

## *Introduction*

When Celia Roady asked me to speak here today, and we fixed the topic — "Accountability of Nonprofit Organizations: The Lawyer's Role" — I thought back to some ideas I first expressed in March of 1991 in a talk at the Mandel Center at Case Western Reserve University in Cleveland. Because (as I hope) none of you were there, I will borrow a bit from those remarks now. Much has happened, of course, since March 1991, and this audience (of lawyers) has a different focus of interests than my audience then, so much of what I say here today will be different from then.

In the main hall of the magnificent United Way of America building in Alexandria is a bust of Alexis de Tocqueville, the trenchant 19th-century French observer of the United States. He is thus honored for his oft-quoted writing about the propensity of Americans to form voluntary-action groups:

"Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, . . . but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools."<sup>1</sup>

Another somewhat-less-well-known de Tocqueville insight concerns the role of lawyers in America. He said:

"As the lawyers form the only enlightened class whom the people do not mistrust, they are naturally called upon to occupy most of the public stations. They fill the legislative assemblies and are at the head of the administration; they consequently exercise a powerful influence upon the formation of the law and upon its execution."<sup>2</sup>

Today, I want to weave those two thoughts together. My talk has to do with the ways in which law intersects with the activities of voluntary action groups and charities

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1. A. DE TOCQUEVILLE, *DEMOCRACY IN AMERICA*, Second Part, Second Book, ch. V, at 114 (H. Reeve ed., revised, Vintage Books 1945).

2. A. DE TOCQUEVILLE, *DEMOCRACY IN AMERICA*, First Part, ch. XVI, at 289-90 (H. Reeve ed., revised, Vintage Books 1945).

generally. My three theses are: (1) that the nonprofit sector today is much less accountable than the other major sectors of our society, (2) that it should and will be more regulated in the future, and (3) that it is important for lawyers to participate constructively in the design of such regulation. In particular, I want to urge this Committee to analyze and comment on the idea of "intermediate sanctions" for public charities.

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#### *Accountability*

It will not surprise *this* audience (although it often surprises others) that the nonprofit sector of our society is quite large. It is estimated to comprise more than 1.3 million organizations, of which more than two-thirds are charities or social-welfare entities (which together make up the so-called independent sector).<sup>3</sup> Nearly ten percent of the U.S. labor force works in that sector.<sup>4</sup> The net value of assets held by charities alone<sup>5</sup> is nearly \$500 billion today.<sup>6</sup> Charitable giving in this country has exceeded \$100 billion annually for the past few years.<sup>7</sup> Even that large number has

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3. VIRGINIA A. HODGKINSON & MURRAY S. WEITZMAN, NONPROFIT ALMANAC 1992-1993: DIMENSIONS OF THE INDEPENDENT SECTOR Table 1.1, at 23 (1992) [hereinafter cited as "DIMENSIONS"]. As used in this paper, "charities" means organizations which are tax exempt under § 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), and social-welfare organizations means those which are tax exempt under § 501(c)(4) of the Code.

4. DIMENSIONS, Table 1.5, at 28-29. The number includes both compensated and volunteer workers.

5. Social-welfare organizations are not included here.

6. That figure derives from a linear extrapolation from the data in DIMENSIONS, Table 4.1, at 145.

7. GIVING USA, Table 2, at 9 (1990).

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accounted for less than 30 percent of the receipts of the independent sector; *total* annual receipts — which also included dues, fees, charges, investment income, and government payments — were nearly \$375 billion in 1988 and must be greater now.<sup>8</sup> By any measure, the independent sector in our country is very substantial.

Lawyers, more than most, are often involved in controversies and litigations. Perhaps that makes us somewhat cynical, but I would suppose that *anyone*, contemplating the dimension of the numbers I have adduced, would conclude that there will probably be a few bad apples in a basket that big. Not all who claim the independent sector mantle are honorable. Furthermore, because of the nature and importance of the role of the sector in our society, and the many special benefits afforded it, the damage done by the few bad apples in this *particular* basket is *particularly* offensive. Evil done in the name of goodness is evil indeed.

