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SANCTIONS AND ENFORCEMENT:

FEDERAL AND STATE LAWS

By

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Much of this conference already has been devoted to the elaboration of the varieties of misconduct -- criminal and otherwise -- that can afflict nonprofit organizations. These behaviors cover the range of human infirmities, both malum in se and malum prohibitum. I have been asked to address the conference on the subject of sanctions for such misdeeds and "enforcement," presumably how government goes about deploying the manifold sanctions available to it.

The mere iteration of these sanctions could occupy most, if not all, of my allocated time as a presenter. I doubt whether such an exercise would do much to illuminate the subject of this conference or my presentation. In any case, others already have done this much better than I could, most recently Marion Fremont-Smith earlier this year in *Governing Nonprofit Organizations: Federal and State Law and Regulation*.

Instead, I'd like to draw on my experience of more than 35 years as a civil prosecutor, counsel for nonprofits and occasional scholar to offer my, perhaps, idiosyncratic views about the nonprofit enforcement terrain and a critique of some of the more salient features of that landscape, together with one or two reluctant suggestions for change.

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[1] I would like to express my gratitude to my colleague, Coleen M. McGrath, whose mastery of bluebook form, research skills and indefatigable labors have enabled me to establish the scholarly support for much of what I say here.

Except for the enactment of the eponymous foundation rules in 1969,[2] several of which were aimed directly and indirectly at the subjects of today's conference (i.e., the prohibitions against self-dealing, the ban on jeopardizing investments and the limit on excess business holdings), federal law, including, of course, the Internal Revenue Code was essentially devoid of efforts to regulate nonprofit corporate conduct (or misconduct). That field remained almost the exclusive preserve of the states, typically through the enactment of a patchwork of statutes and a common law process that empowered each state's attorney-general.[3]

The impact of the foundation rules, of course, is quite circumscribed. While the limits on excess business holdings retains some utility, that provision effectively had done its work when the last of the substantial grandfathered holdings were disposed of at the turn of the century.[4] Certainly, I suspect that any survey of the foundation world would be likely to reveal a sharply diminished excess business holding population -- testament, I would submit, to the rule's effectiveness. The jeopardizing investment ban, unlike the excess business holdings limit, has not run its course but, instead, was overtaken by the juggernaut of modern portfolio management theory. But, even in its heyday, no one, including the IRS, seemed to fully grasp how and when to deploy it. That leaves us with the cardinal sin of self-

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[2] 26 U.S.C.A. §§ 4940-4948 (2002).

[3] *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW §§ 115, 520, 706(d), 714(c), 720(a)(1) & (2) & 1101 (McKinney 1997); N.Y. EST. POWERS & TRUSTS LAW §§ 8-1.4(m) & 8-1.4(r) (McKinney 2002); N.Y. EXEC. LAW §§ 173(3), 175 & 177 (McKinney 1996 & Supp. 2004). I cite New York statutes because I am a New York lawyer and not necessarily because they are representative of the laws of 50 states; they, in fact, may not be.

[4] 26 U.S.C.A. § 4943(c)(4)(B)-(D) (2002).

dealing, the most potent weapon in the regulatory arsenal and still one which retains enormous vitality. We will return to that subject later.

At first blush, it might not appear that the evils at which this trio of foundation rules are aimed can be grouped under the heading of greed and pillaging. I would submit that they are direct manifestations of underlying behavior about which Congress legitimately was concerned and only can be described as self-interested conduct run amok. Certainly, retaining excess business holdings often represented an effort to enhance, unfairly, control of a business organization, with, presumably, self-enrichment as the result. And, the investments once characterized as jeopardizing simply were not isolated instances of aberrant conduct, like betting on the outcome of a horse race, but more typically a back-door means of advancing self-interest by what often was a less than arm's-length arrangement.

In any case, the rules impact only a fraction of the nonprofit universe.[5] As to the rest -- public charities of one variety or another -- the Code was <u>silent</u> until § 4958 was enacted in 1996[6] (with final regulations only being promulgated in 2002).[7] So, when we discuss sanctions and enforcement, at least for the specific sorts of behaviors under examination here, we are talking predominantly about state law.

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[5] The Internal Revenue Service's April 2004 Exempt Organizations Business Master File sets the number of recognized exempt organizations at 1,379,703, with 801,174 of that number classified as public charities and 105,579 as private foundations. Data available from National Center for Charitable Statistics at http://nccsdataweb.urban.org/NCCS/Public/index.php.

[6] 26 U.S.C.A. § 4958 (2002).

[7] Treas. Reg. §§ 53.4958-1 to 53.4958-8 (2002).

With, of course, one major exception. That is, of course, the criminal law -- both federal and state. It would be incomplete to have a conference on, among other things, greed and pillaging without a discussion of the criminal law. Indeed, a presentation on "enforcement" and "sanctions" that overlooked criminal law enforcement and its numerous sanctions would border on the risible. And, indeed, the criminal law has been not infrequently deployed to punish some of the more egregious nonprofit malefactors over the years. William Aramony, the head of United Way of America, was prosecuted by the U.S. Attorney for the Eastern District of Virginia for fraud, money laundering and filing false tax returns in 1994 and, ultimately convicted of various counts of fraud, interstate transportation of fraudulently acquired property and filing false tax returns and spent several years in prison;[8] James Halperin, a New York lawyer, was indicted in a criminal proceeding after the Attorney General uncovered evidence of more than $6 million in misappropriated foundation funds (he eventually pled guilty and served a brief prison term);[9] and, the head of New Era Philanthropy (an ironic name if there was one) was prosecuted by the U.S. Attorney for the Eastern District of Pennsylvania and pleaded no contest to charges of fraud and money laundering.[10] More recently, Lorraine Hale, President of Hale House, pled guilty to a single felony count and was

[8] *See* Tim Weiner, *United Way's Ex-Chief Indicted in Theft,* N.Y. TIMES, Sept. 14, 1994, at A12. *See also United States v. Aramony*, 166 F.3d 655 (4th Cir. 1999).
[9] *See* Kathleen Teltsch, *Abrams Says Head of Foundation Lived Well on Charity's Millions*, N.Y. TIMES, Dec. 18, 1988, at 75; *Lawyer Admits Bilking Foundation He Headed,* N.Y. TIMES, July 30, 1991, at B3; Kathleen Teltsch, *2d Jail Term Looms for Man Who Plundered a Foundation*, N.Y. TIMES, July 7, 1992, at B3.
[10] *See Head of Bankrupt Charity Fund Pleads No Contest in Fraud Case,* N.Y. TIMES, Mar. 27, 1997, at D17.

sentenced to five years probation (she already was in her 70s at the time of sentencing).[11]

There are, of course, numerous others, great and small. Marion Fremont-Smith, in her excellent article in *Exempt Organizations Tax Review* last year,[12] combed newspaper files for instances of nonprofit misconduct and identified more than 150 such instances, of which approximately two-thirds represent criminal conduct. And, of course, there is plain old employee theft -- usually some species of embezzlement among both high and low, as there is in any business.

