ Erie, Pennsylvania successfully challenged the hospital's real estate tax exemption. Hamot Medical is a large hospital and either directly or through related companies, it owns the local marina, a senior housing project and substantial real estate.⁵⁸ The court reviewed an extensive record, and rejected Hamot Medical's claim to a continued tax exemption because the hospital operated on a profit-motive basis.⁵⁹ The court rejected the argument that the hospital provided charity through its community education and its health care for the needy. "Hamot's community education programs and giveaways were nothing but "loss-leaders" offered to attract customers for higher

financial resources in some [Boston] area hospitals." According to the editorial, "[t]he sums cited are so vast that they warrant analysis by a select government commission."

52. *Texas v. Methodist Hosp.*, (No. 494, 212) (1993).

53. Sandy Lutz, *Charity Care and the Law: Methodist Hospital of Houston Wins a Round in the Tax Exemption Fight, but Not-For-Profits Face More Challenges from State, Local Governments*, Mod. Health Care, March 8, 1993 at 26.

54. 1993 TEX. GEN. LAWS § 360. The new law provides: "A nonprofit hospital shall provide health care services to the community and shall comply with all federal, state and local government requirements for tax exemption in order to maintain such exemption. These health care services to the community shall include charity care and government-sponsored indigent health care and may include other components of community benefits . . ." TEX. ALS § 360-311.043. The law also requires that the hospital have an indigent admission policy and a community-wide needs assessment. TEX. ALS 360-311.044 (1993).

55. Daniel Moskowitz, *Strapped Governments Eye Nonprofit Hospitals*, Med. and Health, Aug. 1, 1993.

56. *AG, Methodist Hospital Reach Agreement*, Texas Lawyer, June 7, 1993 at 46.

57. 602 A. 2d 407 (Pa.Cmwlt. 1992).

58. *Id.* at 410.

59. *Id.* at 414.

paying items," the court found.⁶⁰ Regarding the claim of indigent care, the court chided the hospital that it "accepts defeat only after collection and execution processes fail to yield fruit. [Hamot's] charity is determined when the debt is deemed uncollectible, not prospectively upon admittance."⁶¹ Due in large part to the commercial attitude found at the hospital, the organization was required to pay local real estate taxes.

The results of this growing public perception are causing state officials to take action, but in membership organizations they can also provide an incentive for an aggressive reassessment by the membership. The same cannot be said for the non-membership organization. For hospitals which have no "membership," the lack of standing to bring a derivative suit⁶² results in the same lack of proxy-type control of the board of directors. There is no one with standing to vote against the incumbent's policies of increasing wealth and decreasing services. It should be noted, however, that the health care industry is somewhat unique in the current national debate on the role of non-profit and for-profit providers. The perceived evils of hospital economics is part of the larger call for health care reform. As an industry under intense scrutiny, salaries and services are being watched more closely than in any other industry today.

Whatever the industry, for serious misconduct to take place, both the paid staff and the volunteer leadership must be implicated. Either through active participation, or through failure to become aware of the operations of the organization, both lay leadership and professional leadership must have a hand in the wrongdoing. Once the improprieties have become public knowledge, the membership can act to remove the old board of directors and bring in "reformers" who will work to renew the organization. To be effective, however, this action must be taken quickly and decisively before all public goodwill has been eroded.

All of the proxy and derivative action mechanisms are contingent on the activity of the interested membership. While this is a valid mechanism when available, many organizations are formed without a membership or other voting population. Instead, the board of directors nominates and elects the subsequent board of directors. This relationship has obvious self-dealing implications. A board comprised of self-selecting directors can perpetuate itself without concern that

60. *Id.*

61. *Id.*

62. *See generally*, Lewis, 858 F.2d 233 n. 46 and accompanying text.

donors will rebel and throw them out. Just as the lack of a membership creates a lack of standing to sue on the part of donors to redress the wrongs suffered by the corporation,⁶³ the lack of an annual membership meeting and the right of interested members to call special meetings eliminates any self-regulatory mechanism from the nonprofit agency.

For the membership agency, however, membership meetings should serve to increase the visibility of issues and encourage more frank and open discussions. In these organizations, the existing mechanism should be encouraged, and new suggestions for nonprofit governance can utilize this existing protection to further encourage the charity's responsibility to the community.

4. Existing State Regulation

Because of the lack of traditional corporate governing controls for non-membership charities, state regulation has become the primary source of nonprofit control. State regulation takes the place of the corporate securities regulation,⁶⁴ and serves to add an additional layer of protection to the public. Much of this regulation has centered on the methods of fundraising and the role of professional fundraising solicitors or consultants. As the Attorneys General for the states of Maine and Connecticut explain in the *Amici Curiae* brief for *Riley v. National Federation of the Blind*,⁶⁵ “[S]tate regulation of charitable solicitations generally serves one of two (or perhaps both) strong state interests: the prevention of fraud by charities and professional fundraisers and the dissemination of information to potential donors so they can make informed decisions as to whether to contribute.”⁶⁶ In this way, the state regulation serves as a replacement for traditional securities laws at both the state and federal level. Federal securities regulations govern the dissemination of full and fair disclosure of material information,⁶⁷ while state securities laws, in the form of “blue

63. See note 45, *supra*, and accompanying text.

64. See note 70, *infra*.

65. 487 U.S. 781 (1988). See *Riley*, *infra* at 93.

66. Brief of the *Amici Curiae*, States of Maine and Connecticut in Support of Appellants, *Riley v. Lighthouse for the Blind of North Carolina*, 487 U.S. 781 (1988) (No. 87-328) (hereinafter “Maine Brief”).

