

PHONY PHILANTHROPY: THE ATTACK AND DEFENSE OF NONPROFIT ORGANIZATIONS FROM FRAUD AND ABUSE*

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I. INTRODUCTION

A. *An American Ensign*

In 2002, over 70% of Americans donated money to charities, totaling over \$240 billion in contributions.¹ Giving 2.3% of the gross domestic product to these charitable organizations² has made the United States the most generous nation on earth.³ The financial power of these organizations collectively is greater than the budgets of all but a few nations.⁴

America's nonprofit⁵ organizations are a great asset to our country. They show to the world our willingness to share our wealth. One survey revealed while 43% and 44% of French and German citizens, respectively, gave money to a charitable organization in the previous year, over 70% of Americans donated to charity.⁶ Aside from helping various special interests, these nonprofits help generous individuals by providing an organized way to contribute to the "general well-being"⁷ of society.

1. Press Release, American Association of Fundraising Council, *Charity Holds Its Own in Tough Times (Giving USA 2003, The Annual Report on Philanthropy for the Year 2002)*, (June 23, 2003), available at http://www.aafrc.org/press_releases/trustreleases/charityholds.html.

2. *Id.*

3. See Judith L. Maute, *Changing Conceptions of Lawyers' Pro Bono Responsibilities: From Chance Noblesse Oblige to Stated Expectations*, 77 TULANE L. REV. 91, 162 n.397 (2002) (citing Karl Taro Greenfeld, *A New Way of Giving*, TIME, July 24, 2000, at 49) (stating "[o]ur generosity may be the best measure of our humanity").

4. JOHN P. LIDSTRO, NONPROFIT ORGANIZATIONS ACCOUNTING AND REPORTING 1 (2d ed. 1998).

5. Charities typically achieve their nonprofit status by qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code. I.R.C. § 501(c)(3) (2003). There are numerous organizations that also qualify for tax-exempt status under the different subsections of section 501(c). §§ 501(c)(4)-(28). For the purposes of this article, the term "nonprofit organizations" refers to both charities and other tax-exempt organizations, whereas "charity" defines only those organizations "operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition. . . , or for the prevention of cruelty to children or animals. . . ." § 501(c)(3). Nonprofits are "barred from distributing [their] net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." Denise Ping Lee, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 929 (2003) (citing Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J. 835, 838 (1980)). It should also be noted that nonprofits do not need to have a charitable purpose. *Id.* at 930.

6. Greenfeld, *supra* note 3, at 49.

7. *McGowan v. Maryland*, 366 U.S. 420, 445 (1961) (recognizing the trend of state and federal governments trying to improve the general well-being of society).

Nonprofits are also a noteworthy source of employment. They supply jobs for about 8.6 million people, not including volunteers and religious workers.⁸ These jobs pump almost \$700 billion in wages into the U.S. economy every year.⁹

Nonprofit organizations may also play a significant role in our tax rates. Among developed nations, the United States has one of the lowest tax rates as a percentage of gross domestic product.¹⁰ One factor of our low tax rate may be that privately established nonprofit organizations care for a great portion of the social needs of this nation.¹¹ Without this help from America's nonprofits, some of these programs would likely become a public charge. Allowing these organizations to be exempt from taxes, and allowing donors to deduct their contributions, is an "alternative means of accomplishing similar budget policy objectives."¹²

B. *Every Taxpayer Affected*

Nonprofit laws and policies affect every taxpayer, not just the actual donor. Allowing an organization to be exempt from tax and allowing a deduction by the donor is equivalent to a government outlay.¹³ Every taxpayer is therefore affected because a portion of their tax paid is essentially given to the tax-exempt organization and the respective donor.

The "government outlays" decrease the United States' tax base, which must be offset by raising tax rates for other organizations and individuals. The first decrease in the tax base happens by way of charitable deductions by individual taxpayers.¹⁴ Instead of collecting taxes on every earned dollar and then providing government funds to worthy nonprofits, the taxpayer is allowed to donate to the charity of their choice and

8. Lee, *supra* note 5, at 928.

9. *Id.* at 928-29.

10. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD ECONOMIC OUTLOOK NO. 69 171 (2001), *available at* <http://www.oecd.org/dataoecd/44/0/2086223.pdf>.

11. David Saperstein, *Public Accountability and Faith-Based Organizations: A Problem Best Avoided*, 116 HARV. L. REV. 1353, 1356 (2003) (stating "[t]he vast majority of government social service programs are . . . delivered by the private sector. . . ." (i.e. non-government charities)).

12. JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003-2007, at 2 (Comm. Print 2002) [hereinafter JOINT COMM. ON TAXATION].

13. *Id.* (analogizing certain tax provisions to direct outlay).

14. See I.R.C. § 170(a) (2003).

then deduct that amount from their gross income.¹⁵

In theory, sidestepping the government is an efficient way of allocating resources, thereby requiring fewer governmental agencies and employees.¹⁶ Private nonprofits (as opposed to government-run nonprofits) also provide an egress for those who do not wish to contribute to a particular cause.¹⁷ Essentially every taxpayer is required to contribute to government-run social services, regardless of their desire to donate.¹⁸ This dilemma is avoided in the private nonprofit setting.

The second decrease in the tax base arises because taxes are not collected from certain non-profit organizations.¹⁹ These tax exemptions cost taxpayers about \$36.5 billion each year in lost tax revenue.²⁰

Because the tax base is decreased by deductions and exemptions, every taxpayer should be concerned with nonprofit organizations, regardless of individual participation or donation.²¹ When fraud is committed by a nonprofit, or if it abuses the system (without necessarily breaking the law),²² every American is affected to some degree. Therefore, every taxpayer should be concerned with laws and principles aimed at the prevention and punishment of fraud and abuse in the nonprofit realm.

15. *Id.*

16. This posture presupposes the government cannot provide these social needs in a way that is significantly more efficient than private nonprofit organizations. Transactional costs are saved because, theoretically, there are fewer exchanges of money between the donor and the end beneficiary.

17. The outlet is somewhat limited because tax revenue lost to tax exemptions or deductions must be made up by other taxpayers. It is an effective way out to the extent of an individual taxpayer's non-contribution to the nonprofit.

18. See 42 U.S.C. § 14501(a)(4) (2004)(finding "[f]ederal funds are expended on useful and cost-effective social service programs").

19. I.R.C. § 501(c)(3).

20. Lee, *supra* note 5, at 948. Additionally, most states provide nonprofits with exemptions from state income, property, and sales taxes. Karyn R. Vanderwarren, *Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function*, 77 CHI.-KENT L. REV. 963, 966 (2002).

21. See I.R.C. § 170(a)(1) (2003).

22. The Telemarketing Associates case discussed below is a prime example of this. *Infra* Part II.B. Although the "charity" only received up to 15% of the donations collected for them by Telemarketing Associates, the only illegal aspect was that the telemarketers lied about the percentage going to the charity. *Id.* If they had not lied, they would have had no problems. *Madigan v. Telemarketing Assocs.*, 538 U.S. 600, 622 (2003).

C. *Temptations*

While the majority of charities focus on their asserted goal,²³ the enormous wealth surrounding U.S. nonprofit organizations also attracts those with impure motives.²⁴ Some have tainted the image of the nonprofit world by using abusive²⁵ and deceitful practices ranging from overcompensation of executives²⁶ to direct lies designed to open the hearts and wallets of generous Americans.²⁷ Every taxpayer, regardless of their personal generosity, must contribute to the tax base lost by these fraudulent nonprofit procedures.²⁸

Because the government is circumvented, there is less regulation over these nonprofits than over governmental social services. Without the government holding the purse over these organizations and scrutinizing every administrative decision, it is more difficult to detect fraud and abuse. While the news media and the general public may be an important nonprofit watchdog,²⁹ lawmakers and judges must also do their part to help curb abuse.

II. THE PROBLEMS

Recent chicaneries in the for-profit world have helped turn

23. *Charities and Nonprofit Organizations: What You Get When You Give: Hearing on Abuses in Charitable Gift Giving By Not-For-Profit Organizations As Well As For-Profit Organizations Working on Behalf of Not-For-Profits Before the Subcomm. on Antitrust Monopolies and Bus. Rights of the Comm. on the Judiciary*, 101st Cong. 1 (1989) [hereinafter *Hearing on Abuses in Charitable Gift Giving*].

24. *See id.* It should be noted that nonprofits are also victimized by third parties. GERARD M. ZACK, *FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION* 7 (2003). One example is a vendor who overcharges for goods or services sold to the nonprofit. *Id.* Another example is a person who benefits from the nonprofit's benevolence by lying about their personal situation. *Id.* at 8.

