

SIN, SALVATION, AND THE LAW OF CHARITIES

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Governing Nonprofit Corporations: Federal and State Law and Regulation. By Marion R. Fremont-Smith. *Belknap Press*, 2004. 570 pages, \$95.

Charity creates a multitude of sins.

— Oscar Wilde¹

INTRODUCTION

The United States has a larger collection of charitable organizations than any other nation in the world, and the number is growing quickly.² In 1997, fully 5.8% of all of the legal entities in the United States were nonprofits.³ Unfortunately, the growth of the nonprofit⁴ sector is outstripping both the government and business sectors.⁵ Despite a doubling in charitable giving and a

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1. OSCAR WILDE, *THE SOUL OF MAN UNDER SOCIALISM AND SELECTED CRITICAL PROSE* 128 (Penguin Books, 2001).

2. Stephanie Strom, *Accountability; New Equation for Charities: More Money, Less Oversight*, N.Y. TIMES, Nov. 17 2003, at F1.

3. MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 7 (2004) [hereinafter *GOVERNING*].

4. Despite the name, nonprofits are not actually prohibited from *earning* a profit; they are barred from *distributing* those profits to the organization's directors, officers or members. Excess revenues must either be saved or expended to further the goals of the organization. Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1307 (2003).

5. Strom, *supra* note 2, at F1 (noting that the Internal Revenue Service has only 800 employees to monitor almost 1.6 million charities and other tax-exempt

near doubling in the number of private foundations between 1992 and 2002, “state and federal money spent monitoring them remained flat or declined.”⁶

Charities are generally thought of as organizations that perform good works and serve public policy.⁷ This perspective has historical underpinnings and guides our legal view of such organizations to this day.⁸ Despite this public purpose, the nonprofit sector is often marked by a lack of accountability to the public.⁹ This is exacerbated by the fact that “[a] distinguishing feature of the nonprofit sector is the freedom within which its component entities are allowed to operate.”¹⁰

Charitable organizations often fall short of the lofty ideals we ascribe to them. Just as the for-profit sector has experienced its share of scandals in recent years, so too has the non-profit sector been tarnished by illicit activity.¹¹ Between 1995 and 2002, “[h]igh-level charity officials stole or misused at least \$1.28-billion from 152 nonprofit organizations . . . , but the organizations recovered less than half that amount while many perpetrators received minor punishment.”¹² As substantial as these numbers are, they likely understate the problem. The figures are based on newspaper accounts of charity fraud; because many of those accused of impropriety are not prosecuted, a substantial number of incidents probably never make the headlines.¹³

organizations).

6. *Id.*

7. Obviously people have competing ideas about what constitutes a “good work” and what direction public policy should take. Likewise, nonprofit organizations range across the socio-political spectrum. Although any given organization reflects a particular view of public good, nonprofits, taken as a whole, may arguably be seen as pursuing public purposes and fulfilling societal needs, broadly defined.

8. See Margaret Graham Tebo, *Greater Scrutiny for Nonprofits*, 90 A.B.A. J. 51 (June 2004) (noting the origins of nonprofits’ tax-exempt status in seventeenth-century English common law).

9. James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 222.

10. GOVERNING, *supra* note 3, at 1.

11. See Fishman, *supra* note 9, at 219 n.1 (providing examples of recent scandals involving nonprofit organizations).

12. Brad Wolverson, *Study: Charity Fraud Exceeds \$1-Billion*, CHRON. OF PHILANTHROPY, Nov. 27, 2003, at 26.

13. *Id.*

THE LAW OF NONPROFITS

Although Marion Fremont-Smith's new book is entitled *Governing Nonprofit Organizations*, its focus is on that segment of the nonprofit sector described as "charitable." Charitable organizations form the principal part of the sector and are the organizations that are most closely aligned with the original focus of the law of nonprofits.¹⁴ They can be distinguished from other nonprofits, such as fraternal organizations, labor organizations, or credit unions, by virtue of their "public focus."¹⁵