67. The Securities Act of 1933 was formulated under the philosophy espoused by Justice Louis Brandeis that “sunshine is said to be the best of disinfectants; electric light the most efficient policeman.” Larry Soderquist, UNDERSTANDING THE SECURITIES LAWS 2 (Practicing L. Inst. 2d Ed. 1990), citing Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959). Such disclosure may be indirect in nature. Such disclosure serves a remedial purpose of holding the transaction up to the light of scrutiny, even if such disclosure only serves to “push issuers to fair, honest transactions.” *Id.* at 103.

sky laws," regulate the substantive fairness of the offering.⁶⁸ The logic behind this two-pronged regulatory scheme has led states to create statutes which requires both substantive review of the charity's financial structure and full disclosure to the potential donor regarding the solicitation fees.

In pronouncing a new statutory scheme for regulation of charitable solicitation, the California legislature's statement of findings establishes a clear goal for the most recent types of state legislation:

The [California] Legislature finds that there exists in the area of solicitations and sales, solicitations for charitable purposes a condition which has worked fraud, deceit and imposition upon the people of the state which existing legal remedies are inadequate to correct. Many solicitations or sales solicitations for charitable purposes have involved situations where funds are solicited from the citizens of this state for charitable purposes, but an insignificant amount, if any, of the money solicited and collected actually is received by any charity. The charitable solicitation industry has a significant impact upon the well-being of the people of this state.⁶⁹

These findings state the fundamental presumption of a large number of states that fundraising, in general, and professional solicitation, in particular, are a growing source of fraud which is seemingly immune from traditional fraud statutes.⁷⁰ Many of these laws take the form of permit requirements and disclosure of fundraising activities prior to the commencement of fundraising.⁷¹ In *Schaumburg v. Citizens for a Better Env't*,⁷² a local permit requirement was challenged before the United States Supreme Court because the permit requirements "among other things, contain '[s]atisfactory proof that at least seventy-five percent of the proceeds of such solicitations will be used

68. The purpose of blue sky regulation "is to protect stockholders and the investing public generally from fraudulent and worthless securities, and also, to some extent, to protect persons dealing with, and creditors of, the corporations. 11 WILLIAM M. FLETCHER, FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5158 (perm. ed. rev. vol. 1990) (citations omitted).

69. CAL. BUS. & PROF. CODE § 17510(a) (West 1987).

70. For a comprehensive overview of state regulatory schemes, See Ellen Harris, Lynn S. Holley & Christopher J. McCaffrey, *Fundraising into the 1990's: State Regulation of Charitable Solicitation after Riley*, 24 U.S.F. L. REV. 571 (Summer 1990).

71. E.g., CAL. BUS. & PROF. CODE § 17510.3 (West 1987 & Supp. 1993); MINN. STAT. § 309.556 (1984); N.Y. EXEC. LAW § 174-b & § 174-c (McKinney 1993); N.M. STAT. ANN. § 57-22-8 (Michie 1987); N.C. GEN. STAT. § 31c-16.1 (Supp. 1993); OR. REV. STAT. § 128.836 (1990); R.I. GEN. LAWS § 5-53-3.2 (1987).

The Illinois statute provided "[e]very charitable organization . . . which solicits or intends to solicit contributions from any person in the State by any means" must file a registration statement with the Illinois Attorney General. ILL. REV. STAT. ch. 23, para. 5102(a) (1977). This statute was declared unconstitutional in *Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620, 624 n.5 (1980). See following note and accompanying text.

72. 444 U.S. 620 (1980).

directly for the charitable purpose of the organization.’”⁷³ Citizens for a Better Environment, a nonprofit environmental group, challenged the ordinance on First and Fourteenth Amendment grounds after the Village of Schaumburg (“Village”) denied the permit on the grounds that CBE could not demonstrate that seventy-five percent of its fundraising actually went to charitable purposes. The Court quoted the 1939 case of *Schneider v. State*,⁷⁴ to establish the tradition that First Amendment protection attached to house-to-house canvassing and solicitation, “holding that the city could not, in the name of preventing fraudulent appeals, subject door-to-door advocacy and the communication of views to the discretionary permit requirement.”⁷⁵ The Court focused on the importance of the message presented by the solicitor during the solicitation:

Soliciting financial support is undoubtedly subject to reasonable regulation but the latter must be undertaken with due regard for the reality that solicitation is characteristically intertwined with informative and perhaps persuasive speech seeking support for particular causes or for particular views on economic, political, or social issues, and for the reality that without solicitation the flow of such information and advocacy would likely cease. Canvassers in such contexts are necessarily more than solicitors for money.⁷⁶

Thus, the Court recognized that the solicitation process is part of the charitable activity, the activity of disseminating information regarding the charity and the importance of its objectives within the community. The Court then reviewed the requirement that seventy-five percent of all funds raised go directly to the charitable purposes and found that this requirement was “a direct and substantial limitation on protected activity.”⁷⁷ The Village urged that it had an obligation to protect the public from “fraud, crime and undue annoyance,” but the Court found that this concern was only “peripherally” addressed by the seventy-five percent limitation and struck down the ordinance as overbroad.⁷⁸

Despite the clear language in *Schaumburg*, cities and states continued to try restricting the fees paid to professional fundraisers to a “reasonable” amount below 20 to 25 percent of the funds received. The Supreme Court has since addressed this issue twice more. In *Sec-*

73. *Id.* at 624 (quoting SCHAUMBURG VILLAGE CODE ch. 22, § 22-20(g) (1975)).

74. 308 U.S. 147 (1939).

75. 444 U.S. at 628 (citing *Schneider*, 308 U.S. at 163-165).

76. *Id.* at 632.

77. *Id.* at 636.

