

**AN INTRODUCTION TO THE LAW AND REGULATION OF NON-PROFIT
ORGANIZATIONS IN THE UNITED STATES**

W. Cole Durham, Jr.,¹ Brett G. Scharffs,² and Michael W. Durham³

**International Charity Law Comparative Seminar
Beijing, China
October 12-14, 2004**

I. INTRODUCTION

The charitable sector plays a key role in the United States economy. According to one recent governmental report, charitable organizations (excluding churches, which do not generally have to report their income and assets) had \$939 billion in revenues and \$2.07 trillion in assets in the year 2000.⁴ Historically, the United States has had a strong tradition of private philanthropy, which has benefited from a legal regime that supports and encourages that philanthropy. Perhaps the most frequently-cited justification given for the various benefits conferred on the charitable sector has been that by promoting the general welfare, such philanthropy relieves the government “from financial burdens which would otherwise have to be met by appropriations from other public funds.”⁵ But that justification, which emphasizes charities’ role in furthering public purposes, must be incomplete; every year, the government extends tax benefits to a large number of charities whose activities the government would have no desire or obligation to provide in the

¹ Gates University Professor of Law and Director of the International Center for Law and Religion Studies, J. Reuben Clark Law School, Brigham Young University. B.A. Harvard College; J.D. Harvard Law School.

² Professor of Law, J. Reuben Clark Law School, Brigham Young University. B.S.B.A., M.A. Georgetown University, B.Phil Oxford University, J.D. Yale Law School.

³ Associate, Caplin & Drysdale, Washington D.C. B.A., Brigham Young University, M.A. Yale University, J.D. Yale Law School.

⁴ STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF PRESENT LAW RELATING TO CHARITABLE AND OTHER EXEMPT ORGANIZATIONS AND STATISTICAL INFORMATION REGARDING GROWTH AND OVERSIGHT OF THE TAX-EXEMPT SECTOR 1 (2004), *available at* <http://www.house.gov/jct/x-44-04.pdf>.

⁵ H.R. REP. NO. 75-1860, at 19 (1938).

charity's absence.⁶ State courts and regulators enforce charitable gifts according to their terms even when they themselves believe that the public welfare would be better served if the gift had been made with other conditions or for other purposes. In this way and others, the United States views the purposes and methods of charities as fundamentally subject to private, rather than public, control.

It is easy enough to see how the U.S. commitment to pluralism and freedom of association would lead it to allow and protect private activity in furtherance of private individuals' differing conceptions of the public good. But since the government must admit that charities are often furthering private conceptions of the good rather than carrying forward government programs, why does it nevertheless remain a commonplace that such organizations lighten the burdens of the government?

We begin this Report with that puzzle because it reflects the tension that runs throughout the law governing the charitable sector. What is remarkable (though probably not unique) is the United States' dual attitude toward charities, simultaneously recognizing their diversity and commitment to goals and priorities that the government cannot and does not share while nevertheless seeing them as agents of the public good along with the government.

This dual attitude appears strange to the extent one assumes that the government is the exclusive entity through which the people collectively determine and pursue the public good. For if that is true, then any activity that could not appropriately be performed by government must, for that very reason, not be in furtherance of the public good. This, however, is not the model of the United States. Instead, the duty to further the common good rests, fundamentally, not on the government but on the people of the United States. They have chosen to pursue some, but not all, aspects of the public good through government. At the same time, citizens continue to pursue other aspects directly through various charitable associations and activities. Instead of saying that

⁶ Indeed, the government would be constitutionally prohibited from offering directly the religious instruction it supports indirectly through tax exemption.

charities lighten the burdens of government, one might therefore more accurately state that both charities and government are complementary vehicles for lightening the people's burden to provide for the public welfare. Thus, the fact that a particular private charitable purpose is not shared by the state does not necessarily imply that it is not part of the public good. Beneficial treatment is appropriate for charities not only when they further that portion of the public good for which the government shares responsibility but also when they further that portion of the public good that is beyond the government's sphere.

Of course, there are more prosaic reasons for U.S. governmental support for the charitable sector. One is that, given the limited time and information available to the government, many needs may go unnoticed by the government. When private citizens recognize such needs and take steps to solve them, these citizens are lightening the burden on government—even if, and perhaps especially if, they are not doing something that the government would have done on its own. Furthermore, a diversity of approaches provides experience that the government can draw upon in fashioning its own programs.⁷

One cost of having private parties take a more active role in providing for the common good is that those private parties will choose methods different from the ones government would choose. Sometimes those methods will turn out to be superior, sometimes not. But overall, the United States has considered that a risk worth taking.