25. For the purposes of this article, abusive behavior consists of egregious behavior that is not necessarily illegal, but shocks the conscience. Fraudulent behavior includes lies, subterfuge, and other deceptive tactics, which can traditionally be prosecuted under mail fraud, wire fraud, bank fraud, or similar criminal statutes.

26. *See generally* Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 425 (1999) (discussing a charity that compensated the trustees an average of \$900,000 per year).

27. *See generally* *United States v. Bennett*, 161 F.3d 171, 174 (1998) (outlining the biggest charity scam in U.S. history where \$350 million in donations were received under false pretenses over a six-year period).

28. *See* I.R.C. § 170(a)(1).

29. Evelyn Brody, *The Twilight of Organizational Form for Charity: Musings on Norman Silber, A Corporate Form of Freedom: The Emergency of the Modern Nonprofit Sector*, 30 HOFSTRA L. REV. 1261, 1269 (2002) (highlighting that the media "can bring faster and more lasting changes than can government prosecution").

the eyes of Americans to corporate executives.³⁰ The only place it seems the business elite enjoy a rebuttable presumption of innocence is in the courtroom. The public has already handed down the verdict.

Where can those who are still thirsty for blood go next? The nonprofit world. Understanding the different types of schemes and tactics is important before considering possible remedies and safety measures. The more infamous nonprofit gambits illustrate some of the types of fraud and abuse that may exist among nonprofits.

A. *Flagrant Lies – United States v. Bennett*³¹

Some nonprofit maladies come in the form of obvious fraud. While they may not occur as frequently as other problems, cases such as the following illustrate how easy it may be to dupe the openhearted.

In 1989, John Bennett established the Foundation for New Era Philanthropy.³² To generate money for the organization, he devised a plan allowing munificent people to invest their money with New Era for a period of several months with the expectation that an “anonymous” donor would match the investment and give that matched amount to a charity of the investor’s choice.³³ After the set period, the investor’s principal was returned along with a handsome interest payment.³⁴

Unfortunately, there was no “anonymous” donor,³⁵ and the first investments were repaid by soliciting more investors.³⁶ Eventually he solicited investments from legitimate nonprofit organizations.³⁷ He lied to the Internal Revenue Service about the board of directors (which did not actually exist), and made misrepresentations about New Era’s assets and liabilities.³⁸ As a

30. See John Paul Lucci, *Enron - The Bankruptcy Heard Around the World and the International Ricochet of SARBANES-OXLEY*, 67 ALB. L. REV. 211, 212 (2003).

31. *United States v. Bennett*, 161 F.3d 171 (1998).

32. *Id.* at 174.

33. *Id.*

34. *Id.* at 175 n.2. Near the fall of New Era, a fund was offered that would return 150% of the investment. *Id.*

35. *Id.* at 174.

36. *Id.* This is also known as a “Ponzi” scheme. *Id.*

37. *Bennett*, 161 F.3d at 174.

38. *Id.* at 174-75.

result, New Era received tax-exempt status.³⁹

In addition to paying investors a larger-than-life interest rate, Bennett took the opportunity to benefit himself by transferring funds from investors to the accounts of his for-profit businesses and his personal accounts.⁴⁰ As New Era grew, Bennett was unable to cover the funds by receiving new donations.⁴¹ Bennett approached Prudential Securities and took out a loan, which eventually totaled \$50 million.⁴²

Over the course of six years, New Era received over \$350 million, making it the largest charity fraud in history.⁴³ During this time, Bennett transferred over \$3 million to bank accounts under his exclusive control.⁴⁴ He also received more than \$2 million in benefits from payments made on his behalf.⁴⁵

In 1996, Bennett was charged with several counts of mail and wire fraud, one count of bank fraud, forty-two counts of money laundering, and three counts of filing a false tax return.⁴⁶ Bennett subsequently pled *nolo contendere* and was sentenced to twelve years in prison.⁴⁷

This case of obvious fraud serves as a reminder for the need of legal tools to curb this kind of abuse. Other forms of abuse may not be outright illegal, but nevertheless do not sit well with people.

B. *Half-Truths (Well . . . Okay, 15% Truths) – Madigan v. Telemarketing Associates*⁴⁸

Other schemes lead the generous to believe they are helping a worthy cause, when in reality, only a small fraction of the money they give is actually going to the worthy cause.⁴⁹ The contract between VietNow and their telemarketing cronies is a good example of this type of abuse.⁵⁰

39. *Id.* at 175.

40. *Id.* at 174, 188.

41. *Id.* at 175.

42. *Id.*

43. *Bennett*, 161 F.3d at 174. The total loss was over \$100 million, but this amount was reduced to about \$20 million after personal and company assets were turned over. *Id.* at 178.

44. *Id.* at 188.

45. *Id.*

46. *Id.* at 175. In all, there were eighty-two counts in the indictment. *Id.*

47. *Id.* at 174.

48. *Madigan v. Telemarketing Assocs.*, 538 U.S. 600 (2003).

49. *Id.* at 607 n.1.

50. *Id.*

VietNow is a national nonprofit organization aimed at helping veterans.⁵¹ Telemarketing Associates Incorporated and Armet Incorporated (hereinafter collectively referred to as Telemarketers) were for-profit fundraising companies based in Illinois.⁵² VietNow contracted to have Telemarketers seek contributions for their cause.⁵³ In the contract, it was agreed Telemarketers would keep 85% of the proceeds from collecting the money, and VietNow would get the remaining 15%.⁵⁴

Telemarketers also contracted with other fundraisers outside of Illinois on behalf of VietNow.⁵⁵ Under those agreements, the third party fundraiser would keep 70-80% of the donations, Telemarketers would keep 10-20%, and VietNow would get 10%.⁵⁶ These contracts essentially turned Telemarketers into selfish telephonic panhandlers, paying the charitable organization only a small fee for the use of their name.

During the fundraising, solicitors regularly told potential donors the majority of the money would go to the intended cause.⁵⁷ One person even asked what percentage would go to the cause and was told "90% or more [of her donation would go] to the vets."⁵⁸ The heartstrings of others were pulled by hearing their contributions would be used for things such as helping a veteran and his family have a Thanksgiving meal.⁵⁹

Over an eight-year period, Telemarketers collected over \$7 million in donations, and retained about \$6 million as their fee, leaving just over \$1 million for VietNow.⁶⁰

The Illinois Attorney General brought civil charges against Telemarketers alleging fraud.⁶¹ After the case was dismissed by the Illinois trial, appellate, and Supreme Courts, the United

51. *Id.* at 607. The purity of VietNow's motives is highly suspect. The Supreme Court noted only 3% of the money received by VietNow actually went to the programs advertised in the solicitations. *Id.* at 607 n.1. A more detailed profile of VietNow can be found in the amicus brief offered by the Better Business Bureau. Brief of Amici Curiae Council of Better Business Bureaus, Inc. at 13-16, A1-A6, available at <http://www.give.org/news/ryanamicusbrief.pdf> (last visited Jan. 14, 2005).

52. *Telemarketing Assocs.*, 538 U.S. at 606.

53. *Id.* at 606-07.

54. *Id.* at 607.

55. *Id.*

56. *Id.*

57. *Id.* at 608.

58. *Telemarketing Assocs.*, 538 U.S. at 608.

59. *Id.*

60. *Id.* at 607. Thus leaving about \$30,000 for the intended veteran programs. *Id.*

61. *Id.* at 605.

States Supreme Court reversed.⁶²

While just about every element of the facts behind this case would probably not sit well with most Americans, the principle basis for reversing the Illinois courts was that affirmative statements were made as to the allocation of the donations.⁶³ The United States Supreme Court's ruling emphasizes the ability of a telemarketing company to solicit funds for a charity and give only a small portion to the charity. The only restriction is that they cannot lie to the donor.⁶⁴ There is no obligation to inform them of the percentage of the donation going to the charity.⁶⁵

Thus, witty telemarketers may prey on the ignorance of potential donors. Pure-minded people may simply assume when they are being asked to donate to the charity, most of the money may actually go there. Only the well-informed will know enough about nonprofit operations to think to ask what percentage of their donation will go to the charity.

C. *Serious Salaries – Kamehameha Schools Bishop Estate*

While some fraudulent charitable tactics are obviously illegal, other tactics, while technically legal, are still disturbing. Such tactics raise several policy issues that need to be addressed.