Fremont-Smith begins by presenting a brief overview of the nonprofit sector in the twenty-first century. She then embarks on a detailed and surprisingly interesting discussion of the history of the "law of charities." An early system of regulation arose in the ecclesiastical courts of medieval England.¹⁶

During this period . . . charitable gifts acquired three distinct characteristics that still survive: (1) the privilege of indefinite existence; (2) the privilege of validity even if the gift is in general terms, so long as its objective is exclusively charitable; and (3) the privilege of obtaining fresh objects if those laid down by the founder become incapable of execution, known today as the doctrine of cy pres.¹⁷

The starting point for the modern law of charities, however, is the Statute of Charitable Uses, enacted in 1601.¹⁸ The purpose of the statute was to encourage and organize "private almsgiving" by correcting abuses in the administration of charitable gifts and by listing a variety of specific "charitable purposes."¹⁹

This statute had a profound impact on the development of

14. GOVERNING, *supra* note 3, at 3. Determining which organizations are properly defined as "charitable" is not always easy. In popular terms, however, a charity may be thought of as an organization whose *raison d'être* is some type of "public benefit." *See id.* at 3-4.

15. *Id.* at 5. This distinction is, of course, of limited utility. Nonprofit organizations are generally considered to be those granted exemption from income tax by the Internal Revenue Service. Charitable organizations may thus be defined as those falling under section 501(c)(3) or, in some cases, section 501(c)(4) of the Internal Revenue Code. *See generally id.* at 4-8 (discussing the various categories of nonprofits).

16. *Id.* at 22. We may trace this farther back still: the medieval English laws have their origins in Roman concepts of charities. *Id.*

17. *Id.*

18. *Id.* at 28. This statute was also known as the Statute of Elizabeth. *Id.*

19. *Id.* at 29.

charitable organizations in both England and, later, the United States.²⁰ It set the groundwork for the proliferation of charitable trusts in both nations, albeit not without some difficulty. In 1819, the Supreme Court decided *Trustees of Philadelphia Baptist Association v. Hart's Executors*²¹ and threw into doubt the very validity of charitable trusts.²² In *Hart*, Justice Marshall determined that "the law of charitable trusts had its origins in, and was based upon, the Statute of Charitable Uses in 1601, and that with the repeal of that statute by Virginia in 1792, any trust without beneficiaries who were definitely named was invalid."²³ The holding, however, was based on the erroneous impression that charitable trusts did not exist in England prior to the statute.²⁴ They had, in fact, existed before this time; the statute simply increased their popularity.²⁵ Although *Hart* was reversed twenty-five years later,²⁶ it continued to influence the development of charitable trusts in a number of states, including Minnesota.²⁷

Although charitable trusts remained the primary form of charitable organization for many years, the rise of the corporate form in American business led to an ever-increasing use of that form for charitable purposes as well.²⁸ Charitable corporations can be found in the (soon to be) United States as far back as 1756;²⁹ however, use of the corporate form really took off following World War II.³⁰ Today, the nonprofit corporation is the predominant form of charitable organization in the United States.³¹

The bulk of Fremont-Smith's book is devoted to a lengthy discussion of the creation and regulation of charitable organizations in the United States. Although other organizational forms are available, charities are usually created in the legal form of

20. *Id.* at 28-29.

21. 17 U.S. (4 Wheat.) 1 (1819).

22. GOVERNING, *supra* note 3, at 44-45.

23. *Id.* at 44.

24. *Id.* at 45.

25. *Id.*

26. *Hart* was reversed by *Vidal v. Girard's Executors*, 43 U.S. (2 How.) 127 (1844), in which the Court held that charitable trusts could be recognized in the United States regardless of statutes abolishing English laws. *Id.*

27. *Id.*

28. *Id.* at 49-50.

29. *See id.* at 50 (discussing a corporate charter granted by the Massachusetts General Court to promote public education).

30. *Id.* at 52-53.