Lest you suspect I am trivializing the subject, there also are far graver species of criminality endemic to certain varieties of nonprofit organizations. As almost any federal prosecutor will tell you, there is widespread fraud and criminality involving many programs funded by federal dollars.[13] This, of course, extends to, perhaps, the largest programs, including Medicare and Medicaid billing fraud, the prosecution of which is a staple in virtually any US Attorney's office and in many states as well.[14] While the latter, of course, are not behaviors specific to nonprofits, many of the institutions at which such misconduct occurs, indeed, are nonprofit institutions.

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[11] *See* Terry Pristin, *Hale House Sentencing*, N.Y. TIMES, Oct. 25, 2002, at B4.
[12] Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORGANIZATION TAX REVIEW 25 (2003).
[13] 18 U.S.C. § 666 is a favorite tool of federal prosecutors.
[14] *See, e.g., HCA to Pay $95 million in Fraud Case*, N. Y. TIMES, Dec. 15, 2000, at C1; Jennifer Steinhauer, *Beth Israel to Pay $1.2 Million for False Medicare Claims*, N.Y. TIMES, Dec. 5, 2000, at B7.

Obviously, if we were going to cover the entire universe of sanctions for greed and pillaging, we necessarily would have to focus much -- maybe the bulk -- of our discussion on the criminal law. Yet, I am reasonably confident, sight unseen, that little, if any, of the preceding expositions on greed and pillaging dwell long on the mundane aspects of state and federal criminal statutes used to prosecute such misconduct.

At the same time, I am confident that a presentation on the application of criminal statutes to the depredations of nonprofit fiduciaries and others would not be warmly received. I suspect that the reason for that is that we see such criminality as a more general concern, flourishing in numerous environments, but having no particular nexus to the nonprofit world.

There, in fact, is no bright line dividing criminality from the more egregious violations of fiduciary conduct that are so well known. At what point, for example, does excessive compensation become criminal conduct? Thus, in the case of The Spingold Foundation, whose President, in 1989, pled guilty to Penal Law violations, the defense was one frequently encountered in the defense of civil actions -- that the accused devoted substantial efforts to the fulfillment of his responsibility in overseeing and administering the foundation's activities and he was being compensated accordingly (at rates comparable to a lawyer's hourly rate). Similarly, a mistrial recently was declared in Dennis Kozlowski's trial on criminal charges for conduct that, had it been engaged in by a nonprofit executive, simply might have been treated as violations of fiduciary obligations, giving rise to civil liability only.[15] Thus, although it may be difficult to view executive compensation as the basis for criminal charges, at some unspecified outer limit, perhaps, the criminal law may come into play.

Obviously, then, both state and federal criminal law represent a substantial and effective sanction which already accounts for most of the reported enforcement activity. There, in fact, may be no reason to believe that more is needed or desired. However, there also are other enforcement regimes that, while part of the enforcement arsenal, often go unnoticed because they are administered neither by the IRS nor attorneys general. Any deeper understanding of enforcement needs would have to take such oversight activities into account. Such a program would include, for example, prohibitions on conflicting interest transactions in certain federally funded programs and the use of funding disallowances to recoup expenditures in violation of such prohibitions.[16] On an even larger scale, while, perhaps, not implicating individual greed, the use by research universities of excessive overhead rates in administering federal research funds certainly is suggestive of institutional "greed" and has been dealt[17] with accordingly.

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[15] *See* Alex Berenson, *Tyco Chief and His Deputy Avoid Convictions, but Not Tattered Reputations*, N.Y. TIMES, Apr. 3, 2004, at C5.

[16] *See, e.g.*, Office of Management and Budget, *Circular A-122: Cost Principles for Non-Profit Organizations*, Attachment B §§ 8d & 37 and *Circular A-110: Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*, §§ 42 & 62.

[17] *See, e.g.*, Andrew Pollack, *New Questions Raised on Stanford Research Costs*, N.Y. TIMES, Sept. 30, 1991, at A12; Claudia H. Deutsch, *Academia Fails The Ethics Test*, N.Y. TIMES, Nov. 3, 1991, at §4A (Education Life Supplement), at 26; William Celis 3d, *Navy Settles a Fraud Case on Stanford Research Costs*, N.Y. TIMES, Oct. 19, 1994, at A16.

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I also wish to make it clear that I do not regard a discussion of sanctions and enforcement with respect to issues of terrorism to be particularly illuminating. These, of course, are grave issues and, at various points, they touch the lives of nonprofit organizations. But, I believe that the war against terrorism, including its financing, will be fought on many fronts, but not, except occasionally, the nonprofit front.

This program already encompasses a discrete presentation on terrorism. And, although, at this writing I cannot be aware of what that paper will address nor, certainly, what its commentators will say, I cannot imagine any discussion of terrorism that will fail to dwell at some length on sanctions and enforcement. We, of course, may lament the toothlessness of sanctions dealing with the more mundane varieties of corruption or venality, but no one can doubt the seriousness of charges of terrorism nor the severity of the penalties such charges can invoke.[18]

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[18] Included among those penalties are suspension of an organization's tax-exempt status, blocking of an organization's assets and the imposition of civil and criminal penalties. For example, under Presidential Executive Order 13224, the assets of an organization found to have indirectly and unknowingly aided, assisted or supported terrorists or terrorist organizations can be blocked. Under the newly enacted Internal Revenue Code § 501(p), the tax-exempt status of any organization designated as a terrorist organization pursuant to an Executive Order or the Immigration and Nationality Act can be suspended, with the organization having no recourse to challenge the suspension in any administrative or judicial proceeding. **Under the USA Patriot Act, fines and terms of imprisonment up to 15 years can be imposed on any entity that provides material support or resources knowing or intending that they be used in terrorist acts or by foreign terrorist organizations; a maximum penalty of life imprisonment can be imposed if the terrorism results in the death of any person**. *See* 18 U.S.C.A. §§ 2339A(a) & 2339B(a)(1) (2000 & Supp. 2004). In addition, 18 U.S.C.A. § 2333 provides private parties with a civil cause of action against those who provide material support for terrorism; potential civil penalties include treble damages as well as court costs and attorneys' fees.

The government, of course, has at its disposal awesome weapons to deal with terrorism.[19] The interest in nonprofit corporations, of course, is their potential for providing material support to terrorist organizations or, at least, serving as the vehicle through which such support may be delivered to terrorist organizations around the world. That some such support has flowed through charitable and religious organizations is undeniable. That support for terrorism in the guise of charity is significant is not as clear. In the recent *Holy Land Foundation* case,[20] among the remedies sought and obtained by the government, was freezing $12 million in assets, targeted to support Hamas' terrorist activities. At the same time, I would note that the government froze more than $6 billion in assets of the former Iraqi regime.[21] In any case, after picking off the "low lying fruit" of such obvious targets as the Holy Land Foundation and others of that ilk, I doubt it there are substantially more such easy targets.

There are, I am sure, other similar targets of interest. But, as I am sure you have heard, the government has cast a rather wide net, seeking, understandably, to apprehend anyone supporting such nefarious activity. The problem is, I believe, that the pickings are likely to be slim, at best. Hamas, Hezbollah, Al-Qaeda and other terrorist organizations cannot be sustained on fortuitous grants from the Ford Foundation that go astray nor from the cash passed to a refugee camp guard

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[19] *See, e.g.*, Executive Order 13224 and the regulations thereunder, 31 C.F.R. Part 594; International Emergency Economic Powers Act; Antiterrorism and Effective Death Penalty Act of 1996; USA Patriot Act; and Enhanced Border Security & Visa Entry Reform Act of 2002.

