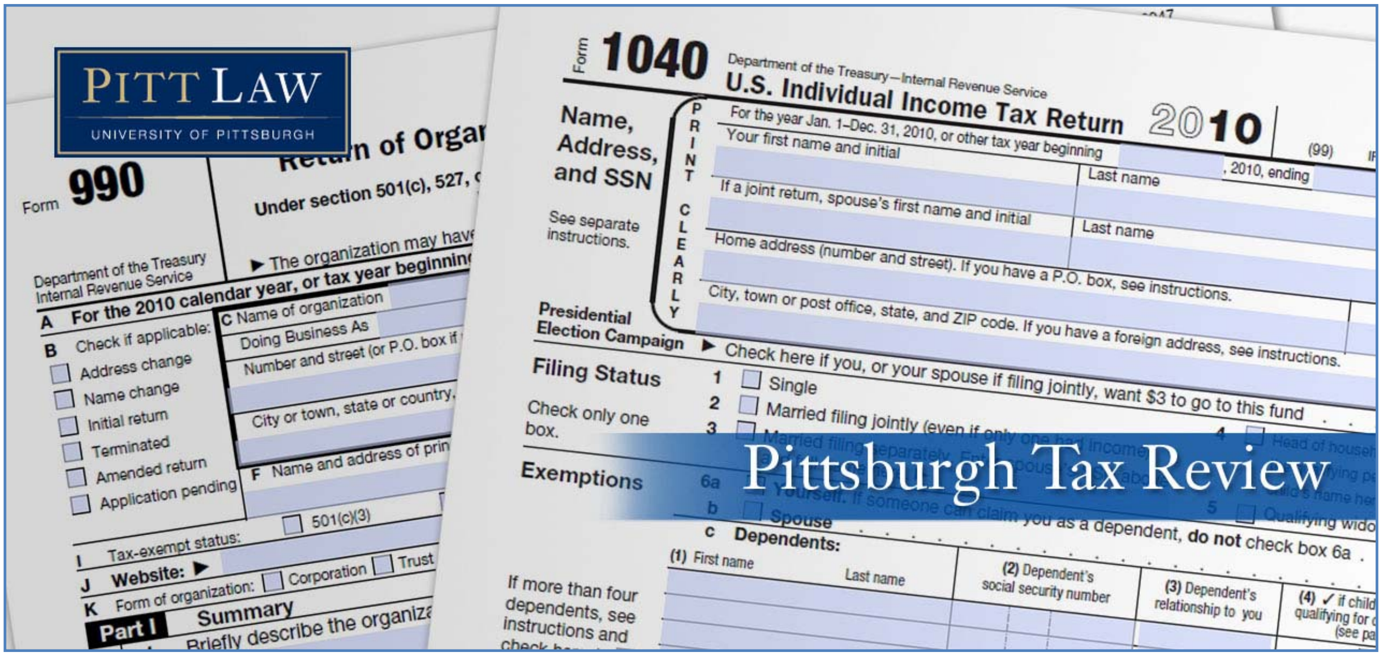


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# SYMPOSIUM

## AALS Section on Nonprofit and Philanthropy Law

## January 2015 Meeting

# WHO CAN REGULATE FRAUDULENT CHARITABLE SOLICITATION?

*James J. Fishman*

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### WHO CAN REGULATE FRAUDULENT CHARITABLE SOLICITATION?

*James J. Fishman*[*]

### I. INTRODUCTION

The scenario is common: a charity, typically with a name including an emotional word like "cancer," "children," "veterans," "police," or "firefighters," signs a contract with a professional fundraiser to organize and run a campaign to solicit charitable contributions. The charity may be legitimate or a sham. The directors of the charity may be allied or co-conspirators with the fundraiser, or just as likely, well-meaning but naïve individuals. The fundraiser raises millions of dollars through telemarketing, Internet, or direct mail solicitation. The charity receives but a small percentage of the amount. In some cases, at the close of the campaign, the organization owes the solicitor more than the amount raised for the charity.[1]

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[1] Out of 573 telemarketing campaigns conducted in New York State in 2013, expenses exceeded contributions, so the charity suffered an overall loss, in 17.6% or 101 of them. Charities Bureau, N.Y. State Law Dep't, Office of the Att'y Gen., *Pennies for Charity Where Your Money Goes: Telemarketing by Professional Fundraisers* 8 (2014), http://www.charitiesnys.com/pdfs/2014_Pennies.pdf. This can

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Thereafter, the state attorney general investigates the charity and finds fraud in the solicitation or an improper use of the funds raised. As part of the settlement, the professional solicitor agrees to be barred from operating in that particular state. Thereafter, the fundraiser moves to a neighboring jurisdiction, opens business (perhaps under a different name), and commences the same cycle of fraudulent fundraising using another charity.[2] Deception in solicitation and misuse of monies raised for charitable purposes is not only a fraud on the donor; it also can be a diversion of tax dollars from state or federal treasuries.

This article examines several approaches for regulating unscrupulous professional fundraisers and preventing carpetbagging, moving from jurisdiction to jurisdiction, committing fraud, or willfully violating regulatory requirements. It examines limitations in the existing regulatory framework to prevent charity fraud and offers possible solutions to the problem. As a first solution, the Internal Revenue Service (IRS) should revitalize and extend the "private benefit doctrine" as a tool of enforcement. Second, Congress and the Service should amend § 4958 to address excess benefit transactions to more clearly include unscrupulous solicitors.

A third possible resolution to the problem outlined would be the expansion of the Federal Trade Commission's (FTC) enforcement authority to cover charitable solicitation generally. Currently, the FTC has authority over telemarketing by for-profit fundraisers.[3] The legislation proposed

occur when the fundraising contract does not guarantee the charity a specific dollar amount or specific percentage of the gross receipts, including when fundraising is incidental to the telemarketing campaign, or when the contract does not hold the charity harmless for expenses/fees that exceed the gross amount contributed. *Id.* Some of these losing campaigns were not intended to raise money, but focused on funding new and promising donors or educating individuals unaware of the organization and its mission.

[2] According to a series of articles by the Center for Investigative Journalism and the *Tampa Bay Times*, this is a depressingly common occurrence. *See* Kris Hundley & Kendall Taggart, *America's 50 Worst Charities Rake in Nearly $1 Billion for Corporate Fundraisers*, TAMPA BAY TIMES & CTR. FOR INVESTIGATIVE REPORTING (June 6, 2013), http://www.tampabay.com/topics/specials/worst-charities1.page. Even after a lifetime ban from New York, a fundraiser remained active in the state brokering fundraising agreements for charities. *See* Kris Hundley & Kendall Taggart, *Telemarketing Consultant for Questionable Charities Fined $50,000*, CTR. FOR INVESTIGATIVE REPORTING (Apr. 2014), http://cironline.org/blog/post/telemarketing-consultant-questionable-charities-fined-50000-6294.

[3] The FTC regulates nonprofit organizations only indirectly. See *infra* note 116 for a description of the FTC's jurisdiction over nonprofit organizations. A recent solution to the problem posed occurred when the FTC and the attorneys general of the fifty states and the District of Columbia jointly filed a complaint against four sham cancer charities that had raised $187 million from 2008 to 2012. The

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would enable the creation of a self-regulatory organization under FTC aegis that fundraisers would be required to join. This new organization would enforce norms and rules for professional fundraisers, have the authority to discipline and, if necessary, to bar dishonest fundraisers from the fundraising industry.

A final recommendation is the creation of an online, readily accessible database containing records of violations of professional fundraising companies and the individuals who own and work for them, the contracts between professional solicitors and the charities they work for, the results of fundraising campaigns listing the percentage of dollars raised that goes to the charity, and the texts of settlement agreements between state charity officials and fundraisers and the charities involved. An important issue not addressed in detail is the fiduciary responsibility of charity boards to carefully select the firms that manage their solicitation campaigns.

## II. Examples of the Problem

### *A. Quadriga Art*

In June 2014, the New York State Attorney General reached a $25 million settlement with Quadriga Art, one of the nation's largest direct mail companies that for seven years conducted misleading fundraising for the Disabled Veterans National Foundation (DVNF).[4] From the formation of DVNF in 2007 to 2013, Quadriga raised $116 million. More than 90% went toward the cost of the direct-mail solicitations. Despite all of this fundraising, DVNF was indebted to Quadriga for $14 million! Under the terms of the settlement, Quadriga was forced to pay $10 million in damages

individuals involved will be barred from engaging in charitable solicitation and charity work. *See* Fed. Trade Comm'n v. Cancer Fund of America, Inc., No. 2:15-cv-00884-NVW (D. Ariz. May 18, 2015). This is an extraordinary action and obviously does not involve an efficient solution to the problem. Most of the money is long gone.

[4] *See* Suzanne Perry, *N.Y. Wins $25-Million in Fundraising Abuse Case*, The Chron. of Philanthropy (June 30, 2014), http://philanthropy.com/article/NY-Wins-25-Million-in/147445/; David Fitzpatrick & Drew Griffin, *Charity Marketing Group Investigated by Two States for Possible Fraud*, CNN (July 1, 2014), http://www.cnn.com/2012/09/26/us/senate-charities-investigation/index.html. *See* 2014 N.Y. Op. Att'y Gen. 145 (June 11, 2014), www.ag.ny.gov/pdfs/DVNF-Quadriga-Convergence-AOD_14-145.PDF, for the full settlement agreement.

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and to forgive the debt, and the founding board members of the charity had to resign.[5] Quadriga also agreed to refrain from engaging in a "funded model," by which it would pay all of the startup costs and fundraising costs for its clients in the hope of profiting down the road.[6]

The New York investigation found that the charity was a front for Quadriga, whose lawyer incorporated and obtained tax-exempt status for the organization and drafted the agreement between the fundraiser and DVNF. It also concluded the parties were guilty of misleading solicitations. For example, the mailings highlighted a story about a wounded veteran that the DVNF never helped. The organization falsely claimed it had a robust national network of veterans' advocates and benefit coordinators.[7] There was also a conflict of interest. A sales agent commissioned by Quadriga Art also served as a consultant to the veterans' charity, which then hired his daughter as chief administrative officer. As for any assistance to disabled veterans, it consisted of hand sanitizers, M&M'S candies, chefs' hats, coats, and leftover shoes.[8] Quadriga remains in business, and DVNF is still tax exempt.[9]

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[5] In addition, DVNF could no longer do business with Quadriga for three years unless the company was a legitimate low bidder and the attorney general permitted.

[6] The settlement calls for both Quadriga Art and Convergence Direct Marketing, of Bethesda, Maryland, to take the following actions: to fully disclose all potential conflicts of interest, refrain from dealing with a start-up charity that does not have its own legal counsel, and perform "due diligence" to ensure fundraising appeals are accurate. The companies must also provide more information to charities about the costs involved in fundraising campaigns when they cover the up-front expenses of such efforts. *See* 2014 N.Y. Op. Att'y Gen. 145, *supra* note 4.

[7] Quadriga had been the subject of ongoing investigations by CNN and the Senate Finance Committee since 2010. The Committee's focus was also on DVNF and whether it should be tax exempt. CNN reported on a fundraising contract signed with the St. Bonaventure Indian Mission School of Gallup, New Mexico after which nine million dollars was contributed but almost nothing went to the school, which ended up owing more than five million to Quadriga. At least eleven other Quadriga clients were in the same financial situation. Fitzpatrick & Griffin, *supra* note 4.