78. *Id.*

retary of State of Md. v. Joseph H. Munson Co.,⁷⁹ the Court reviewed a Maryland statute which prohibited a charity from paying more than twenty-five percent of the gross income raised during a solicitation to the professional fundraiser.⁸⁰ The Court reviewed *Schaumburg*, explaining that the goal of preventing fraud was not accomplished by capping the percentage of funds raised which could go to the professional solicitors.⁸¹ "The justification for the limitation was an assumption that any organization using more than 25% of its receipts on fundraising, salaries, and overhead was not charitable, but was a commercial, for-profit enterprise. Any such enterprise that represented itself as a charity thus was fraudulent."⁸² The Court then went on to reject this argument, pointing out that one of the factors increasing the costs of solicitation was the expense involved in "dissemination of information, discussion, and advocacy of public issues, an activity clearly protected by the First Amendment."⁸³

Unlike *Schaumburg*, the Maryland statute at issue in *Munson* provided an administrative waiver of the 25% limitation if the charity could demonstrate financial necessity.⁸⁴ The Court rejected this modification as a sufficient remedy and again rejected the "mistaken premise that high solicitation costs are an accurate measure of fraud."⁸⁵

The Supreme Court addressed yet another statute which regulated the fees paid to professional solicitors in *Riley v. National Fed'n of the Blind of N. C.*⁸⁶ Again the Court overturned a state statute which regulated the fees paid to professional solicitors.⁸⁷ The North

79. 467 U.S. 947 (1984).

80. *Id.* at 950, n.2. (citing MD. LAWS, ch. 787 (1982), § 103D(a)) provided:

A charitable organization other than a charitable salvage organization may not pay or agree to pay as expenses in connection with any fundraising activity a total amount in excess of 25 percent of the total gross income raised or received by reason of the fundraising activity. The Secretary of State shall, by rule or regulation in accordance with the 'standard of accounting and fiscal reporting for voluntary health and welfare organizations' provide for the reporting of actual cost, and of allocations of expenses, of a charitable organization into those which are in connection with a fund-raising activity and those which are not. The Secretary of State shall issue rules and regulations to permit a charitable organization to pay or agree to pay for expenses in connection with a fund-raising activity more than 25% of its total gross income in those instances where the 25% limitation would effectively prevent the charitable organization from raising contributions.

81. 467 U.S. at 961.

82. *Id.*

83. *Id.*

84. See n. 80, *supra*.

85. 467 U.S. at 966. In the accompanying footnote the Court referenced the state legislative purpose clause that the regulations "assure that contributions will be used to benefit the intended purpose." *Id.* at n.14. "The State's justification therefore may be read as an interest in preventing mismanagement as well as fraud. The flaw in the statute, however, remains. The percentage limitation is too imprecise a tool to achieve that purpose." *Id.*

86. 487 U.S. 781 (1988).

87. *Id.* at 803.

Carolina statutory scheme appears to have responded to the rhetoric in *Schaumburg* and *Munson* by regulating the percentage of income received by professional solicitors with a more narrowly-tailored, three-tiered standard of reasonableness. A fee paid to professional solicitors of under 20% was automatically considered reasonable; a fee of 20% to 35% would be deemed unreasonable "if the party challenging the fund-raising fee also proves that the solicitation does not involve the dissemination of information, discussion or advocacy relating to public issues;"⁸⁸ and a fee in excess of 35% was presumed unreasonable, but this presumption could be overcome if the professional solicitor could "successfully defend" the fee because it involved advocacy, information or dissemination, or because the fee was necessary financially to allow the charity to raise money.⁸⁹ This regulatory scheme provided for a more finely-tuned mechanism for determining reasonableness of the solicitor's fee, but such reasonable-

88. N.C. GEN. STAT. § 131C-17.2(c) (1986).

89. 487 U.S. at 784, 785. The statute in question provides: "Any person who acts as a professional fund-raising counsel or professional solicitor shall apply for and obtain an annual license from the Department, and shall not act as a professional fund-raising counsel or professional solicitor until after obtaining such license. A person who is authorized to act on behalf of a licensed professional fund-raising counsel or a licensed professional solicitor is not required to obtain a license under this section." N.C. GEN. STAT. § 131C-6 (1986).

The regulations regarding reasonable fees are as follows:

"(a) No professional fund-raising counsel or professional solicitor who contracts to raise funds for a person established for a charitable purpose may charge such person established for a charitable purpose an excessive and unreasonable fund-raising fee for raising such funds.

"(b) For purposes of this section a fund-raising fee of twenty percent (20%) or less of the gross receipts of all solicitations on behalf of a particular person established for a charitable purpose is deemed to be reasonable and nonexcessive.

"(c) For purposes of this section a fund-raising fee greater than twenty percent (20%) but less than thirty-five percent (35%) of the gross receipts of all solicitations on behalf of a particular person established for a charitable purpose is excessive and unreasonable if the party challenging the fund-raising fee also proves that the solicitation does not involve the dissemination of information, discussion, or advocacy relating to public issues as directed by the person established for a charitable purpose which is to benefit from the solicitation.

"(d) For purposes of this section only, a fund-raising fee of thirty-five percent (35%) or more of the gross receipts of all solicitations on behalf of a particular person established for a charitable purpose may be excessive and unreasonable without further evidence of any other fact by the party challenging the fund-raising fee. The professional fund-raising counsel or professional solicitor may successfully defend the fund-raising fee by proving that the level of the fee charged was necessary:

"(1) Because of the dissemination of information, discussion, or advocacy relating to public issues as directed by the person established for a charitable purpose which is to benefit from the solicitation; or

"(2) Because otherwise ability of the person established for a charitable purpose which is to benefit from the solicitations to raise money or communicate its ideas, opinions, and positions to the public would be significantly diminished.

