MEMORANDUM

To: MEMBERS OF NON-PROFIT FORUM
From: MARION R. FREMONT-SMITH
Date: APRIL 1, 1998
Re: APRIL 16, 1998 MEETING

My contribution for April 16 departs from precedent, but I want to assure you that Harvey has given his approval to the change. What I am sending to you is a proposal for a research project submitted last fall to the new Hauser Center for Nonprofit Organizations at Harvard. It was accepted in January; I am now a "Senior Research Fellow" based at the Kennedy School and just getting my feet wet in academe, albeit on a very part-time basis. And so, rather than enlighten you, I am asking you to enlighten me. Specifically, I hope you will provide a critique of the project, suggestions for improvement and advice on the practicalities of carrying it out.

I look forward to seeing you on the 16th.
RESEARCH PROPOSAL FOR STUDY OF THE
ACCOUNTABILITY OF THE PHILANTHROPIC SECTOR
MARION R. FREMONT-SMITH
NOVEMBER 12, 1997

I. BACKGROUND STATEMENT

LEGAL DUTIES OF OFFICERS AND DIRECTORS OF TAX-EXEMPT CHARITIES

Society confers benefits on non-profit philanthropic organizations and allows them a wide degree of freedom in which to operate. In exchange, we expect that the fiduciaries responsible for their administration will act for the benefit of the public, and not to further their private interests. The law imposes a set of duties on these individuals. In fact, under law the persons who direct and manage exempt organizations are called "fiduciaries", a term that carries with it the connotation of a person with duties to others. Under state law, there are two fiduciary duties which are overriding - a duty of loyalty and a duty of care. Both of these stem from the law of trusts but apply, albeit with somewhat more lenient standards in some jurisdictions, to corporations established for philanthropic purposes. The duty of loyalty demands faithfulness to the purposes of the charity, which in turn includes a prohibition against self-dealing transactions that could be detrimental to the charity. The duty of care is a standard to which fiduciaries will be held in carrying out the mission of the organization. It demands that they act with the same degree of prudence as the ordinary person in similar circumstances. All fiduciaries will be held accountable for acts of gross negligence; in a few instances they will be held liable for ordinary negligence, but in no case will the courts second-guess their decisions made in good faith and with due care.

The tax laws also impose duties on officers, directors and trustees of organizations exempt from tax under section 501(c)(3) of the Internal Revenue Code. In order to be eligible for tax-exemption, the charity
must be organized and operated for exclusively charitable, educational, religious or scientific purposes, defined in federal law by reference to the common law definitions used in the states. The Code also prohibits private inurement, private benefit, participation in any political campaigns and excessive lobbying. However, until 1996 there were no prohibitions applicable to fiduciaries of tax exempt charities other than private foundations; rather the prohibitions were directed toward the organization, and the only sanction was loss of tax exemption. This meant that in a state with no active program to enforce fiduciary obligations, should tax exemption be lost, the charitable fiduciaries whose acts led to the loss could remain in office with no constraint on their activities. Legislation imposing "Intermediate Sanctions" on certain charitable fiduciaries was enacted late in 1996 and, for the first time, the Internal Revenue Service had the power to impose personal penalties on managers of charities other than private foundations and on insiders who were found to have received "excess benefits" from their dealings with the organization. However, the only fiduciaries who are subject to these new limitations are those who are found to be in a position to "exercise substantial influence" over the affairs of the organization, so that the effectiveness of the legislation is curtailed.

STANDING TO SUE TO ENFORCE COMPLIANCE WITH FIDUCIARY DUTIES

Primary responsibility for assuring the proper administration of charitable organizations rests on the state attorney general as representative of the general public, which is the ultimate beneficiary of all funds held for charitable purposes. In some states, this power is specifically conferred by statute, in some by reason of a general understanding of the duties of the office of Attorney General, and in still others by judicial decision. Furthermore, except in rare instances, it is an exclusive power, and members of the public, whether actual or potential beneficiaries of the charitable funds, cannot compel the attorney general to exercise his enforcement power,
although he may on his own motion appoint private individuals to act on his behalf.