II. PROVISIONS OF THE GENERAL LAWS

A. Consistency and Clarity of the Laws

The United States has a federal system of government, with power divided between the federal government and the individual states that together form the country. As a general matter, the creation and operation of nonprofits and other legal entities (corporations, partnerships, trusts,

⁷ For an overview of these and other justifications for the preferences charities receive under U.S. law, see BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* §§ 1.3–.7 (8th ed. 2002).

etc.) is governed by the individual states. States may also have their own rules for exemption from state taxes. While state laws governing nonprofits have broad similarities, they vary considerably in their details (although a growing number of states are adopting model nonprofit corporation acts, thus increasing uniformity across states).⁸ Differences among state nonprofit regimes not only increase the overall complexity of the system but also allow nonprofits a certain degree of flexibility by allowing them to incorporate in a state with laws that fit the organization's needs.⁹ When a charity is organized in one state but operates in another, conflict-of-law puzzles as to which state's law applies to a particular question may create complications that a unitary system would not face (although other countries may face parallel difficulties when foreign organizations operate within their borders).¹⁰

The federal government also exerts substantial influence over nonprofits through its control of federal income tax and the related exemption for charitable nonprofits. This means, in effect, that most nonprofits must act with an eye to both federal and state laws, which sometimes impose overlapping but not identical requirements. For instance, a charitable organization selling real estate to a director must make sure not to breach state rules against self-dealing and also federal tax rules, which impose various penalties if the transaction confers an excess benefit on the director.

Despite the complications of its federal regime, the United States benefits from a long history of experience with charitable organizations. It is thus common to find detailed regulations

⁸ The Model Nonprofit Corporation Act was passed in 1964, and versions of it are currently in effect in Alabama, the District of Columbia, New Jersey, North Dakota, Texas, Virginia, and Wisconsin. The Revised Model Nonprofit Corporation Act, based loosely on California law, has been passed with varying amounts of modification in Alaska, Arizona, Colorado, Georgia, Hawaii, Idaho, Indiana, Maine, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, Oregon, South Carolina, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming. See MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION, app. tbl. 3, 514–17 (2004).

⁹ It should be noted, though, that nonprofits tend to shop for the most attractive jurisdiction much less than their for-profit counterparts do.

¹⁰ For instance, the traditional rule governing conflicts of law involving trusts is that interpretation of the substantive provisions of the trust is controlled by the state where the trust was created, while questions of

or well-developed bodies of case law governing many specific questions that arise in the course of operating a nonprofit. Of course, gray areas still remain between nonprofits and political organizations, or nonprofits and for-profit businesses, where it seems impossible to remove all ambiguity about what constitutes a nonprofit.

B. General Constitutional and Legal Framework

The United States Constitution guarantees the right of the people “peaceably to assemble.”¹¹ Furthermore, the Supreme Court has recognized that freedom of speech also carries with it some additional protection for nongovernmental organizations. The watershed case recognizing a right to association in the United States was *NAACP v. Alabama ex rel. Patterson*,¹² in which the Supreme Court held that

[e]ffective advocacy of both public and private points of view, particularly controversial ones, is undeniably enhanced by group association It is beyond debate that freedom to engage in association for the advancement of beliefs and ideas is an inseparable aspect of the “liberty” assured by the Due Process Clause of the Fourteenth Amendment, which embraces freedom of speech.¹³

Because this right is grounded in freedom of speech, it is concerned primarily with “expressive” association. It allows organizations to determine whom they will admit as members, insofar as those organizations have an expressive message that would be compromised otherwise.¹⁴

Some state constitutions guarantee that certain charitable entities will be tax-free.¹⁵ Others merely permit the legislature to enact such exemptions.¹⁶ For historical reasons, state

the administration of trust law are controlled by the law of the state where the trust is operating. Unfortunately, the line between substantive and administrative matters is often hazy.

¹¹ U.S. CONST. amend. I.

¹² 357 U.S. 449 (1958)

¹³ *Id.* at 460.

¹⁴ *See* *Boy Scouts of America v. Dale*, 530 U.S. 640 (2000) (holding that the Boy Scouts had a constitutional right to exclude a homosexual member because of their disagreement with his way of life). Both the majority and the dissent recognized that the relevant standard was whether the Boy Scouts had an expressive agenda that would be compromised by allowing homosexual men to participate in the organization. *See id.* at 560–66; *id.* at 573–78 (Stevens, J., dissenting); *id.* at 701 (Souter, J., dissenting) (“[N]o group can claim a right of expressive association without identifying a clear position to be advocated over time in an unequivocal way.”).

¹⁵ *See, e.g.*, ALASKA CONST. art. IX, § 4; CAL. CONST. art. XIII, § 3.