[20] *Holy Land Foundation for Relief and Development v. Ashcroft*, 333 F.3d 156 (D.C. Cir. 2003).

[21] *See* Christopher Quay, *Treasury Nominees Discuss Combating Terrorist Financing*, 45 EXEMPT ORGANIZATION TAX REVIEW, No. 2 at 209 (2004).

somewhere in East Asia who might be a sympathizer. Yet, we seem to have a system geared to interdicting such stray contributions. To me, at any rate, it seems to involve an enormous effort unlikely to produce much of value. The organizations that have been targeted successfully themselves provide the refutation to such an appeal. They, in fact, are organizations wholly or substantially dedicated to supporting terrorism, not otherwise admirable charities which, through inadvertence, end up providing the occasional "terrorist" grant.

In any case, whatever role charities and religious organizations have played in financing terrorist activities, that role, undoubtedly, is just one of many such avenues. Clearly, the normal channels of trade and finance present numerous opportunities for money laundering, just as they have done for many years in financing a whole range of criminal activities from arms smuggling to the drug trade.[22] There is little reason to think that such channels are not used by terrorists and it would not be surprising were such activities to dwarf the contributions, inadvertent or otherwise, of charity.

I would add one caveat. Religious organizations -- be they charities, synagogues, churches, etc. -- are almost totally opaque from a regulatory or

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[22] *See, e.g.*, Patick Healy, *U.S. Indicts 11 in Chop Shop in Brooklyn Worth Millions*, N.Y. TIMES, Sept. 10, 2004, at B5 (money laundering among charges in case involving theft and resale of automobiles); *Jewelers Accused of Laundering*, N.Y. TIMES, Aug. 24, 2004, at B6 (money laundering alleged in case involving jeweler dealers in diamond district); *A HealthSouth Trial Delay*, N.Y. TIMES, Aug. 17, 2004, at C9 (money laundering among charges in case involving accounting fraud at hospital chain); Susan Saulny, *Check Cashers Indicted*, N.Y. TIMES, July 16, 2004, at B4 (money laundering charges brought in case involving commercial check-cashing business); William K. Rashbaum, *Detective Fired in Aftermath of New York Policy Inquiry*, N.Y. TIMES, Sept. 24, 2004, at B1 (money laundering alleged in case involving the sale of drugs); William Glaberson, *Career of a Crime Boss Ends With Sweeping Convictions*, N.Y. TIMES, July 31, 2004, at B1 (money laundering among charges in case involving racketeering).

financial disclosure point of view, although they, of course, are exempt institutions. Given what we know of the religious underpinnings of the terrorists and what has been uncovered both here and in western Europe about the role of some religious leaders, it would come as no surprise to learn that religious organizations may give cover to financing terrorist activities.[23] There are obvious prohibitions from pursuing such activities,[24] but some of the solutions are obvious. Religious organizations, of course, could be compelled to apply for recognition of exemption and file Forms 990 and be subject to audit, without the constraints the Code currently affords them. That, of course, would raise the ire of religious leaders and organizations representing most, if not all, denominations. However, some effort to identify such organizations and require some information would be a start and it may be that in the current environment such steps may be feasible.[25]

I have one additional observation concerning the intersection of terrorism and the nonprofit world. The Treasury Department's "best practices" remind me, to its disadvantage, of the screening of airline passengers but without, perhaps, the strong argument for necessity of the latter. The screening process, of course, has been subject to much public criticism because it touches the lives of so many. Each

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[23] *See, e.g.*, *Radical Cleric Sought by U.S. Arrested*, LOS ANGELES TIMES, Aug. 27, 2004, at A4; Julia Preston, *Lawyer Relayed Statement of Terrorist, Reporter Says*, N.Y. TIMES, Sept. 14, 2004, at B6; Alan Cowell, *U.S. Lays Out Case in British Court to Extradite Cleric*, N.Y. TIMES, July 24, 2004, at A2; William Glaberson, *Yemeni Cleric Is Said to Urge Revenge Against Americans*, N.Y. TIMES, Sept. 22, 2004, at B7.
[24] 26 U.S.C.A. § 7611 (2002); Treas. Reg. § 301.7611-1 (restrictions on church tax inquiries and examinations).
[25] Certainly, from a legal/constitutional perspective, courts appear willing to give short shrift to what otherwise might be compelling constitutional arguments inhibiting government's prerogatives. In *Holy Land Foundation for Relief and Development v. Ashcroft*, 333 F.3d 156 (D.C. Cir. 2003), the D.C. Circuit observed repeatedly in its nine page opinion that there is no constitutional right to support or engage in terrorism when First Amendment claims were advanced. A similar approach to religion-based First Amendment claims is not inconceivable.

year millions of passengers emplane at US airports and each of these, as we have learned indelibly, must be screened.[26] We all are familiar with the instances of absurdity -- the agent who refused to allow Senator Edward Kennedy to board because he was on a "no fly" list[27] or the Newsweek columnist who recently recounted the humiliating ordeal endured by her frail 84 year old father. Nevertheless, no one among us would wish to be relaxed or casual about airline security. And, given the enormous numbers of screenings, the need for thousands of screeners, the obvious impossibility that all so employed will be capable of exercising suitable discretion (and I don't think we'd want them to) and the necessary speed of processing embarking passengers, we inevitably must accept some inefficiencies and even arbitrariness. A mistake or any laxity, as we have sadly learned, leads to disaster. So, we err on the side of rigidity and inflexibility. We simply don't want airport screeners to exercise much or, perhaps, any discretion -- the stakes are too high.

But, that analysis leads to precisely the opposite result when you look at the Treasury best practices.[28] There is no safe harbor.[29] Secondly, the penalties, at

[26] *See* C. J. Chivers, *Russians Cite Porous Security in Terror Bombings of 2 Planes*, N.Y. TIMES, Sept. 16, 2004, at A8.
[27] *See* Rachel L. Swarns, *Senator? Terrorist? A Watch List Stops Kennedy at Airport*, N.Y. TIMES, Aug. 20, 2004, at A1.
[28] U.S. Department of The Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities (November 7, 2002), available at www.treas.gov/press/releases/docs/tocc.pdf.
[29] The opening paragraph of the Guidelines provides as follows: "[c]ompliance with these guidelines shall not be construed to preclude any criminal or civil sanctions by the Department of the Treasury or the Department of Justice against persons who provide material, financial, or technological support or resources to, or engage in prohibited transactions with, persons designated pursuant to the Antiterrorism and Effective Death Penalty Act of 1986, as amended, or the International Emergency Economic Powers Act, as amended."

least potentially,[30] are vastly disproportionate to the harm. What, in fact, is the potential harm if a single grant of modest size strays? It is not, of course, the single transaction that leads ineluctably to the horror we are striving to avoid but the aggregation of innumerable such transactions to provide the financial support necessary to provide weapons of destruction and all the other expenses of such an operation. This, indeed, is precisely the area in which automatic and inflexible penalties make little sense, but where a thoughtful risk-based approach, as so many have urged,[31] makes eminent sense and poses no real risk.