The idea of a nonprofit organization tends to conjure up thoughts of honorable men and women working for a modest salary toward a common goal. This is not always the case. In 1884, Princess Bernice Pauahi Bishop of Hawaii died, leaving an extraordinary will.⁶⁶ At the time of her death, Princess Bishop was the wealthiest woman in the Kingdom of Hawaii.⁶⁷ In the

62. *Id.* at 606.

63. *Id.* at 622-24.

64. *Telemarketing Assocs.*, 538 U.S. at 606 (leaving room for a fraud claim in spite of first amendment rights).

65. *Riley v. Nat'l Fed'n of the Blind*, 487 U.S. 781, 795, 798 (1998). This proposition has been upheld by the United States Supreme Court, which declared as unconstitutional any law imposing such an obligation. *Id.* (holding a law violates free speech rights if it requires the charity to disclose the percentage of charitable funds collected in the past twelve months, which actually were given to the intended charity). This case raises serious issues, specifically, that states can no longer regulate certain procedures of nonprofit organizations. *Id.* at 795-96, 798-99, 801. Like most Supreme Court cases, this one seems insurmountable. State legislatures will have to take creative approaches in drafting laws aimed at protecting potential donors while not offending free speech rights. *Id.* at 800.

66. Judge Robert Mahealani M. Seto & Lynne Marie Kohm, *Of Princesses, Charities, Trustees, and Fairytales: A Lesson of the Simple Wishes of Princess Bernice Pauahi Bishop*, 21 U. HAW. L. REV. 393 (1999).

67. *Id.*

will, she ordered the establishment of the Kamehameha Schools.⁶⁸ To fund the schools, she left over 400,000⁶⁹ acres at the disposal of trustees.⁷⁰ Since her death, the trust fund has swelled to over \$6 billion,⁷¹ and the school system has become the largest independent K-12 school in the nation.⁷²

While the average trustee salary of foundations with more than \$1 billion in assets is just over \$14,000,⁷³ the Kamehameha trustees' salaries averaged \$900,000 per year between 1994 and 1997.⁷⁴ Even the CEO's of large foundations paled in comparison, receiving an average salary of just over \$320,000.⁷⁵ Like most nonprofits, the Kamehameha Schools are tax-exempt.⁷⁶ It appears questionable whether an organization this generous to its trustees really needs the government and the American public to support it by allowing it to be tax-free.

*D. Internal Exploitation and the Role of Trustees – U.S. v. Aramony*⁷⁷

Another temptation among nonprofits comes from the lack of checks and balances. Most for-profit corporations have shareholders who are looking after their own interest in the corporation.⁷⁸ Most nonprofits, however, do not have anyone who plays a role similar to stockholders in supervising managerial decisions.⁷⁹ The board of directors is thus left with the

68. *Will of Bernice Pauahi Bishop*, 13th article (Oct. 31, 1883), available at <http://www.ksbe.edu/pauahi/will.php> (last visited Jan. 14, 2005).

69. Seto & Kohm, *supra* note 66, at 393. As of 2003, the foundation owned more than 360,000 acres. KAMEHAMEHA SCH., 2002-2003 ANNUAL REPORT 21 (2003), available at http://www.ksbe.edu/allpdfs/annualreport03/KSAnnual_Report2003.pdf (last visited Jan. 17, 2005).

70. *Will of Bernice Pauahi Bishop, Codicil No. 1*, 17th article (Oct. 4, 1884), available at <http://www.ksbe.edu/pauahi/codicil1.php> (last visited Jan. 14, 2005).

71. Seto & Kohm, *supra* note 66, at 393. In 1998, the fund produced over a quarter of a billion dollars in income. *Id.* at 393-94.

72. Kamehameha Schools Hawai'i Campus, LEGACY OF A PRINCESS, available at http://www.ksbe.edu/pdf/factsheet_hawaii.pdf (last visited Jan. 14, 2005).

73. Frumkin & Andre-Clark, *supra* note 26, at 427.

74. *Id.* at 425.

75. *Id.* at 427-28.

76. Letter from L.B. Jerome, Chief, Exempt Organizations Branch, IRS, to Frank E. Midkiff et al., Trustees, Bernice P. Bishop Estate 1,2 (Apr. 16, 1969), available at http://www.ksbe.edu/newsroom/tax_info/exempt_ltr.html (last visited Jan. 14, 2005).

77. *United States v. Aramony*, 88 F.3d 1369 (4th Cir. 1996).

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

79. Daniel L. Kurtz, *Nonprofit Governance*, GEO. C.L.E. 1, 7 (2003), available at 2003 WL 22002113.

responsibility of directing these affairs, and the trust of society falls primarily in their hands.⁸⁰

As witnessed in the Bennett case, one unsupervised person can wreak havoc in the nonprofit world by establishing a bogus organization.⁸¹ Sometimes one person, or a small group of people, can do similar damage to a legitimate nonprofit even with supervision.⁸² While the perpetrator(s) certainly should take the blame, “uninvolved or aloof”⁸³ trustees may also factor into the equation.

In 1970, William Aramony was appointed as chief executive officer of United Way of America (UWA).⁸⁴ By the mid-1980’s, Aramony began mixing business with pleasure by inappropriately using UWA funds.⁸⁵ Some of Aramony’s exploits do not appear too serious, such as his use of UWA funds to pay for both business and personal chauffeuring services;⁸⁶ some of his other acts, however, are more flagrant.

An over-trusting board of directors gave Aramony broad discretion as to how certain UWA funds were used.⁸⁷ With this latitude, he transferred money to another nonprofit he created.⁸⁸ He then used the money to finance his frolics with women, including the purchase of a condominium so he could have a place to visit one of his girlfriends.⁸⁹ UWA funds were also used to finance vacations for Aramony and another girlfriend.⁹⁰ All it took was a naïve board of directors and a crafty accountant who was serving as the chief financial officer.⁹¹

80. *Id.* Directors have three principal duties to the nonprofit. (1) Duty of care (referring to the standard of conduct normally expected of reasonable directors); (2) Duty of loyalty (referring to their duty to exclusively dedicate themselves to the interests of the organization); (3) Duty of obedience (meaning their duty to make sure the purposes of the organization are practiced faithfully). *Id.*

81. *United States v. Bennett*, 161 F.3d 171, 174 (3d Cir. 1998).

82. *See id.* at 175.

83. Kurtz, *supra* note 79, at 2.

84. *Aramony*, 88 F.3d at 1373. United Way of America is a nonprofit organization, which provides services for local United Way organizations throughout the United States. *Id.*

85. *Id.*

86. *Id.* at 1373-74. In a two-year period, the chauffeur bill totaled over \$100,000. *Id.*

87. *Id.* at 1374.

88. *Id.*

89. *Id.* at 1374-75.

90. *Aramony*, 88 F.3d at 1374.

91. *Id.* at 1373-74. Thomas Merlo, the certified public accountant and chief financial officer, was convicted of several fraud-related charges. *Id.* at 1373. In addition Stephen Paulachak, a former employee of United Way of America, was convicted of several charges relating to tax fraud. *Id.*

Apparently the UWA trustees needed a little more encouragement as to how to govern their nonprofit organization. Since each nonprofit dollar fraudulently used affects every taxpayer,⁹² regulations should protect taxpayers from careless trustees.

E. The List Goes On

Nonprofit fraud and abuse is not limited to the types of cases discussed. Some strategies involve “look-alike” charities with names or logos similar to other charities.⁹³ These charities piggyback on the goodwill of more prominent charities to get people to donate to their organization.⁹⁴ Another issue that has arisen is the claim by some for-profit businesses that the nonprofits are unfairly competing against them.⁹⁵ Nonprofit organizations have a definite edge over their for-profit counterparts by way of tax exemptions, reduced postage rates, general goodwill and other benefits that come with being a nonprofit.⁹⁶

III. DISCUSSION

While fraud and abuse certainly exist among both nonprofit and for-profit organizations, sometimes the nonprofit status can aggravate the circumstances. An example of this is the Kamehameha case, where the directors received a multi-million dollar salary.⁹⁷ If a director or CEO of billion-dollar for-profit company took home a salary similar to the Kamehameha trustees, feelings of envy would probably arise before feelings of societal unfairness.

Additionally, when a for-profit business is victimized by one of its own employees, past customers will probably not discontinue doing business with the company.⁹⁸ When a

92. See JOINT COMM. ON TAXATION, *supra* note 12, at 2.

93. *Hearing on Abuses in Charitable Gift Giving*, *supra* note 23, at 2.

94. *Id.* An example of this would be the “American Heart Foundation” instead of the notable “American Heart Association”.