[8] Why if DVNF was giving veterans anything, would it be the items listed in the text? The answer is another important and growing disreputable practice—gifts-in-kind. A new or shell charity may not be doing anything because it has insufficient cash to maintain real programs. It can dress up its balance sheet and programs through gifts-in-kind, thereby impressing donors. The charity might receive goods that are outdated, hard to value, or worthless, such as pharmaceuticals that are outdated or illegal to sell in the United States. A middleman, for example Charity Services International (CSI), will receive goods from a corporate donor, who will receive a charitable deduction if they are passed on to a charity. Assume the corporation values the goods at $20 million. The corporation will take a $20 million deduction. Upon receipt the charity dresses up its balance sheet to reflect $20 million in donations and will allocated the contribution to program revenue. The goods are disposed of, perhaps given to

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*B. Coalition Against Breast Cancer*

The Coalition Against Breast Cancer (CABC) was a New York charity whose stated mission was to help women survive. CABC claimed to do this by providing research relating to breast cancer, a mammography van where women could get free mammograms, "constant" [sic] seminars and forums for women, and a mammography fund that would provide free mammograms for women who had no insurance. None of these statements was true.[10] In 1995, Andrew Smith, a director of CABC and Garrett Morgan, commenced a fundraising campaign for the organization.[11] From the inception of the charity, Morgan, CABC's sole outside fundraiser, played an active and central part in CABC's fundraising expenditures. Beginning in 2005, CABC outsourced all of its fundraising business to the Campaign Center, a fundraising solicitation firm owned by Morgan. Campaign Center managed CABC's campaigns either directly or through the use of additional firms. Morgan received an additional broker's fee from CABC. The CABC contract with the Campaign Center and Morgan chose

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recipients, or if outdated pharmaceuticals are involved, sent to a foreign country, where they are given to another charity or disposed of. The middleman takes care of the paperwork. Another synonym for this practice is accounting fraud. *See* Charity Watch, *The Alice in Wonderland World of Charity Valuation* (Aug. 1, 2011), https://www.charitywatch.org/charitywatch-articles/the-alice-in-wonderland-world-of-charity-valuation/13.

For a description of the work of Charity Services International, see David Fitzpatrick & Drew Griffin, *No Sign of $40 Million in Donations*, CNN (Feb. 10, 2014), http://www.cnn.com/2014/02/10/world/americas/guatemala-charities-missing-donations/; *see also* Kendall Taggart & Kris Hundley, *No Accounting for What Charities Ship Overseas*, TAMPA BAY TIMES & CTR. FOR INVESTIGATIVE REPORTING (Jan. 24, 2014), http://cironline.org/reports/no-accounting-what-charities-ship-overseas-5817?utm_source=CIR&utm_medium=social_media&utm_campaign=twitter.

[9] As often happens after a publicized settlement, Quadriga, along with eight affiliates, has been folded into a new company called Innovairre Communications, which refers to itself as a "sophisticated, more-efficient fundraising powerhouse." *See* Suzanne Perry, *Quadriga, Accused of Misleading Donors, Reorganizes Under New Name*, THE CHRON. OF PHILANTHROPY (Dec. 17, 2014), http://philanthropy.com/article/Quadriga-Accused-of/150915/?cid=pw&utm_source=pw&utm_medium=en.

[10] At best the statements were extremely misleading. "[B]etween 2008 and 2011[,] despite raising over $4 million, CABC funded mammograms for only eleven women." People v. Coalition Against Breast Cancer, Inc., No. 20432-2011, 2013 N.Y. Misc. LEXIS 3583, at *8 (N.Y. Sup. Ct. May 2, 2013).

[11] "[A]t approximately the same time as Morgan was working as a fundraiser for another sham charity on Long Island, 'Meals on Wheels,' which the State shut down after requiring Morgan and others to comply with measures to protect the public against fraudulent fundraising practices." *Id.* at *2.

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the firms and the latter two received a minimum of 80–85% of the funds raised.[12]

Campaign Center and the other fundraising firms were successful. From 2005 through 2011, the Campaign Center generated $4,861,224 in contributions for CABC through its own direct fundraising activities, and CABC paid the Campaign Center $3,908,262 for such services (80% of the Campaign Center generated contributions). Of the amount CABC retained, 85% was spent ($1,474,688) to pay compensation to its Directors ($918,951) and for overhead expenses. Less than 4.4% of the nearly $10 million raised was expended for charity related to breast cancer.[13]

The New York Attorney General charged that the Campaign Center utilized fraudulent fundraising tactics to maximize donations,[14] falsely filed with the state the amounts that CABC paid for brokerage services ($130,685), and utilized a fundraiser who was banned from such activity in

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[12] While alarming, this figure alone isn't a violation of law. The Attorney General alleged that CABC was in violation of several provisions in Article 7A of N.Y. Executive Law, forbidding fraudulent solicitation. "In 2010, CABC made Morgan's broker agreement exclusive." *Id.* at *5.

[13] [C]haritable activities between 2005 and 2011, while the Campaign Center was its official fundraiser, were limited to the following:

> 1) a scholarship program for students with a relative with breast cancer (3.4 percent of total expenditures); 2) funding mammograms and treatment for approximately 40 women (.49 percent of total expenditures); and 3) donations to women's health events (.22 percent of total expenditures).

*Id.* at *3.

[14] CABC, through the Campaign Center, utilized the following fraudulent fundraising tactics to maximize donations collected:

> 1) the Campaign Center sent donors an "official invoice" claiming the donor agreed to make a pledge when such donor declined to do so; 2) some "pledge donors" never even received a solicitation call; 3) the Campaign Center sent out repeated invoices, even after the pledge had been paid; 4) the Campaign Center stated that it was calling for a local charity, and the telemarketers changed the town of their script so that it matched that of the potential donor to convey the false impression that donations would stay in the community; 5) the solicitors used false names, varying their last name in an attempt to identify the perceived racial, religious, or ethnic group of the potential donor; 6) the solicitors routinely stressed that CABC gave free mammograms, when virtually no funds were utilized for such purpose; and 7) the solicitors for the Campaign Center never stated that they were paid professional solicitors employed by a professional fundraiser.

*Id.*

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New York state.[15] The court granted judgment against defendant board members and fundraisers in a combined amount of $1,555,000, ordered CABC to be dissolved, barred individual board members from serving in any manner for any entity or person that held or solicited charitable contributions in New York, or from receiving any benefits derived from solicitation of contributions for charitable organizations in New York. Campaign Center and its owner Morgan had to pay restitution for the fraud and were barred from any further charitable solicitation in New York. The settlement required the Campaign Center to be dissolved.

*C. U.S. Navy Veterans*

In other scenarios, the charity is a complete sham: such was the situation with the U.S. Navy Veterans. Although some Americans may object to the political justifications for going to war, almost all appreciate the sacrifices made by veterans and eagerly support charities that assist them. Fraudulent organizations preying on these good intentions, purportedly raising funds to help veterans, have proliferated in recent years. The U.S. Navy Veterans Association in 2009 at its peak raised $27.6 million and an estimated $100 million in all. It boasted of a membership of 66,000 and offices in 41 states, none of which existed. The offices were actually rented mailboxes, and of the 84 purported officers, the only one who could be traced was an individual calling himself Bobby Thompson, whose identity had been stolen from a civilian in Washington State. Thompson claimed he was a retired Navy lieutenant commander and ran the organization from St. Petersburg, Florida. He donated substantial sums in his own name to conservative causes and funded a successful lobbying effort in Virginia that led to legislation exempting veterans groups from registration requirements. The professional solicitors received 90% of the funds raised, but were not part of the conspiracy.

The gaps in oversight in this area are demonstrated by the fact that U.S. Navy Veterans were unmasked not by federal or state charity oversight, but through investigative reporting by the Tampa Bay Times.

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[15] The individual was Mark Gelvan, who in 2004 had agreed had agreed to a lifetime ban on raising funds for charities in New York. He was fined $50,000 by the attorney general. *See* Hundley & Taggart, *supra* note 2.

The Ohio Attorney General brought a criminal prosecution. U.S. Navy Veterans received recognition of tax-exempt status in 2002 and filed annual information returns. In 2008 the IRS audited the Connecticut "chapter." After reviewing documents and speaking to "Commander" Thompson and his tax counsel, a law professor, the Service issued a no action finding.[16]

The three examples differ. DVNF was a charity run by naïve people, clueless about their fiduciary responsibilities, which allowed the organization to become a vehicle for the fundraiser. The board breached its duty of care in the selection of the solicitor.[17] There were connections between the fundraiser and DVNF's administrators, though not the board members. The charity provided no assistance to its beneficiaries beyond the worthless gifts-in-kind.[18]

CABC operated as a charity that provided minimal resources to achieve its mission, though the funds were not used as the solicitation scripts promised—for research on breast cancer or a mammogram van. Less than 4.4% of funds raised were expended for charity related to breast cancer. U.S. Navy Veterans was a sham. There was no separate existence between the fraudster and the organization beyond forged documents and

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[16] The individual posing as Thompson "disappeared shortly after being indicted in Ohio on federal charges of identity theft, fraud and money laundering. Ohio's Attorney General took the lead in pursuing Thompson because Navy Veterans had a chapter in that state." Kris Hundley, *Bobby Thompson, Fugitive from Navy Vets Charity, Caught on West Coast*, TAMPA BAY TIMES, May 1, 2012, http://www.tampabay.com/news/business/article1227828.ece; *see also* Jeff Testerman & John Martin, *In 2008, IRS Audited Navy Veterans and Gave the Phony Charity a Clean Bill of Health*, ST. PETERSBURG TIMES, Nov. 19, 2010, http://www.tampabay.com/news/politics/national/article1135104.ece. The Florida Attorney General, the jurisdiction where the sham charity was based, initiated legal action but dropped it when Thompson became a fugitive. Thereafter, the Service opened a criminal investigation and other attorneys general became involved.

After a cross-country search, U.S. Marshals apprehended Thompson in Portland, Oregon. Thompson's true identity was revealed to be John Donald Cody, a 1972 graduate of Harvard Law School! A jury ultimately found Cody guilty of 23 counts of fraud, money laundering, and theft. An Ohio judge then sentenced him to 28 years in prison. Kris Hundley, *U.S. Navy Veterans Association Charity Fraud Trial Ends with Bobby Thompson Guilty on All Counts*, TAMPA BAY TIMES, Nov. 14, 2013, http://www.tampabay.com/news/courts/criminal/us-navy-veterans-association-charity-fraud-trial-ends-with-bobby-thompson/2152382; Brian Ross et al., *Navy Vet Scammer 'Bobby Thompson' Gets 28 Years*, ABC NEWS (Dec. 16, 2013), http://abcnews.go.com/Blotter/navy-vet-scammer-bobby-thompson-28-years/story?id=21232519.

[17] *See infra* pp. 24–25, 28, 42 for discussions of the duty of care.

[18] *See supra* note 7.

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shell organizations. Quadriga and CABC involved consent agreements with the charity and the fundraiser. U.S. Navy Veterans was a successful criminal prosecution.

While the three examples are egregious, they are depressingly common scenarios. Why do often well-meaning charities get involved with fundraisers that take such a large percentage of the amount raised? How could U.S. Navy Veterans fool so many regulators? The supposed advantage to charities of using a contingent fee professional solicitor is that the charity feels it bears no financial risk, and every dollar received, even if it is only five or ten percent of the total take, is a dollar more than it otherwise would have had.[19] This is usually true; small or unpopular charities must pay substantial percentages to fundraisers because of the difficulty of attracting donors.[20] In 2013, the *Tampa Bay Times* and the Center for Investigative Reporting published a report entitled "The Worst Charities in America"[21] that examined 6,000 charities which used professional fundraisers to garner donations. It focused on the fifty worst, determined by the ratio of funds raised to the amount received by the charity. The fifty raised a total of $1.3 billion from contributors over the past decade, and only $300 million reached the charities. Most of the charities' shares were used for salaries, overhead, and consulting arrangements with related parties.

The report found that the fifty nonprofits devoted less than four percent of the monies raised to direct financial assistance. Many charities had costs of fundraising over 90% year after year. As in the Quadriga example, many were more indebted to the fundraisers every year, no matter how much had been raised. There were numerous instances of self-dealing, excessive compensation, misleading and fraudulent representations to donors, related party transactions, and the use of satellite charities, often run by family members of the individuals behind the original organization.

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[19] Ellen Harris et al., *Fundraising into the 1990s: State Regulation of Charitable Solicitation After* Riley, 24 U.S.F. L. REV. 571, 578 (1990).