"(e) Where the fund-raising fee charged by a professional fund-raising counsel or professional solicitor is determined to be excessive and unreasonable, the fact finder making that determination shall then determine a reasonable fee under the circumstances. The difference between the fee charged and the reasonable fee as determined by the fact finder shall be paid by professional fund-raising counsel or professional solicitor to the person established for a charitable purpose which initially was charged the excessive and unreasonable fee." N.C. GEN. STAT. § 131C-17.2 (1986).

ness remained relevant only if the Court was willing to accept that there exists a direct relationship between the money raised and the percentage which is used for charitable purposes. Again the statute was based on this hypothesis, despite its having been twice rejected by the Court.

The Court in *Riley* reiterated its rejection of this argument. The majority was unimpressed by arguments that the fees paid to professional solicitors bore any direct relation to the protection of the public against fraud.⁹⁰ The Court went further to discourage the notion that the hearing process reduced the burden on speech. The costs of the hearing process, the uncertainty of the outcome in a particular case, the vagueness of the standard under which the burden is placed on the fundraisers to establish reasonableness, and the potential for litigation all serve to increase rather than decrease the negative impact on the First Amendment right of the charities.⁹¹

The Court also rejected the North Carolina argument that the state has an interest in ensuring that the maximum amount of funds reach the charity.⁹² The Court characterized this interest as paternalistic; a role which the Court has often rejected in cases involving First Amendment rights of free speech. “[T]he government, even with the purest of motives, may not substitute its judgment as to how best to speak for that of speakers and listeners; free and robust debate cannot thrive if directed by the government.”⁹³

The second prong of *Riley* stands out as equally important, and raised issues not addressed in either *Schaumburg* or *Munson*. The North Carolina statute called for mandatory disclosure at the time of the solicitation. The disclosure required the solicitor’s name, the name and address of the professional solicitor’s employee or fundraising counsel, and the “average of the percentage of gross receipts actually paid” to the charity in the past 12 months.⁹⁴

90. 487 U.S. at 788-789.

91. *Id.* at 794.

92. *Id.* at 789-790.

93. *Id.* at 791.

94. The North Carolina statute provides:

“During any solicitation and before requesting or appealing either directly or indirectly for any charitable contribution a professional solicitor shall disclose to the person solicited:

“(1) His name; and

“(2) The name of the professional solicitor or professional fund-raising counsel by whom he is employed and the address of his employer; and

“(3) The average of the percentage of gross receipts actually paid to the persons established for a charitable purpose by the professional fund-raising counsel or professional solicitor conducting the solicitation for all charitable sales promotions conducted in this State by the professional fund-raising counsel or professional solicitor for the past 12 months, or for all completed

Since requiring speech the speaker would not have otherwise made is presumed to alter the speech, mandatory disclosure is a form of content-based speech regulation.⁹⁵ The State did not argue that this is not content-based regulation, but that the standard applied should be the “more deferential standard” applied to commercial speech. The Court rejected this analysis.⁹⁶

The standard to apply in speech regulation is the totality of the speech “taken as a whole and the effect of the compelled statement thereon.”⁹⁷ As in *Schaumburg*, parts of the solicitation cannot be dealt with separately from other parts. The request for funds and the dissemination of information are inexorably linked, the fundraising “intertwined with informative and perhaps persuasive speech.”⁹⁸ The standard of review must be applicable to the entire content of the speech, rather than to one segment of the communication. As a result, the disclosure requirement must be viewed as a content-based regulation and as applied is unduly burdensome and not narrowly tailored to meet the state need to protect potential donors from abuses by professional solicitors.⁹⁹

The result of this trilogy of Supreme Court case law has been to eliminate existing state mechanisms or require substantial revision of many of the state statutes regarding disclosure and solicitation fees. Although it has been over twelve years since *Schaumburg* was first decided, the effects of *Riley*, *Munson*, and *Schaumburg* are only beginning to be felt throughout the country. Many of the most publicized abuses in the nonprofit sector, however, have come after *Riley*, and the public sentiment remains strong that something must be done. Whatever that “something” is, it must directly address the two First Amendment concerns expressed by the Supreme Court in *Riley*: (i) that the regulation cannot connect reasonableness with the fees paid to professional solicitors; and (ii) that the state cannot mandate any disclosure as part of the solicitation process.

charitable sales promotions where the professional fund-raising counsel or professional solicitor has been soliciting funds for less than 12 months.” N.C. GEN. STAT. § 131C-16.1 (1986).

95. *Id.* at 795 (citing *MIAMI HERALD PUBLISHING CO. v. TORNILLO*, 418 U.S. 241, 256 (1974)) (“statute compelling newspaper to print an editorial reply ‘exact[s] a penalty on the basis of the content of a newspaper’”).

96. *Id.* at 795-796.

97. *Id.* at 796.

98. *Id.*, (quoting *Schaumburg*, 444 U.S. at 632).

99. *Id.* at 798.

III. HOME REMEDIES FOR CHARITABLE REGULATION

Whether accomplished by state or federal legislation, action must be taken to address the perception problem charities are facing with the public, while effectively combating the increasing fraud which is alarming both the public and the state governments. The solution must also comply with *Riley*, not only because *Riley* will now serve as a threshold test for appropriateness of legislative action, but because the Supreme Court's concerns in *Riley* accurately assess the impact of poorly tailored legislative efforts at curtailing professional fundraising.