It seems logical, then, to expect the independent sector to be at least as accountable for its activities as the for-profit or governmental sectors. Astonishingly, exactly the reverse is the case. There is virtual unanimity, among informed observers of our legal system, that nonprofit entities are significantly less regulated than the other portions of our society. There are two explanations for this. *First*, nonprofits do not have shareholders or partners, who have proved to be quite potent in calling management to account in the for-profit universe. Indeed, there are very few classes of persons who have legal standing to question the activities of not-for-profit organizations, and even those who have standing often lack any significant interest in asserting it.<sup>9</sup> *Second*, government regulators (and most particularly state Attorneys General, to whom the law confides the principal role in policing charities) tend to allocate their

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8. DIMENSIONS, Table 4.1, at 145.

9. But see the forthcoming study referred to at p. 8, below.

scarce regulatory resources to other more-politically-potent portions of their domains. In most states, the Charity Bureau of the Attorney General's office is inactive, ineffective, understaffed, overwhelmed, or some combination of these.

There are, to be sure, some countervailing forces. The Internal Revenue Service, on the Federal level, scrutinizes some (but far from all) aspects of the operations of tax-exempt organizations. State regulation of charitable fundraising has increased. Many charities impose high standards on themselves, and police their own activities carefully. Some associations of nonprofits and a small number of standards-setting organizations occasionally exert a helpful hortatory influence. The news media, now including several vigilant nonprofit-sector newspapers and magazines as well as a number of reporters on the "philanthropy beat," sometimes cast penetrating gazes on abusive conduct in the independent sector. All of this is generally welcome, even though any of us could complain about particular aspects of it. It would be unfair to dismiss it as irrelevant. A balanced judgment, nevertheless, would still find the nonprofit community to be much less accountable and much less scrutinized than the other major sectors of our society.

My thesis here is: this state of affairs cannot and should not continue. To restate this point: I believe that additional scrutiny is inevitable, and that independent sector groups should favor this trend even though it will entail additional compliance burdens and costs. There are several reasons for this.

*First*, if my diagnosis is correct, leaders of the nonprofit community should be prepared to come forward to support steps to redress the imbalance between the growing importance of the sector and the inadequacy of existing legal structures for its accountability. Our sector differs from government and business in many ways, but one has been a deeper devotion to values and ethics. We contribute to society not only through the pursuit of our core missions but through the exemplary way in

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which we conduct ourselves. We should be, and we should be seen to be, willing to have our activities scrutinized. We should be, and we should be seen to be, anxious to expose abuses of the many privileges we are given. We should be, and we should be seen to be, willing to hold ourselves to a higher standard. We are properly proud to be serving our country's needs. As the great Judge Nathan Benjamin Cardozo said, describing the conduct of a fiduciary, "the punctilio of a honor the most sensitive, is then the standard of behavior."<sup>10</sup>

*Second*, I believe I am recommending not only the course of honor but the course of prudence. If increased accountability is inevitable, wisdom suggests constructive participation in molding its forms rather than futile opposition to their development. Our voices will not be heard if we are perceived as merely self-serving opponents to such changes. Only through constructive participation can we hope to balance the demands of accountability with the claims of our unique sector, including the central claim of diversity and pluralism, which could come undone if too much or too rigid regulation stifles charitable initiative and inventiveness.

*Third*, abuses hurt the sector. In the wake of the televangelist scandals, donations to almost *all* television ministries fell dramatically.<sup>11</sup> When Father Ritter came under criticism, Covenant House was severely and adversely impacted.<sup>12</sup> Contributions to United Ways are down significantly in the aftermath of the Aramony affair.<sup>13</sup>

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10. Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

11. See, e.g., New York Times, March 3, 1991, section 1, p. 24, col. 1.

12. See Suzanne Daley, Hard Times at Covenant a Year After Ritter's Ouster, N.Y. TIMES, Feb. 20, 1991, at B1. See also CHARLES M. SENNOTT, BROKEN COVENANT (1992).

13. See Bruce Millar, United Way Cutbacks Squeeze Charities, THE CHRONICLE OF PHILANTHROPY, June 29, 1993, at 1, and chart at 22-23.

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It is too early to assess the impact of the recent Philadelphia Inquirer series.<sup>14</sup> Although government can raise funds by forced exaction, and business can tempt investors with profits, the nonprofit sector has nothing to offer except its good image, good purposes, and good activities. We should be vigilant to seek out and eliminate undesirable conduct before it corrodes and tarnishes the lustre of our activities. We should be concerned, then, when an inadequate level of supervision and scrutiny leaves an enlarged scope for undetected abuses.