[20] Riley v. Nat'l Fed'n of the Blind, 487 U.S. 781, 793 (1988).

[21] Hundley & Taggart, *supra* note 2.

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Similar to CABC, several nonprofits were fronts for their fundraisers.[22] Many used similar names to well-known legitimate nonprofits with the words "cancer," "kids," "children," and "veterans" in the name.[23] There were omissions or deceptions in the Form 990, the annual information return filed with the IRS, or in the state filings. When some of the charities were shuttered by a state regulator, they would merely relocate to another jurisdiction.

### III. Cost of Fundraising as an Evaluative Measure

"The Worst Charities in America" deservedly raised awareness of the extent of charitable fraud or deception, but its conclusions were based on the organizations' cost of fundraising (CFR), which is not necessarily an indication of wrongdoing. Attorneys general (AG) have an interest in CFR and are aware of its strengths and weaknesses as a measure of efficiency. Because of their other responsibilities and finite resources, CFR is used as a public education tool in several jurisdictions, through the publication of an annual report on the offices' websites, often titled "Pennies for Charity." This report shows the percentage amount that goes to the charity compared to the professional solicitor.[24] The investigations and prosecutions of solicitors who engage in misleading or fraudulent fundraising tend to be

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[22] *See* discussion *infra* Part V.

[23]

> Of the 53 charities CharityWatch[, a nonprofit rating organization,] currently rates in its Veterans & Military category, [] about half (26 of the 53) receive an 'F' grade, including some of the largest and most famous groups such as AMVETS, Military Order of the Purple Heart Service Foundation, Paralyzed Veterans of America, and Veterans of Foreign Wars of the U.S.

*A Donor's Guide to Serving the Needs of Veterans and the Military*, CharityWatch (Jan. 26, 2015), https://www.charitywatch.org/charitywatch-articles/a-donor-39-s-guide-to-serving-the-needs-of-veterans-and-the-military/150. The ratings reflect financial efficiency. *See id.*

[24] *See, e.g.*, Charities Bureau, N.Y. State Law Dep't, Office of the Att'y Gen., *Pennies for Charity: Where Your Money Goes: Telemarketing by Professional Fundraisers* (2014), http://www.charitiesnys .com/pennies_report_new.jsp; *see also* Charities Bureau, Cal. Dep't of Justice, Office of the Att'y Gen., *Summary of Results of Charitable Solicitation Campaigns Conducted by Commercial Fundraisers in Calendar Year 2013* (Nov. 2013), http://oag.ca.gov/sites/all/files/agweb/ pdfs/charities/publications/ 2013cfr/cfr2013.pdf.

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episodic, and AG intervention may not originate or be driven by the office in the jurisdiction where the fraud was based.[25]

Despite the common wisdom that a high cost of fundraising results in few pennies on the dollar actually going to support the charitable mission, it does not mean the organization is engaged in fraud. There is no proven, direct correlation between the cost of fundraising and charitable outcomes. It takes money to raise money or to educate the public, particularly if the cause or organization is new or unpopular.

A high ratio of expenses to CFR, though controversial, does not necessarily indicate that a nonprofit is mismanaged, corrupt, or inefficient. CFR is but one piece of data used to evaluate a charity.[26] A nonprofit's CFR may be high because: it is a nascent organization with an unfamiliar mission; the campaign is an attempt to recruit new supporters or donors; the solicitation's primary purpose is educational; or the average contribution received is small. Other factors beside the CFR, such as salaries and administrative costs, quantitative and qualitative measures of mission attainment, and the number of people actually served by the charity compared to other organizations in the same field, are equally important.

Nor does a low CFR in and of itself indicate an ethical high ground. Fundraising costs can be hidden through allocating such expenses into categories such as public education, program services, general expenses, or administration or gift-in-kind accounting schemes instead of fundraising.[27] Some organizations such as major universities have low fundraising costs because of economies of scale or advantageous connections with potential donors. Charities, even well-known ones, often cheat willfully by failing to report or under-reporting fundraising expenses, so as not to offend donors

[25] In U.S. Navy Veterans, the scheme was based in Florida, but the Ohio attorney general led the prosecution. While the Florida AG opened an investigation after the *Tampa Bay Times* exposé, it dropped the matter when Thompson disappeared. Eight other AG offices in states where donors resided joined the litigation, but were in a subordinate role. *See* Hundley, *supra* note 16. Quadriga was a Louisiana corporation but that state's attorney general was not involved.

[26] JAMES J. FISHMAN ET AL., NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 247 (5th ed. 2015); Richard Steinberg & Deborah Morris, *Ratio Discrimination in Charity Fundraising: The Inappropriate Use of Cost Ratios Has Harmful Side-Effects*, 1 VOLUNTARY SECTOR REV. 77, 77–95 (2010).

[27] *See supra* note 6.

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and to foster an image of efficiency.[28] Assume a charity signs a contract with a professional fundraiser providing that any funds received by the charity will be after expenses and the fundraiser has taken out costs. Can the charity validly claim that it has no fundraising costs?

Several studies have found a substantial percentage of charities report on their Form 990 annual informational tax return that they incurred no fundraising costs, while state filing records revealed that in fact the organization spent substantial amounts on fundraising.[29] A 2012 analysis by the Scripps Howard News Service of the most recent Form 990 returns of 37,987 charities and other nonprofits that raised at least one million dollars through fundraising reaffirmed the conclusions of an earlier study by the Urban Institute that a substantial number of charities report no fundraising expenses. Forty-one percent of the charities (15,389) that raised a total of $116.7 billion stated they spent nothing for advertising, telephone solicitations, mailed appeals, professionally prepared grant applications or staff time for face-to-face solicitations. For example, 48 of Goodwill Industries' 127 major affiliates reported raising $387 million at no cost. Of the 22,598 organizations that did report fundraising expenses, the cost of fundraising was but seven cents for every dollar raised.[30]

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[28] According to an investigation by ProPublica and NPR, the American Red Cross has misrepresented to donors how their dollars are used, claiming that it spends less on fundraising and other overhead costs than it does. On its website and in public comments by top executives, the Red Cross said that 91 cents of each dollar donated goes directly to services. But a review of financial statements shows that fundraising costs averaged 17 cents per donated dollar during the last five years. One year, the fundraising expenses alone were 26 cents of every donated dollar. *See* Jesse Eisinger et al., *The Red Cross CEO Has Been Serially Misleading About Where Donors' Dollars Are Going*, PROPUBLICA & NPR (Dec. 4, 2014), http://www.propublica.org/article/red-cross-ceo-has-been-misleading-about-donations.

[29] A 2003 study examining the Urban Institute's Center on Nonprofit and Philanthropy and the Center on Philanthropy at Indiana University examined 2000 tax year data and reviewed the tax returns of more than 125,000 nonprofit groups, and conducted surveys of overhead costs and accounting practices at 1,500 of them. The study found that more than a third of nonprofit groups that reported on their Form 990 that they raised $50,000 or more claimed that they spent nothing on fundraising, even though that was often not true. The researchers concluded that many groups that receive the best ratings from watchdog groups were not as efficient as they seemed, and that many charities lack the capacity to track such costs accurately. *See* CTR. ON NONPROFIT AND PHILANTHROPY, URBAN INST., NONPROFIT OVERHEAD COST PROJECT (Feb. 2004), http://nccsdataweb.urban.org/kbfiles/313/Brief%201.pdf.

[30] Thomas Hargrove & Waqas Naeem, *Thousands of Nonprofits Misreport Fundraising Costs*, SCRIPPS HOWARD NEWS SERVICE (May 21, 2012), http://www.kitsapsun.com/news/local-news/many-charitable-nonprofits-misreport-fundraising. Robert Ottenhoff, former CEO of GuideStar and COO of

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Normally, nonprofit organizations allocate expenditures functionally into three categories: program service expenses, management and general administrative expenses, and fundraising expenses. These programmatic allocations reflect general accounting principles.[31] They are also desired by donors and required by governmental agencies such as the IRS in the Form 990 Annual Information Return, one part of which demands that any 501(c)(3) and 501(c)(4) organization present a statement of functional expenses. Failing to have such a standard is at best a soft-core sort of fraud or misrepresentation.

Watchdogs have criticized the emphasis on overhead ratios or CFR, and suggest donors should focus on the charity's effectiveness, measured by impact of the organization on its beneficiaries.[32] Furthermore, there is concern that the emphasis on CFR and overhead damages legitimate charitable activity. Recently, Independent Sector, which represents major

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the Public Broadcasting Service, said, "It is ridiculous to think an organization could raise significant amounts of money without spending money to do it. . . . I must be doing something wrong. I've never seen it growing on trees." *Non-Reporting of Fundraising Expenses Widespread—US Report*, PRO BONO AUSTRALIA (May 22, 2012), http://www.probonoaustralia.com.au/news/2012/05/non-reporting-fundraising-expenses-widespread-us-report#.

[31] *See* Am. Inst. of Certified Pub. Accountants, *Statement of Position 98-2: Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities that Include Fundraising*, 20,456 (Mar. 11, 1998), http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820927486&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs. SOP 98-2 establishes accounting standards to assure nonprofit organizations accurately state the amount of fundraising and other costs. This requires allocation of fundraising costs even if they are a joint activity with a programmatic or administrative function. If the fundraising cannot be reasonably allocated in part to another functional classification, it should be reported as fundraising costs. *Id.*

[32] *See* Press Release, Tim Ogden, Philanthropy Action, The Worst (and Best) Way to Pick a Charity This Year (Dec. 1, 2009), http://philanthropyaction.com/nc/the_worst_and_best_way_to_pick_a_charity_this_year/. Less than two weeks after the publication of the "America's Worst Charities" report, BBB Wise Giving Alliance, Charity Navigator, and Guidestar, three charity rating organizations, commenced a campaign to persuade donors to look beyond overhead costs when deciding which groups to support because overhead is a poor measure of a charity's performance. The statement concedes "at the extreme" high spending on overhead can tip off donors to fraud or poor financial management. The three organizations did not invite a fourth watchdog, CharityWatch, to participate, because it rates charities exclusively on their financial performance. *See* Suzanne Perry, *3 Major Charity Groups Ask Donors to Stop Focusing on Overhead Costs*, THE CHRON. OF PHILANTHROPY (June 17, 2013), http://philanthropy.com/article/3-Major-Charity-Groups-Ask/139881/?cid=pt&utm_source=pt&utm_medium=en; *see also* Suzanne Perry, *Overhead Costs Pose Dilemma for Charities*, THE CHRON. OF PHILANTHROPY (May 19, 2013), http://philanthropy.com/article/Overhead-Costs-Pose-Dilemma/139329/.

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charities, loosened its guidelines for overhead expenses.[33] Charity Navigator, which rates charities, has deemphasized overhead in its rating system. State AGs ignore these developments. There is a large gap between the views of organizations calling for downplaying overhead costs and the reality of extensive abuse by charities and their fundraisers, not to speak of the difficulties of donors in determining how effective a charity is in achieving its mission.

At some point, does a high CFR over many years indicate the charity is serving a private purpose, which would make the organization ineligible for tax exemption? Though every fundraising campaign tries to include educational speech, which is protected, after years of high CFR and little expenditure on mission, should this indicate the speech component is merely formulaic, or even deceptive rather than meaningful, and that no one is listening?

## IV. The Appropriate Locus of Regulation

In the first instance, charitable regulation is a state responsibility. State regulatory schemes typically provide for mandatory disclosure through state and local registration and licensing requirements that make financial and operational information available to the public. Fraudulent solicitation activities are unlawful, and perpetrators are subject to fines and criminal prosecution, but the latter remedy is infrequent, save in egregious situations such as U.S. Navy Veterans, where the charity is a sham.