¹⁶ *See, e.g.*, PA. CONST. art. VIII, § 2.

constitutions also commonly prohibit state legislatures from passing special acts to incorporate particular organizations.¹⁷ In nineteenth-century America, all corporate charters were created by special case-by-case legislative enactments. That system produced favoritism and corruption; there were even cases of people using political favor to get a charter solely to sell that charter to the highest bidder.¹⁸ Concern over these abuses led to a “great movement for the equal right to incorporate.”¹⁹ As a result, the states moved to the modern system, in which there is a general incorporation statute that makes incorporation a routine, bureaucratic matter not subject to the whim of the legislature or any other government official. The states’ constitutional prohibitions against special corporate charters are in recognition of the dangers for abuse associated with giving officials broad discretion in determining which organizations will be allowed to exist and which will not.

C. Types of Organization

1. State Law

a. Nonprofit Corporations

The most common legal vehicle for charitable activities in the United States is the nonprofit corporation. Generally, nonprofit corporations, like their for-profit counterparts, provide legal-entity status, limited liability,²⁰ and perpetual duration. They are governed by a board of directors, which usually has broad discretion to decide how best to pursue their charitable objectives. The chief difference from for-profit corporations is that nonprofit corporations abide by what has been termed the “nondistribution constraint”: they do not distribute profits to members, shareholders, or other insiders.²¹ Typically, they are not allowed to

¹⁷ See, e.g., N.Y. CONST. art. X, § 1; KY. CONST. § 59; MD. CONST. art. III, § 48.

¹⁸ DeHaven v. Pratt, 73 A. 6 (Pa. 1909).

¹⁹ *Id.*

²⁰ That is, members, directors, and other insiders of the organization are not personally responsible for the organization’s liabilities.

²¹ The Revised Model Nonprofit Corporation Act defines a nonprofit corporation as “a corporation no part of the income or profit of which is distributable to its members, directors or officers.” The Act also

issue stock or have shareholders at all, and even in the few states that do allow nonprofits to issue stock, that stock cannot represent a right to a share in the proceeds of the organization's activities (as it would in a normal corporation). It is worth noting that a large variety of organizations besides charitable organizations—ranging from political organizations to trade associations to special-interest clubs—also use the nonprofit form. Many of these organizations are “mutual benefit” organizations—that is, organizations that primarily provide benefits to their members. Typical examples might be social or athletic clubs.

Some states, including California and New York, have made the distinction between “mutual benefit” and “public benefit” (charitable) organizations part of their law. The more common approach, however, has been to leave such distinctions to the laws governing tax benefits. Indeed, although the Revised Model Nonprofit Corporation Act adopts California's distinction between public and mutual benefit organizations, many of the states adopting that act have declined to adopt the mutual/public distinction.²² In the states that do distinguish between mutual and public organizations, incorporators must specify which type of entity they are forming in the articles of incorporation. Public benefit organizations are likely to be subject to special regulations to ensure that the organizations' assets remain devoted to their charitable purposes. Mutual benefit organizations, on the other hand, may be allowed to distribute their assets back to their members.²³

b. *Trusts*

The chief alternative to the nonprofit corporation is the trust. While corporations are created pursuant to statute, the law of trusts is largely a creation of the common law (though

prohibits all distributions, except that it allows certain distributions of assets upon dissolution of a mutual benefit corporation. *See* REVISED MODEL NONPROFIT CORP. ACT §§ 13.01–.02 (1987).

²² These states include Alaska, Arizona, Colorado, Hawaii, Idaho, Iowa, Mississippi, Utah, and West Virginia. *See* FREMONT-SMITH, *supra* note 8, app. tbl. 1 at 476–95

many states have, to varying extents, passed statutes codifying trust law). Fundamentally, a trust is a device by which one or more legal persons hold legal title to property, but do so for the benefit of some other person, class, or purpose. Thus, the conceptual focus of trust law is not on the trust as a separate legal entity, but rather on the duty of the trustees to use the property as the settlor (creator) of the trust wished, and not for their own private purposes. Because a trust is not technically a legal person, historically trustees were sometimes held personally liable for contracts and torts associated with the trust. However, the modern trend has been to distinguish between a trustee acting in his personal capacity and a trustee acting in his capacity as trustee, allowing an action directly against the trust for damages to third parties resulting from the trustee's actions on its behalf. Thus, at least the contractual obligations of the trust do not normally run to the trustee (although if the trustee commits a tort on behalf of the trust, both may be liable). Similarly, the trustee's personal creditors cannot seek to recover his personal debt from trust property. Thus, in practice trust law provides at least some of the advantages of separate legal personhood.