31. *Id.* at 116; Fishman, *supra* note 9, at 225.

either a corporation or a trust.³² The applicable legal standards vary substantially depending upon which organizational form is used.³³

Directors of all nonprofit organizations are fiduciaries.³⁴ Exactly what this fiduciary relationship entails, however, depends upon the organizational form of the nonprofit.³⁵ Fiduciary responsibilities for directors of charitable trusts are governed by “restrictive and demanding” trust law principles.³⁶ In contrast, regulation of charitable corporations is built on a “more lenient” foundation of business corporate law.³⁷ As a result, the choice of organization entails a trade-off between the greater flexibility of the corporate form and the higher standard of care embodied in the trust.³⁸

“A distinguishing feature of charity regulation is that it is a dual system, with state and federal rules and enforcement programs that parallel each other to a large degree.”³⁹ This has not always been the case; regulation of charities fell almost exclusively to the states until the enactment of federal tax laws in the early 1900s.⁴⁰ These laws marked the beginning of a dual system that persists to this day.⁴¹

The primary responsibility for the oversight of charities rests with the states.⁴² “Charities are the creatures of the states, and the laws governing their establishment, their right to continuous existence, their freedom to operate, any limitations on the nature of their holdings, and the conditions for their dissolution have

32. GOVERNING, *supra* note 3, at 116. Among the other organizational forms available are voluntary associations and limited liability companies (LLCs). *Id.*

33. *Id.* at 117. *See also* Fishman, *supra* note 9, at 222-27 (discussing the forms of organization and the varying legal standards that accompany them).

34. Fishman, *supra* note 9, at 227.

35. *See generally* GOVERNING, *supra* note 3, at 187-211 (discussing the distinct fiduciary duties of directors of charitable trusts and charitable corporations).

36. Fishman, *supra* note 9, at 225.

37. *Id.* The question of whether trust or corporate fiduciary standards should apply to directors of charitable corporations was not clearly answered until the latter half of the twentieth century. Now, however, “the majority of states have opted to apply the more lenient [corporate] standards” GOVERNING, *supra* note 3, at 200.

38. *See* Fishman, *supra* note 9, at 225-26.

39. GOVERNING, *supra* note 3, at 428.

40. *Id.* at 53-54.

41. *Id.* at 54.

42. *Id.* at 377.

been and continue to be determined at the state level.”⁴³

Within the states, enforcement of the fiduciary duties of the managers of charitable organizations is, with rare exceptions, left to the courts.⁴⁴ In such a system, the attorneys general are charged almost exclusively with the enforcement of laws governing charitable trusts and corporations.⁴⁵ This provides them with an enormous amount of potential power to wield over nonprofits.

The range of court actions that an attorney general may request a court to take to enforce fiduciary duties is as broad as the power of the courts to devise remedies for breach of fiduciary duties. He may request accountings, removal of trustees, dissolution of corporations, forced transfer of corporate property, or a combination of these. He may ask the court to force charitable fiduciaries to restore losses caused by breach of duty and to return profits made in the course of administering the trust. He may seek to enjoin trustees from further wrongdoing or from continuing certain specific actions. Furthermore, transactions involving a breach of the duty of loyalty may be voided at the option of the attorney general unless he decides that it is in the public interest to affirm them. The attorney general, as well as trustees, may bring actions requesting modification or deviation from the terms of a trust or cy pres application of funds.⁴⁶

In most states, the enforcement powers of attorneys general have been enhanced in the years since World War II by a variety of regulations and reporting statutes.⁴⁷ Minnesota is among the states to have adopted such a statute, enacting the Supervision of Charitable Trusts and Trustees Act⁴⁸ in 1989.⁴⁹ This Act requires charitable trusts and foundations to register with the attorney general's office,⁵⁰ provide copies of all tax information,⁵¹ and notify

43. *Id.*

44. *Id.* at 301. Supervision of some aspects of administration of charities may be provided by agencies such as departments of health or education or secretaries of state. *See id.* at 364-70.

45. *Id.* at 301.

46. *Id.* at 309. There are, of course, limits to this power. *See id.* at 309-11.