Most states have an elaborate registration system that requires charities and fundraisers to register with the state if the charity or the fundraiser will solicit funds in that jurisdiction. Compliance reporting under solicitation laws is divided into two pieces: 1) registration, which provides an initial base of data and information about an organization's finances and governance; and 2) annual financial reporting, which keeps the state apprised about the organization's operations with an emphasis on

[33] The Revised Principles for Good Governance and Ethical Practice provide more flexibility for overhead costs. Previously, the Principles stated that charities should spend a significant amount of their expenses on programs with a target of 65% of expenses. The revision says spending 65% of expenses on program activities and more on overhead is sometimes necessary. Alex Daniels, *New Charity Guidelines Deal with Online Fraud, Overhead, and Executive Pay*, The Chron. of Philanthropy (Feb. 25, 2015), https://philanthropy.com/article/New-Charity-Guidelines-Deal/227877.

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fundraising results and practices.[34] Typically, states require both registration (at least an initial registration) and annual financial reporting. Thirty-six states and the District of Columbia use the Unified Registration statement, a standardized form that requires charities that are engaged in fundraising and professional fundraisers to register with the appropriate state agency.[35] Other states have their own registration requirements, and five have no registration mandates. Commercial fundraisers must register in forty-three states, and all contracts between a charity and fundraiser must be filed with the particular state where the fundraising takes place.[36] The fact that a charity registers to solicit contributors and to file fundraising contracts does not necessarily prevent fraud.[37]

There are a number of difficulties in effectively overseeing solicitation. First, there are many charities; in New York alone, there are an estimated 65,000, and nationally, there are 1,117,941.[38] Well-established constitutional precedents protect charities and their fundraisers.[39]

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[34] NAT'L ASS'N OF ATTORNEYS GEN. & NAT'L ASS'N OF STATE CHARITIES OFFICIALS, STANDARDIZED REGISTRATION FOR NONPROFIT ORGANIZATIONS UNDER STATE CHARITABLE SOLICITATION LAWS 1 (4th ed. 2010). State regulators also make use of the Form 990, Annual Information Return a public document filed with the Internal Revenue Service.

[35] *See id.* at 1. The Unified Registration Statement (URS) represents an effort to consolidate the information and data requirements of all states that require registration of nonprofit organizations performing charitable solicitations within their jurisdictions. The effort is organized by the National Association of State Charities Officials and the National Association of Attorneys General, and is one part of the Standardized Reporting Project, whose aim is to standardize, simplify, and economize compliance under the states' solicitation laws. *See generally* THE UNIFIED REGISTRATION STATEMENT (Mar. 2014), http://multistatefiling.org/index.html.

[36] *See* N.Y. EXEC. LAW § 173-a(1) (Consol. 2015).

[37] For a critique of the effectiveness of mandated disclosure, see Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011).

[38] These are organizations exempt under § 501(c)(3) of the Code. This figure does not include an estimated 300,000 religious organizations that are not required to register with the Internal Revenue Service. DEP'T OF THE TREASURY, I.R.S., CATALOG NO. 21567I, INTERNAL REVENUE SERVICE DATA BOOK (2014).

[39] The Supreme Court has established in a surprising number of cases that solicitation though subject to reasonable regulation involves a variety of speech interests that are within the protection of the First and Fourteenth Amendments. Riley v. Nat'l Fed'n of the Blind, 487 U.S. 781 (1988) (state's definition of reasonable fee, using percentages, was not narrowly tailored to state's interest in preventing fraud; requirement that professional fund raisers disclose a potential donor's percentage of charitable contributions collected during previous year which were actually turned over to charity was unduly burdensome and unconstitutional); *id.* at 795–96 (requirement of professional solicitor to disclose to

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Professional solicitation is a form of speech, and such appeals are cast, in part, as transmitting educational information. As such, the First Amendment protects them.

Registration is not synonymous with enforcement of the law, oversight by the attorney general or prevention of fraud. Forms, once filed, are not reviewed in most jurisdictions until and unless there are complaints about a particular charity. Thus, if false information is filed, it is unlikely to be discovered. Other reasons why state enforcement is episodic, save in a few jurisdictions, is that prosecuting charity fraud is time-consuming and expensive.[40] Effective oversight is beyond the resources of state attorneys general.[41] It also may be the result of staffing choices. Charity enforcement may not be a highly visible issue in some states. There may not be a constituency of aggrieved voters who have been harmed and demanding

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potential donors average percentage of gross receipts turned over to charity by fundraiser unconstitutionally infringed on speech; commercial speech doesn't retain commercial character when intertwined with otherwise protected speech); Sec'y of Md. v. Munson, 467 U.S. 947 (1984) (statute that forbade contracts if fundraiser retained more than 25% after deduction of costs was a direct restriction on protected First Amendment activity and unconstitutional); Schaumburg v. Citizens for a Better Env't, 444 U.S. 620, 632 (1980) (ordinance that did not use at least 75% of receipts for charitable purposes unconstitutionally overbroad in violation of First and Fourteenth Amendments); Bates v. State Bar of Ariz., 433 U.S. 350, 363 (1977) (*Cantwell* implied solicitation of funds involves interests protected by First Amendment's guarantee of freedom of speech); Va. Pharmacy Bd. v. Va. Citizens Consumer Council, 425 U.S. 748, 761 (1976); Jamison v. Texas, 318 U.S. 413, 417 (1943) (although purely commercial leaflets could be banned from the streets, state could not prohibit or unreasonably obstruct or delay distribution of handbills of a clearly religious activity merely because they invite purchase of books for improved understanding of religion or because handbills seek in lawful fashion to promote raising of funds for religious purpose); Cantwell v. Connecticut, 310 U.S. 296 (1940) (condition solicitation of aid for perpetuation of religious views or systems upon a license, grant of which rests on perpetuation of religious views or systems, the grant of which rests with in exercise of determination by official as to what was a "religious cause" invalid prior restraint on free exercise of religion); Schneider v. State, 308 U.S. 147 (1939) (ordinance that prohibited door to door soliciting, canvassing or distribution of circulars from house to house without permit, issuance of which rested in discretion of public officials overbroad as it applied to anyone who wished to present views on political, social and economic questions); *see* Lovell v. Griffin, 303 U.S. 444 (1938) (ordinance criminalizing distribution of any handbill at any time or place without permit invalid on face and First Amendment grounds).

[40] There is some low-hanging fruit where if the attorney general becomes involved, settlement is swift.

[41] A survey by Professor Gary W. Jenkins of the Ohio State School of Law found that states have dedicated a median of one full-time equivalent attorney to charity oversight. Seventy-four percent of the states responding had one or fewer full-time equivalent attorneys working on nonprofit oversight, with seventeen states reporting no such lawyers at all. Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128–29 (2007).

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action. Legitimate charities and reputable fundraisers may feel the bad press affects all fundraising. As presently conducted, state regulation clearly is not the solution to the problem posed.[42] While a few attorneys general may join an action against a fraudulent fundraiser, it is not a national effort with national results. Penalties, when imposed, are meager, usually around $500.[43]

The regulatory system is bifurcated. The IRS grants tax-exempt status, audits financial filings and can revoke tax-exempt status, but incorporation is a state function and state regulators handle oversight. Despite recent efforts to improve the sharing of information, much work remains to render such coordination effective.[44] There are efforts to digitalize state filings, but paper remains the norm. State regulators do not communicate effectively among themselves, and they have no database of charities or fundraisers that have been disciplined.[45]

## V. The Internal Revenue Service as Primary Regulator

A logical place to situate regulation is within the IRS, which regulates the nonprofit sector through setting the criteria for recognition of tax-exempt organizations. One of the Service's functions has become the regulation of the fiduciary behavior of trustees, directors, managers, and donors, a police function. Traditionally, this was the role of state law, since nonprofits were creatures of state corporate law and state fiduciary standards. In recent years, the Service has preempted state law in regulation

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[42] For a proposal to dramatically improve the state's role, see Putnam Barber & Megan Farwell, Charitable Solicitations Regulation and the Principles of Regulatory Disclosure 29–34 (Feb. 20, 2015) (unpublished manuscript) (on file with author).

[43] Cole Goins, *Finding a Path to Better Charity Oversight*, CTR. FOR INVESTIGATIVE REPORTING (July 17, 2013), http://cironline.org/blog/post/finding-path-better-charity-oversight-4951.

[44] State regulators can request tax information to assist them to prosecute wrongdoing without undertaking time consuming initial investigations, but the Service has been less than helpful. *See* I.R.C. § 6103(p)(4); *see also* Barry Meier & Rebecca R. Ruiz, *Patchwork Oversight Allows Dubious Charities to Operate*, N.Y. TIMES, May 21, 2015, at B1 (stating that the IRS has been "little help" in the efforts to monitor potential fraud at charities).

[45] The Center for Investigative Reporting established such a database, which is a beginning but incomplete. Goins, *supra* note 43.

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of charities in certain areas.[46] The Service has three approaches to deal with excessive payments to charities or fundraisers: the prohibitions against private inurement and private benefit, and intermediate sanctions on excess benefit transactions under § 4958.

### *A. Private Inurement*

Under § 501(c)(3), organizations are prohibited from engaging in activities that result in "inurement" of the organization's net earnings to insiders, such as founders, directors, and officers. The inurement prohibition states that no part of the "net earnings" may inure to the benefit of any private shareholder or individual.[47] The term "no part" is absolute. The organization loses tax-exempt status if even a small percentage of income inures to a private individual. The sole beneficiary of a charity's activities must be the public at large.[48] The essence of inurement is that a person in a position to influence the decisions of an organization receives disproportionate benefits, such as excessive compensation or rent, a below-market rate loan, or improper economic gain from sales or exchanges of property with the tax-exempt organization.[49]

### *B. The Private Benefit Doctrine*

The inurement limitation only extends to excess economic benefits received by insiders. The related private benefit prohibition denies exemption when persons other than insiders receive more than an incidental "private benefit." The IRS and the courts view inurement and private benefit as distinct requirements. Private benefit is the broader concept

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[46] *See* James J. Fishman, *Stealth Preemption: The I.R.S.'s Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545 (2010).

[47] I.R.C. § 501(c)(3); *see also* Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 2014).

[48] Church of Scientology of Cal. v. Comm'r, 823 F.2d 1310, 1316 (9th Cir. 1987).

[49] FISHMAN ET AL., *supra* note 26, at 417 ("Historically, the Service has invoked the inurement limitation only in the most egregious cases of insider misconduct. Since the only sanction was the ultimate death sentence—revocation of exemption—enforcement was lax. Congress gave the Service a new and more effective weapon in 1996 when it enacted the § 4958 intermediate sanctions regime. Insiders who receive excess economic benefits now are subject to monetary penalties, as are organization managers who approve of such transactions.").

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because it extends beyond insiders, but the inurement proscription is unforgiving (there is no *de minimis* exception) while "incidental" private benefit, viewed in a qualitative and quantitative sense, is not fatal.[50] The "private benefit" doctrine prohibits a § 501(c)(3) organization from providing a substantial economic benefit to individuals who do not exercise any substantial formal control over the organization. One could argue that the DVNF existed for the private benefit of Quadriga Art.

The private benefit limitation is a product of the Treasury Regulations, which require a § 501(c)(3) organization to serve "a public rather than a private interest" and "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[51] Professor John Colombo has criticized the private benefit proscription for lack of doctrinal content and inconsistent interpretation by the Service.[52] The concept of private benefit has deep roots in the common law through the idea that a charitable trust must benefit a sufficiently large and indefinite class rather than specific individuals.[53] Thus, a trust to benefit a town's cemetery would be charitable, but one to maintain an individual's tomb would not.[54]

Unlike private inurement, which rests on a statutory basis in § 501(c)(3) and has been defined as the siphoning off of a charity's

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[50] *Id.* at 429.

[51] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2014).

[52] *See* John D. Colombo, *Private Benefit: What Is It—And What Do We Want It To Be?* 1 (2011), SSRN: http://ssrn.com/abstract=2350470 or http://dx.doi.org/10.2139/ssrn.2350470 (The private benefit doctrine "literally has no doctrinal content . . . [and] no statutory basis in § 501(c)(3). Though the IRS claims the doctrine flows from the 1959 Treasury Regulation, it is . . . questionable given the language used, and in any event, this interpretation of the regulations appears not to have been 'discovered' until at least a decade after the regulations were promulgated."). This history "illustrates a doctrine in disarray. From its beginnings as a restatement of the requirement of a broad charitable class, private benefit has morphed into a phrase used as cover to deny tax exemption in a variety of circumstances that have no doctrinal link." *Id.* at 16.