95. GARY M. GROBMAN, *THE NONPROFIT HANDBOOK: EVERYTHING YOU NEED TO KNOW TO START UP AND RUN YOUR NONPROFIT ORGANIZATION* 225 (3d ed. 2002). Keep in mind that a nonprofit does not need to have a charitable purpose. See Lee, *supra* note 5, at 930.

96. GROBMAN, *supra* note 95, at 225.

97. Frumkin & Andre-Clark, *supra* note 26, at 425.

98. ZACK, *supra* note 24, at 15.

nonprofit is victimized, the nonprofit will probably see reduced public support.⁹⁹ In the years following the unraveling of William Aramony's wrongdoings, United Way of America saw less support from the public.¹⁰⁰ This highlights the need for nonprofits to stay far away from fraud or abuse, whether as the perpetrator or the victim.

Many of the vulnerabilities of nonprofits are shared by for-profit organizations.¹⁰¹ Some of the vulnerabilities of nonprofits, however, are enhanced by typical traits of nonprofits.¹⁰² Author Gerard Zack lists some attributes that may differentiate nonprofits from most for-profit organizations:

- An environment of trust unlike that found in for-profit enterprises
- Excessive control by a founder, executive director, or substantial contributor
- Failure to include individuals with financial oversight expertise on the board of directors
- The existence of nonreciprocal transactions (contributions) that are much easier to steal than other forms of income
- Failure to devote adequate resources to financial management
- Job Security (and perhaps compensation) linked to program and financial reporting, especially with respect to government grants¹⁰³

Analyzing the differences and similarities between nonprofit and for-profit organizations is important not only to understand the vulnerabilities of the organizations, but also to understand the governing laws influencing regulation on fraud and abuse.

A. *Applicable Laws and Doctrines*

Congress and state legislatures have taken some steps towards curbing fraud and abuse among nonprofit organizations. Some laws have relevance for both nonprofit and for-profit organizations.¹⁰⁴ Others are less clear as to their application or

99. *Id.*

100. *Id.*

101. *Id.* at 3.

102. *Id.*

103. *Id.*

104. Basic federal criminal statutes such as mail fraud and wire fraud do not discriminate between for-profit and nonprofit organizations (however, they do make for an enhanced penalty if the fraud affects a specific for-profit organization, namely, a

efficacy in the nonprofit world, and some apply specifically to only nonprofits or only for-profits.¹⁰⁵ A few of the laws that are unclear will be outlined, as well as those designed for for-profit organizations.

1. The Business Judgment Rule

The business judgment rule is a common law principle that affords a degree of protection to corporate officers from repercussions of managerial decisions.¹⁰⁶ While it has a valuable place among for-profit corporations, it should not be applied in the nonprofit context.

The business judgment rule gives a presumption to the business directors that they “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹⁰⁷ This presumption essentially protects officers from personal liability as long as they are not grossly negligent.¹⁰⁸

Some justifications for the business judgment rule include:

- “[P]romoting risk-taking and allowing shareholders to voluntarily undertake risk”¹⁰⁹
- “[E]ncouraging competent directors to serve”¹¹⁰
- “[P]reventing judicial second-guessing”¹¹¹
- “[A]llowing directors sufficient leeway in managing the corporation”¹¹²
- “[P]ermitting more effective market mechanisms to manage director behavior”¹¹³
- Recognizing the fact that directors are often “removed from the epicenter of information and actual decisionmaking”¹¹⁴

financial institution). 18 U.S.C. §§ 1341, 1343 (2003).

105. *E.g.* The Sarbanes-Oxley Act of 2002 applies specifically to publicly traded corporations. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 750 (codified in various sections of 15 U.S.C.).

106. Lee, *supra* note 5, at 927.

107. *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 807 (7th Cir. 2003) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

108. Lee, *supra* note 5, at 939.

109. *Id.* at 945.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. Lee, *supra* note 5, at 940 (quoting Stuart R. Cohn, *Demise of the Director's Duty*

As nonprofits and the laws regulating them have evolved, nonprofit directors began to be regulated by the same or very similar laws designed for their for-profit counterparts.¹¹⁵ Some courts have applied the business judgment rule to nonprofit organizations, while others refuse to apply it.¹¹⁶ To determine if the business judgment rule should be used to protect nonprofit directors from liability, it is helpful to analyze the benefits and burdens that come from using the business judgment rule.

One reason why a court might apply the business judgment rule to a nonprofit is that nonprofits perform tasks similar to for-profit organizations, with the main difference being nonprofits do not distribute profits to shareholders.¹¹⁷ It may also be argued nonprofit directors should be held to a lower standard of care because they are frequently compensated with below-market salaries, if they get paid at all.¹¹⁸

Conversely, some argue nonprofit directors should be held to the higher strict liability standard of trustees¹¹⁹ and thus the business judgment rule should not protect them. It may be difficult to justify using the business judgment rule for nonprofit directors when the justifications for the rule have little application in the nonprofit world.

The main justification for the business judgment rule in the for-profit context is to promote risk taking.¹²⁰ The theory is that corporate directors should not refrain from taking certain chances because of the fear of being held personally liable if the situation does not turn out as planned.¹²¹ This allows businesses to choose their own risk level, and allows investors to do the same.¹²²

This justification has little weight in the nonprofit realm.¹²³ Donations to nonprofits are generally not seen as an investment. Upon receiving a donation, the nonprofit has a fiduciary obligation to the donor,¹²⁴ but that obligation is not limited to the

of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591, 599 (1983)).

115. *Id.* at 926-27.

116. *Id.* at 942-43.

117. *Id.* at 937-38.

118. *Id.* at 943-44.

119. *Id.* at 944.

120. Lee, *supra* note 5, at 945-46.

121. *Id.* at 946.

122. *Id.*

123. *Id.*

124. *Id.* at 947.

donor.¹²⁵ Since tax exemptions and deductions affect every taxpayer regardless of personal donations,¹²⁶ the nonprofit has somewhat of a fiduciary obligation to all taxpayers. This special relationship to society should create an obligation to wisely manage funds. If this obligation is imposed, nonprofit directors should be regulated by an ordinary negligence standard of care,¹²⁷ which will preclude the use of the business judgment rule.

In addition to the special relationship created between nonprofit directors and society, another difference between for-profit organizations and nonprofits, which should discourage the use of the business judgment rule, is the autonomy of the board of directors. In a for-profit corporation, directors are chosen by shareholders.¹²⁸ In a nonprofit organization, directors are frequently “autonomous and self-perpetuating, which by definition is the case when they have no voting members, directors can [therefore] frequently misuse revenues and privileges due to the lack of monitoring.”¹²⁹

Although there are similarities among nonprofit and for-profit organizations, the obligations owed to society by nonprofit directors and the high degree of autonomy possessed by nonprofit directors create significant differences in how they should be regulated. Therefore, the business judgment rule should not be used in evaluating the conduct of nonprofit directors, and they should be held to the ordinary negligence standard.¹³⁰ If

125. See JOINT COMM. ON TAXATION, *supra* note 12, at 2 (explaining that any reductions in tax liabilities of taxpayers are in reality tax expenditures which increase budgeted federal spending).

126. Reductions in the tax burdens of particular individuals affect all taxpayers because the reductions are equivalent to tax expenditures or federal budget outlays, which increase the total tax revenue that must be collected in order to meet budgetary needs. *See id.*

127. Lee, *supra* note 5, at 948.

128. Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 271 (2003).