47. *See id.* at 311-21. A number of these were modeled after the Uniform Act for Supervision of Trustees for Charitable Purposes. *Id.* at 312-14.

48. MINN. STAT. §§ 501B.33-45, codified by 1989 Minn. Laws ch. 340, art. 1, § 25.

49. GOVERNING, *supra* note 3, at 313. Although the Act makes no reference to the Uniform Act, it contains similar provisions. *Id.*

50. MINN. STAT. § 501B.37, subd. 2 (2003).

the attorney general of any court proceedings involving the organization.⁵² It also provides that all records will be open for public inspection⁵³ and allows the attorney general to bring a civil suit against managers for breach of trust.⁵⁴ Organizations formed as corporations are separately regulated under Chapters 309⁵⁵ and 317A⁵⁶ of the Minnesota Statutes.

Such power obviously carries with it the potential for misuse. Fremont-Smith notes two “disturbing trends” in state regulation of charities.⁵⁷ The first is the use of the threat of litigation by attorneys general to force charities into settlements that are substantially more restrictive than required by law or likely to be imposed by courts.⁵⁸ The second is the “politicization” of the regulation of charities by attorneys general.⁵⁹

The politicization of regulation has raised questions nationally.⁶⁰ Of particular concern is the idea that attorneys general are becoming “headhunters,” using their regulatory power to replace board members with hand-picked successors.⁶¹ Although this is an issue in many states, “no other attorney general has drawn more attention for such appointments than Mike Hatch of Minnesota.”⁶² Proponents argue that such actions are nothing more than zealous guardianship of charitable assets. Opponents express concerns with the ethical dangers of attorneys general regulating their own appointees.⁶³

The primary federal source of regulation for nonprofits is the Internal Revenue Service.⁶⁴ For many charities, assuring that they

51. MINN. STAT. § 501B.38, subd. 1 (2003).

52. MINN. STAT. § 501B.41, subd. 2 (2003).

53. MINN. STAT. § 501B.39 (2003).

54. MINN. STAT. § 501B.41, subd. 7 (2003).

55. MINN. STAT. §§ 309.50-72 (2004) (regulating Social and Charitable Organizations).

56. MINN. STAT. §§ 317A.001-909 (2004) (regulating Nonprofit Corporations).

57. GOVERNING, *supra* note 3, at 446-47.

58. *Id.* at 446.

59. *Id.*

60. *See, e.g.,* Stephanie Strom, *Strong-Arm Shaking of Charities Raises Ethics Qualms*, N.Y. TIMES, May 11, 2003, at A22.

61. *Id.*

62. *Id.*

63. *See generally id.*

64. *See generally* GOVERNING, *supra* note 3, at 238-41 (providing an overview of Section 501(a) of the Internal Revenue Code, which confers tax-exempt status on a variety of organizations such as religious organizations, child-care organizations and social welfare organizations).

will be exempt from federal taxes and eligible to receive tax-deductible contributions is a major consideration.⁶⁵ Most charitable organizations are granted exemption from taxes under section 501(c)(3) of the Internal Revenue Code,⁶⁶ but certain “social welfare organizations” are exempt under section 501(c)(4).⁶⁷

Despite the importance of the IRS in regulating charities, this role was not foreseen when Congress first voted to grant tax exemptions to charitable organizations.⁶⁸ “In fact, it is only since 1969 that the Service became an effective regulator of fiduciary behavior and not until the end of the twentieth century that this power was extended to the vast majority of charitable fiduciaries.”⁶⁹

Current IRS regulation has a number of components. The Service issues revenue rulings on points of law and revenue procedures that address the process for dealing with the IRS⁷⁰ They are legally binding on the Service, but are subject to court review.⁷¹ Information releases and notices issued by the Service likewise have the force of law.⁷² The IRS also issues private letter rulings, general counsel memos, and technical advice memoranda.⁷³ Such determinations are “private” and therefore not precedential; however, they do provide legal guidance for organizations.⁷⁴ Finally, the Internal Revenue Code allows for public disclosure of returns⁷⁵ from exempt organizations.⁷⁶ This allows for a certain level of public oversight of nonprofits.⁷⁷

As a last resort, tax matters may be litigated. Litigation with respect to these matters is bifurcated in the federal system.⁷⁸ With

65. *See generally id.* at 238-52 (explaining the basic requirements for obtaining and retaining tax-exempt status as well as the permitted purposes of tax-exempt charities).