[53] RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (2013).

[54] Colombo, *supra* note 52, at 4; *see* 6 AUSTIN W. SCOTT, WILLIAM F. FRATCHER & MARK L. ASCHER, SCOTT & ASCHER ON TRUSTS § 38.7.10 (5th ed. 2013) ("By statute . . . a trust for perpetual care of an individual grave is now valid in most states."). Some statutes treat such trusts as charitable. Others do not. *Id.*

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earnings to its founder, members of its board, or anyone else who is an insider,[55] the meaning of private benefit appears not in the Code, but as previously mentioned, in the Treasury Regulations, and its meaning has varied over the years.[56] The early private benefit cases and rulings were consistent with the more limited common law concept. In *Ginsberg v. Commissioner*,[57] an organization formed to dredge a navigable waterway fronting the homes of its member-donors did not qualify for exemption, because the waterway was rarely used by the general public and dredging greatly benefited the property owners.[58]

The common law private benefit concept was gradually expanded by the IRS, primarily as a weapon in its response to changes in the health care sector, which resulted in complex corporate structures, incentive-based compensation plans for physicians and other key personnel, and joint ventures with for-profit firms. The new economics of nonprofit health care often were driven by a desire to maximize profit, while minimizing or eliminating charity care other than the obligatory open emergency room.[59] Some of the arrangements involved staff physicians, who did not neatly fit in the "insider" category because they were not in any position to influence the hospital's finances. Initially, the IRS attempted to elevate their status so as to use the inurement hook, but in many situations, such as with a large

[55] United Cancer Council v. Comm'r, 165 F.3d 1173, 1176 (7th Cir. 1999).

[56] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2014) (noting that the first effort to clearly distinguish private benefit from private inurement was in a 1987 General Counsel Memorandum). *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) ("An organization is not described in § 501(c)(3) if it serves a private interest more than incidentally. . . . A private benefit is considered incidental only if it is incidental in both a qualitative and quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity."). The Treasury Regulation, published in 1959, does not clearly separate private benefit from private inurement. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2014).

[57] 46 T.C. 47 (1966).

[58] However, in Rev. Rul. 70-186, 1970-1 C.B. 129, an organization formed to preserve and improve a lake used extensively as a public recreation facility qualified for exemption even though property owners derived an incidental private benefit.

[59] *See* Rev. Rul. 69-545, 1969-2 C.B. 117.

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hospital, revocation of exemption based on inurement would be unsuccessful. The fallback argument became private benefit.[60]

The Service used private benefit to focus on the economic benefits that flowed to a for-profit entity or individuals as a result of serving a charitable class, which met the size requirement.[61] In the healthcare area, the Service alternated in its interpretations of private benefit. In looking at joint venture agreements, the Service focused on the balance between the claimed advancement in charitable purpose from the venture and the private benefits conferred on individual investors.[62]

In areas other than health care, the IRS revoked or denied exemptions on grounds of private benefit in situations far removed from the doctrine's common law roots. This expanded notion of private benefit received judicial endorsement in *American Campaign Academy v. Commissioner*,[63] where the Tax Court held that a nonprofit school operated to train individuals for careers as political campaign professionals did not qualify for the 501(c)(3) exemption because it conferred more than an incidental benefit on the Republican Party. The academy under scrutiny was created and funded by the National Republican Congressional Committee. Applicants were not required to disclose their party affiliation, but the clear implication from the record was that virtually all students were Republicans and most graduates worked for Republican candidates.

The Tax Court held that even though the school provided primary benefits to a charitable class (its students, Republicans in general, the

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[60] *See* I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) (involving an arrangement, where a hospital and a group of surgeons formed a limited partnership to purchase from the hospital the right to the net revenues from a surgery clinic. The agenda was to give the surgeons a sufficient financial stake in the clinic so they would be motivated to refer patients. After first finding that the arrangement constituted inurement because the surgeons were insiders, the IRS contended in the alternative that the hospital's exemption still should be revoked because of the presence of more-than-incidental private benefit to the surgeons.). This was the first use of private benefit as a distinct doctrine. A general counsel memorandum only reflects the Service's view of the law. Subsequently in the healthcare area, the Service has backed away from the use of private benefit in certain situations. *See* FISHMAN ET AL., *supra* note 26, at 430.

[61] Colombo, *supra* note 52, at 6.

[62] I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983).

[63] 92 T.C. 1053 (1989).

political system, or all of the above) and did not violate the inurement proscription, nonetheless it conferred more than incidental "secondary" benefits to private interests (the Republican Party) and thus did not qualify for exemption.[64]

In a more recent case with an unusual fact pattern, a software engineer incorporated a California nonprofit public benefit corporation and sought recognition of tax exemption, which was denied by the Service. The organization's purpose was to provide sperm free of charge to women seeking to become pregnant. The petitioner was the only sperm donor, and he and his father were the sole board members and officers of the organization. The Tax Court upheld the IRS's denial of the § 501(c)(3) exemption. The court acknowledged that the free provision of sperm might qualify as "charitable," but in this case the class of beneficiaries was not sufficiently large to benefit the community as a whole. The "smoking pistol" was that the petitioner was the only donor and his personal preferences (women "from families whose members have a track record of contributing to their communities" and who had "better education") narrowed the class of eligible recipients.[65] Therefore, the organization served the private benefit of the sperm donor.[66]

### *C. The Use of Private Benefit to Regulate Charitable Fundraising:* United Cancer Council v. Commissioner[67]

In *United Cancer Council v. Commissioner*, a decision by Judge Richard Posner, the Service sought to extend the private inurement and

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[64] FISHMAN ET AL., *supra* note 26, at 459–60.

[65] Free Fertility Found. v. Comm'r, 135 T.C. 21, 23 (2010) ("Women seeking to receive sperm from petitioner are required to submit answers to a questionnaire created by Naylor [the petitioner] and his father . . . . The questions related to the woman's family background, living environment, age, history of fertility treatment, educational attainment, personal achievements, and desire to have a child. Preference is given to women 'with better education' and no record of divorce, domestic violence, or 'difficult fertility histories' and are from families 'whose members have a track record of contributing to their communities'; who are in 'a traditional marriage situation'; who are under age 37; who are ethnic minorities; and who are 'from locations where * * * [petitioner has] not previously accepted recipients.' Naylor scores the questionnaires by hand, transfers the information to a computer-readable form, and enters the information into a computer program which assigns a score to each woman.").

[66] Query whether the donor hoped to take a tax deduction for contributing his sperm to the bank?

[67] 165 F.3d 1173 (7th Cir. 1999).

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private benefit doctrines to charitable fundraising. The United Cancer Council (UCC) was a charity that sought, through affiliated local cancer societies, to encourage preventive and ameliorative approaches to cancer, as distinct from searching for a cure, the emphasis of the better-known American Cancer Society. UCC entered into an agreement with a fundraising firm, Watson & Hughey (W & H).[68]

Because of UCC's perilous financial condition, a board committee wanted W & H to "front" all the expenses of the fundraising campaign, though it would be reimbursed by UCC as soon as the campaign generated sufficient donations to cover those expenses. W & H agreed, but it demanded in return that it be UCC's exclusive fundraiser during the five-year term of the contract, that it be given co-ownership of the list of prospective donors generated by its fundraising efforts, and that UCC be forbidden, both during the term of the contract and after it expired, to sell or lease the list, although it would be free to use it to solicit repeat donations. There were no restrictions on W & H.[69]

Over the five-year term of the contract, W & H mailed 80 million letters soliciting contributions to UCC. Each letter contained advice about preventing cancer, as well as a pitch for donations; 70% of the letters also offered the recipient a chance to win a sweepstakes. As a result of these mailings, UCC raised $28.8 million, but its expenses, the costs borne by W & H for postage, printing, and mailing the letters soliciting donations (costs reimbursed by UCC according to the terms of the contract), were $26.5 million. The balance of $2.3 million, the net proceeds of the direct-mail campaign, was spent by UCC for services to cancer patients and on research for the prevention and treatment of cancer.[70]

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[68] W & H had a long history of conflict with state regulators. *See* Commonwealth v. Watson & Hughey Co., 563 A.2d 1276 (Pa. Commw. Ct. 1989). Over a two year period from 1989 to 1991, W & H was found guilty of violations of charitable solicitation laws in fourteen states and paid fines and restitution of $2.1 million. *See America's Worst Charities*, TAMPA BAY TIMES & CTR. FOR INVESTIGATIVE REPORTING (2013), http://charitysearch.apps.cironline.org/detail/watson-hughey-12448. Today, Watson & Hughey is known as Direct Response Consulting Services. The McLean, Virginia-based fundraising firm changed its name in 1992.

[69] *United Cancer Council*, 165 F.3d at 1175.

[70] UCC did not renew the contract when it expired by its terms in 1989. Instead, it hired another fundraising organization with disastrous results. The following year, UCC declared bankruptcy, and within months the IRS revoked its tax exemption retroactively to the date on which UCC had signed the

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The IRS revoked UCC's charitable exemption. The Service alleged that UCC was not operated exclusively for charitable purposes, but also for the private benefit of the fundraising company, and also claimed that part of the charity's net earnings inured to the benefit of a private shareholder or individual, W & H. UCC appealed to the Tax Court, which upheld the revocation on the ground of private inurement, but did not reach the private benefit issue. There followed an appeal to the Seventh Circuit Court of Appeals.

Judge Posner found no private inurement.[71] The Service had not contended that any part of UCC's earnings found its way into the pockets of any members of the charity's board, or that any members of the board were owners, managers, or employees of W & H, or relatives or even friends of any of W & H's owners, managers, or employees. It conceded that the contract between charity and fundraiser was negotiated at an arm's length basis.[72] However, the contract was so advantageous to W & H and so disadvantageous to UCC that the charity must be deemed to have surrendered the control of its operations and earnings to its professional solicitor.

As far as the high fundraising costs, the Seventh Circuit found that W & H got a "charitable bang" from the mailings, which contained some educational materials in support of its educational goals. Importantly, it said that the cost of fundraising (that is, the ratio of expenses to net charitable receipts), is unrelated to the issue of inurement.[73] W & H's favorable contract was due to the desperation of UCC, rather than disloyalty by the board. Nor was there any diversion of assets to insiders. Judge Posner then suggested that the private benefit doctrine, in certain situations, could be used to deal with particularly harsh agreements:

> Suppose that UCC was so irresponsibly managed that it paid W & H twice as much for fundraising services as W & H would have been happy to accept for

contract with W & H. The effect was to make the IRS a major creditor of UCC in the bankruptcy proceeding. *Id.* at 1176.

[71] *Id.* at 1178–79.

[72] A committee of the board picked W & H, and another committee of the board was created to negotiate the contract between the charity and the professional solicitor. *Id.* at 1175.

[73] *Id.* at 1178.

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> those services, so that of UCC's $26 million in fundraising expense $13 million was the equivalent of a gift to the fundraiser. Then it could be argued that UCC was in fact being operated to a significant degree for the private benefit of W & H, though not because it was the latter's creature. That then would be a route for using tax law to deal with the problem of improvident or extravagant expenditures by a charitable organization that do not, however, inure to the benefit of insiders.[74]

The improvident or extravagant expenditures would be a dissipation of the charity's assets and a violation of the duty of care by the board of directors. The Court remanded the private benefit issue to the Tax Court.[75] A problem with using the breach of the duty of care as a hook for private benefit is that in many state jurisdictions, the concept has eroded. In Delaware, an organization can amend its governing rules to shield the directors from damages for most duty of care violations.[76]

### *D. Private Benefit as a Failure to Preserve Charitable Assets*

Professor John Colombo has offered a definition of private benefit, which is more coherent than the case law and consistent as a principle than the Service's positions. Additionally, it is distinguishable from private inurement and provides a useful tool when applied to situations of excessive fundraising costs or fraud.[77] He builds upon Judge Posner's comment in *United Cancer Council v. Commissioner* that private benefit could occur in a situation where the charity was operated to a significant degree for the advantage of the fundraising firm, rather than for the benefit

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[74] *Id.* at 1179.