I do not mean to suggest that greater accountability will eliminate all charitable abuses. It will not. Yet more scrutiny should deter abuses to some extent. If the independent sector were already highly accountable, we could debate whether the benefit of further regulatory strictures would outweigh their costs. But the sector is not highly accountable. It will not do to argue against change on the ground that abuses will continue even if accountability increases; that will be perceived as perverse. Rather, we should support enhanced scrutiny of the sector in the hope that abuse potential will be reduced, and in the certain knowledge that an appropriate level of accountability will be a cloth with which to polish and enhance the lustre of all charitable organizations.

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14. Gilbert M. Gaul & Neil A. Borowski, Nonprofits: America's Growth Industry, PHILA. INQUIRER, Apr. 18, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, The Rise of Medical Empires, PHILA. INQUIRER, Apr. 19, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, A Tax Break Colleges Can Bank On, PHILA. INQUIRER, Apr. 20, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, The IRS, An Enforcer That Can't Keep Up, PHILA. INQUIRER, Apr. 21, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, In High-Level Jobs at Nonprofits, Charity Really Pays, PHILA. INQUIRER, Apr. 22, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, For Nonprofits Only: A Cheap Pool of Money, PHILA. INQUIRER, Apr. 23, 1993, at A1; Gilbert M. Gaul & Neil A. Borowski, Foundations Build a Giant Nest Egg, PHILA. INQUIRER, Apr. 24, 1993, at A1.

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Where does this line of reasoning lead? It might suggest broadening the class of persons with standing to call charitable organizations to account. In addition to Attorneys General and the Internal Revenue Service, we might, for example, allow donors access to the courts to challenge transgressions. (It is surprising to many that we do not allow this, generally, today, i.e., that a donor normally is *not* permitted to bring suit even to enforce the agreed terms and conditions of the gift.<sup>15</sup>) We might consider permitting customers and beneficiaries of nonprofit entities to sue, not merely for injuries suffered directly but also to rectify perceived management abuses.<sup>16</sup> The problem is the risk of undue harassment of nonprofit organizations, which — even if ultimately vindicated — would have to endure and pay for the pains and costs of litigation.

I have several observations about these suggestions. On the one hand, they are not much more radical than what the law today provides with respect to *for-profit* entities, given Rule 10b-5<sup>17</sup> and the procedural device of class actions.<sup>18</sup> On the

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15. A donor generally lacks standing to enforce the terms of the charitable trust created by his gift. G.G. BOGERT & G.T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 415, at 448 (Rev. 2d ed. 1979). A more limited right, called the visitation power, sometimes permitted the *first* and *original* donor to scrutinize the activities of the charitable donee. The visitation power, however, although not formally abolished, is "of decreasing importance" and "a relic of earlier times." G.G. BOGERT & G.T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 416, at 458 (Rev. 2d ed. 1979).

16. See, e.g., Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 367 F. Supp. 536 (D.D.C. 1973); Hooker v. Edes Home, 579 A.2d 608 (D.C. Ct. App. 1990). But see Christiansen v. Nat'l Sav. & Trust Co., 683 F.2d 520, 527-28 (D.C. Cir. 1982), distinguishing and adopting a narrow reading of the Stern decision.

17. Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

other hand, I am troubled by the risk of engendering excessive litigation and by the policy choice of confiding to the courts too much of the task of scrutinizing charitable activities. There is more diversity and disagreement within the independent sector than between it and government or business. That signals a danger that, given standing, ideologically opposed organizations might too often take their opponents to court to advance their competitive goals. If donor standing or beneficiary standing were authorized, it would be easy in many instances to become one or the other in search of a law suit.<sup>19</sup> Nevertheless, the law is perceptibly moving in the direction of granting standing to more types of plaintiffs, as a soon-to-be-released (and lengthy) study — prepared by N.Y.U. Law School students under the sponsorship of our Program on Philanthropy and the Law — will show.

On balance, I reject the posture of seeking to retain the current and, in my view, unacceptably-under-accountable status quo. Nevertheless, I am sufficiently concerned about increasing the class of third-parties with standing, because of my apprehension about too much litigation and too large a role for the courts, not to recommend that course too vigorously. I come, then, by a process of elimination, to supporting increased governmental regulation as the best route to follow. Governmental regulation is not free. It entails costs both for the regulator and for the regulated. In my view, given the current state of the legal regime, those costs are well justified.