Trusts can be either private or charitable. A private trust must always have some interest in property subject to the trust and some definite beneficiaries who can enforce the trust by suing the trustee in court if he does not properly perform his duties. Thus, if the trust beneficiaries are not definitely ascertainable, the trust is void.²⁴ Private trusts have historically been limited in duration; they are generally void if they are not sure to terminate, giving the beneficiaries full ownership and control over the trust property within a certain amount of time.²⁵ Charitable trusts, on the other hand, cannot be designed to benefit particular individuals but must have a larger, less

²³ See REVISED MODEL NONPROFIT CORP. ACT § 13.02 (1987).

²⁴ RESTATEMENT (SECOND) OF TRUSTS § 112 (1957).

²⁵ This is because of the "rule against perpetuities," an old doctrine designed to facilitate the alienability of property by voiding dispositions of property that might restrict its transferability for more than twenty-one years past the life of anyone living when the disposition is made. Thus, in the typical case, a testator could leave property in trust to be distributed among his children when they reached the age of 21; the testator could not, however, direct how that property was to pass over the next five generations. See FREMONT-SMITH, *supra* note 8, at 135–36.

definite class of beneficiaries. Because they serve public benefit purposes that are worthy of having assets permanently dedicated to them, they are allowed to be perpetual in duration.

It should be noted that because of the flexibility of the trust form, it can be employed not only as an alternative to the nonprofit corporation but also in conjunction with it. For example, a nonprofit university's charter might state its purposes as furthering education in a broad sense, but a donor might give the university a large grant to be held in trust for the more narrow purpose of establishing a medical school. This would guarantee that in addition to the ordinary remedies of contract law, trust law's full panoply of enforcement mechanisms would be available to ensure that the donated funds were used in accordance with the donor's wishes. Thus, besides providing an informal alternative to the corporate form, trust law encourages donation by providing a mechanism for assuring that donated funds are used as promised.

c. Unincorporated Associations

Besides the nonprofit corporation and the trust, one other form of organization deserves mention. First, groups of individuals can form unincorporated associations governed only by their mutual agreement, and requiring no registration with the state. These membership associations are extremely flexible but possess the drawback of having no legal personality. Thus, unincorporated associations have traditionally been able neither to sue or be sued in their own name nor to own property (any property they hold is actually owned collectively by their members). In addition, because of the ease and familiarity of forming nonprofit corporations and trusts, the law governing unincorporated associations is relatively undeveloped and uncertain. In the last few decades, some states have acted to remedy these deficiencies by passing laws that clarify the basic rules governing unincorporated associations and provide them with some of the aspects of legal personality. However, even these laws stop short of giving unincorporated associations limited liability, so except for relatively risk-free, informal activities, incorporation remains a preferable alternative.

2. Forms of Entity: Federal Tax Law

As in many countries, the basic distinctions between the fundamental forms of organization discussed thus far are formal and structural; one cannot tell much, if anything, about what an organization does or how it operates simply by discovering whether it is organized as a nonprofit corporation or a trust. This is beneficial insofar as it provides a simple framework that can accommodate a great variety of organizations. But that very flexibility means that the distinctions between fundamental forms are not particularly relevant in determining what kind and degree of regulation is appropriate to a given organization, for that depends on such features as an organization's size, sources of funding, manner of operation, and purposes. Therefore, the United States has developed a separate set of distinctions in the tax code that distinguish between organizations based on their functional attributes. The most important of these distinctions, of course, is the distinction between charitable organizations and the rest. But in addition to this, U.S. law further subdivides the class of public benefit organizations based on such attributes as their sources of funding and methods of achieving their statutory purposes.

a. Charitable Organizations

The most important category, of course, is the category of charitable organizations. These are often referred to as 501(c)(3) organizations, because this is the key Internal Revenue Code provision governing such entities. Charitable organizations must be both (1) organized and (2) operated exclusively for one or more public benefit purposes. Thus, a charitable organization's founding articles, in conjunction with applicable law, must prohibit it from ever distributing its net earnings to members, directors, or other insiders (even upon dissolution). In addition, the articles must limit the organization's purposes exclusively to charitable ones. They must not authorize the organization to conduct any substantial amount of activity that does not further its stated charitable purposes. Moreover, if an organization does not abide by these restrictions in practice, it cannot qualify as a charitable organization.