The exclusion was based, not on a denial of the public's interest in the charitable trusts, but on the practical consideration that it would be difficult to manage charitable funds, or even to find individuals to take on the responsibility, if the fiduciaries were to be constantly subject to harassing litigation.

There are a few instances in which the courts have permitted exceptions to the attorney generals's exclusive jurisdiction, but only to the extent of granting standing to persons who can demonstrate that they have a specific, defined interest in the affairs of the organization, either as members or directors of a corporation or as part of a class of narrowly defined persons who can demonstrate a "special interest" distinguishable from the general public. In short, without a major revision of state law, effective enforcement requires an Attorney General committed to carry it out.

EXTENT OF STATE ENFORCEMENT PROGRAMS

The extent of enforcement by the Attorneys General country-wide is slight and sporadic. This is the case despite the fact that for more than three decades commentators have uniformly called for increasing state enforcement programs. In the mid-sixties, the Uniform Supervision of Charitable Trusts Act or statutes with similar provisions requiring the filing of annual financial reports with the attorney general and granting enhanced enforcement powers to his office were in effect in ten states: namely, California, Illinois, Massachusetts, Michigan, New Hampshire, New York, Ohio, Oregon, Rhode Island and Washington. Since that time, no state has enacted a similar statute and Michigan and Washington no longer require financial reporting. The attorneys general in Connecticut, Texas and Pennsylvania do have charities divisions with active enforcement programs but their efforts are directed primarily at enforcement of the laws regulating solicitation of charitable funds. Furthermore, they operate without the benefit of a mandatory
reporting statute and, in some instances, any requirement that they be given notice of legal actions involving charitable funds, so that their effectiveness is hampered. Nonetheless, the accomplishments in these states indicate that an attorney general interested in fulfilling his duties in regard to charitable funds who has a budget sufficient to maintain an active enforcement program can produce tangible benefits. Recent examples are to be found in the cases involving the sale of non-profit hospitals and HMOs to for-profit entities, where intervention by the attorney general has assured the preservation of charitable funds in a number of these jurisdictions. No attempt has been made, however, to compare the degree of compliance in any of these states with those where there is no attempt at enforcement.

In addition to their investigative, audit and prosecutory functions, the attorneys general in several states have inaugurated programs designed to educate the managers of charities as to their duties and responsibilities. The Oregon attorney general has published and distributed a Guide to Non-Profit Board Service in Oregon. An Advisory Committee on Public Charities has operated in Massachusetts since 1963, meeting with the attorney general and his staff several times a year and assisting in public education efforts relating to the costs of solicitation, amendments to the reporting forms, and suggestions for legislative change. The Massachusetts attorney general has also sponsored an annual conference for charity directors, designed as a forum to review current policies and problems facing his office and as an educational tool. In several other states, efforts of this nature are viewed as inappropriate for a state prosecutor and the posture of the office is to keep a distance from the subjects of regulation. No attempt has been made to date to evaluate the efficacy of these divergent approaches.

RECENT EXAMPLES OF NON-COMPLIANCE WITH FIDUCIARY DUTIES

In 1996, the Board of Regents of the University of the State of New York removed eighteen of the nineteen trustees of Adelphi University on the grounds that they had been negligent in approving excessive compensation
agreements with the president and certain of the trustees. In 1993 the
Attorney General of Massachusetts reached an out-of-court settlement with the
Trustees of Boston University who were charged with abuse of their fiduciary
duties in connection with certain self-dealing transactions between them and
the University, the payment of excessive compensation to the president and the
authorization of certain speculative investments. During this same time period
the chief executives of United Way and the New Era Foundation were found
guilty of criminal behavior arising out of abuses of their fiduciary duty,
abuses that in some instances were tolerated by the organization's board
members and in some were allowed to occur through their inattention.