129. Lee, *supra* note 5, at 935.

130. It may be a more compelling argument to use the business judgment rule in the context of a commercial nonprofit organization, as opposed to a donative nonprofit. Lee, *supra* note 5, at 947. These nonprofits look more like a business, and it may be argued they should take more risks. *Id.* This argument, however, does not consider the effective federal grant given (by means of the tax-exempt status) to the commercial nonprofit (meaning a non-charitable nonprofit, such as a fraternal club, a cemetery, or chamber of commerce. See Bazil Facchina, Evan A. Showell & Jan E. Stone, *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85, 87-88 (1993)). Therefore, nonprofits should be regulated by the business judgment rule only on those decisions pertaining to activities that are not tax exempt.

jurisdictions insist on using the business judgment rule in nonprofit settings, there should be an exception to the rule if it can be shown the director's actions were "self-dealing."¹³¹

2. The Corporate Veil

In addition to the business judgment rule, the "corporate veil" is another obstacle offering a degree of protection to nonprofit directors and owners. Piercing the corporate veil "is an equitable remedy developed by courts to hold individuals responsible for acts commissioned by a corporation."¹³² Although many states do not have provisions speaking to piercing the veil of a nonprofit organization, courts in some states have extended the ability to pierce to nonprofit cases.¹³³ By allowing the veil to be pierced, the directors have further incentive to be loyal to the organization's cause.¹³⁴

Like other issues that may create liabilities for the directors and officers, this may have the undesired effect of turning away potential qualified officers and directors.¹³⁵ A New York law shows one way to prevent this externality. In New York, if the officer or director serves without pay, he is immune from any liability.¹³⁶ If a court does not preemptively strike the request to pierce the nonprofit veil, the plaintiff will still have to meet the requirements for piercing the corporate veil in that state. New York law, for example, requires the plaintiff show the defendant is the "de facto" owner of the entity.¹³⁷ After this has been established, the plaintiff must show the defendant had "complete domination of the corporation" regarding the transaction in question, and that domination was used to defraud or injure the

131. Matthew D. Caudill, *Piercing the Corporate Veil of a New York Not-For-Profit Corporation*, 8 FORDHAM J. CORP. & FIN. L. 450, 454 (2003).

132. *Id.* at 463.

133. *Id.* at 484-86 (citing the following examples: *Macaluso v. Jenkins*, 420 N.E.2d 251, 255 (Ill. App. Ct. 1981); *Pub. Interest Bounty Hunters v. Bd. Of Governors of the Fed. Reserve Sys.*, 548 F. Supp. 157, 162-63 (N.D. Ga. 1982); *Barineau v. Barineau*, 62, So.2d 1008, 1009 (Fla. Dist. Ct. App. 1995)).

134. *See generally id.*

135. *Id.* at 488 n.244 (citing Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 245 n.70).

136. Caudill, *supra* note 131, at 461. This may be helpful in preventing fear among directors, but might be a loophole, whereby directors could refuse a salary or other overt payment, but get kickbacks, or other less obvious benefits. *See id.* at 454 (describing one Foundation's losses when the directors refused to sell certain stocks held for investment so the price would remain high; in the meantime other equity holders (and possibly the directors) sold their stock at the elevated price).

137. *Id.* at 489.

plaintiff.¹³⁸

Never knowing whether the courts will allow veil piercing to carryover to the nonprofit world, states should specifically address this issue in their statutes. By codifying the process for piercing the nonprofit veil, states can further protect the interests of the nonprofit world by placing personal liability on the officers and directors, just as the for-profit world does.

3. Sarbanes-Oxley Act of 2002

Another legal prophylactic that is relevant to the prevention of nonprofit fraud and abuse is the Sarbanes-Oxley Act of 2002.¹³⁹ Following the wave of scandals that ripped through large for-profit corporations, politicians set their sights on combating this problem. The Sarbanes-Oxley Act came as a result¹⁴⁰ of these circumstances.¹⁴¹

The Sarbanes-Oxley Act applies principally to publicly held for-profit organizations that have securities registered with the Securities and Exchange Commission.¹⁴² Some of the provisions of the Act apply directly to nonprofits, such as the provisions establishing new penalties for destroying documents of interest related to an investigation by a federal agency are applicable to nonprofits.¹⁴³ Most provisions, however, are not directed at nonprofits, and they are not required to follow them.¹⁴⁴

The quixotic belief that nonprofits and their directors have pure intent is not enough to regulate and monitor their behavior. Nonprofit organizations and the general public can both receive a benefit by requiring nonprofits to use the safeguards found in the Sarbanes-Oxley Act.

138. *Id.*

139. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in various sections of 15 U.S.C.).

140. Kurtz, *supra* note 79, at 2.

141. Specifically, the Act was designed to protect investors "by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (preamble).

142. Kurtz, *supra* note 79, at 2. However, nonprofits must generally adhere to federal securities laws. Timothy L. Horner & Hugh H. Makens, *Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations*, 27 STETSON L. REV. 473, 473-75 (1997). The principal statutes applicable to nonprofits include the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940. *Id.* at 475-76.

143. ZACK, *supra* note 24, at 12; *see also* 18 U.S.C. § 1519 (2003).

144. *See generally* Kurtz, *supra* note 79, at Part V.

(a) Certification

Among other things, the Sarbanes-Oxley Act mandates publicly held companies and their directors to meet certain certification requirements.¹⁴⁵ It requires the “principal executive officer or officers and the principal financial officer or officers” certify each annual and quarterly report submitted under the Securities and Exchange Act of 1934.¹⁴⁶ The certification must indicate:

- (1) the signing officer has reviewed the report;
- (2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers—
 - (A) are responsible for establishing and maintaining internal controls;¹⁴⁷
 - (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - (C) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and
 - (D) have presented in the report their

145. *Id.* at Part V.C.

146. 15 U.S.C. § 7241(a) (2003).

147. The purpose of the internal controls is to ensure important information regarding the company will be reported to the company’s officers. Kurtz, *supra* note 79, at 2.

- conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- (5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)-
 - (A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
 - (6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.¹⁴⁸

These can be effective deterrents to prevent fraud and abuse among for-profit companies because these certifications place personal liability on the directors.¹⁴⁹ Without the benefit of the corporate veil, the officers will theoretically be less likely to flagrantly abuse the system.

Just as the certification requirement of the Sarbanes-Oxley Act can help prevent fraud among for-profit companies, it can help the nonprofit world. Currently, nonprofits are required to file a Form 990 with the IRS each year.¹⁵⁰ This form is similar to an annual report,¹⁵¹ describing the institution's financial

148. 15 U.S.C. § 7241(a).

149. Kurtz, *supra* note 79, at 2.

150. ZACK, *supra* note 24, at 14.

151. *Id.* This form is a public document and the nonprofit must provide a copy of it to any person making a request for it. *Id.* It is presently the easiest way to evaluate the financial operations of a nonprofit organization. *Id.*

situation and answering questions regarding their programs and operations.¹⁵² While the Form 990 requires authentication of the correctness of the information given in the form, it does not require the officers to certify there is an internal control system established.¹⁵³ Requiring nonprofits to certify there are internal controls in place could help to prevent fraud by ensuring the officers are made aware of any material information regarding the information that is in the form.

(b) Audit Committee

In addition to the certification requirements, the Sarbanes-Oxley Act also uses audit committees to prevent possible fraudulent behavior.¹⁵⁴ The audit committee is composed of chosen members of the board of directors who must otherwise be independent from the corporation. In order to be “independent,” they may not receive any consulting fee and may not be affiliated with the corporation or a subsidiary, aside from their membership on the board and committees.¹⁵⁵ The committee must create procedures for receiving complaints concerning accounting, internal controls, and auditing issues.¹⁵⁶ The committee is also responsible for choosing, paying, and overseeing the accounting firm that performs the audit.¹⁵⁷

The requirements of the audit committee can be applied to nonprofits with little difficulty.¹⁵⁸ Nonprofit boards are generally large¹⁵⁹ and the board members are normally not paid.¹⁶⁰ Because

152. *Id.* Although the form is filed with the Internal Revenue Service, the IRS has little interest in the content of the form. *Id.* This is because if the numbers were incorrect, it would have little, if any, tax consequence. *Id.* Therefore, the IRS will likely not find any fraud, and it is up to the general public to interpret the Form 990. It may be for these reasons that examination rates of nonprofit organizations have dropped in recent years. *Id.*

153. IRS Form 990, Return of Organization Exempt from Income Tax (OMB No. 1545-0047)(2004), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> (last visited Jan. 17, 2005). This form requires the information to be correct under penalties of perjury. *Id.*

154. ZACK, *supra* note 24, at 12.

155. 15 U.S.C. § 78j-1(m)(3) (2003). One member of the audit committee should be considered a “financial expert.” 15 U.S.C. § 7265(a) (2003). This is a strong suggestion, and if no member is a “financial expert,” it should be disclosed why there is not one on the board. *Id.*

156. 15 U.S.C. § 78j-1(m)(4) (2003). The procedures must allow for anonymous submission of complaints. *Id.*

157. 15 U.S.C. § 78j-1(m)(2) (2003).

158. Kurtz, *supra* note 79, at 18.

159. *Id.* Nonprofits have an average board size of more than thirty members. Lee, *supra* note 5, at 951.