For an organization to be charitable, no part of its net earnings can inure to the benefit of insiders to the organization. In essence, this restriction on private inurement is designed to

“prevent anyone in a position to do so from siphoning off any of a charity’s income or assets for personal use.”²⁶ While the clearest example would be an outright dividend, the Internal Revenue Service (“IRS”) and the courts have recognized that there are many other ways that a supposedly charitable organization can confer advantages on its insiders. Thus, the ban on private inurement also prohibits charitable organizations from paying excessive compensation or making interest-free loans to insiders, or otherwise engaging in transactions in which a “disproportionate share of the benefits of exchange” is captured by the private insider.²⁷

A second, related restriction is that a charitable organization must not confer a private benefit, or have the purpose of so doing. Charitable organizations, like charitable trusts, must serve a broad and indefinite class of beneficiaries, not specific individuals. Of course, in the course of serving their public benefit purposes, such organizations benefit private parties in many ways, for instance by employing them. Universities undoubtedly benefit the private individuals they educate. These incidental benefits do not threaten a charitable organization’s status. But if an organization confers a private benefit that is not incidental to its charitable purposes, it violates the private benefit doctrine. Unlike the private inurement doctrine, this doctrine applies even if the recipient of the benefit is not an insider.

The line separating public and private benefit is not always sharp. An important purpose of the charitable sector is to take advantage of private individuals’ charitable impulses, but those impulses are often focused on benefiting some subgroup of the general public with which the donor has a particular connection. Thus, while a charity cannot be organized to benefit a particular individual or family (however needy), charities are often organized to promote economic development in particular areas, to provide aid to impoverished members of particular professions or disadvantaged ethnic groups, etc. At the same time, if these limitations are designed to give indirect advantages to a less open-ended class, they will be rejected. Examples

²⁶ Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

²⁷ Tech. Adv. Mem. 91-30-002 (March 19, 1991), *quoted in* Hopkins, *supra* note 7, § 19.1.

of this include a school that gives a broad range of students training but intends that most will use that training on behalf of a particular noncharitable organization,²⁸ or a charity that helps doctors provide medical services abroad but does so with a substantial purpose of producing revenue for a particular travel agency.²⁹

b. Social Welfare Organizations

Social welfare organizations (501(c)(4) organizations) are very similar to charitable organizations. Both must keep their assets permanently devoted to their public benefit purposes, and neither is allowed to distribute net earnings. Both are subject to the private inurement and private benefit tests. The main difference is that social welfare organizations may engage in advocacy or other activity geared to influence legislation in furtherance of their public policy goals. Thus, for example, a social welfare organization dedicated to stopping drunk driving could devote a substantial amount of its activity to contacting legislators and urging them to enact harsher penalties for that crime.

c. Public Charities and Private Foundations

The tax code distinguishes between two principal classes of charitable organization: the public charity and the private foundation. The difference between these two, in rough terms, has to do with the nature of their funding and their susceptibility to being captured by private interests. Certain types of organizations including schools, hospitals, churches, and medical research organizations are automatically public charities. Other organizations must meet one of two support tests designed to measure the extent to which the organization gets its support from a broad section of the public rather than from a few individual donors.³⁰ Organizations with

²⁸ See *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053 (1989).

²⁹ See *Int’l Postgraduate Med. Found.*, 56 T.C.M. (CCH) 1140, 1143 (1989).

³⁰ The first test ignores income from the organization’s charitable activity. To qualify automatically as a public charity, an organization must receive no more than two-thirds of its total support as non-public support (investment income or donations from private parties in excess of 2% of total support). Organizations that receive more than 90% of their income from these sources are automatically disqualified. Between these extremes, organizations are evaluated on a case-by-case basis to determine whether they are organized and operated to attract public support.

relatively broad support from a large number of individuals are generally public charities while organizations that depend principally on a few large donors or their own investments are private foundations. In addition, an organization may qualify as a public charity if it is dedicated solely to supporting one or more public charities, and its relationship with the supported organization(s) is sufficient to guarantee that the supported organization has a sufficient voice in the supporting organization. Charitable organizations not falling into one of these categories are determined to be private foundations, which are subject to special restrictions. Private foundations that actually conduct charitable activities, as opposed to merely making grants to others, are further classified as private *operating* foundations.³¹

The rationale for distinguishing between public charities and private foundations is that although there is always some risk that charitable organizations will improperly use their resources to serve private interests, that risk is not the same for all types of organization. When a small group of closely related donors create a private foundation funded and controlled entirely by insiders, a greater potential for abuse exists because the donors are able to dedicate the assets to charitable purposes on paper while maintaining control over their use.³² By contrast, public charities are less likely to be controlled by any one particular donor. Moreover, because they depend to a larger extent on donations and business from the public, they have a greater stake in

The second test takes into account income from the charitable activity as a source of public support, thus making it possible for organizations that rely primarily on the sale of services for income to qualify as public charities. However, using this test the organization must stay below the two-thirds threshold for non-public support; there is no case-by-case evaluation. In addition, the organization must receive no more than one-third of total support from investment income. For a more detailed explanation of the rules governing these support tests, see BETSY BUCHALTER ADLER, *THE RULES OF THE ROAD: A GUIDE TO THE LAW OF CHARITIES IN THE UNITED STATES* 19–22 (1999).