These four examples, each widely publicized, and a number of
similar instances of misconduct occurring in various parts of the country have
alarmed supporters of the voluntary community who are fearful of the backlash
that could occur if the public believes that the trust generally afforded to
charitable fiduciaries is misplaced. The situation is exacerbated by the fact
that, although there is anecdotal evidence of abuse, the nature and extent of
breaches of fiduciary duties are not known. Furthermore, although there are
several national voluntary organizations that do attempt to educate trustees
and officers as to their duties, their audience is small and consists
principally of persons who are already aware of their duties. They do not
reach out to the smaller organizations which comprise the vast majority of all
tax exempt charities, although representing a small minority of charitable
dollars.

STATE-MANDATED AUDITS AS AN ENFORCEMENT TOOL

One of the tools used by a few states to compel compliance with fiduciary
duties has been enactment of a statutory requirement that charities of a
certain size conduct, and submit to the state, an annual audit. Massachusetts,
for example, requires complete audited financial statements examined by an
independent certified public accountant in all cases in which gross support or
revenue exceeds $100,000. No study has been made of the effectiveness of this
technique as an enforcement tool. It would be useful to attempt to ascertain instances in which the process of audit has led to correction of abuses without the need for state intervention.

ENFORCEMENT THROUGH THE INTERNAL REVENUE CODE

As noted above, exemption from federal income, estate and gift taxes is conditioned on adherence to standards set forth in the Internal Revenue Code. The Code prohibitions against private benefit and inurement are applicable to all exempt charitable organizations; strict rules against self dealing are applicable to private foundations; and transactions involving publicly supported charities that result in private benefit to insiders are also prohibited. The Service initially obtains information on these transactions by means of questions included in Form 990, the tax information return. The audit process is designed to bring to light other instances of non-compliance, but in recent years the scope of the program has been drastically curtailed, with the number of audits dropping to less than 0.5% of all tax exempt organizations. Unfortunately, public information on the outcome of audits is meager and in the cases where a settlement is reached as an alternative to litigation, the terms of the settlement made often not made public.

Nonetheless, it may be possible to obtain some of the pertinent statistics from the Service. Of particular interest would be information from which one could compare the number of revocations of tax status in years with high audit activity with those during which it was limited.

There is one other aspect of the federal enforcement scheme that may warrant review. Among the restrictions on private foundations enacted in 1969 was a requirement that all exempt foundations include in their governing documents a provision explicitly requiring compliance with the federal rules, unless a state statute was enacted requiring such compliance. At the same time, provision was made under which the Service could share with state charity officials information regarding audit results and particularly activities leading to revocation of exemption. Under Treasury Regulations,
the ability of the Service to effectuate these exchanges is greatly curtailed and little is known as to whether this enforcement tool has been of assistance to state enforcement officers. Analysis of available information on this aspect of federal-state cooperation could be valuable for an analysis of the effectiveness of enforcement activities.

SEC-TYPE OVERSIGHT AS AN ALTERNATIVE TO TAX ENFORCEMENT

One of the studies prepared for the Filer Commission on federal regulation of charities recommended establishment of a separate commission modeled on the Securities and Exchange Commission to provide oversight of charitable activities on a national basis, supplanting the role of the Internal Revenue Service in this respect. The complicated financial arrangements involved in many recent conversions and sales of tax-exempt non-profit health care organizations to for-profit entities has led to renewed interest in this proposal. The rationale for such a proposal is that only an agency with the expertise of an SEC would be equipped to determine the fairness of transactions of this nature. It would be appropriate to revisit this proposal as an alternative to regulation by the IRS, whether for all charities or only for those presenting particular problems which require expertise not available through the Internal Revenue Service.