160. Kurtz, *supra* note 79, at 6.

of these two factors, it will be easy to find members who are not otherwise associated with the organization who can serve on the audit committee.¹⁶¹ It may be more difficult, however, to find a “financial expert” among the board to be on the committee (as suggested by the Act¹⁶²) because board members often lack this type of financial experience.¹⁶³

With an audit committee in place in the nonprofit, the most important function of the committee is to review the internal controls of the organization.¹⁶⁴ These controls will help prevent internal fraud from going undetected.¹⁶⁵ Some of the controls may include the separation of certain duties among the financial staff members, review of executive expenses, and verification that staff members do not have absolute control and access to the nonprofit’s bank accounts.¹⁶⁶

The necessity for such controls is best illustrated by the United Way case. An investigation was conducted to determine the circumstances surrounding William Aramony and the United Way.¹⁶⁷ It was concluded there were no internal controls in place to detect the fraud Aramony committed.¹⁶⁸ If there had been internal controls in place, Aramony’s fraud would probably have been detected much earlier, and could possibly have been altogether prevented.¹⁶⁹ Just as the fraud could have been prevented or detected early on in United Way’s situation, fraud can also be curbed among other nonprofits if they are universally required to have an audit committee. This committee should establish and regulate internal controls to prevent the occurrence of fraudulent activities. The audit committee function of the Sarbanes-Oxley Act should therefore be enforced in nonprofit organizations to provide security for the reputation

161. *Id.* at 18. This may not be true for private foundations because the boards are frequently smaller, and the members are often paid for services besides their position on the board. *Id.*

162. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in various sections of 15 U.S.C.).

163. Kurtz, *supra* note 79, at 6 (declaring nonprofit directors are more likely to be teachers, social workers or physicians than financial experts). *See also* Lee, *supra* note 5, at 952-53 (stating that nonprofit boards are often composed of directors with few other corporate or legal experiences).

164. Vanderwarren, *supra* note 20, at 982.

165. *Id.*

166. *Id.* at 983.

167. *Id.* at 984-85.

168. *Id.* at 984.

169. *Id.*

of our nation's nonprofit organizations.

(c) Audits

The Sarbanes-Oxley Act also places restrictions on audits in an attempt to restrict fraudulent behavior among publicly held corporations.¹⁷⁰ The Act does this by prohibiting the public accounting firm that is auditing the corporation from also providing any non-audit service to the corporation.¹⁷¹ Additionally, the head audit partner must be rotated out of the audit after five years.¹⁷² The accounting firm is also prohibited from performing the audit if the chief executive officer, chief financial officer, or the equivalent, of the corporation being audited worked for the auditing firm within one year prior to the audit.¹⁷³

If an audit committee is in place, it should not be difficult for a nonprofit to implement the audit restrictions. The committee can take the steps necessary to verify the auditor meets the requirements of the Act. Therefore, the auditing restrictions found in the Sarbanes-Oxley Act should be applied to nonprofits.

(d) Burdens of Implementing the Act on Nonprofits

Requiring nonprofits to abide by unaltered Sarbanes-Oxley requirements may place a significant burden on nonprofits. While all nonprofits can probably benefit from following the guidelines of the Act, the benefits may be outweighed by the cost of implementing it. If the end goal is to protect legitimate nonprofits as a whole, then a direct carryover of the Act to the nonprofit world might not be a good idea.¹⁷⁴

Many of the corporations subject to the Sarbanes-Oxley Act are very large, and already have the resources to deal with the requirements of the Act.¹⁷⁵ Many nonprofit organizations, however, are small in comparison, and the costs of the Act may be much more detrimental.¹⁷⁶

170. 15 U.S.C. § 78j-1(g) (2003).

171. *Id.* Examples of non-audit services include bookkeeping, and design or implementation of financial information systems. *Id.* Any non-audit services performed by the firm must be pre-approved. 15 U.S.C. § 78j-1(h) (2003).

172. 15 U.S.C. § 78j-1(j).

173. *Id.*

174. Kurtz, *supra* note 79, at 22.

175. *Id.*

176. *Id.* The Securities and Exchange Commission estimated the cost of establishing a recommended "Qualified Legal Compliance Committee" to conform to the Act would be

The need for internal controls and the size of the burden created by requiring internal controls may depend on factors such as the size of the nonprofit. A possible solution to ease the burden placed on nonprofits is to only require larger nonprofits to abide by the Act. One proposed bill in New York requires all nonprofits receiving over \$250,000 in annual gross revenue to meet requirements similar to the certification requirements in the Sarbanes-Oxley Act.¹⁷⁷ It might be assumed that nonprofits receiving more revenue have a larger budget for administrative matters and will be less affected by the increased costs of following the Act.

Another negative effect the imposition of the Act may have on nonprofits is the unattractiveness of opening up personal liability by certifying financial documents.¹⁷⁸ Noble people who work for substandard wages may not be willing to give their labors if they are going to be personally liable for any mistakes in the organization's statements.¹⁷⁹

Although the certification requirement of the Act may serve as a deterrent to some nonprofit CEO's, it seems to be the easiest of all the requirements to meet. Even if nonprofits were not required to meet the Act's audit committee and auditing standards, it would be simple for the top officers to certify that they are unaware of any false information in on the Form 990. At a minimum, the repercussions for knowingly filing a Form 990 with false information should be personal financial liability, in addition to the current threat of penalties under perjury.¹⁸⁰

(e) Sarbanes-Oxley Conclusion

Requiring all nonprofits to follow the provisions of the Sarbanes-Oxley Act would be counterproductive because it might place too great a burden on the already budget-strapped

\$1.5 million. *Id.* at 6. A survey of companies with revenues over \$1 billion revealed 38 percent of the executives felt compliance with the Sarbanes-Oxley Act would be costly. Pete Collins, *Senior Executives Divided on Cost of Complying with Sarbanes-Oxley Act*, MGMT. BAROMETER (PricewaterhouseCoopers), July 2, 2003, available at <http://www.pwcglobal.com/extweb/ncpressrelease.pdf/DocID/BF5439CBB406BB585256D5600687C63>. Of the companies with less than \$1 billion in annual revenue, fifty eight percent of the executives feel the implementation will be costly. *Id.* These numbers tend to indicate the stress on the companies increases as the size of the company decreases.

177. Kurtz, *supra* note 79, at 4.

178. *Id.* at 22.

179. *Id.*

180. IRS Form 990, *supra* note 153, at 6.

organizations.¹⁸¹ Every dollar that goes to administrative matters, such as internal controls, is a dollar that cannot be spent towards the organization's goals. The Act should be amended to include specific provisions applying to certain nonprofit organizations, while imposing a minimal burden on them. For bigger nonprofits, more provisions should be required to be followed. These measures can help protect America's great asset: the nonprofit organization.

4. The Telemarketing Sales Rule

Another recent move by the federal government has a significant effect on charitable organizations that hire "telefundlers"¹⁸² to solicit donations for their charity.¹⁸³ These new regulations enabled the creation of the national do-not-call registry and other rules affecting nonprofit organizations.¹⁸⁴

Due to frequent complaints from consumers concerning the relentless onslaught of telemarketing calls, Congress passed the Do-Not-Call Implementation Act.¹⁸⁵ This Act authorized the Federal Trade Commission (FTC) and the Federal Communications Commission (FCC) to create and enforce regulations over these solicitations.¹⁸⁶ With this authority, the FTC and FCC issued orders establishing a national do-not-call registry.¹⁸⁷ The "Telemarketing Sales Rule" (TSR) is the name of the governing rule and can be found in the Federal Register.¹⁸⁸

Under the TSR, virtually every unsolicited business call to people on the do-not-call registry is prohibited.¹⁸⁹ The rules make a specific exception for charitable telemarketing solicitations.¹⁹⁰

181. Kurtz, *supra* note 79, at 22.

182. FED. TRADE COMM'N, COMPLYING WITH THE TELEMARKEETING SALES RULE 5, available at <http://www.ftc.gov/bcp/online/pubs/buspubs/tsrcomp.pdf> [hereinafter FED. TRADE COMM'N].

183. *E.g.*, VietNow's contract with Telemarketing Associates. *See infra* Part II.B.

184. Daniel A. Cotter, *Don't Call Me, I'll Call You: The FCC and FTC's Do-Not-Call Registry*, 2003 CHI. B. REC., 42, 42.