Finally, however, what must be kept in mind is the ordinariness of these government responses to terrorism. As we have been reminded regularly in the last three years, we, in effect, are at war. And, as in other wars, now and earlier, here and elsewhere, "[t]he power of the state trumped the rights of the individual…a matter of natural law."[32]

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As I have reiterated earlier in this discussion, the federal government, through the Internal Revenue Service primarily, is a newcomer in the enforcement

[30] As previously noted, potential penalties range from the blocking of assets to a maximum penalty of life imprisonment. *See supra* note 18.

[31] *See, e.g.*, Committee on Exempt Organizations, American Bar Association, *Comments in Response to Internal Revenue Service Announcement 2003-29, 2003-20 I.R.B. 928 Regarding International Grant-Making and International Activities by Domestic 501(c)(3) Organizations, in* Nonprofit Organizations Law 2003 7, 21-76 (Practising Law Institute 2003).

[32] HEW STRACHAN, THE FIRST WORLD WAR 235 (2000). Strachan observes that in France the Law of Siege gave the army the power to requisition goods, control the press, apply military law to civilians and subordinate the police to military control. The British did scarcely better. The Defense of the Realm Act also permitted trial of civilians by courts martial and allowed press censorship. The United States, despite its briefer and more remote involvement in that conflict, witnessed the virtual extirpation of German language and culture, the effective erasure of the distinctiveness of America's second largest ethnic grouping. We also saw the passage of the Espionage Act of 1917 and its amending legislation, the Sedition Act of 1918. *See also Abrams v. U.S.*, 250 U.S. 616 (1919) (upholding the Espionage Act).

of laws against pillaging and greed, apart from its successes in the foundation world, a relatively small subset of the charity universe. In fact, it is fair to say that it had no effective tools (i.e., sanctions) to attack those evils specifically. Indeed, it was this very situation that gave rise to intermediate sanctions legislation in 1996 and the accompanying 2002 regulations. What is most striking about the intermediate sanctions regime is its virtual absence as an enforcement tool. It has been employed by the Service in fewer than a handful of instances -- in the *Caracci* case,[33] the Bishop Estate[34] and one other unidentified instance.[35] Now, the Service -- perhaps, under pressure from the Senate Finance Committee -- is undertaking an ambitious examination of compensation practices of exempt organizations.[36] What will happen, of course, is a question mark.

One of the foci of this effort is high-earning chief executives. If we take a recent issue of *The Chronicle of Philanthropy* at face value,[37] most of the million dollar CEOs -- with a few exceptions -- run large, complex health care organizations which, in many ways, have more in common with public companies than with most charities, whether measured by assets, revenues, employees or the management of

[33] *Caracci v. Comm'r*, 118 T.C. 25 (2002).
[34] *See* Rick Daysog, *IRS Study: Bishop Trustees Overpaid*, HONOLULU STAR-BULLETIN, Aug. 6, 1999, at 1; Rick Daysog, *IRS Says Peters Owes It $6 Million*, HONOLULU STAR-BULLETIN, Aug. 18, 2000, at 1; *Bishop Estate Closing Agreement Conditioned on Publication*, 85 TAX NOTES 1368 (Dec. 13, 1999); *Hawaiian Court Approves IRS Settlement with Educational Trust*, 85 TAX NOTES 1541 (Dec. 20, 1999).
[35] *See* Tech. Adv. Mem. 2002-43-057 (July 2, 2002). A study of those instances might not give pause to a potential wrongdoer. The Bishop Estate involved a situation that was flagrant and continued unredressed for many years. Despite the egregious wrongdoing, criminal proceedings were dropped eventually. *See* Rick Daysog, *IRS OKs Ex-Trustees' Settlement*, HONOLULU STAR-BULLETIN, Dec. 22, 2000, at 1. The *Caracci* case, too, is hardly a paradigm for effective enforcement. It took almost a decade to bring the perpetrators to justice and, because the IRS had only limited success in the valuation battle, the modest 4958 penalty might be seen as an acceptable cost for a successful and ultimately profitable health care conversion.
[36] *See IRS Initiative Will Scrutinize EO Compensation Practices*, I.R.S. News Release IR-2004-106 (Aug. 10, 2004).
[37] *See* Elizabeth Schwinn, *Big Nonprofit Salaries Face Government Scrutiny*, CHRONICLE OF PHILANTHROPY, June 24, 2004, at 34.

recondite knowledge. I'd certainly hesitate to say that $1 million or so for such individuals is necessarily "excessive," whether or not they scrupulously adhered to the safe harbor prescription of § 4958. Of course, what this says about the other 1,950 I can't really say. But, I have doubts about the IRS' capacity and determination to pursue this adequately. Recently, as many of you may know, the IRS has engaged in a round of "limited scope" audits, in response to criticism of the lack of field audits. The problem, at least anecdotally, is that the scope of this initiative is so limited, that not much can be expected.

The history of § 4958 is instructive. The statute has been on the books for the better part of a decade. Even the regulations, after several iterations, have been around for almost three years. As mentioned earlier, its use as an enforcement tool has been virtually nonexistent. What becomes of current initiatives very much remain to be seen.

There have been other results, however, arising from the adoption of § 4958 and the promulgation of the accompanying regulations. Although my observations either are experiential (mine) or anecdotal (that of other practitioners), it is clear to me that major beneficiaries of § 4958 have been lawyers, accountants and compensation experts who have been guiding exempt organizations through the safe harbor provisions and, dare I say it, suggesting its widespread utility even, perhaps, when common sense would dictate otherwise. Substantial charitable resources have been devoted to a meaningless compliance with the law's requirements without successfully inhibiting excessive compensation (compensation being the main focus of § 4958 although its scope expressly is broader).

I also suspect that overall compensation, especially for highly paid CEOs and other senior officers, is likely to have increased. The statute itself and the regulations explicitly opened the door to comparisons of nonprofit salaries with their for-profit counterparts. While the impetus for this radical break with prior law may be found in the origins § 4958 itself during the onslaught of massive health care conversions in the late 1980s and 1990s,[38] when such comparisons may have been appropriate, it has permitted -- indeed, encouraged -- sector-wide opportunities to make comparisons between the compensation of nonprofit executives, and business executives when the two spheres historically have been separated by one or two orders of magnitude. The result, almost certainly, has been to push the floor for compensation up dramatically, at least for the upper ranks of nonprofit executives.

Other serious shortcomings inhere in § 4958's emphasis on process, the nature of any valuation process and institutional deficits faced by the IRS in taking on such an ambitious program. The roots of § 4958 may not be "gnarled" [39] but they certainly are over-determined, as analysts might say. Clearly, much of the impetus for § 4958 -- an idea that, in various guises, had been around for years -- was the

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[38] *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 260-262 (2004).
[39] John G. Simon, *The Gnarled Roots of Nonprofit Law* (February 18, 2004) (on file with author).

impact of the major health care conversions.[40] That, indeed, may explain why the IRS opened the door in benchmarking the process to allow comparability to business organizations. In the health care arena, of course, such comparability is a (relatively) compelling argument. The scale and complexity of a CEO or CFO role at one of the major nonprofit health care networks, after all, is not much different than that of comparable officers at Tenet, Humana or similar providers.