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18. (...continued)

18. See Rule 23 of the Federal Rules of Civil Procedure.

19. A carefully-circumscribed grant of standing to particular groups might avoid much of this risk, however. For example, standing might be available only to donors responsible, in the aggregate, for more than 20 percent of the entire giving to the organization over the most-recent three years. Such limited grants of standing might be more helpful than harmful. On a state-by-state basis, I would support some experimentation with this idea. If too much litigation or too much harassment ensued, the granted standing could be rolled back.



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*Regulation*

Like it or not, the independent sector will be more scrutinized and more regulated. It is not only futile but, as I have argued, perverse to struggle unduly against this trend. Our country has always honored diversity, and has always been distrustful of unchecked power, authority, and privilege. As the size of the nonprofit sector grows, it seems inevitable that regulation of it will grow. Because it has been perhaps the least regulated portion of our society, the rate of regulatory growth may well be even more swift than the growth of the sector itself. If we within the sector truly value pluralism, we should welcome and support much of this.<sup>20</sup> The alternative is a vision of our vast independent sector continuing to be much less scrutinized than any other feature in our landscape. That vision is fundamentally flawed and ultimately destructive.

In the design of an appropriate regulatory regime, many details will need to be considered. I have skimmed over the landscape without being very precise about exactly what sorts of abuses need to be uncovered and what aspects of conduct need to be regulated. Without more precision on that score, it would be foolhardy to decide what sort of regulation might be called for.<sup>21</sup> If the concern was poor financial management, one sort of regulatory scheme might seem desirable. If the concern was excessive private inurement, quite another might seem best. We can best deal with

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20. At first blush, it may seem contradictory to talk about regulation *promoting* pluralism. It is commonplace, however, for this to occur when the regulation is aimed at preventing abuses which otherwise might tend to weaken the sector or diminish fair competition within it. A good example is the antitrust laws.

21. Indeed, in some particular instances, arguments for *reduced* regulation are no doubt well founded.

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these questions by participating in, even by initiating, the discussions which may then lead to legislation. It is beyond my purpose here to explore the details or design the scheme.

I am not arguing that all regulation is desirable, or that all burdens should be cheerfully shouldered. For example, even if state regulation of charitable solicitation increases, there is no reason why every state needs to regulate differently: multiple diverse state regulatory schemes make compliance difficult. In the analogous area of state regulation of securities offered by *for-profit* firms, much has been accomplished to coordinate the regulatory scheme among states. Although Blue Sky Law compliance is still a real — and often-annoying — burden on for-profit corporations seeking to raise funds, a reasonable reduction of the burden has been achieved through interstate coordination. Perhaps this model might work, over time, with charitable fundraising regulations too. (I am not ignoring the important differences between charitable and for-profit fundraising, including most importantly that the former is entitled to constitutional protection under the free-speech clause of the First Amendment.<sup>22</sup>)

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### *Intermediate Sanctions*

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22. See, e.g., Village of Schaumburg v. Citizens for a Better Env't, 444 U.S. 620 (1980); Secretary of State of Md. v. Joseph H. Munson Co., 467 U.S. 947 (1984); and Riley v. National Fed'n of the Blind of N.C., Inc., 487 U.S. 781 (1988). See also the very useful general discussion of this issue in Ellen Harris, Lynn S. Holley & Christopher J. McCaffrey, Fundraising into the 1990s: State Regulation of Charitable Solicitation After Riley, TOPICS IN PHILANTHROPY 1 (N.Y.U. School of Law 1989). This article, prepared by three N.Y.U. law students under the aegis of the N.Y.U. Law School Program on Philanthropy and the Law, has been republished in 24 U. SAN FRAN. L. REV. 571 (Summer 1990).

There is an important issue currently before all of us. This Committee can perform a meaningful service by undertaking to study and comment on it. It concerns the question of "intermediate sanctions."