185. *Id.*

186. *Id.*

187. *Id.* The orders encountered stiff resistance from various courts. *See id.* at 42-43. One district court ruled the FTC did not have authority to set up the do-not-call list, and another court said the list was unconstitutional because it violates free speech protections by favoring charitable speech over commercial speech. *Id.*

188. Telemarketing Sales Rule, 68 Fed. Reg. 4580, 4580 (Jan. 29, 2003)(to be codified at 16 C.F.R. pt. 310).

189. Cotter, *supra* note 184, at 43. There are certain exceptions to this general rule. *Id.* One example is if a business relationship already exists between the solicitor and the consumer. *Id.*

190. *Id.* The FTC acquired the authority to regulate telemarketing done on behalf of

The exception, however, is not without limitation. While nonprofits are not prohibited from calling people on the do-not-call registry,¹⁹¹ the rules impose several requirements on the telemarketing companies soliciting charitable contributions on behalf of the charities.¹⁹²

The TSR requires the telefunder¹⁹³ to promptly disclose two things after placing a call to a potential donor. First, they must disclose the identity of the charitable organization they are representing.¹⁹⁴ Second, they must inform the person that the phone call is for the purpose of soliciting a charitable donation.¹⁹⁵

The TSR also places tight restrictions on misrepresentations made by telefundors in outgoing phone calls made to potential donors. The telefundors may not make any misrepresentations about the “nature, purpose, or mission of any entity on whose behalf a charitable contribution is being solicited.”¹⁹⁶ Additionally, no misrepresentations may be made as to the tax deductibility of the donation.¹⁹⁷ The rule also prohibits misleading statements about the purpose of the donation, including how it will be spent and the area that will receive the benefit of the donation.¹⁹⁸ Telefundors are forbidden from making misrepresentations about the percentage of the donation the charitable organization will actually receive.¹⁹⁹ They may not slant material facts about prize promotions in connection with

charitable organizations after the Telemarketing Act was amended as part of the USA Patriot Act of 2001 to include charitable solicitations in the definition of “telemarketing”. Telemarketing Sales Rule, 68 Fed. Reg. at 4582.

191. FED. TRADE COMM’N, *supra* note 182, at 8.

192. *See id.* at 6.

193. All the requirements in the TSR are applicable to all telemarketers making calls across state lines. *Id.* at 4. Telefundors are actually telemarketers, but their client is a charitable organization. *Id.* at 6. They must follow all rules applicable to other telemarketers, except they may ignore the National Do-Not-Call Registry. *Id.* at 8. The telefundors must maintain an individual do-not-call list for the charitable organizations for whom they are soliciting. *Id.* at 35. If they call someone who already asked not to be called by that charity, the telefundors may be liable for \$11,000. *Id.* at 54.

194. *Id.* at 20.

195. *Id.*

196. *Id.* at 23. “Misrepresentation” appears to mean the undue stretching of the truth, such as a solicitation “on behalf of a charity that seeks to protect endangered species if the [real] purpose of the charity is to support a local petting zoo of barnyard animals.” *Id.*

197. FED. TRADE COMM’N, *supra* note 182, at 23.

198. *Id.*

199. *Id.* at 24.

the solicitation.²⁰⁰ Also, telefunders cannot falsely claim endorsement, sponsorship, or affiliation with any person, organization, or government entity.²⁰¹

In addition to the restrictions on outgoing calls from telefunders to potential donors, the TSR also places certain requirements on incoming calls from potential donors to the telefunders. These restrictions are similar to those on outgoing calls, and they apply if the phone calls are initiated because of direct mail advertising sent out by the telefunders.²⁰²

The no-material-misrepresentation requirement is a step in the right direction but it does not go far enough. A telefunder may get around it by simply not indicating whether donations are tax deductible, or how much of the donation will go to the charitable organization.²⁰³ Rather than only restricting misleading statements, it would be more helpful to potential donors if affirmative statements were required to be communicated to the potential donor, telling him or her more about how the money will be used.²⁰⁴

Perhaps the TSR's most significant restraint that will help curb abuse by telefunders is the wonderfully vague requirement that telefunders disclose all material information to the potential donor.²⁰⁵ "Material information" is defined as "any information that would likely affect . . . the person's decision to make a charitable contribution."²⁰⁶ This information must be disclosed before the person makes a donation and it must be communicated in a "clear and conspicuous" manner.²⁰⁷

The material information requirement is helpful because it puts the burden on the telemarketers to disclose what a reasonable person would want to know. Because "material information" is not explicitly defined, it may encourage telefunders to err on the side of caution by disclosing more

200. *Id.*

201. *Id.*

202. *Id.* at 11.

203. See FED. TRADE COMM'N, *supra* note 182, at 11.

204. This problem is mitigated, however, because the Telemarketing Sales Rule requires the telefunders to disclose material information that may affect their decision to donate, even if the potential donor is the one who initiates the phone call. *Id.* at 14.

205. *Id.*

206. *Id.*

207. *Id.* To be clear and conspicuous, it must be presented as effectively as the sales presentation. *Id.* For example, if the sales presentation is written, the disclosures must be in a type size that a consumer can readily see and understand. *Id.* If the disclosures are oral, they must be communicated at a comprehensible speed, and in the same tone of voice at the same volume as the rest of the presentation. *Id.*

information so they do not violate the TSR. For example, the fact that Telemarketing Associates kept 85-90% of the donations they collect for VietNow probably would have affected the person's decision to make a charitable contribution.²⁰⁸ A cautious Telemarketing Associates would therefore disclose this information without being asked by the potential donor.

A violation of TSR invites civil liability of up to \$11,000 for each occurrence.²⁰⁹ Private citizens, however, cannot bring a suit against the telefundors unless the citizen's damages total more than \$50,000.²¹⁰ Otherwise the suit may only be brought by the state attorney general or other officer authorized to bring suits on behalf of the general public.²¹¹

The requirements of the Telemarketing Sales Rule as a whole make progress toward preventing moral fraud being perpetrated by organizations such as VietNow and Telemarketing Associates.²¹² By creating an action for private citizens, the size of the policing body is immensely increased. With the threat of possible litigation, telefundors will theoretically be more careful as to the claims they make. Behavior that teeters on the border of fraud will be pushed back, and the reputation of honorable nonprofit organizations will be preserved.

5. Pennsylvania's Solicitation of Funds for Charitable Purposes Act

While Congress clearly has the authority to regulate nonprofit organizations,²¹³ some states have taken the initiative to curtail nonprofit fraud. One such state is Pennsylvania.²¹⁴ By enacting the Solicitation of Funds for Charitable Purposes Act, Pennsylvania established certain procedures that help protect

208. See *supra* Part II.B.

209. FED. TRADE COMM'N, *supra* note 182, at 54.

210. *Id.*

211. *Id.*

212. The South Carolina Secretary of State website provides a list of other charitable "scrooges", who give very little of their revenue to the cause they proclaim to support. See 2004 Scrooge List, at http://www.scsos.com/angels_and_scrooges.asp.

213. *Camps Newfound/Owatonna, Inc. v. Harrison*, 520 U.S. 564, 584 (1997) (ruling the nonprofit nature of an organization does not exclude it from the control of the Commerce Clause).

214. See generally Solicitation of Funds for Charitable Purposes Act, PA. STAT. ANN. tit. 10, § 162 (West 2003).

potential donors.²¹⁵

Under the Act, no charitable solicitations may be made in the state unless the organization has first obtained approval by registering with the proper state authorities.²¹⁶ Among other things, the registration requires a statement, which must indicate what the charitable funds will be used for.²¹⁷ The organization must also include a financial statement for the previous year, which must have:

a balance sheet and statements of revenue, expenses and changes in fund balances indicating the organization's gross revenues, the amount of funds received from solicitations or other fundraising activities and all expenditures for supplies, equipment, goods, services, programs, activities or other expenses, a detailed list of all salaries and wages paid and expenses allowed to any officer or employee if the organization is not required to file an Internal Revenue Service Form 990 and the disposition of the net proceeds received from solicited contributions or other fundraising activities.²¹⁸

If the charity receives more than \$50,000 during a year in contributions, an independent public accountant must review the financial records.²¹⁹ If more than \$125,000 is received, the records must be audited by an independent public accountant.²²⁰ Disclosure of these comprehensive financial records ensure the government will know the activities of the organization and will facilitate the state's policing responsibilities.²²¹

The Act contains additional requirements similar to those found in the Telemarketing Sales Rule, such as a requirement that the solicitor disclose the purpose of the charitable solicitation.²²² If the nonprofit out-sources to telefundors to solicit contributions, the contract between the two must be filed with the state, and must contain, *inter alia*, the percentage of

215. *Id.* § 162.2.

216. *Id.* § 162.5(a). Certain nonprofits are exempt from the registration requirement; most of these, however, are regulated to a degree by some other government entity. *Id.* § 162.6(a).

217. *Id.* § 162.5(b)(9).

218. *Id.* § 162.5(e).

219. *Id.* § 162.5(f).