[75] *Id.* at 1179; *see also* Lisa A. Runquist, *How to Keep Your Nonprofit out of Trouble with the IRS*, NONPROFIT RESOURCES (Oct. 1, 2015), http://runquist.com/how-to-keep-your-nonprofit-out-of-trouble-with-the-irs (On remand the private benefit issue was never reached, for the case was settled. UCC, which had filed for bankruptcy, conceded it was not entitled to exemption for the years 1986–1989, and the IRS restored UCC's exemption for 1990 forward. As a condition of the settlement, UCC agreed to cease raising funds from the general public and to limit its activities to accepting charitable bequests and transmitting them to local cancer counsels for direct care of patients.).

[76] DEL. CODE ANN. tit. 8, § 102(b)(7) (2015). There is still liability for breaches of the duty of loyalty, actions or omissions not in good faith or knowing violations of the law or transactions where the director received an improper benefit. The real danger to nonprofit directors, derelict in their duties, is not money damages, but "shame risk," the fear that one's name will appear in the local paper as a director of a nonprofit that is in the midst of some scandal.

[77] Colombo, *supra* note 52, at 24–25.

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of the charity.[78] This becomes a breach of the governing board's duty of care. Essentially, private benefit is a kind of corporate waste, a dissipation of the charity's assets because it is paying so much for the fundraising services that the board negligently diverts the charity's resources, even though the transaction is arms-length. Professor Colombo calls this a "failure to conserve charitable assets for the benefit of the charitable class." Entering into unfavorable contracts causes an outflow of those assets.[79]

Overly high fundraising costs are an economic waste of assets that otherwise should be used to further the organization's mission. The monies raised go to the fundraiser rather than to the beneficiaries served by the nonprofit organization.[80] In the charitable solicitation context, such a diversion of assets might occur where the nonprofit is forced to share with the fundraiser donors' names it has attracted in support of its mission. The ownership lists are property that should belong exclusively to the charity.[81]

Professor Colombo limits the use of this interpretation of the private benefit doctrine to transactions between the charity and a for-profit provider, where the charitable entity enters into an economic arrangement involving core services that grants a competitive advantage to the for-profit and results in a negligent failure to conserve assets on the part of the charity.[82] If a charity enters into a contract to lease office equipment or to purchase electricity for its offices, the doctrine would not apply, because it does not relate to a core service or mission of the charity. However, if the charity outsources the delivery of core services to a for-profit entity, in this case the core service being the educational message in the solicitation, the failure to conserve asset test would apply.

One of the problems with this approach is proving that the transaction consists of a waste of assets. Professor Colombo suggests using the same strategy used under § 4958, which imposes a tax on excess benefit

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[78] *United Cancer Council*, 165 F.3d at 1179.

[79] Colombo, *supra* note 52, at 24–25.

[80] *Id.* at 21.

[81] *See* 2014 N.Y. Op. Att'y Gen. 145, *supra* note 4, at 11–12 (stating that Quadriga's funded model controlled the ownership lists).

[82] Colombo, *supra* note 52, at 47–48.

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transactions to certain disqualified persons.[83] The Treasury Regulations provide a safe harbor in determining whether salaries escape the excess benefit tax by requiring the board of a charity to use comparable salary data and to document the basis of the decision.[84] If this procedure is followed, there is a presumption that a transaction is not an excess benefit transaction. In the private benefit context, jumping through similar hoops could create a presumption that the agreement with the professional solicitor was not a failure to conserve assets.

Another solution might be to utilize the technique recently introduced in New York's Nonprofit Revitalization Act (Revitalization Act) for "related party transactions," a synonym for conflicts of interest.[85] Under the Revitalization Act, no corporation can enter into a related party transaction unless the transaction is determined by the board to be fair, reasonable and in the corporation's best interest at the time of such determination. Any director or "key employee"[86] who has an interest in a related party

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[83] *Id.* at 31. Section 4958 is known as the Intermediate Sanctions legislation because it imposes a tax rather than requiring revocation of the charity. Some have suggested that the failure of the IRS's lead arguments in UCC led to the enactment of § 4958. *See* Mark Hrywna, *10 Years Later*, THE NONPROFIT TIMES (July 1, 2009), http://www.thenonprofittimes.com/news-articles/10-years-later/.

[84] Treas. Reg. § 53.4958-6(a) (2001); *see also id.* § 53.4958-6(c)(C)(iii)(E)(2)(iv) (2002) (exploring the unintended consequence of using comparables, such as the upward movement of compensation).

[85] N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (McKinney 2014). A related party transaction is "any transaction, agreement or any other arrangement in which a related party has a financial interest and in which the corporation or any affiliate of the corporation is a participant." *Id.* § 102(a)(24). The Act defines a related party as:

> (i) any director, officer or key employee of the corporation or any affiliate of the corporation; (ii) any relative [defined as such person's "(i) spouse, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren, and spouses of brothers, sisters, children, grandchildren, and great-grandchildren; or (ii) domestic partner as defined in section twenty-nine hundred ninety-four-a of the public health law."] or (iii) any entity in which any individual described in clauses (i) and (ii) . . . has a thirty-five percent or greater ownership or beneficial interest or, in the case of a partnership or professional corporation, a direct or indirect ownership interest in excess of five percent.

*Id.* § 102(a)(22)–(23).

[86] A "key employee" means

> any person who is in a position to exercise substantial influence over the affairs of the corporation, as referenced in 26 U.S.C. § 4958(f)(1)(A) ["any person who was, at any time

transaction must disclose in good faith to the board or an authorized committee of the board the material facts concerning such an interest.[87] In considering a related party transaction involving a charitable corporation and in which a related party has a substantial financial interest, the board or an authorized committee shall: 1) prior to entering the transaction, consider alternative transactions; 2) approve the transaction by not less than a majority vote of the directors or committee members present at the meeting; and 3) contemporaneously document in writing the basis for the approval, including its consideration of alternative transactions.[88] The requirement of seeking alternative transactions and documenting that fact would provide a reasonable justification for the board's action and protect itself from second-guessing and claims of a breach of the duty of care.

The essence of Professor Colombo's theory is that the law of tax exemption should frown on transactions where boards do not diligently conserve assets for the benefit of the organization's charitable class.[89] Applying his theory to the *United Cancer Council* facts, Professor Colombo would require in such situations that the charity have a reasonable justification for why it entered into a contract that gave the fundraiser over 90% of the gross amount raised. He concludes under this theory: "it is not unreasonable to presume UCC could have done better (and thus conserved more assets for its charitable purpose) either by taking fundraising in-house or by contracting with a different outside fundraiser."[90] By converting the private benefit concept to mean a failure to conserve charitable assets, tax law could deal with problems of fraudulent or excessive fundraising costs.

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during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization"] and further specified in 26 C.F.R. § 53.4958-3(c), (d) and (e), or succeeding provisions.

*Id.* § 102(a)(25).

[87] *Id.* § 715(a).

[88] *Id.* § 715(b).

[89] Colombo, *supra* note 52, at 42.

[90] *Id.* at 42–43.

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*E. The Use of § 4958, the Intermediate Sanctions Legislation*

Another approach to an IRS focus on the regulation of charitable solicitation could be through the application of § 4958, the so-called intermediate sanctions legislation.[91] Section 4958 applies to "excess benefit transactions"; that is, transactions in which an economic benefit is provided by a tax-exempt organization to or for the use of any insider, or in the jargon of the legislation, a "disqualified person"[92] if the value of the economic benefit provided directly or indirectly exceeds the value of the consideration received for providing such benefit.[93] Under the legislation, a tax is imposed where the consideration exchanged is in excess of the value received between a 501(c)(3) or 501(c)(4) organization and the disqualified person at any time during the preceding five year period ending on the date of the transaction.[94]

## VI. Does the Intermediate Sanctions Framework Apply to the Professional Solicitor?

An argument can be made that the problems discussed in this paper could be dealt with through the intermediate sanctions framework, though the fit may be tenuous at this time. The starting point is whether the professional solicitor is a "disqualified person." If the solicitor is not a founder of the organization, a substantial contributor, or someone whose

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[91] The intermediate sanction refers to an excise tax imposed for excess benefit transactions by insiders. The tax is an intermediate sanction compared to revocation of exemption, previously the only available sanction, which was so draconian that it was rarely imposed.

[92] A disqualified person, is any person who was, at any time during the five-year period preceding the excess benefit transaction in a position to exercise substantial influence over the affairs of the organization. I.R.C. § 4958(f)(1)(A); Treas. Reg. § 53.4958-3(a)(1) (2002).

[93] I.R.C. § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(a)(1) (2002). This includes the direct or indirect provision of services. *Id.*

[94] I.R.C. § 4958(e)(1), (2). It does not include private foundations as defined in I.R.C. § 509(a). An initial tax of 25% of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200% of the excess benefit applies if the violated is uncorrected. A tax of ten percent of the excess benefit, not to exceed $20,000 with respect to any excess benefit transaction, is imposed on an organization manager who knowingly participated in the excess benefit transaction. *Id.* § 4958(d)(2). There are rules for abatement of the taxes under certain conditions. *Id.* §§ 4961, 4962.

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revenues are not based on revenues from the activities of the organization, the Treasury Regulations present several situations where persons are defined to be disqualified persons under the statute.[95]

Where a professional solicitor is not within the statutory categories of disqualified persons,[96] the test is one of facts and circumstances.[97] The facts and circumstances test also applies to a person in position to exercise substantial influence by virtue of their powers and responsibilities, such as officers or voting members of the governing body, or persons who have ultimate responsibility for managing the finances of the organization, or certain persons with a material financial interest in a provider-sponsored organization.[98] Under certain circumstances, a professional solicitor and her firm could be considered disqualified persons under § 4958.

Among the facts and circumstances that would show a professional solicitor's substantial influence: the person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;[99] the person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;[100] or the person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.[101]

These sections of the Treasury Regulations can apply to professional fundraisers. In many fundraising campaigns, the charity surrenders the control of its operations and resources for the campaign to the fundraiser. A fundraising operation often can be a major portion of the charity's assets, income, and expenses, and is under the control of the solicitor. Aside from the fundraising campaign, the assets and activities of the charity may be

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[95] Treas. Reg. § 53.4958-3 (2002).

[96] *Id.* § 53.4958-3(b)(1)–(2).

[97] *Id.* § 53.4958-3(e).

[98] *Id.* § 53.4958-3(c).

[99] *Id.* § 53.4958-3(e)(2)(iv).

[100] *Id.* § 53.4958-3(e)(2)(v).

[101] *Id.* § 53.4958-3(e)(2)(vi).

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very small, and the fundraiser controls substantial assets of value of the organization.

Examples (5) and (6) of Treasury Regulation § 53.4958-3 could apply to a professional fundraiser. Example (5) deals with an organization that enters into a contract with a company that operates bingo games and does everything in return for a percentage of the revenue generated. The charity only provides a venue for the bingo activity. The gross bingo revenues represent more than half of the organization's total annual revenue. The bingo operator is in a position to exercise substantial influence over the affairs of the organization and is a disqualified person with respect to the organization. Example (6) adds the additional fact that an individual owns a controlling interest in the bingo company. That individual is also a disqualified person with respect to the organization.[102] Change the bingo operator and owner of the firm to solicitor, and there is a situation similar to many of the egregious fund raising campaigns.