While such a comparison may be appropriate in that specific context, it opened the door to consideration by organizations of similar situations that may not be remotely comparable but have an obvious pretextual value. While the regulations themselves (and, particularly, the examples employed) would appear to discourage such a casual approach to elaborating the presence of true comparability, too much room is left to argue over this fact intensive issue -- not easily resolved -- and, of course, enables organizations to claim "safe harbor."

The emphasis on process also suggests that there are no substantive limits. That may be good law, but it is not good policy. An investing public may tolerate "excessive" compensation for business executives (as long as stock prices rise and, sometimes, even if they don't) but I think it profoundly unwise to have no constraints on compensation. Indeed, we may see, if *Spitzer v. Grasso*, ever goes to trial, precisely what those limits are (although the context -- a nonprofit trade association -- is less favorable to the Attorney General than would be a charity). With a process orientation, nothing is disallowed if the process is followed and, with

[40] *See* MARION R. FREMONT-SMITH, *supra* note 38, at 260-262.

good lawyering, the approved process can be adhered to almost all the time, making it exceedingly difficult and costly to challenge.[41]

Finally, and not at all trivially, is the weakness of any appraisal process. Economic appraisals, of course, are used in many contexts -- generally for the purpose of establishing a value which will be used for judicial fact-finding, regulatory or other similar purposes. Such valuations are common, for example, in the estate tax arena,[42] to establish fairness for purposes of asset sales,[43] for excess benefit purposes and in numerous other situations. Regardless of the context, however, these engagements are emphatically not abstract economic exercises; instead, they invariably are outcome driven. That is not to say that a valuation can make the proverbial silk purse out of a sow's ear, but they are enormously flexible instruments. Although this is not empirical, but anecdotal, I recall many years ago, when inquiring what the initials M.A.I. signified -- I had first noticed these initials appended to the name of a highly regarded real estate professional who performed an appraisal in connection with a matter I was working on as a young lawyer -- I was informed that they meant "made as instructed"! I subsequently learned that they stood for Master, Appraisal Institute, manifesting a high degree of professional training and attainment.

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[41] A further irony is the encouragement of obvious anticompetitive behavior, *i.e.*, a virtual requirement that the compensation information be shared within an industry, trade or professional group.
[42] *See, e.g.,* Treas. Reg. § 20.2031-3.
[43] *See, e.g.,* Office of the New York State Attorney General, *A Guide to Sales And Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 510-511 and Religious Corporations Law § 12* at 5, available at http://www.oag.state.ny.us/charities/forms/sales.pdf.

While, perhaps, a humorous designation, the anecdote carries a great deal of truth. After all, appraisers -- whether evaluating a parcel of real property or assaying reasonable compensation -- are retained and paid by clients to achieve a specific objective. I won't say it never happens, but I think when the subject matter is a CEO salary, there almost always is a specific objective in mind which it is then the surveyor's obligation to support. Notwithstanding the prescription for achieving the rebuttable presumption, I have grave doubts that the required survey or other use of comparables precedes at least some discussion of salary by the principals. I certainly do not think that when seeking to re-engage a successful CEO, the question of future increases is ever approached abstractly. In other words, I don't think boards typically conduct a survey and then decide what can be offered as inducement. That's just not the way it happens in the real world. What this means, of course, is that the "safe harbor" is something of a charade because before the governing board ever formally considers the "comparable" there's been some consideration and discussion of ranges of compensation often, more or less definitive, i.e., what the CEO has in mind; what the board has in mind.[44]

There also is a larger point to be made in what I see as the ultimate futility in placing the IRS at the center of our nonprofit enforcement efforts. Indeed, I would suggest that making the Internal Revenue Code and the IRS the focus of our enforcement efforts is fundamentally mistaken. And, in fact, except for the anomaly

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[44] A similarly counterproductive process apparently is common in setting executive compensation for public companies as well. *See The New Compensation Committee Responsibilities: A Roadmap For Meeting The New Standards and Avoiding Personal Liability*, THE CORPORATE COUNSEL, Vol. XXIX, No. 5 (September-October 2004), at 1, 1-3.

of the foundation rules, corporate oversight and corporate reform, i.e., stymieing corporate misdeeds, is a task for which neither the Code nor the Service are well suited.

Although I am sure there are many -- economists, law teachers, philosophers -- who can expound at length on where the tax law fits precisely in our national polity, I think it fair to say that many of the shallow, trite, even vulgar, observations frequently heard about our tax law -- particularly, in a campaign season, are true. The tax laws are enormously dense and complex. There are, of course, many reasons for this but one of the most important flows from the nature of the taxing transaction and the well known injunction to citizens in a democratic society that, while taxes may be the price we pay for civilization, we are under no obligation -- either individually or collectively -- to pay a penny more than we are legally obligated to pay. So tax advisers -- principally, lawyers and accountants -- figure out myriad and often devious ways to find the irreducible (and legal) minimum. The result, of course, is the endless game of cat and mouse between tax writers and those charged with the administration and enforcement of tax laws, on the one hand, and the taxpayers, with their phalanxes of skilled professionals, on the other. Thus, also, the endless quest for "guidance" so that the tax advising role can be more skillful, more nuanced and more confident of not making a costly misstep. I believe that the enforcement of fiduciary obligations suffers gravely from such an approach. Indeed, in such a context I view "guidance" as merely an invitation to clever chicanery or further too-clever efforts at skirting the law's intent by cleaving to its letter.

Let me offer some instructive examples, which, while, perhaps, not perfectly apposite, suggest a useful contrast. In 1970, the Racketeer Influenced and Corrupt Organizations (RICO) Act was signed into law.[45] Its genesis was inspired by just what a casual inspection of its title might suggest -- efforts to combat on a national basis the spread of organized crime into so called legitimate business enterprises and other areas of American life (e.g., labor unions). Its application has grown enormously, far beyond what its original sponsors could have imagined and, although there were sporadic attempts in early years to limit its spread by invoking its origins,[46] those efforts were almost wholly unsuccessful. Today, of course, RICO prosecutions, along with its use in private rights of action, have become a major tool in combating financial fraud and corruption, i.e., pillaging and greed, if not terrorism.

RICO's success, in part at least, has come about the way most successful enforcement schemes do. Prosecutors and private plaintiffs deploy these tools creatively and a growing body of decisions establish the parameters of future conduct. Those who would challenge these proscriptions then do so at their peril. I would suggest that its utility would be very different were there RICO regulations and RICO private rulings and the entire apparatus of guidance to enlighten those

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[45] 18 U.S.C.A. §§ 1961-1968 (2000).
[46] *See, e.g., U.S. v. Frumento*, 563 F.2d 1083, 1090-1092 (3d Cir. 1977); *Haroco v. American National Bank & Trust Co.*, 747 F.2d 384, 398-399 (7th Cir. 1984); *Sedima, SPRL v. Imrex*, 473 U.S. 479, 499-500 (1984).

who otherwise might be found to run afoul of its penalties. The approach we necessarily adopt under § 4958 and, perhaps, other initiatives under IRS guidance is to present faithless fiduciaries with a precise and detailed road map for avoiding the full burden of their fiduciary obligations.