220. *Id.*

221. Typically, "the only parties who have standing to sue for breaches of fiduciary duty by a nonprofit director are the attorney general or a director." Vanderwarren, *supra* note 20, at 974. Therefore the state, as one of two who has standing to sue a director, has a heightened duty to police nonprofits.

222. tit. 10, § 162.13(b)(3).

donations each party will keep.²²³

Pennsylvania's Act stands as a good sentinel for other states to follow. The Act's registration requirements provide assurance the state will know about the organization before solicitation begins. The registration will also serve as a reminder for the organizations that the state is just around the corner if anything does not look right. For these reasons, other states will be well-served to enact legislation similar to Pennsylvania's Solicitation of Funds for Charitable Purposes Act.

6. Reasonable Compensation and Private Inurement

As previously discussed, one form of potential abuse of the nonprofit system is to pay excessive salaries.²²⁴ Private inurement is prohibited in nonprofit organizations.²²⁵ As noted by the Tax Court, "The payment of reasonable salaries does not constitute prohibited inurement, but the payment of excessive salaries does."²²⁶

In situations where the trustees, directors, or other officers receive outrageous salaries,²²⁷ such as the salaries of the Kamehameha trustees,²²⁸ it will have to be determined whether the salaries represent "reasonable compensation."²²⁹ The test used is the same as the "ordinary and necessary" test used to determine deductibility of business expenses from for-profit organizations.²³⁰ The two chief methods used to penalize a nonprofit organization that has privately inured someone are to tax the beneficiary, or to revoke the organization's tax-exempt

223. *Id.* § 162.9(f)(4)–(5).

224. *See supra* Part II.C.

225. I.R.C. § 501(c)(3)(2004).

226. *Good Friendship Temple v. Commissioner*, 55 T.C.M. (CCH) 1310 (1988)(mem).

227. The author of this article worked at Children's Miracle Network, a nonprofit organization, prior to law school. The CEO of that organization has a salary exceeding \$450,000. *See Give.org Report on Children's Miracle Network, available at* <http://www.give.org/reports/index.asp> (last visited Jan. 19, 2005). The author understands the need for qualified leaders, which may only come at a price. If one person can raise \$1,000,000 per year for a nonprofit, and draw a salary of \$40,000, while another person's leadership and creativity can produce \$10,000,000 per year but requires a higher salary, it makes sense to pay for the latter. Nevertheless, the author believes there is a line, albeit blurry, where an exorbitant salary becomes abusive or fraudulent.

228. *See supra* Part II.C.

229. Frumkin & Andre-Clark, *supra* note 26, at 433 (citing *World Family Corp. v. Commissioner*, 81 T.C. 958, 969 (1983)).

230. *Id.*

status.²³¹

In 1996, a provision was passed that taxes the excess benefit of a transaction received by a disqualified person.²³² An excess benefit is the economic benefit that exceeds the value of the consideration.²³³ A disqualified person includes a person “in a position to exercise substantial influence over the affairs of the organization.”²³⁴ Under this statute, the disqualified person is taxed 25% of the excess benefit if corrected in the same taxable period.²³⁵ If it is not corrected, the disqualified person must pay a tax of twice the value of the excess benefit.²³⁶

This penalty will certainly discourage blatantly outrageous salaries. Unfortunately, there remains the gray area of salaries that are shocking to the public, but do not rise to a level clearly beyond the value of the excess benefit. One notable idea is to simply require broader disclosure of salaries to the public and interested parties, which will help guide people as to which nonprofits they will support.²³⁷ This could be effective because in some nonprofit organizations, low salaries help people trust the organization.²³⁸ Thus, media “can bring faster and more lasting changes [to nonprofits] than can government prosecution.”²³⁹

B. *Additional Issues*

In addition to the mentioned laws and principles, there are numerous other issues to consider regarding nonprofit fraud and abuse. Among those are the issues of separation of church and state, and who has standing in a civil suit against nonprofits.

1. Separation of Church and State

Statutes attempting to curb fraud and abuse will inevitably affect religious organizations.²⁴⁰ Appropriate exemptions to churches should be made to avoid the problem of “excessive

231. *Id.* at 430.

232. I.R.C. § 4958(a)(1)(2004).

233. *Id.* § 4958(c)(1)(A).

234. *Id.* § 4958(f)(1)(A).

235. *Id.* § 4958(b).

236. *Id.*

237. *See* Frumkin & Andre-Clark, *supra* note 26, at 428.

238. *Id.* at 472.

239. Brody, *supra* note 29, at 1269.

240. Religious organizations fall under the Internal Revenue Code’s list of organizations exempt from taxes. I.R.C. § 501(c)(3).

government entanglement with religion.²⁴¹ States should also take caution so they do not force provisions upon an organization that may favor one religion over another.²⁴² For example, in *Larson v. Valente*, the United States Supreme Court addressed a Minnesota statute designed to prevent fraud among charities.²⁴³ The statute required religious organizations to register with the state before making solicitations if they received more than half of their contributions from people who were not members of their church.²⁴⁴ Seeing this as religious favoritism, the Court struck down the statute.²⁴⁵

2. Standing

When a nonprofit director breaches a fiduciary duty, most states only allow the state attorney general or another director to have standing in a suit against the breaching director.²⁴⁶ By not allowing private citizens to pursue fraudulent charities through civil actions, citizens (and their attorneys) are not able to fully police nonprofits.²⁴⁷ It is probably better, however, if the attorney general is left to file cases because of the onslaught of litigation that may result from allowing private causes of action against nonprofits.²⁴⁸ If private citizens were allowed to bring cases, honest nonprofits would incur large expenses to defend the suits and less money would be left for the charitable purpose.²⁴⁹ Therefore, it is best to leave the policing power to the state attorney general and other directors.

C. *The Taxpayer*

Although individual taxpayers generally do not have standing to sue a nonprofit organization when a fiduciary duty has been breached,²⁵⁰ they are not completely helpless.

241. *Lemon v. Kurtzman*, 403 U.S. 602, 612-13 (1971) (citing *Walz v. Tax Comm'n*, 397 U.S. 664, 674 (1970)).

242. *Larson v. Valente*, 456 U.S. 228, 244 (1982).

243. *Id.* at 230-31.

244. *Id.* at 231-32.

245. *Id.* at 255.

246. *Vanderwarren*, *supra* note 20, at 974. Any resulting award is typically paid to the charity. *Id.*

247. *Id.*

248. *Id.*

249. *Id.*

250. *See supra* Part III.B.2.

Taxpayers can educate themselves by doing a little investigative work before they give to a charity or otherwise participate in a nonprofit organization. A starting point is the Better Business Bureau's website that evaluates charitable organizations.²⁵¹ Also, a potential donor can ask questions before making a donation. According to the Telemarketing Sales Rule, these questions must be answered truthfully.²⁵² For fraudulent activities in a non-charitable nonprofit organization, the citizen can help by reporting it to the proper authorities, including the attorney general.²⁵³ Collectively, the public can punish negligent or fraudulent nonprofits (both charitable and non-charitable) by withdrawing support for the organization.²⁵⁴

IV. CONCLUSION

The American nonprofit organization is a valuable asset to our country, and it must be preserved. When a nonprofit organization uses fraud or abuse to satisfy personal greed, it affects every taxpayer, who must subsidize the wasted tax revenue.

To defend legitimate nonprofit organizations, each state should enact laws to impose stiffer penalties for breaking the fiduciary duty owed to society. Legislation and common law principles applied to the for-profit can be an effective instrument if used correctly.

Allowing the "corporate veil" to be pierced and waiving the "business judgment rule" in certain circumstances can serve as a deterrent for a potential racketeer. Required audit committees similar to those required in the Sarbanes-Oxley Act can help ensure directors are aware of the happenings in their organization.

Furthermore, states can enact laws to tighten the grip of the

251. See *supra* note 227. This website (www.give.org) provides an excellent appraisal of many, but not all, charitable organizations. It indicates the charity's purpose, the salary of the president or chief executive officer, shows how much of the income goes to their programs, and includes many other important facts. A donor can also file a complaint about a charity. *Id.*

252. FED. TRADE COMM'N, *supra* note 182, at 15.

253. Vanderwarren, *supra* note 20, at 974.

254. ZACK, *supra* note 24, at 15.

Telemarketing Sales Rule. Doing so can improve the legitimacy of telephone solicitations for a charitable purpose. The public should be made aware of the potential dangers and how to avoid them. The effort of legislatures and the public can thwart nonprofit fraud and strengthen the foundation of America's nonprofit organizations.