## VII. The Initial Contract Exception[103]

The tax on excess benefit transactions does not apply to an initial written agreement with fixed payments between an organization and an individual, who will become a disqualified person upon signing the contract. In other words, there is an initial contract exception.[104] This removes from the intermediate sanctions regime the initial contract between the fundraiser and the tax-exempt organization. Neither the statute, the legislative history, nor the proposed regulations to § 4958 contained an initial contract exception. It emerged in the fallout from the Service's defeat in *United Cancer Council*, where the court held that private inurement could not result from a contractual relationship negotiated at arms-length with a party having no prior relationship with the exempt organization, regardless of the relative bargaining strengths of the parties. The initial

[102] *Id.* § 53.4958-3(g), exs. (5)–(6).

[103] Initial contract means a binding written contract between an applicable tax-exempt organization and a person, who was not a disqualified person within the meaning of I.R.C. § 4958 and Treas. Reg. § 53.4958-3 prior to entering the contract.

[104] Treas. Reg. § 53.4958-4(a)(3) (2002).

contract exemption removed certain fixed payments made pursuant to an initial contract between an organization and the third party.[105]

However, there may be a loophole in the initial contract exemption that allows such contracts to come under § 4958. A fixed payment does not include any amount paid to a person under a reimbursement or similar arrangement where any person with respect to the amount of expenses incurred or reimbursed exercises discretion.[106] The standard fundraising agreement contains a percentage of receipts from the campaign that belong to the solicitor. Nevertheless, the solicitor also has the right of reimbursement of expenses and manages the campaign. It can control the amount of expenses incurred, the primary reason that many fundraising campaigns wind up with the charity not only failing to obtain additional resources, but still owing the solicitor for expenses beyond the amount raised. In the course of running the campaign, the solicitor controls the expenses. This would seem to be a non-fixed liability and one could argue not subject to the initial contract exception.

The regulations reinforce this interpretation, though it is far from a sure thing. In Example (7), a nonprofit hospital enters into a contract with a company that will provide a wide range of hospital management services to the hospital. Upon entering the contract, the company becomes a disqualified person with respect to the hospital. The hospital pays the management company a fixed fee of *X* percent of adjusted gross revenue determined by a fixed formula specified in the contract. The cost accounting system objectively defines the direct and indirect costs of all health care goods and services provided as charity care. Section 4958 does not apply because of the initial contract exception.[107]

Example (8) deals with a situation similar to the typical fundraising contract. The facts are the same as Example (7), except that the management services contract also provides that the hospital reimburse the management company on a monthly basis for certain expenses incurred that are attributed to services provided to the hospital. Although the

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[105] STAFF OF J. COMM. ON TAX'N, 109TH CONG., REPORT ON OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 268 (Comm. Print 2005).

[106] Treas. Reg. § 53.4958-4(a)(3)(ii)(A) (2002).

[107] *Id.* § 53.4958-4(a)(3)(vii), ex. (7).

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management fee itself is a fixed payment not subject to § 4958, the reimbursements are not fixed payments, because the management company exercises discretion with respect to the amount of expenses incurred. Therefore, any reimbursement payments are evaluated under § 4958.[108] Change the facts from a hospital management company to a professional solicitor entering into a contract with a tax-exempt organization, and Example (8) seems to be a common situation of contracts with fundraisers. The fundraiser is in charge of the campaign and its expenses; that is why so many campaigns owe money to the fundraiser beyond amounts raised when it is over. It is not rational that a charity would plan to lose money, unless it was a sham organization serving the private benefit of the fundraiser, or the charity did not mind because the sole purpose of the telemarketing was education about the organization's mission.

Unfortunately, the regulations do not provide a definitive answer to the arguments made herein. The cleanest way to bring fundraising arrangements under § 4958 would be to eliminate the original contract exception. The Joint Committee on Taxation in 2005 recommended this, as part of several changes in § 4958, because of the continued reports of abuses by insiders, managers of public charities, and private foundations.[109] The questionable activities raised questions about the extent to which excess benefits were still provided to insiders and the effectiveness of § 4958.

The Joint Committee's Report doubted that in cases where the organization contracts with an individual (who will have the capacity to exercise control or substantial influence over the organization upon entering into the contract), the organization can conduct negotiations entirely at arm's length and free of the influence of the third party.[110] The nonprofit may fear that it might lose the individual or entity if bargaining is too hard or it will provide an initial contract with an excess benefit to the counterparty. The initial contract exemption encourages fixed payments

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[108] *Id.* § 53.4958-4(a)(3)(vii), ex. (8).

[109] STAFF OF J. COMM. ON TAX'N, *supra* note 105, at 261, 268–69.

[110] *Id.* at 268.

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rather than performance-based compensation.[111] The best way to clear up the ambiguity in the regulations would be for Congress to just eliminate the initial contract exception, or for the Service to amend the applicable Treasury Regulation.

As result of the uproar from the Congress and other politicians over the targeting of certain 501(c)(4)'s on a political basis, the IRS is in a situation which can be described as "agency post-traumatic stress disorder." It is in disarray, and the Tax Exempt and Government Entities Division is marginalized and filled with inexperienced people.[112] Given the turmoil enveloping the Service at this particular time, there is little chance that it will use the tools available or begin an investigation of these problems. Even absent the political issues, the resources of the Service are so limited and the size of the nonprofit sector so great, one must turn elsewhere for a solution to the problem raised in this article.[113]

### *A. A Solution to the Problem: Creation of a Self-Regulating Organization Under FTC Aegis*

The FTC does not have direct authority to regulate nonprofit organizations.[114] Federal Trade Commission Act § 4 defines a corporation

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[111] *Id.* at 269. Fundraising contracts are protected somewhat from excess benefit situations by the requirement in over forty states that such contracts are terminable at will by the tax exempt organization. Exercise of that right, however, is asking for litigation from the solicitor to obtain reimbursement of expenses.

[112] *See* MARCUS S. OWENS, N.Y.C. BAR ASS'N, CITY BAR CTR. FOR CONTINUING LEGAL EDUC., I.R.S. PRIORITIES AND ACTIONS REGARDING CHARITIES (2014), Westlaw 20140424A NYCBAR 18.

[113] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-164, TAX-EXEMPT ORGANIZATIONS: BETTER COMPLIANCE INDICATORS AND DATA, AND MORE COLLABORATION WITH STATE REGULATORS WOULD STRENGTHEN OVERSIGHT OF CHARITABLE ORGANIZATIONS 20 (2014) ("[The] IRS examines only a small percentage of charitable organizations that file returns, including private foundations . . . . [Exempt Organization] examination rates were lower, relative to other IRS divisions. For charitable organizations, the examination rate was about 0.7 percent in 2013, while for individual and corporate tax returns it was 1 percent and 1.4 percent, respectively. . . . [T]he number of employees performing exams has declined while the number of returns filed has increased. From fiscal year 2011 to 2013, the exam rate decreased from .81 percent to .71 percent (by about 12 percent).") (footnotes omitted).

[114] *See Statutes Enforced or Administered by the Commission*, FED. TRADE COMM'N, https://www.ftc.gov/enforcement/statutes/federal-trade-commission-act (last visited Sept. 24, 2015) (citing 15 U.S.C. §§ 41–58 (2012)) ("[T]he Commission is empowered, among other things, to (a) prevent unfair methods of competition, and unfair or deceptive acts or practices in or affecting commerce; (b) seek monetary redress and other relief for conduct injurious to consumers; (c) prescribe trade regulation rules

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covered by the FTC's jurisdictional mandate to prevent unfair methods of competition as one "which is organized to carry on business for its own profit or that of its members, and has shares of capital or capital stock or certificates of interest."[115] If a purported charity is a sham, it is not a nonprofit, and therefore is organized for profit and would come under the FTC's jurisdiction. The FTC does have authority to regulate deceptive telemarketing acts or practices by professional solicitors, which are for-profit business that come under FTC jurisdiction. Through the Telemarketing and Consumer Fraud Abuse Prevention Act of 1994, the FTC has the power to promulgate rules prohibiting deceptive telemarketing soliciting or practices, including charitable telephonic solicitations by for-profit solicitors.[116]

The statute also empowers state attorneys general to bring action in federal district court to enforce the rules of the FTC if residents of their

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defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices; (d) conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and (e) make reports and legislative recommendations to Congress.").

[115] 15 U.S.C. § 44 (2006).

[116] The Telemarketing and Consumer Fraud Abuse Prevention Act of 1994, Pub. L. No. 103-297, 108 Stat. 1545 (codified in titles 7 & 15 U.S.C.), which became effective in 1995, authorizes the FTC to prescribe rules prohibiting deceptive telemarketing acts or practices and can be used to regulate charitable solicitation. The statute also empowers state attorneys general to bring action in federal district court to enforce the rules of the FTC, if residents of their state have been affected by deceptive telemarketing but does not supersede existing authority of state officials from action under state laws.

In October 2001, Congress enacted the USA PATRIOT Act, which contained a section (section 1011) entitled "Crimes Against Charitable Americans." Pub. L. No. 107-56, 115 Stat. 396 (2001). This section amended the Telemarketing Act in three significant ways: 1) Congress inserted the phrase "fraudulent charitable solicitations" in its general description of what "deceptive telemarketing acts or practices" the FTC should regulate, 15 U.S.C. § 6102(a)(2); 2) Congress added a new subsection specifically directing the FTC to include a requirement that any person engaged in telemarketing for the solicitation of charitable contributions, donations, or gifts of money or any other thing of value, shall promptly and clearly disclose to the person receiving the call that the purpose of the call is to solicit charitable contributions, donations, or gifts, and make such other disclosures as the Commission considers appropriate. *Id.* § 6102(a)(3)(D); and 3) Congress altered the Act's definition of "telemarketing" to include a reference to charitable solicitations. *Id.* § 6106(4). The USA PATRIOT Act did not purport to alter the FTC's jurisdiction, which is still governed by the jurisdictional provisions in the Federal Trade Commission Act, which do not cover non-profit organizations. The USA PATRIOT Act, therefore, expanded what "*acts and practices*" could be regulated by the FTC under the Telemarketing Act, but it did not change what *type of entity* was subject to the FTC's control. *See* Nat'l Fed'n of the Blind v. FTC, 420 F.3d 331, 338 (4th Cir. 2005).

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state have been affected by deceptive telemarketing, but it does not supersede existing authority of state officials from action under state laws. In fact, the FTC's regulatory activity in this area has been very modest, which is unsurprising given the scope of the commission's responsibilities, particularly in consumer protection and the relative lack of donor complaints over deceptive fundraising. There have been a few enforcement efforts against fundraisers, which have been undertaken with state attorneys general or charity officials.[117]

A resolution to the problem of fundraisers that repeatedly violate state solicitation requirements is to federalize fundraisers' registration and oversight through legislation empowering the FTC to have authority over charitable solicitation beyond telemarketing. In 1990, a bill was introduced in the House of Representatives, the Fair Fund Raising Act of 1990,[118] to amend the Federal Trade Commission Act so as to permit the FTC to regulate fundraising activities of § 501(c)(3) and 501(c)(4) charities. The legislation would have prohibited charities from having officers or directors who were also officers, directors or agents of a professional fundraising organization employed by the charity.[119] Such conflicts have been dealt with under § 4958[120] and by conflict of interest statutes in most states.

The bill also required notification of the professional status of the fundraiser, the name of the individual receiving funds for the charity, and uniform accounting principles governing the cost of fundraising and annual reports to state agencies. It preempted any state or local requirements inconsistent with the requirements in the bill, though state and political subdivisions could seek an exemption if the jurisdiction afforded a greater level of protection to the public. The bill never passed. Similar legislation

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[117] The FTC joined with 61 attorneys general and secretaries of state in 49 states to bring 76 enforcement actions against 32 fundraising companies and 22 nonprofits or purported nonprofits and 31 individuals for fraudulent telemarketing to help police, firefighters or veterans. The cases were settled with final judgments and orders for permanent injunctions. *See, e.g.*, FTC v. Marleau, No. C09-5289BHS (W.D. Wash. 2009), https://www.ftc.gov/sites/default/files/documents/cases/2009/05/090618marleaujdgmt.pdf; FTC v. Am. Veterans Relief Found., No. CV09-3533-AHM (RNBx) (C.D. Ca. 2009), https://www.ftc.gov/sites/default/files/documents/cases/2009/05/090520avrfjdgmt.pdf.