VOLUNTARY SECTOR INITIATIVES TO PROMOTE AND FACILITATE COMPLIANCE

There are a number of nation-wide organizations dedicated to improving the performance of the philanthropic sector. Independent Sector, the Council on Foundations, and the National Center of Non-Profit Boards all, in varying degrees, attempt to foster understanding of and compliance with fiduciary duties. State and local Bar Associations and organizations supported by the accounting profession offer educational programs as well as hands-on assistance to tax-exempt organizations, particularly in regard to organizational and reporting requirements. There are also regional, state and local organizations, such as the Nonprofit Coordinating Committee of New York,
as well as state and local organizations of grant makers, that attempt to improve the performance of their constituents. A network of "Support Centers", operating throughout the country, offers courses and seminars designed to improve compliance with state and federal rules and to encourage efficiency and effectiveness. Other organizations focus on specific areas of philanthropy, such as the Association of Governing Boards which is supported by colleges and universities, there is another supported by the trustees of health care organizations, and there are myriad entities that provide support to artistic and cultural organizations. No survey has been made of the extent of these programs nor any analysis of their effectiveness. Such a study will be necessary in order to determine whether self-regulation can be considered an appropriate means for enhancing compliance.

II. PURPOSE OF THE STUDY

The purpose of the study would be to ascertain, to the extent possible, the degree of noncompliance and its causes - whether deliberate or due to mistake or ignorance - and the extent to which adequate compliance assistance is currently available to the voluntary sector or might be made available in the future. As to the question of compliance, there are no completely satisfactory ways to obtain the required information, due in part to the wide diversity in the extent of enforcement programs in the states and the drastic reduction in the audit activities of the Internal Revenue Service in recent years. Nonetheless, the procedures outlined below should provide some first steps toward an understanding of the situation and a context within which it will be possible to suggest state and voluntary remedial actions that will be consonant with the facts and neither overreactions to the most egregious abuses nor palliative measures that will, in the long run, fail to result in improvement and thus result in erosion of public confidence in the sector.
III. PROTOCOL

A. SUMMARY:
The purposes of the study are: (a) to survey and report on the extent and nature of non-compliance with state and federal laws regulating the behavior of charitable fiduciaries; (b) to determine the adequacy of compliance assistance and training offered to tax-exempt organizations; and (c) to suggest remedial actions for the both the public and private sectors.

B. METHODOLOGY
1. Review literature on enforcement efforts, and compliance results, including results of surveys, testimony at congressional hearings and press reports.
2. Establish an advisory committee composed of present and former state and federal regulators (including members of NAAG and NASCO), members of the voluntary sector and of the academic community who have particular interest and knowledge of the subject matter of the project to assist in the design of the project and be available to review and advise on results and recommendations.
3. Review nature and extent of existing voluntary sector programs designed to improve compliance and evaluate their effectiveness.
   - examine voluntary efforts by state and local bar associations and members of the accounting professions; the National Association of Attorneys General; state, regional and local non-profit associations, such as the Lawyers Alliance; programs sponsored by special purpose organizations such as art associations, and programs undertaken by national organizations such as Independent Sector.
   - review of continuing education programs and clinics offered by colleges and universities to trustees and executives.
4. Conduct studies to measure the extent and nature of non-compliance with substantive fiduciary laws and, if it appears warranted, with reporting requirements.
STATE PROGRAMS
-survey of existing enforcement programs
-evaluation of enforcement efforts in selected states
sufficient in number to include a large percentage of
philanthropic activity throughout the country in states with
active, moderate and little or no enforcement programs
-include information as to the attitudes of the regulators toward
their role - are they interested in improved performance or only
in their role as prosecutors

FEDERAL PROGRAMS
-extent of study will depend on accessibility of information made
available by the IRS but will cover at least all information
available to the general public
-review of available statistics on non-compliance
-interviews with present and former IRS officials, Treasury
personnel and Congressional committee staff members
-review of Service and Treasury efforts to encourage compliance
-comparison of SEC-type enforcement with reliance on the Internal
Revenue service

5. Survey selected charitable organizations to determine their knowledge of
the law, activities they have undertaken to ensure compliance with law, and
their views on the burdens imposed by regulation.
-If appropriate and warranted, survey focus groups of trustees and
executive directors as to their knowledge of and responsiveness to
the state and federal laws and regulatory regimes

6. Frame recommendations for remediation at state, federal and local levels to
be included in a final report suitable for general dissemination.
-changes to be adopted by the states and the federal government
-changes to be implemented within the voluntary sector