That phrase is anything but intuitively clear. For the benefit of those who — like me — hear the words, "intermediate sanctions," without any particular synapses being triggered, let me explain. The phrase is a label for a solution to a problem (assuming, of course, that you agree that there is a problem and that the chosen response is a solution). *First, the problem* — under the Code, if a tax-exempt organization violates certain rules, its exempt status is terminated. From one point of view, that seems to be tantamount to a beheading, a fairly harsh punishment. Interestingly, in some instances it is actually ineffective as a sanction. In many cases, it produces collateral consequences which everyone agrees are very undesirable. *Second, the solution* — craft a punishment which more nearly suits the crime. The best example is the set of sanctions imposed, under chapter 42 of the Code, on certain transgressions of private foundations. Those excise taxes provide graduated penalties which vary in severity according to the nature of the offense. They are referred to as "intermediate sanctions," because they are less severe than capital punishment.<sup>23</sup>

Although the chapter 42 sanctions apply only to private foundations, for years there have been suggestions that they (or some analogous sanctions) should be extended to public charities. As only one example, a 1989 report of an IRS Task Force on Civil Tax Penalties contains an extensive and quite interesting discussion of the private-foundation rules, including a policy analysis of the reasons why some or all of

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23. See also Code §§ 4911 (imposing an excise tax on excess lobbying expenditures of organizations electing Code § 501(h)) and 4955 (imposing an excise tax on certain political expenditures of charities).

the chapter 42 rules might be applied to public charities. Its recommendations include this sentence:

"The types of sanctions imposed on private foundations should be extended to some or all public charities with respect to self-dealing, excess business holdings, and taxable expenditures." EXECUTIVE TASK FORCE, COMMISSIONER'S PENALTY STUDY, REPORT ON CIVIL TAX PENALTIES at IX-41 (Internal Revenue Service Feb. 22, 1989).<sup>24</sup>

In announcing the first of the quite recent (June 15, 1993) hearings on public charities, Congressman J.J. Pickle, Chairman of the Oversight Subcommittee of the House Ways and Means Committee, made clear that he intended to introduce legislation which would establish intermediate sanctions on public charities. In her testimony at that hearing, IRS Commissioner Richardson said in part:

"The lack of a sanction short of revocation of exemption in cases in which an organization violates the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue. For example, assume that an examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to that paid to presidents of comparable universities. Alternatively, the university may have provided the president with a substantial interest-free loan. It may have paid for costly and luxurious amenities in the president's official residence. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community — employees, students, and area residents. Moreover, even if the organization's exemption were revoked, the president would be able to retain the benefits inappropriately received from the university. In short, the Service may be faced with the difficult choice of revoking an organization's exemption or tak-

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24. Of course, that particular recommendation was *not* implemented when the rest of the Task Force suggestions were largely adopted in the Improved Penalty Administration and Compliance Tax Act ("IMPACT"), which was enacted into law as part of the Budget Reconciliation Act of 1989.

ing no enforcement action as long as the compensation in question has been reported accurately on the individual's income tax return."

The example given is compelling. Revocation would punish the innocent, disrupting many important relationships and expectations. It would have little or no impact on the recipient of the inurement. Commissioner Richardson further said, "[I]t would be useful to provide the Service with a sanction short of revocation to address violations of these standards," and she added, "[I]n considering any new sanctions, consideration should also be given to the possibility of clarifying the standards for tax exemption."

The example given could be multiplied, and it would be good if this Committee formulated and considered other examples. At the second Oversight Subcommittee hearing, earlier this week, Howard Schoenfeld and Marcus Owens presented three further examples, involving a television ministry, a college, and a hospital. These, too, should be analyzed.

Even more helpful would be a careful consideration of the sorts of intermediate sanctions which might be appropriate and the sorts of cases in which such sanctions might be applicable. One recent article, by Bob Boisture and Milt Cerny, contains some valuable thoughts and insights.<sup>25</sup>

Finally, an analysis of the most challenging part of Commissioner Richardson's testimony might also be worthwhile: should the standards for tax exemption be clarified? If so, in what respects? Should legislation address this, or is some other method of clarification better?

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25. Robert A. Boisture & Milton Cerny, Hearings Raise the Prospect of Intermediate Sanctions and New Disclosure Requirements for Public Charities, 8 EXEMPT ORG'S TAX REV. 121 (July 1993), reprinted at 60 TAX NOTES 225 (July 12, 1993).

For myself, I doubt that Congressman Pickle's legislation will move on a fast track during this session of Congress. But the issues raised are important, are of long standing, and will not go away. It is a good time to enhance and advance the public debate. I hope that each of you, and this Committee, will find a way to contribute to this over the coming months.