[118] H.R. 3964, 101st Cong. (1990).

[119] *Id.*

[120] I.R.C. § 4958.

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would need to be enacted. The legislation proposed below would also require fundraisers to join a self-regulatory organization under FTC aegis.

To solve the problem of recidivist wrongdoers and itinerant fundraisers who move from jurisdiction to jurisdiction, there should be created a self-regulating organization, the Charitable Professional Fundraisers' Regulatory Association ("CHAPFRA") under the aegis or supervision of the FTC. This new organization would have the responsibility of enforcing norms and rules for professional fundraisers, and the authority to discipline, and, if necessary, bar dishonest fundraisers from their profession. The strengths and weaknesses of this approach will be discussed.

The framework of a self-regulatory organization that comes to mind is FINRA, the Financial Industry Regulatory Authority ("FINRA"), a private corporation that acts as a self-regulatory organization for market entities such as the New York Stock Exchange. FINRA has been granted authority through Congressional authorization in connection with securities exchanges.[121] This authority allows FINRA to promulgate rules, license securities participants, investigate violations, and discipline violators of those rules in tribunals formed by FINRA.[122] These disciplinary proceedings act as a deterrent against and remedy for unfair and illegitimate business practices.

## VIII. Advantages and Disadvantages of the SRO Model

Self-regulation can be more effective than government regulation because of industry or professional expertise. Industry representatives will want to weed out the "bad apples" because they tarnish the reputation of the profession as a whole. There is greater acceptance of regulation if it is done by ones' peers. Additionally, industry regulators may be able to enforce

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[121] 15 U.S.C. § 78o-3(a) (2012).

[122] *See id.* § 78o-3. FINRA received its ability to carry on its activities through Congress enacting the Maloney Act, which allows the Securities and Exchange Commission ("SEC") to approve registration of securities associations in order to assist in regulation of activities related to securities exchanges. *Id.* The Securities and Exchange Commission has supervisory authority over such securities organizations as FINRA through provisions providing the SEC with approval measures for FINRA rulemaking, licensing, disciplinary proceedings, and administration. *Id.*; *see, e.g.*, 17 C.F.R. § 201.420 (2013).

ethical standards loftier than mere legal compliance.[123] The threat of expulsion from a mandatory membership organization, which also happens to be a monopoly in the profession, incentivizes members to obey its rules.[124]

Self-regulatory organizations are financed directly by the industries they regulate, independent of government budgets and the politics that surround regulatory budget making. Government regulators thereby can focus on their agenda.[125] Standards are established through a largely consensual process. SROs are a counterpart for negotiations with government agencies seeking to introduce regulatory initiatives. Self-regulation can also strike the correct balance between overregulation and under-regulation of an industry. It will be more flexible than governmental rules and is driven by the needs of the industry. The regulated industry bears the cost. Self-regulation extends beyond governmental regulation with respect to the rules by its ability to establish ethical and best practices principles.[126] According to the theory of self-regulation, the administrative agency overseeing an SRO in an industry should counter and alleviate the self-protective and anti-competitive elements.[127]

Unfortunately, the history of self-regulation has often been self-protection of the industry self-regulated.[128] Viewing the nearly eighty year

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[123] Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23, 26 (2013); *see also* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1459 (1997) (asserting that SROs can adopt higher standards based on just and equitable principles than those set by federal or state law).

[124] Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 967 (2012) (arguing that the effective enforcement powers of an SRO are a function of its market power).

[125] Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1250–51 (2007).

[126] *Id.* at 1252 (citing *Self-Regulatory Organizations: Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 109th Cong. (2006) (statement of Robert Glauber, Chairman and CEO, National Association of Securities Dealers), http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5ae67766-cec8-440c-93e9-d39d2a3b7bf1).

[127] *Id.* at 1256.

[128] According to a 1973 report of the Senate Subcommittee on Securities:

> The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the

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history of self-regulation in the securities industry, one finds that Congress repeatedly had to give the Securities Exchange Commission increased authority over the rules and practices of the self-regulating organizations to make the process work. There is a natural lack of enthusiasm for regulation by people who will be regulated.[129] Larger firms in the industry tend to dominate the SRO and attempt to advance their interests through anti-competitive restraints on less powerful and newer members. There is a temptation to use the softer touch of self-regulation to ward off more rigorous rules imposed by government.

Despite these reservations, if an appropriate balance is achieved, self-regulation can be a satisfactory and effective means of raising business practices. In the case of charitable solicitation, self-regulation can protect charities and donors from dishonest and unfair practices by outliers in the fundraising profession.

## IX. How CHAPFRA Would Work

CHAPFRA would be less proactive than FINRA in terms of undertaking investigations on its own.[130] It would not involve itself, at least initially, in dispute resolution such as arbitration or mediation. Its disciplinary and sanctioning activity would occur after FTC investigations

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> temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.

S. DOC. NO. 93-13, at 145 (1973).

[129] Black, *supra* note 123, at 25–26 (quoting the SEC stating that "[i]nherent in self-regulation is the conflict of interest that exists when an organization serves both the commercial interests of and regulates its members or users," and citing S. DOC. 93-13, at 145 (1973)).

[130] The financial services industry is far larger than the fundraising profession. In 2012, FINRA brought approximately 1,500 disciplinary actions against broker-dealer firms and associated persons, imposed fines of more than $68 million, and ordered restitution of $34 million to injured investors. FINRA expelled thirty firms, barred 294 individuals, and suspended another 549 individuals. FINRA, *FINRA 2012 Year in Review and Annual Financial Report*, at 8 (2013), https://www.finra.org/file/finra-2012-year-review-and-annual-financial-report. Most of FINRA's disciplinary proceedings are mundane and do not grab headlines. Consisting of a single broker accused of simple fraud, the proceedings are frequently uncontested, or if contested, the broker appears pro se. Black, *supra* note 123, at 24.

followed by discipline, or more frequently, after state jurisdictions have found fraud or violations of state solicitation statutes after litigation or settlement by the wrongdoer. Another contrast with FINRA would be that while a central location facilitates the ability of markets to monitor breaches of fiduciary duty that reduce improper behavior, fraudulent fundraising can be more effectively monitored at the state level because not every campaign is national in scope, and despite the weaknesses of state enforcement, it is still more effective than the FTC, which has many other responsibilities and has been less proactive in this area.

A primary purpose of CHAPFRA would be to create a registration or membership requirement in the SRO for professional fundraisers and fundraising counsel[131] as a condition of entering the fundraising profession,

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[131] There are four kinds of fundraising personnel: professional fundraisers, commercial co-venturers, fundraising counsel, and professional solicitors. N.Y. EXEC. LAW § 172-a(4) to (6), (9) (Consol. 2015). Volunteer solicitation generally is not regulated other than through the anti-fraud provisions of the statute. *See id.* § 172-d.

A professional fundraiser is defined as:

> Any person who directly or indirectly, *by contract, including but not limited to sub-contract, letter or other agreement or other engagement on any basis*, for compensation or other consideration (a) plans, manages, conducts, carries on, or assists in connection with a charitable solicitation or who employs or otherwise engages on any basis another person to solicit *from persons* in this state for or on behalf of any charitable organization or any other person, or who engages in the business of, or holds himself out to persons in this state as independently engaged in the business of soliciting for such purpose; (b) solicits *on behalf of a charitable organization or any other person*; or (c) who advertises *that the purchase or use of goods, services, entertainment or any other thing of value* will benefit a charitable organization but is not a commercial co-venturer.

*Id.* § 171-a(4) (footnotes omitted).

A "professional solicitor" is a person employed or paid by a professional fundraiser to solicit contributions. *Id.* § 171-a(5).

> A "fundraising counsel" is a person who is paid to consult with a charitable organization or to plan, manage, advise, or assist with solicitation of contributions but does not herself solicit and does not have access to contributions or authority to pay expenses. *Id.* § 171-a(9). Fundraising counsel, usually work for a flat fee, have established charities as clients, and perform little or no in-person or telephone solicitation.

Renee Jones, *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1639 (1992).

A "commercial co-venturer" is someone who regularly and primarily engages in profit-making trade or commerce and advertises that the purchase or use of goods, services, entertainment, or anything else of value will benefit a charitable organization. She does not raise funds. N.Y. EXEC. LAW § 172-

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a $335 billion dollar business in 2013.[132] Volunteer fundraisers (those who receive no compensation for their efforts), would be exempt from registration, as is the practice in many state jurisdictions. Another important purpose of the SRO would be to create a public database of fundraisers who have violated state or federal requirements. *De minimis* violations would not be on the database unless there are a specified number of repetitions. This database would be useful to state regulators, who now have little knowledge of what is happening in other jurisdictions, and to charities considering retention of a professional fundraiser. Professional solicitors would be required to file a list of client charities that would be updated every six months. This would not be public information for competitive reasons.

CHAPFRA would also create professional standards and offer educational programs and resources to the public. After a due process hearing, the SRO could impose a variety of sanctions, if appropriate, ranging from censure, limitation of activities, fines, and suspensions to expulsion. Sanctions, except for expulsion, would not be punitive (that is, retribution for wrongdoing), but remedial. SROs are private bodies and the disciplinary hearing is a civil matter. CHAPFRA's rules could be reviewed, abrogated, or deleted by the FTC, but hopefully, this would be infrequent.

CHAPFRA disciplinary procedures would involve a hearing before a panel of three, consisting of two professional hearing officers and one industry representative. The SRO's investigatory and disciplinary powers would be subject to FTC review. After the CHAPFRA hearing, the FTC could impose additional or lesser sanctions. The FTC could institute a *de novo* review, but this would likely be infrequent. The SRO decision would

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a(6). Unlike a professional fundraiser, a co-venturer is not acting directly on behalf of the charity but is engaged in a commercial venture that will ultimately benefit a charitable organization, among others. The strategy employed here is sometimes referred to as charitable sales promotion or cause-related marketing. Commercial co-venturers do not have to register, but are required to provide the charitable organization with a copy of the contract. *See generally* VICTORIA B. BJORKLUND ET AL., NEW YORK NONPROFIT LAW AND PRACTICE § 6.03[1] (2d ed. 2013).

[132] According to "Giving USA," a report compiled by the Indiana University Lilly Family School of Philanthropy, contributions from individuals, corporations and foundations totaled $335-billion in 2013, a three percent increase from 2012, when adjusted for inflation. *See* Alex Daniels, *Charities Try New Strategies as Fundraising Rebounds*, THE CHRON. OF PHILANTHROPY (June 17, 2014), http://philanthropy.com/article/Charities-Try-New-Strategies/147167/.

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be affirmed unless there was an abuse of discretion. The solicitor could ultimately appeal to a federal Court of Appeals, but CHAPFRA could not appeal an FTC reversal of its sanction. Settlements would not be subject to review. The extended due process suggested is necessary, because banning someone from a profession should not be done lightly.

## X. Conclusion

Perhaps the most important recommendation is the creation of a national online readily-accessible database that would contain a comprehensive record of violations of state and FTC fundraising rules and requirements by solicitation firms and the individuals who own or work for such firm. The database would include contracts between fundraisers and charities, results of fundraising campaigns as well as settlement agreements between state and federal officials and professional fundraisers. CHAPFRA and the database would be funded through members' dues. The database of fundraiser violations will place a duty of care burden upon nonprofit boards to access the information, so as to make a reasoned decision before signing a contract with a professional fundraiser, and will ease cooperation between state charity officials and attorneys general.

A self-regulatory model that includes required professional membership, a due process procedure to sanction or permanently ban those who engage in fraudulent solicitation, and a national database of violators of state solicitation laws and those who are permanently banned will provide the most cost effective way of ensuring that a maximum of charitable contributions will go toward an organization's mission. It will also remove a blight that affects the reputation of the whole nonprofit sector.

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