66. *Id.* at 238.

67. *Id.* at 239. Unlike 501(c)(3) organizations, 501(c)(4) organizations are not barred from lobbying activities. They are, however, under the same prohibition against participation in elections. *Id.*

68. *Id.* at 299-300.

69. *Id.* at 300.

70. *Id.* at 395.

71. *Id.*

72. *Id.* at 396.

73. *Id.* at 396-97.

74. *Id.* at 397.

75. The word “return” is broadly interpreted. *See id.*

76. *Id.* at 397-98.

77. *See id.* at 398-400 (discussing Freedom of Information Act inquiries).

78. *Id.* at 400.

the exception of litigation in the Tax Court, all civil litigation arising under revenue laws is handled by the Justice Department's Tax Division.⁷⁹ Additionally, the Justice Department conducts criminal tax prosecutions.⁸⁰

There are also several other federal agencies that help regulate charities. The FBI's Economic Crimes Unit investigates allegations of fraud in telemarketing, federal government procurement, and federally funded programs.⁸¹ Although there is no charity-specific investigation classification, some of the organizations investigated are nonprofits.⁸² The Federal Emergency Management Agency (FEMA) works with charities in coordinating disaster relief operations.⁸³ The Federal Trade Commission (FTC) enforces consumer protection laws, some of which cover solicitation of charitable contributions.⁸⁴ The United States Postal Inspection Service combats mail fraud and has authority to investigate charitable solicitations conducted through the mails.⁸⁵ Finally, the Office of Personnel Management "selects charities to which federal employees may make their charitable contributions through a coordinated appeal."⁸⁶

The final chapter of *Governing Nonprofits* discusses recent modifications in the regulation of charities and assesses some proposals for future improvement. Much of the discussion summarizes the previous chapters and points to the implications of the dual system of supervision.

Prior to the 1970s, the state and federal regulatory regimes had differing aims and utilized divergent enforcement mechanisms.⁸⁷ In contrast to the variety of sanctions available at the state level, enforcement by the IRS was limited to revoking an organization's exemption.⁸⁸ Such revocation often failed to remedy the problem because charitable assets were seized while wrongdoers went unpunished.⁸⁹

Federal options began to broaden with the passage of the Tax

79. *Id.*

80. *Id.*

81. *Id.* at 423-24.

82. *Id.* at 424.

83. *Id.*

84. *Id.* at 424-25.

85. *Id.* at 425.

86. *Id.*

87. *Id.* at 429.

88. *Id.*

89. *Id.* at 429-30.

Reform Act of 1969, which allowed sanctions with respect to private foundations for self-dealing and to managers who knowingly approved the prohibited transactions.⁹⁰ More recent changes have served to bring the state and federal systems closer together by aligning the fiduciary duties of the latter with the former.⁹¹ Under the new federal rules, sanctions available with respect to publicly supported charities are similar to those previously available in cases of private foundation self-dealing.⁹²

In the wake of a number of highly publicized corporate scandals, Congress passed the Sarbanes-Oxley Act in 2002.⁹³ Although this Act was aimed at curbing problematic behavior in the for-profit sector, many of its provisions could be applied to the nonprofit sector as well.⁹⁴ Connecticut has already considered a bill that would do just that,⁹⁵ and it is likely that other states will follow suit.⁹⁶ Even without legal reforms, however, "it can . . . be expected that there will be pressure on nonprofit institutions to borrow some of the principles of good governance espoused by the Act for their own purposes."⁹⁷

Some commentators have proposed that better governance of nonprofits could be effected by moving federal regulation from the IRS to another existing or newly created agency or bureau.⁹⁸ "The most often mentioned suggestion... has been to move it from the Service to a new independent body similar to the Charity Commission in England⁹⁹ or to a separate division within . . . another federal agency."¹⁰⁰

Fremont-Smith argues against such a change, noting that the number of organizations regulated by the Charity Commission is

90. *Id.* at 429.