³¹ See HOPKINS, *supra* note 7, § 18.1; I.R.C. § 4942(j)(3) (2000).

³² Among the perceived abuses that led to the enactment of special restrictions on private foundations in 1969 were the following: (1) Foundations would sometimes provide loans or make purchases on favorable terms to insiders. (2) A trustee could invest charitable assets to acquire large holdings in companies in which the trustee also had an interest, thus allowing the trustee to use the charity's voting rights to solidify control over the companies. (3) Although a foundation's assets were formally dedicated to charitable purposes, those in control of private foundations could invest those funds as they pleased without ever paying out anything for charitable purposes. By doing this, they were able to claim tax advantages for dedicating assets to charity while postponing indefinitely the actual use of the funds for charitable purposes. See FREMONT-SMITH, *supra* note 8, at 76–77.

maintaining a good reputation. So long as their activities are publicly disclosed, the need to attract public support on an ongoing basis provides some measure of accountability.

Although the distinction between public charities and private foundations originated in the tax code, it has since become a part of the basic organizational framework for charitable organizations in the United States. The IRS requires that private foundations' governing documents (or applicable state law) prohibit them from being controlled by substantial donors, holding certain investments, dealing with insiders, etc. As a result, 48 states have passed laws adopting the distinction between private foundations and public charities and prohibiting private foundations from engaging in any of those activities.³³ Even where such state laws do not exist, private foundations routinely include equivalent restrictions in their governing documents. Once included, these restrictions become binding organizational features enforceable under state law.

D. Purposes

Under both state and federal law, charitable organizations of whatever form are defined primarily by their dedication to charitable purposes. However, because most charitable organizations are nonprofit corporations, and because most states allow incorporation of nonprofits without any inquiry into whether the nonprofit is charitable,³⁴ for most charitable organizations the federal definition of charity is the relevant one. (This is not true for trusts, which must also satisfy state-law definitions of charity if they are to be allowed to exist in perpetuity.) Although each state and the federal government are separate jurisdictions with authority to reach differing determinations about which purposes are charitable, for the most part, there is consensus, rooted in the old common-law definition of charity, which reflects a broad and open-ended notion of charitable purposes. One oft-quoted expression of that common-law definition is as follows:

³³ *See id.* at 267.

³⁴ Some state laws have a very broad and nonexhaustive list of the kinds of purposes for which a nonprofit can be formed. The more modern trend is to allow nonprofit incorporation for "any legal purpose," so long as that purpose is not inconsistent with the fundamental nondistribution constraint.

A charity, in the legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, for the benefit of an indefinite number of persons, either by bringing their minds or hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.³⁵

More generally, it is recognized that these categories are only illustrative, and that other purposes of benefit to the community can qualify as charitable. As the Third Restatement of Trusts states, “the role of the court in deciding whether a purpose is charitable is not to attempt to decide which of conflicting views of the social or community interest is more beneficial or appropriate.”³⁶ So long as the purpose is within the universe of those that might reasonably be thought beneficial to the public, that purpose should be permitted.

The federal tax code states that charitable organizations must be organized and 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.”³⁷ It should be noted that this list is construed quite broadly, especially the term “charitable,” which has been interpreted to incorporate the common-law definition of charity.

Given the flexibility in the United States definition of charity, one might wonder why U.S. statutes almost invariably recite litany of typical charitable purposes like those set forth in the federal tax code. Part of the reason for this is that in the United States and the United Kingdom, charitable institutions predated the legal regime that subsequently emerged to regulate them. Thus, regulators were not simply left to imagine which kinds of public purposes private individuals might be willing to support through donations. Rather, there was already substantial private support for institutions such as schools, religious organizations, and science. Our decision to include certain classes of charity was based not only on their theoretical value but also on the

³⁵ *Jackson v. Phillips*, 96 Mass. 539, 556 (1867), *quoted in* FREMONT-SMITH, *supra* note 8, at 119.

³⁶ RESTATEMENT (THIRD) OF TRUSTS § 28, cmt. (a)(2) (2003).

³⁷ I.R.C. § 501(c)(3) (2000).

proven value of such institutions' contributions over a long history. Thus, for example, while one can perhaps imagine circumstances being otherwise in theory, in the American tradition, religious organizations have played a substantial role not only in religious worship but also in establishing many of the great American universities, feeding the poor, and providing other secular benefits. The United States experience with charitable organizations has been favorable in part because it was structured not only to allow innovation but also to support the particular forms of public benefit activity that had spontaneously emerged in the private populace.