Equally important, the solutions developed must be acceptable to the vast number of well-run, respected charities. Over sixty organizations filed as Amici Curiae in support of the Lighthouse for the Blind in *Riley*, and these briefs included a large number of law enforcement associations as well as other highly regarded public charities.¹⁰⁰ These

100. The Brief of Amici Curiae Alabama Sheriffs' Association et. al. in support of Appellees at 1, *Riley v. National Federation of Blind*, 487 U.S. 781 (1988) (No. 87-328) included: Alabama Sheriffs' Association, Colorado Professional Fire Fighters, Combined Law Enforcement Associations of Texas, Florida Association of State Troopers, Inc., Florida Peace Officers' Association, Florida Police Benevolent Association, Fraternal Order of Police California State Lodge, Fraternal Order of Police Colorado State Lodge, Fraternal Order of Police Louisiana State Lodge, Fraternal Order of Police Illinois State Lodge, Fraternal Order of Police Nebraska State Lodge, Fraternal Order of Police Ohio, Inc., Fraternal Order of Police Virginia State Lodge, Georgia State Firemen's Association, Iowa State Troopers' Association, Maryland Sheriffs' Association, Michigan State Fire Fighters Union, Minnesota State Patrol Troopers Association, Missouri Peace Officers' Association, Missouri State Troopers' Association, Inc., Nebraska Professional Fire Fighters Association, Nevada Highway Patrol Association, Ohio Association of Professional Fire Fighters, Ohio Troopers' Coalition, Inc., Peace Officers' Association of Georgia, Tennessee Law Enforcement Officers' Association, Virginia State Sheriffs' Association, Virginia State Association of Professional Fire Fighters, Wisconsin Law Enforcement Officers' Association, Wisconsin Troopers' Association, Inc..

The Brief of Amici Curiae Independent Sector, American Cancer Society, American Red Cross, Care, Inc., Certain Other Independent Sector Members and Other Nonprofit Organizations in Support of Appellees at 1, *Riley v. National Federation of Blind*, 487 U.S. 781 (1988) (No. 87-328) included: Independent Sector Members, AAUW Educational Foundation, Aid Association for Lutherans, American Association of Fund-Raising Counsel, Trust for Philanthropy, American Cancer Society, American Committee on Africa, American Diabetes Association, American Foundation for the Blind, American Institute for Cancer Research, American Leadership Forum, American Lung Association, American Red Cross, American Social Health Association, Arthritis Foundation, Association of Governing Boards of Universities and Colleges, Asthma and Allergy Foundation, CARE, Inc., The Carroll Center for the Blind, Catholic Charities, USA, Center for Creative Management, Chorus America, The Committee for Healing Community, Huntington's Disease Society of America, Institute for Nonprofit Organization Management, International Association of Psycho-Social Rehabilitation Services, Lutheran Resources Commission, March of Dimes Birth Defect Foundation, National Alliance for the Mentally Ill, National Association of Homes for Children, National Association for Hospital Development, National Council for International Visitors, National Council for Research on Women, National Easter Seal Society, Inc., National Health Council, National Institute for Dispute Resolution, National Multiple Sclerosis Society, National Society to Prevent Blindness, National Sudden Infant Death Syndrome Foundation, Inc., National Training & Information Center, Native American Rights Fund, NOW Legal Defense & Education Fund, Order Women's League, Opportunities Industrialization Centers of America, Planned Parenthood Federation of America, Inc., Support Centers of America Theatre Communications Group, United Board for Christian Higher Education in Asia, World Wildlife Fund/The Conservation Fund,

police association and other charities will welcome efforts which reduce fraud and boost community confidence. Effective regulation will serve the community-minded charities as well as the state regulators, while ineffective or counterproductive regulation will continue to fuel the conflict between the state officials and the fundraising professionals, further eroding public confidence as a result of the debate.

The Court decision in *Riley* should serve as a starting point for developing the most reasonable mechanism to curtail fraud and improve public perception: The potential donors.

A. *Membership for All Organizations*

In an ideal world, nonprofit organizations would not require greater regulation than for-profit corporations. Optimists would argue that even today, the majority of charitable organizations are run by public-minded individuals, and that these organizations actually need far less regulation than do their for-profit counterparts. The optimists may be right but, even so, some effective regulatory tools are necessary. As discussed in Part II, Section D., nonprofits have a greater need for some form of additional regulation since so few of the for-profit self-regulatory mechanisms are available in the nonprofit, non-membership organization.

A membership requirement or creation of a statutory membership category would instantly create a self-selecting police force of individuals who have a vested interest in the organization but who currently have no voice. Necessary governance issues including proper management, efficiency, purpose and scope of the organization would have an appropriate body to address these issues.

The membership should be treated like the shareholders in a for-profit organization. Absent good faith or in the case of exceptionally bad judgment, a director will be responsible to the corporation and to the membership. A board of directors acting in good faith will remain under the doctrine of the "Business Judgment Rule" and be protected from interference by the membership.¹⁰¹

YWCA of USA National Board. Other Nonprofit Organizations joined in the brief include Americans for Indian Opportunity, National Hemophilia Foundation, Nurses House, Inc., Public Voice for Food and Health Policy, Religious Coalition for Abortion Rights, and Tourette Syndrome Association, Inc.

101. *Stern v. Lucy Webb Hayes Nat. Train. Sch. for Deacon. & M.*, 381 F. Supp. 1003 (D.C. Cir. 1974) (business judgment rule and the duty of care is applicable for nonprofit directors, but such directors must exercise good faith and reasonable care to avoid liability); *cf. Christiansen v. National Sav. and Trust Co.*, 683 F.2d 520 (D.C. Cir. 1982) (holding that director's duties run to corporation and not to beneficiaries of the organization).

The business judgment rule stems from the well established business principle that the board of directors is vested with the rights and duties of corporate management, that the directors must act in good faith, and with some standard of reasonable care.¹⁰² "The rule itself 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"¹⁰³

The business judgment rule does not protect directors from liability based on fraud, self-dealing or conflicts of interest. Many state statutes include procedures for dealing with situations involving conflicts of interest. Such rules require a majority vote of disinterested directors to approve of any transaction involving a financial conflict of interest. Prior to the vote, all material facts must be disclosed and the transaction must be fair and in the interests of the corporation.¹⁰⁴ A director must follow these statutes to be insulated from personal liability. Otherwise, the self-dealing director can be held personally liable for the damages to the corporation.