91. *Id.* at 430.

92. *Id.*

93. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18, 28 & 29 U.S.C.).

94. *See, e.g.*, Szymanski, *supra* note 4 (discussing application of Sarbanes-Oxley to nonprofits); Tebo, *supra* note 8 (same).

95. Szymanski, *supra* note 4, at 1305. Provisions applying such reforms to nonprofits were omitted from the final bill. *Id.*

96. GOVERNING, *supra* note 3, at 431.

97. Szymanski, *supra* note 4, at 1305.

98. *See* GOVERNING, *supra* note 3, at 461-66 (discussing proposals to change the situs of federal regulation).

99. This commission, which has "broad regulatory as well as quasi-judicial powers over charitable fiduciaries[.]" has regulated charities in England for over a century. *Id.* at 464.

100. *Id.* at 462.

far fewer than would fall under the auspices of a similar agency in the United States.¹⁰¹ In addition, because deductibility of contributions is much more limited under British law, the scale of oversight required is substantially less.¹⁰² Moreover, Fremont-Smith notes that changes in the structure of the IRS in the last thirty years have made it much more responsive to the needs of nonprofits and its record in resisting political pressures “has been unusually unblemished.”¹⁰³ This, she says, “is an advantage that should not be lost.”¹⁰⁴ While it is true that such an advantage *should* not be lost, establishment of a separate agency to govern nonprofits does not mean that it *would* be lost. Fremont-Smith suggests as much, however, without explaining why this would occur.

Fremont-Smith advocates, at minimum, two changes in nonprofit law. First, and in her view the most important, would be “to remove the almost complete protection from liability given to fiduciaries in the latter part of the twentieth century.”¹⁰⁵ Such a proposal would provide greater accountability. The primary drawback may be an increased reluctance of individuals to take on positions of responsibility. This could present an especially significant problem for smaller organizations that rely heavily on volunteer leadership because the possibility of lawsuits may discourage some from becoming involved. Whether or not this would be a significant impediment for charities is difficult to judge.

Fremont-Smith’s second proposal is to provide greater funding to regulatory agencies to allow them to more effectively carry out their enforcement duties.¹⁰⁶ While certainly beneficial, whether such action would find support in the current fiscal environment remains to be seen.

CONCLUSION

Governing Nonprofits presents a detailed summary of the laws governing charitable organizations. It is unlikely that attorneys experienced in the area of nonprofit law will find much new in this work. Nonetheless, the book would prove useful for students or for practitioners who occasionally work with charities and desire an

101. *Id.* at 465.

102. *Id.*

103. *Id.* at 465-66.

104. *Id.* at 466.

105. *Id.* at 471.

106. *Id.*

overview of the legal landscape. Fremont-Smith's book is most valuable with respect to federal law. Its utility regarding state law is more limited due to variations among multiple jurisdictions; however, the book does provide a synopsis of general trends.

Particularly helpful in dealing with multi-jurisdictional issues is the appendix. It contains several tables summarizing the laws of each state governing the creation, administration, and dissolution of charities; the standards for applicability of the cy pres doctrine in each jurisdiction; and the fiduciary duties required in each state. These tables provide a handy roadmap to the applicable sections in each state's statutes.

My primary criticism of *Governing Nonprofits* relates to Fremont-Smith's discussion of proposed improvements to laws governing charities. I would have preferred a more detailed assessment and analysis regarding various suggestions. After the detailed history and analysis of current state and federal law, the discussion of proposals for future reforms seemed incomplete.

Such criticism aside, *Governing Nonprofits* provides a functional general reference to the law of charities. Students and practitioners looking for an introduction to this area may find it a useful addition to their bookshelves.