Besides the broad range of acceptable purposes, there are certain purposes that a charity must *not* have. Organizations must not be organized in order to break the law, for example, even if they intend to do so in order to further some charitable objective. In a few cases, organizations have been found to have features so contrary to established public policy that they did not merit the benefit of tax exemption. The Supreme Court applied this doctrine to uphold the denial of an exemption for a school that, although otherwise exempt as an educational organization, was racially discriminatory.³⁸ In addition, if a substantial purpose is to confer a benefit on some private party, the organization might violate the private benefit test, the private inurement test, or both.

E. Registration or Incorporation Requirements

It is remarkably easy to form a charitable entity in the United States. A person can create a charitable trust simply by executing and delivering a deed, contract, or other instrument conveying the trust property to another person (or even to herself) in trust for the charitable purpose. No government approval is required any more than government approval is required for a contract or a deed conveying property. Of course, the trust instrument may be challenged in court and ultimately held void if one of the requirements for valid charitable trusts is not met. Thus, in dispensing with registration, the United States has not left trusts altogether unregulated.

³⁸ Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

Rather, in recognition of the fact that most trusts are unproblematic, it has opted to deal with problems if they arise *ex post* rather than scrutinizing every trust *ex ante*.

In the United States, only the state can create a corporation. Therefore, founders must apply to a state official (usually the secretary of state, commissioner of corporations, or other office responsible for registering commercial corporations) for incorporation. To incorporate under the Revised Model Nonprofit Corporation Act, for instance, one or more persons deliver articles of incorporation to the secretary of state.³⁹ The articles need contain only (1) the name and address of the incorporators; (2) the name and address of the corporation and its initial agent; (3) whether the corporation is public benefit, mutual benefit, or religious; (4) whether or not the corporation will have members; and (5) rules for distributing assets on dissolution.⁴⁰ State laws are broadly similar in this respect, although they commonly also require the articles to state in general terms the purposes, powers, and duration of the corporation, along with the names of its initial directors, if any.⁴¹

All but a handful of states require only one incorporator. The state of Nebraska requires two, the District of Columbia, Alaska, Florida, and South Dakota all require three, and New Hampshire requires five.⁴² Generally, states impose no restrictions on who may serve as an incorporator except that a substantial minority require the incorporator to be an adult or at least old enough to enter binding contracts. Some states allow legal persons to serve as the incorporator; others do not.

Some states still allow the incorporating authority to perform some review of the incipient organization's materials to verify that the organization's structure and purposes comply with the law. In the past, this power has occasionally been used to prevent the incorporation of organizations whose purposes the secretary of state considers objectionable. For instance, in

³⁹ REVISED MODEL NONPROFIT CORP. ACT § 2.01 (1987).

⁴⁰ *Id.* § 2.202.

⁴¹ See FREMONT-SMITH, *supra* note 8, 152–53.

⁴² See ANTHONY MANCUSO, HOW TO FORM A NONPROFIT CORPORATION IN ALL 50 STATES (4th ed. 1997).

1974 the Supreme Court of Ohio upheld its Secretary of State's refusal to incorporate an organization that promoted homosexuality as a way of life.⁴³ However, the approach of that decision was outdated even then;⁴⁴ the trend has been to make clear, by statute or by judicial interpretation, that the incorporating authority has no discretion to deny incorporation unless the organization's purpose violates some prohibition of law, not just the authority's personal notion of public policy.⁴⁵ This not only keeps the secretary of state from usurping the legislature's position as the body primarily responsible for shaping its state's public policy but also avoids the danger for abuse or corruption in the incorporation process.

If for any reason an application for incorporation is rejected, that rejection may be challenged in court. More typically, however, the application is granted, and if the organization is in fact operating in an illegal manner, the attorney general can petition the courts to revoke the corporate charter at a later time when such wrongdoing has been demonstrated. One advantage of waiting until problems actually arise to challenge an organization is that attempting to screen out all potential bad actors *ex ante* often results in many legitimate applications being denied, deterring or at least delaying their contributions to the public good. It is easiest to tell whether an organization is abusing its privileges once it has actually commenced operations. Thus, there are strong arguments for allowing relatively easy access to charitable legal entities, provided that adequate tools are available to prevent abuses determined on an *ex post* basis.

F. Charitable Organization Register

Registries of nonprofit corporations (and other entities, including for-profit corporations) are kept by the various states. Increasingly, at least some information in a state's registry will be

⁴³ State *ex rel.* Grant v. Brown, 313 N.E.2d 814 (Ohio 1974).