In this way, the legal presumptions and well developed body of corporate law will guide the relationship between members and the board of directors. The application of the duty of care and duty of loyalty already works for existing membership organizations, and nothing seems to indicate that this structure would not provide the same results for existing nonprofits which were encouraged to open up a membership structure.

An alternative to a required membership category would be a "statutory membership" category. For non-member organizations, the state could designate that existing donors may be treated as members for state law purposes. This would provide standing to sue in the case of membership derivative suits and require reporting to these statutory members under state reporting requirements.¹⁰⁵

Giving standing to a major contributor to an organization has a strong nexus to the issue of accountability and reduction of fraud. The individual who stands the greatest chance of being injured has the best opportunity to stop the injury or sue for redress. Taking a cue

102. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Some nonprofit corporate statutes include statutory definitions of the duty of care and loyalty. *E.g.*, CAL. CORP. CODE § 7231 (Deering 1993); KY. STAT. ANN. § 273.215 (1988); N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 1993); 15 PA. CONS. STAT. § 5715(A) and (D) (1993).

103. *Id.*, quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

104. *E.g.* ILL. C.S. ANN. CH. 805 ILCS 105/108.60 (1993); MINN. STAT. § 317A.255 (1992); N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 1993).

105. *See infra* part 2.

from the professional solicitors, the statutory membership could be set as a minimum percentage of existing donors with the largest financial stake in the organization. A general rule of thumb in the fundraising community is that twenty percent of the donors contribute eighty percent of the revenue.¹⁰⁶ Following this rule, state or federal legislation can mandate that in non-member organizations, any donor who has made contributions which would put that donor in the upper twenty-percent of donors would have the same rights to standing as if that contributor were a member of the organization.

A statutory membership which entitled all of the contributors in the upper twenty percent of giving to have standing in the case of a derivative action may create more reform than any of the other actions proposed to date. As has been shown with for-profit corporations, the role of outsiders is not so much to aggressively stop improper activity, as to remind the key leadership that there is someone who has the right to review the operations. Such review actively discourages self-dealing and provides a mechanism to redress such wrongs if they occur.

Well run organizations will turn this burden into a benefit. As statutory members, these donors may be treated with more regard. Increased attention and involvement should lead to a healthier organization with a stronger level of public support.

A necessary element of such change is greater protection from personal liability to the officers and directors, particularly the volunteer directors. For those situations in which no self-dealing is established, damages should be limited to injunctive relief and rescission. The officer or director should be indemnified and protected from personal liability unless the individual personally committed misconduct. The purpose of the contemplated changes must be to encourage better government of our charitable institutions. If a side effect of new regulations creates a strong disincentive to serve with a charity, the pur-

106. Telephone Interview with Gary Tobin, Director of The Cohen Center for Jewish Studies at Brandeis University (October 14, 1993). The figure of twenty percent is an approximation of financial information gathered from years of fundraising by major umbrella organizations such as United Jewish Appeal and United Way. Such a guide should serve only as a starting point for legislative hearings on the development of a formula for determining the minimum number of donors or minimum percentage of donors which will have sufficient impact to serve a regulatory function.

The actual number may not have to be very large to become effective. As seen in the securities industry, the number of people who actually read a prospectus prior to purchasing securities is not large, but the process of preparing the information, the knowledge that the information is public and the impact the disclosure has if improperly done all serve to make securities disclosure extremely effective. LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 103 (1990), *supra*, note 67.

pose of the rules are undermined. The instances of fraud will involve the necessary self-dealing to provide for personal liability against the wrongdoer.¹⁰⁷ Opening the board of directors to all forms of tort liability will undermine the purpose of these proposals, discourage voluntarism and risk encouraging speculative lawsuits which would further erode public confidence in otherwise well-managed charities.

Granting voting rights to statutory members of charities would further strengthen the self-enforcement principle being suggested. Members are involved in the organization and overall policies of their agencies. To receive an annual meeting notice, to review the names of the proposed slate of officers and directors, and to participate in the democratic process that would come to the organization cannot help but encourage the members and result in a more responsive charity, committed to the needs of the community.

Organizations which object to giving voting rights to only select donors can expand voting rights to all donors, or to all donors over any minimum threshold set by the organization. The statutory scheme should establish that the upper twenty percent of donors be guaranteed voting rights, but that the organization may expand voting rights quite broadly, in whatever manner the agency deems to be in the best interest of the organization. This democratization of charitable life will force insulated leadership to come out of the back rooms and address the organization's concerns directly before the charity's interested constituency.

The state need only become involved in those (hopefully) rare instances where the charity tries to avoid its obligations to its newly democratized population. This solution allows the state, the agency and the donor to all benefit without running afoul of the *Riley* prohibitions or concerns.

The requirement of voting rights for religious organizations may be more difficult to require by statute. Under the Establishment Clause of the First Amendment, religious organizations are constitutionally protected from laws which entangle government in religion.¹⁰⁸

107. There are, of course, instances of fraud or misrepresentation which do not include self-dealing. For example, in *Marcus v. Jewish Nat. Fund*, 557 N.Y.S. 2d 886 (1990), the fundraising organization was permanently enjoined from misleading advertising because its promotional materials improperly suggested that funds went not only to Israel but to the occupied territories, when in fact no funds had been expended in these areas. This example illustrates why injunctive relief should be the exclusive remedy against the board of directors, and no personal liability should attach as the result of such misrepresentation.