A couple of examples can illustrate the capacity of alternative enforcement schemes. Many older New Yorkers (at least older than 40 or so) will remember the B. Altman stores, a civilized Mecca for slightly upscale retail merchandising. The stores, whose flagship store was on the corner of Fifth Avenue and 34th Street, was owned wholly by the Altman Foundation. The stores generated modest dividends, paid to the Foundation, its owner, which then generated a modest level of philanthropy (I don't recall the precise numbers). It also was immune from market forces and allowed the controlling family comfortable executive positions across the generations.

Advisors to the foundation had convinced themselves that they had found a way to comply with the mandates of § 4943, at the same time enabling management to maintain effective control. The New York Attorney General made it clear that the clever expedient would be unavailing, that there was an irremediable structural conflict, no matter how control was apparently diffused, and that only divestiture and a redeployment of foundation assets would enable the Foundation to fulfill its mission. Ultimately, of course, just such a divestiture took place and today, the Altman Foundation is one of New York's leading philanthropies, providing over $ 10 million annually to support a full range of charitable endeavors.[47] A similar approach achieved a comparable result several years ago when Attorney General Spitzer forced the Wallace-Reader's Digest Foundation and its supporting organizations to relinquish control of the Reader's Digest Association.[48]

In the Adelphi University matter, state law, again, served as the vehicle, both to deal with greed, if not pillaging, and, perhaps, even more importantly, to reform and revive an entire institution.[49] The trier of fact, in that matter was a panel of New York's Board of Regents, sitting as a trial court. After 27 (non-consecutive) trial days, the panel found -- a finding upheld by the full Board of Regents -- that there was excessive compensation paid to the President without the knowledge and participation of the University's Board of Trustees, except for a small committee of trustees whose members themselves engaged in self-dealing transactions.[50] The entire Board (bar one) was removed by the Regents and a new Board put in place.[51] By all accounts, the outcome was extremely successful, rescuing an utterly demoralized institution from destructive internecine warfare among its constituents. The legal proceedings were governed by New York's

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[47] *See* Altman Foundation Annual Report 2003, available at www.altmanfoundation.org.
[48] *See Spitzer Announces Resolution Involving $3.2 Billion Legacy Left By Founders of Reader's Digest*, Press Release, N.Y. Attorney General's Office, May 4, 2001, available at http://www.oag.state.ny.us/press/2001/may/may04a_01.html. *See also* Ralph Blumenthal, *13 Institutions Obtain Control of Vast Bequest*, N.Y. TIMES, May 4, 2001, at A1.
[49] *Committee to Save Adelphi v. Diamandopoulos*, decision of the Board of Regents of the University of the State of New York (Feb. 5, 1997).
[50] *Id.* at 12-33.
[51] *Id.* at 49; *See also* State *Regents Oust 18 of 19 Adelphi University Trustees, Citing Neglect of Duty*, N.Y. TIMES, Feb. 11, 1997, at A1; Joseph Berger, *Law Lets Regents Punish Leaders, Sparing Colleges*, N.Y. TIMES, Feb. 11, 1997, at B6.

Education Law (which, by and large, incorporates by reference most of the provisions of the Not-For-Profit Corporation Law).[52]

The lengthy (49 page) opinion is a model of thoughtful and precise analysis, anticipating, in many ways, how a decision explicating the § 4958 "safe harbor" might read. Without being prescriptive, it did what good triers of fact always do -- measuring what happened against what should have happened. My point is simply that, using state law, a state fact finder dealt with an emergent situation in a thoughtful, reasoned manner, flexibly adapting the law generally to a good end, a result that § 4958 could not produce.

There are, of course, other reasons why the Code and the IRS are particularly inapt choices as the locus of enforcement initiatives. The Code imposes, and the IRS is subject to, powerful injunctions regarding confidentiality and it strictly circumscribes information-sharing with other enforcement agencies. While there have been critics of these limitations, and now may be a propitious time for some relaxation of these constraints,[53] those aspects of tax administration are, and will be viewed as, paramount values if this nation is to continue to have a successful, largely voluntary system of taxation that depends on honest and forthright self-regulation. Indeed, precisely such policies are the very cornerstone of an equitable system of taxation. The IRS also can rarely be seen -- and I am not being critical

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[52] N.Y. EDUC. LAW § 216-a (McKinney 2000).

[53] Indeed, at least one step already has been taken to do so. The Victims of Terrorism Tax Relief Act of 2001 (Pub. L. No. 107-134), enacted in January 2002, amended I.R.C. § 6103 to permit disclosure of certain return information to government law enforcement agencies outside of the Treasury involved in investigating or responding to terrorist incidents, threats and activities.

here -- as a “nimble” agency, ready to take on a new mission and adapt swiftly to changed circumstances. This results partly from its size as one of the largest government agencies and partly from its inherent institutional caution, appropriately, as the fiscal arm of government.

In thinking about how best to enforce fiduciary obligations of actors within the nonprofit community, we also must be mindful of the shift in the public, as well as the official perception of, the IRS as an enforcement arm. Tax collectors, of course, have been excoriated in the popular imagination for centuries and no one would ever regard the IRS as anyone’s poster child for government, big or small. Nevertheless, until 1980 or so, the IRS was viewed, as being honest and, perhaps like the legendary “Mounties”, likely to pursue doggedly and, ultimately, successfully, those seeking unfair or illegal advantage or seeking to subvert the tax system.

The fact is, unfortunately, that both government generally and the tax system, in particular, have endured a relentless 25 year assault. Among other things, the Internal Revenue Service has been constrained by law and a solicitousness for the “rights” of taxpayers against over-zealous tax enforcement and the broad perception that, somehow, the IRS represents arbitrary and abusive governmental power. This, of course, has been exacerbated by the emphasis on the beneficent role of limited government, the recrudescence of the new federalism and other events almost too numerous to describe. Not surprisingly, the IRS has been starved of resources for most of this time (a situation now only being corrected slowly and haltingly).[54]

None of the many consequences of these developments are good for tax administration and tax enforcement. And, while, public ire has been directed overwhelmingly at IRS interactions, real and imagined, with individual taxpayers, the overall effect has been to strike at the legitimacy of government and the IRS, in particular. Such an environment cannot but impair the effectiveness of the IRS in pursuing an expanded role as the prime enforcer of fiduciary duties in the exempt organization field. Unfortunately, the important role of the IRS in the exempt organizations area cannot be insulated from the impact of its broader role in society which, for the past generation, has been seriously diminished.

So, if we reject an expanded and enhanced role for the IRS in the enforcement of sanctions to counter greed and pillaging -- and I am not necessarily urging that conclusion yet -- where does one turn. One answer is obvious -- to the attorneys general of the 50 states. The problem with that, of course, is, at least in some respects not much different than the shortcomings of IRS enforcement, except, perhaps, that they are even more acute. Attorneys general certainly have the tools, ranging, in most cases, from the ability to employ the heavy arsenal of the criminal law to the remedies available under state nonprofit corporation laws to the

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[54] *See, e.g.*, Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. No. 105-206). *See also* David Cay Johnston, *Corporate Risk of Tax Audit Is Still Shrinking, I.R.S. Data Show*, N.Y. TIMES, Apr. 12, 2004, at C1; J. Christine Harris, *ABA Meeting: Enhanced Enforcement Will Help EO Division Do More With Less, Officials Say*, 43 EXEMPT ORGANIZATION TAX REVIEW, No. 3 at 240 (2004); Brad Wolverton, *Rethinking Charity Rules: Senate Panel Offers 200 Ideas For Revising Nonprofit Regulation*, CHRONICLE OF PHILANTHROPY, July 22, 2004, at 31; Christopher Quay, *I.R.S. Officials Discuss Attempts to Ensure EO Compliance*, 45 EXEMPT ORGANIZATION TAX REVIEW, No.2 at 209 (2004).

penalties that can be imposed for violations of the laws governing the administration of charitable assets and the solicitation of funds for charitable purposes, as well as state consumer protection laws.[55]

The problems with relying on the chief legal officers of the 50 states are too well known to be reviewed at length. The resources simply are not there. Apart from the well-known handful of states, most jurisdictions lack any capacity either to administer or enforce the laws governing charities, except in the rarest instances. In fact, there is no reason to believe there's been much change since a NAAG survey of eight years ago establishing that most states devoted no full-time efforts to the supervision of nonprofits.[56] And, there's little likelihood that this picture will change.

A major expansion of government except, perhaps, in some areas viewed as emergent like, for example, combating terrorism and enhancing national security, seems unlikely. And, the fact is that on the agenda of tasks for attorneys general -- even ones like Eliot Spitzer -- such responsibilities are not highly ranked. Firstly, all attorneys general are the chief legal officers in their respective states and the preponderance of their resources and manpower are devoted to the defense of the state and its agencies. Then, of course, in all but eight states, attorneys general are elected and are among a small number of statewide elected officials. The consequences, among other things, is that it is rare for an attorney general not to

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[55] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW §§ 8-1.4(m) & 8-1.4(r) (McKinney 2002); N.Y. EXEC. LAW §§ 174, 174-a, 175 & 177 (McKinney 1996 & Supp. 2004).
[56] NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, STATISTICS ON THE OFFICE OF ATTORNEY GENERAL 18-20 (1996).

have aspirations for higher political office -- governor or senator. This means, of course, that in formulating a political agenda with broad appeal, an agenda which often determines which areas are pursued within their discretionary agendas (i.e., apart from the defense of the state), charities often go unnoticed in favor of such areas as environmental and consumer protection, civil rights, antitrust and, these days, the financial markets. In fact, even Eliot Spitzer, who has clearly had a keen interest in this area does not always identify charities enforcement as being among his signal accomplishments (in fact, it's scarcely mentioned, if at all, in many of his fundraising appeals or reports to constituents).[57]

And, once again, where does this leave us in terms of both meaningful sanctions -- which certainly exist -- and enforcement which consistently has been found wanting.

However, before I proffer one or two (unoriginal) recommendations for change, I'd like briefly to address a couple questions that certainly ought to be examined before embarking on new enforcement initiatives or a new enforcement regime. The questions are two-fold: What is the need for enforcement? And, is that need being met adequately (or, at least, as much as we wish to, which is really the same thing, I think.) As to the first question, I am convinced that we must remain agnostic on that subject. As Marion Fremont-Smith notes in her authoritative survey of government regulation of nonprofits, "...the extent of wrongdoing has

[57] For example, the biography of Attorney General Spitzer posted on the New York State Attorney General's website, which summarizes the initiatives he has undertaken since becoming Attorney General in 1999, makes no mention of any initiatives involving charities. Available at http://www.oag.state.ny.us/bio.html.

always been difficult to determine."[58] Her brief but useful discussion of the problem is based, in part, on her earlier work in surveying press reports of management wrongdoing.[59] She notes only 152 incidents of reported civil or criminal wrongdoing between 1995 and 2002, 98 of which entailed criminal activity.[60] This leaves only 48 instances of noncriminal fiduciary breach and six reflecting attributes of both.[61] Although she suggests that there may be serious underreporting, there is no empirical basis from which such a suggestion can be drawn. Indeed, as Fremont-Smith and others have noted, the press rarely reports outcomes and there is, in her observation, the unstated and untested assumption that press reports are the equivalent of "smoke" as in "where there is smoke…." As one long inured to dealing with the press, I'd only observe: "sometimes." In fact, notwithstanding the settlement of many charity disputes, state attorneys general are notorious for publicizing matters involving their offices and, certainly, are under no statutory inhibitions from doing so, unlike the IRS. She notes, however, that -- and this is where I certainly agree with her -- the survey "does lend support to the view that wrongdoing is not as widespread as some have claimed."[62] Unfortunately, we have no analog to the uniform reporting of crime statistics which, however, imperfectly, tell us if crimes or particular types of crimes are trending up or down.

[58] MARION R. FREMONT-SMITH, *supra* note 38, at 13.
[59] Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORGANIZATION TAX REVIEW 25 (2003).
[60] *See* MARION R. FREMONT-SMITH, *supra* note 38, at 14.
[61] *See id.*
[62] *Id.* at 15.

In the post-Sarbanes-Oxley environment, I have been urging for the past couple of years[63] caution in extending corporate governance initiatives and reforms to the nonprofit sector, absent any credible evidence that there is a crisis in governance in need of such reforms. Such caution should extend equally to promulgating new or enhanced sanctions and more vigorous enforcement for an imagined nonprofit "crime wave."

Obviously, crime occurs within nonprofit organizations as do violations of fiduciary obligations. And, just as clearly, we are, and must be, willing to live with a certain incidence of such misconduct. While we often proclaim "zero tolerance" policies in widely varied areas of American life, such initiatives invariably are less then wholly successful and, in our calmer, more clear-eyed moments, we understand that, human nature being what it is, the commission of both mortal and venial sins are an inescapable part of the human condition.

I, for example, have had client organizations which, unfortunately, have been victimized by employee misconduct -- typically theft and/or embezzlement. Sometimes, the culprits are subordinate employees and, occasionally, not. In most cases the predators are identified and prosecuted. I don't believe that such conduct affects the legitimacy of the larger enterprise. Such conduct, to reiterate the obvious, occurs within religious organizations, among public officials, elected and otherwise, in retail businesses, in financial services and almost everywhere else.

[63] *See, e.g.*, Daniel L. Kurtz, *The Sarbanes-Oxley Act of 2002: Lessons for Nonprofits?*, *in* Nonprofit Organizations Law 2003 79 (Practising Law Institute 2003).

Indeed, I suspect that the incidence of such problems -- namely pillaging and greed -- occurs at a greater rate in organizations other than nonprofits. I don't know if there is any empirical data to support this view, but there are tantalizing suggestions of the truth, here and there. For example, at least one survey has identified strikingly different motivations among nonprofit employees when compared to their peers, both in government and in private industry.[64] In the latter two groups, compensation and employment security were paramount, whereas in nonprofits such motivations took a back seat to devotion to the employer's charitable mission.[65] What this suggests, perhaps, is the relative weakness of pecuniary motives and it is not difficult to see why predatory conduct among such a population might be somewhat attenuated.