108. *Lemon v. Kurtzman*, 403 U.S. 602, 612-613 (1971). *Lemon* establishes a three-prong test to determine if a law violates the Establishment Clause: "First, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion, *Board of Edu. v. Allen*, 392 U.S. 236, 243 (1968); finally, the statute must not

A statute which requires the rights of membership be granted to a group of individuals based on governmental guidelines rather than on religious principles may run afoul of this First Amendment protection. As a result, there may be a limit to the governmental regulation which can be utilized for religious organizations. In *Larson v. Valente*,¹⁰⁹ the Supreme Court reviewed a Minnesota disclosure requirement which was drafted in a manner that gave an exemption to certain religious organizations, including the Roman Catholic Archdiocese.¹¹⁰ The Court said that “[w]e do not suggest that the burdens of compliance with the [Minnesota legislation] would be intrinsically impermissible if they were imposed evenhandedly. But this statute does not operate evenhandedly, nor was it designed to do so”¹¹¹ As a result, there may be First Amendment implications if the state ordered the requirement that members had the right to vote on directors or policy at annual meetings.¹¹² Nonetheless, self-regulation through a system of voting membership remains preferable to regulation by the state. If the First Amendment concerns are voluntarily waived by a religious organization, or if a system can be developed which will withstand the strict scrutiny of First Amendment review, then the model of self-regulation can be expanded to include religious organizations along with other charitable agencies.

B. *Mandatory Disclosure with Riley Guidelines*

While the Court in *Riley* declared mandatory disclosure unconstitutional as part of a solicitation, the Court did not prohibit all mandatory disclosure. The North Carolina statute which requires disclosure of the amount of funds which are given to the charity upon request was not challenged, nor were the solicitation disclosure provi-

foster ‘an excessive government entanglement with religion.’ *Walz* [v. Tax Comm’n, 397 U.S. 664, 674 (1970).”

In drafting any rules on membership and disclosure, the government must be very careful to make the rules neutral regarding all religions and not attempt to disproportionately regulate those religious groups which use door-to-door solicitors or other public forums. Such an act was struck down in Minnesota for having a disproportionate effect on the Unification Church. *Larson v. Valente*, 456 U.S. 228 (1992).

109. *Larson v. Valente*, 456 U.S. 228 (1992).

110. *Id.* at 254.

111. *Id.* at 253.

112. In addition to the Establishment clause issues, a problem may also exist under the Free Exercise Clause if the rules were seen as the imposition of regulations which ran contrary to the government structure required by the religion. See *Wisconsin v. Yoder*, 406 U.S. 205 (1972). Such free exercise requirements do not absolve all government regulations such as social security taxes. *United States v. Lee*, 455 U.S. 252 (1982). Following *Lee*, granting a donor standing to sue a church for improper or fraudulent use of one’s donation should not be a sufficiently onerous requirement on the free exercise of religion to be prohibited under the First Amendment.

sions regarding the name of the solicitor and the name and address of the solicitor's employer.¹¹³

More importantly, the Court focused on the disputed disclosure requirements as part of a general solicitation, when such speech is necessarily entwined with the discussion or advocacy of the organization.¹¹⁴ Nothing in the decision prohibits the requirement of mandatory disclosure in the context of an annual statement to members. To the contrary, the Court itself suggested that "the State may itself publish the detailed financial disclosure forms it requires professional fundraisers to file."¹¹⁵ The reason for this suggestion was that "[t]his procedure would communicate the desired information to the public without burdening a speaker with unwanted speech *during the course of a solicitation*."¹¹⁶

Mandatory disclosure of the charity's basic management and financial status is essentially commercial speech, which should be made available to the membership. Communicated separately from any other discussion or solicitation, this information should fall within the guidelines of *Riley* and satisfy the second prong of the States' interest in ensuring that the public is making an informed decision.¹¹⁷ The requirement that every charity publish a simple, one or two page disclosure statement and mail this statement to the membership will serve this intended purpose well.¹¹⁸ Without the need for any addi-

113. *Riley* 487 U.S. at 799.

114. *Id.* at 796.

115. *Id.* at 800.

116. *Id.* (emphasis added).

117. See Maine Brief, *supra*, note 67, at 28.

118. In *Larson*, the Court Addressed what it deemed a stringent disclosure requirement, and the related exemption to reporting for certain religious organizations. Minnesota Charitable Solicitations Act, MINN. STAT. §§ 309.50-309.61 (1969 and Supp. 1982). The statute required that charitable organizations register with the Minnesota Department of Commerce before soliciting contributions within the State. § 309.52. "With certain specified exemptions, all charitable organizations registering under § 309.52 must file an extensive annual report with the Department, detailing, *inter alia*, their total receipts and income from all sources, their costs of management, fundraising, and public education, and their transfers of property or funds out of the State, along with a description of the recipients and purposes of those transfers. § 309.53. The Department [of Commerce] is authorized by the Act to deny or withdraw the registration of any charitable organization if [it] finds that it would be in 'the public interest' to do so and if the organization is found to have engaged in fraudulent, deceptive, or dishonest practices. § 309.532, subd. 1 (Supp. 1982)." *Larson* at 231.

The Court addressed the exemption to registration for those religious organizations which received more than fifty percent of their fundraising income from members, finding that this exemption was a violation of the Free Exercise Clause of the First Amendment. The purpose and effect of this exemption was to favor some religious organizations over others. *Id.* at 254.

Although the Court found § 309.515 unconstitutional, the Court did not invalidate the disclosure itself. "We do not suggest that the burdens of compliance with the [disclosure requirements] would be intrinsically impermissible if they were imposed evenhandedly."

The opinion of *Larson* must be followed closely to establish a fair and even-handed approach to disclosure requirements so that the impact on all organizations is evenly applied.

tional state action, potential donors will quickly become aware that all charities must provide this information. Soon potential donors will begin to request such information in advance of making a contribution. This would most likely be true even without a law requiring that information requested must be forwarded. "[I]f the solicitor refuses to give the requested information, the potential donor may (and probably would) refuse to donate."¹¹⁹ In those instances where the potential donor does not want the information, there is no sound policy for the state to require that the information be forthcoming.¹²⁰ The request for information should come from the potential donor, and not be required reading.