In other words, I remain unconvinced and unpersuaded that we are confronted with an epidemic of nonprofit crime. I might add, parenthetically, that I think nonprofit hand-wringing on such issues is itself a distinctive phenomenon, one often exacerbated by the broader political context in which nonprofit misconduct is particularly vulnerable to public censure and the flaying of nonprofit abusers can be a facile substitute for what otherwise might be seen to be a class-based politics. We can't or don't, for example, wish to attack the compensation and other perquisites accruing to business titans, regardless of how much or how undeserved (except, perhaps, for Mr. Grasso), but we don't seem uncomfortable in going after nonprofit executives whose compensation may be relatively lavish

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[64] *See* Heather Joslyn, *Mission Driven*, CHRONICLE OF PHILANTHROPY, Oct. 17, 2002, at 19.
[65] *See id.*

within the nonprofit world but is scarcely a fraction of what business executives can reap.

Yet, if we are to yield to the importunings of those who wish to see more or, at least, more effective sanctions, I have a couple of suggestions, not original, but nevertheless, useful. In its potpourri of ideas, the Senate Finance Committee staff had one or two useful suggestions.[66] The primal sin in the nonprofit world is the breach of the duty of loyalty, i.e., self-dealing. Almost all of the extant case law stems from such circumstances and even those, which, at first blush, seem to implicate other duties are, in fact, almost always bottomed on loyalty transgressions (comprehending criminal law violations as well which, I would maintain, are only "supersized" loyalty breaches). Among other things, much of the foundation rules, the excess benefit penalties and a good deal of state law and law enforcement focuses on such issues.

Probably, the least intrusive and least disruptive means of attacking such conduct -- also, the one requiring the least disruption of the regulatory apparatus and the respective roles of the federal and state governments -- would be to extend the foundation rules' self-dealing prohibitions to all exempt organizations, as the Senate Finance Committee report recommends. And, while there are objections to be advanced -- I've invoked them myself on some occasions -- I am not convinced that they are not merely in terrorem arguments without much substance.

[66] Senate Finance Committee Discussion Draft of Proposals for Reforms and Best Practices in the Area of Tax-Exempt Organizations, available at http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.

The typical argument advanced to counter this suggestion is that it would work to the public's disadvantage, particularly in smaller organizations where such self-dealing is often beneficial, enabling small, resource strapped groups to obtain goods and services at less than market value. The fact is that we have virtually no information on the incidence of such practices, nor the extent to which such transactions that actually took place are truly beneficial to the charitable organizations involved. I suspect that there is more myth than reality surrounding such beliefs.

The insistence on the need for flexibility in this area also runs counter to one of the underlying demands of the corporate governance reform movement, broadly supported by these same critics -- i.e., the need for, and critical importance of, **independent** directors. No matter how much of a "bargain" self-dealing may confer, it has the potential not only of impairing the judgment of the self-dealer but of peers and colleagues. Isolated instances of "beneficial" self-dealing may reduce board vigilance generally when less noble self-dealing presents itself and allowing such conduct tends to create a culture inimical to the selfless pursuit of charitable objectives.

Certainly, a total prohibition on self-dealing is nothing new nor, indeed, unusual, even in publicly supported organizations. Traditionally, many old-line charitable institutions which viewed board membership as, perhaps, conferring prestige or honor on a board member often forbade such conduct absolutely. Many organizations still have enshrined such absolute prohibitions in their by-laws, a legacy, perhaps, of the trust law antecedents of charity. If anything, it was the encroachment of a “modern” corporate culture which made self-dealing in some circumstances permissible.[67] Now, of course, the pendulum is moving the other way with increasing emphasis on director independence and a highly skeptical view of self-dealing.

Of course, self-dealing still occurs in the business world, but the business world enjoys one signal advantage over the nonprofit world. Related-party transactions may be newsworthy when they exist in, or occur at, nonprofit organizations, but they often go unnoticed and undetected. The reporting of such matters by public companies is extensive. They appear in prospectuses and in proxy statements which enjoy broad circulation and they appear as well in annual and periodic filings with the SEC, all of which are pored over by a veritable array of analysts and an insatiably curious financial press. Despite the occasional metropolitan daily which assigns a reporter to the charity beat, there simply isn’t the level of information, nor, in fact, the documents to examine. So, disclosure -- the Brandeisian disinfectant -- lacks the concentrated strength of its business counterpart. It cannot, thus, serve as a comparably effective deterrent. In addition, this approach would avoid many of the shortcomings that I attribute to § 4958 and a whole superstructure devoted to avoiding the impact of such rules or calibrating too finely their efficacy. Certainly, the (more or less) absolute prohibitions of § 4941 are vastly easier to administer and with which to comply.

[67] Daniel L. Kurtz, *Non-Traditional Revenue Ventures Of Tax Exempt Organizations: The Role of Trustees*, 39 RECORD OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, No. 2, at 129 (1984).

I would modify, however, the Senate Finance Committee proposal in one or two respects. I do not believe that nonprofits are homogeneous and, in fact, they reflect far more diversity in almost every imaginable way than do business organizations. Nonprofits most certainly are not fungible and should not be subject to precisely the same regulatory and enforcement regimes. The needs, for example, of fledgling and small organizations, are vastly different than those of mature or large organizations. The opportunities for legitimately beneficial self-dealing abound in smaller and new organizations, and I would suggest that appropriate exceptions and other adjustments to such a ban could be made for a variety of organizations. I am not convinced that such a prohibition would work to the detriment of larger organizations. Neither Harvard University nor the Cleveland Clinic need have a significant (or any) business relationship with a member of its governing board. There are myriad ways in which board members of such institutions can benefit an institution without engaging in self-dealing. But, that just may not be true for smaller and fledgling groups which need both the dedication and energy of devoted board members and often the other resources they can bring directly to the board room table.

A ban on self-dealing, with appropriate exceptions, is what I would call the quick fix for what, arguably, ails nonprofits. My more ambitious proposal involves a different regulatory approach, notwithstanding my pessimism about its prospects. As I have already made clear, I view the IRS as particularly ill-suited for administering a broad range of laws regulating fiduciary conduct and imposing sanctions for their violation. The role, indeed, that it oversees now is largely one of default -- principally by the states which have chronically neglected charities enforcement and underfunded it.

There are, of course, powerful arguments against federalizing the law of charities and nationalizing its enforcement. The states, in general, are more congenial forums in which to craft and develop policies responsive to local and regional needs. And, the argument for particularism remains strong in the nonprofit sector where relatively few institutions have a national reach.

Nevertheless, all that (and more) being said, it is, perhaps, unrealistic to think there will ever be adequate interest at the state level. Rather than shift the locus of such activity to the IRS, I would urge creation of an independent agency to assume such responsibilities. While we, manifestly, no longer are in an era of big government when funding prospects for such an endeavor might appear rosy, the creation, staffing and support for such an agency couldn’t be much more burdensome than furnishing the IRS with adequate resources to take on an expanded role it would have to shoulder to be an adequate policeman. And, presumably, some IRS staff and resources even might be shifted to such a new agency, thereby helping trim its budget.

Obviously, many issues would have to be worked out but that, I suspect, is the subject of another conference, or, at least, another paper. What I envision, not surprisingly, is an American adaptation of the UK Charity Commission which, even in my novice's understanding, has matured into a formidable and invaluable presence on the British scene.

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