The content of the short disclosure form must be developed in concert with the interested charitable agencies. Since current law requires charities to make Form 990 tax returns available upon request,¹²¹ this would be a natural starting point for the information required to be disclosed.¹²² The North Carolina statute and others

119. *Riley*, 487 U.S. at 799.

120. When a potential donor purchases cookies or candy, the charitable impact may be only one small part of the decision. Often, the most important factors in such a transaction are the taste of the sweets, the dimples on the six-year-old solicitor and the knowledge that the solicitor's grandparent happens to be the potential donor's boss.

121. I.R.C. § 6104. As in other areas of the law governing religious organizations, this disclosure requirement does not apply to churches and some organizations with religious affiliation. See also n. 108, *supra*, and accompanying text.

122. Certain organizations described in section 501(c)(3). —

Every organization described in section 501(c)(3) which is subject to the requirements of subsection (a) shall furnish annually information, at such time and in such manner as the Secretary may by forms or regulations prescribe, setting forth —

- (1) its gross income for the year,
- (2) its expenses attributable to such income and incurred within the year,
- (3) its disbursements within the year for the purposes for which it is exempt,
- (4) a balance sheet showing its assets, liabilities, and net worth as of the beginning of such year,
- (5) the total of the contributions and gifts received by it during the year, and the names and addresses of all substantial contributors,
- (6) the names and addresses of its foundation managers (within the meaning of section 4946(b)(1)) and highly compensated employees,
- (7) the compensation and other payments made during the year to each individual described in paragraph (g),
- (8) in the case of an organization with respect to which an election under section 501(h) [lobbying election] is effective for the taxable year, the following amounts for such organization for such taxable year:
 - (A) the lobbying expenditures (as defined in section 4911(c)(1)),
 - (B) the lobbying nontaxable amount (as defined in section 4911(c)(2)),
 - (C) the grass roots expenditures (as defined in section 4911(c)(3)), and
 - (D) the grass roots nontaxable amount (as defined in section 4911(c)(4)),
- (9) such other information with respect to direct or indirect transfers to, and other direct or indirect transactions and relationships with, other organizations described in section 501(c) (other than paragraph (3) thereof) or section 527 as the Secretary may require to prevent —
 - (A) diversion of funds from the organization's exempt purpose, or
 - (b) misallocation of revenues or expenses, and
- (1) such other information for purposes of carrying out the internal revenue laws as the Secretary may require. I.R.C. § 6033(b) (1987).

that focus on the percentage of fees retained by professional solicitors do not address the more central issue of charitable efficiency. Annual disclosure requirements should be developed in conjunction within the existing framework of proper accounting procedures for nonprofit agencies. While pay given to professional solicitors may be of interest, it is only one component of the costs of providing charity. Salary expenses, rental expenses, benefits and administrative costs may be equally important in assessing efficiency as the pay for outside solicitors.

Again, the better agencies will turn this obligation into a promotional tool, highlighting the successes of the organization, its efficiency or growth and the effectiveness of selected programs. Thereafter, the marketplace will determine which charities continue to grow and receive donations and which fall out of favor because they do not effectively utilize the contributions received. As Brandeis commented on the securities industry decades ago, "sunshine is said to be the best of disinfectants; electric light the most efficient policeman."¹²³ It is no less true today, nor any less relevant in the area of nonprofit disclosure.

For this to work, the regulatory system must also become easier for charities to understand. Federal legislation, fifty separate state systems and thousands of city, village and county regulations make the registration process a morass of paperwork and encourage the use of professional fundraisers, because only a professional can navigate the roiling regulatory waters. Like the securities laws, federal disclosure guidelines would best serve to provide uniform disclosure upon which the public will come to rely. An organization which has properly filed with the federal government¹²⁴ should be exempt from filing with the state and with each county and city government prior to conducting solicitations. At worst, the same completed form should be required to be sent into both the state and federal offices simultaneously, prior to public distribution.

Additional rules add substantially to the disclosure requirement. 26 C.F.R. § 1.6033-1(a)(4) (1992). These may not serve any additional purpose in the context of public disclosure.

123. Larry D. Soderquist, *Understanding the Securities Laws* at 2 (1990).

124. Filing should be regulated through the Commerce Department, not the IRS. The objective of full and fair disclosure to the public is not directly related to the tax assessment or tax waiver process, and will serve as a barrier to participation by organizations. Of course the Commerce Department can use the Form 990 as a guide in developing disclosure requirements, but the goal is to create a simple-to-read statement of the organization's operations and financial history. It would be naive and counterproductive to put the IRS in charge of developing forms that are "simple to read."

In addition, it may be necessary to create tiers of disclosure depending on the size of the organization as measured by the scope of its gross fundraising activities. The record keeping and reporting requirements of an agency which collects \$12,000 each year must be much simpler than an agency with an operating budget in excess of \$1,000,000. Input is critical, from both accounting professionals and the nonprofit agencies, as to how to require disclosure in the simplest and most coherent fashion.

If such disclosure requirements are well tailored to the needs of the agencies and the concerns of the public, then the government, the organizations and the objects of the charitable work will all be better served.

Annual disclosure coupled with statutory membership will create a two-pronged attack on fraud and public mistrust. The public will no longer have to wait for the local paper to run another expose, detailing the fall of another local institution. The local donors will be aware of problems while they can still be corrected, and involvement will increase as a result. The net effect of these two changes will be to add democratic, market regulation to an area which is in desperate need of positive, rather than punitive, change. Reinvigorating membership and reinventing disclosure is the best next step.

Just as charity begins at home, these suggestions will allow charitable regulation to begin at home as well. At the home of each contributor, at the home office of every agency, and at the home of each annual meeting, the gift of charity will be given and the responsibility of charity will be taught. Charity will again obey reason, and the donor will feel confident that the administration is honest, prudent and capable.