⁴⁴ See Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 526 n.70 (1980) (describing the movement away from discretion beginning in the 1950s, and noting the *Grant* decision as an exception to that trend).

⁴⁵ See *id.* For example, the Revised Model Nonprofit Corporations Act explicitly states that the secretary of state's duty to incorporate is ministerial, and further provides that a refusal to file articles of incorporation has no effect on the validity of those articles. REVISED MODEL NONPROFIT CORP. ACT § 1.25(d) (1987). Similarly, the Court of Appeals of New York (the state's highest court) has held that a judge can

available on the Internet: for instance, the name and address of the corporation, as well as dates of incorporation, dissolution, name changes, and mergers. Often the secretary of state keeps documents relating to a nonprofit corporation open for inspection, such as its articles of incorporation, amendments thereto, articles of merger or dissolution, and periodic reports. These are also becoming available online.

The IRS keeps a master file with basic information about all of the organizations it has recognized as exempt. Publication 78 lists all organizations the IRS recognizes as being exempt from tax under section 501(c)(3) of the Code and is publicly available on the web.⁴⁶ Thus, donors can immediately check whether contributions to a particular organization are tax deductible. The list is kept quite up-to-date. The IRS also lists organizations that have had their exemption suspended.⁴⁷ In addition, it requires exempt organizations to file annual reports containing information about their activities and finances; these reports are public, and third-party organizations have made them easily accessible via the web.⁴⁸

G. General Powers

Modern nonprofit corporation laws generally provide that, unless the corporation's documents limit its powers, a corporation has wide authority to contract, sue and be sued, own and sell all sorts of property, and in general to engage in any legal activity that will further its purposes directly or indirectly.⁴⁹ The modern trend in trust law has also been to allow trustees full power to deal with trust property.

Unincorporated associations are more limited in their powers. Because they lack legal personhood, they may have difficulty owning property or taking other legal actions in their own

disapprove an organization only if it is directly in violation of law. *Ass'n for the Pres. of Freedom of Choice, Inc. v. Shapiro*, 174 N.E.2d 487 (N.Y. 1961).

⁴⁶ See I.R.S., *Search for Charities, Online Version of Publication 78*, at <http://www.irs.gov/charities/page/0,,id=15053,00.html>

⁴⁷ See I.R.S., *Suspension of Exemption and Disallowance of Tax Deduction*, at <http://www.irs.gov/charities/article/0,,id=96136,00.html>

⁴⁸ The most commonly used source is GuideStar (*available at* <http://www.guidestar.org>), which provides access to the forms free of charge.

name; instead, actions taken by the association may be deemed to be the acts of its respective members, who remain individually liable for the association's obligations. Some states have passed legislation that at least allows unincorporated associations to own property in their own name. Still, given the ease of forming either a trust or a nonprofit corporation, unincorporated associations have not been commonly used.

H. Membership Organizations

Most states do not provide any special corporate form for membership organizations. Thus, the only difference between membership and nonmembership organizations is usually in their articles and bylaws. State laws generally leave organizations great flexibility in providing for zero, one, or more classes of members and in deciding what rights (if any) each class of members will have in the governance of the nonprofit. There are some exceptions to this rule, however, particularly in states that distinguish between mutual benefit and public benefit forms. Some of those states, like New York, require mutual benefit organizations to have memberships.⁵⁰ However, individuals cannot be compelled to join an association, nor can they be forced to remain members once they have joined.⁵¹ On the other hand, organizations generally have a right to set conditions on membership and to decide to expel particular members. Courts will not generally disturb these internal decisions so long as they are made in good faith pursuant to fair and reasonable procedures.

As in other areas, courts applying these rules over the years have recognized that the propriety of intervention depends on the nature of the organization in question. Courts are especially reluctant to intervene in the internal affairs of religious organizations and intimate associations. As one moves along the spectrum to organizations that are large, relatively anonymous, and geared primarily to provide certain benefits or privileges to members,

⁴⁹ See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 3.03 (1987).

⁵⁰ See VICTORIA B. BJORKLUND ET. AL., NEW YORK NONPROFIT LAW AND PRACTICE § 4-1(a) (2004).

membership in the organization begins to appear more like a property right that the courts can appropriately protect. Thus, for instance, courts have been somewhat more willing to review decisions of medical associations denying membership to a doctor (and thus effectively disqualifying him from the practice of medicine).

An organization's right to control its own membership is partially grounded in the constitutional guarantee of freedom of association. Thus, if an organization's purposes or message requires it to exclude certain members, the legislature cannot force the organization to accept those members, at least absent a compelling interest; such an organization can exclude members even on bases that the legislature has forbidden. However, it is worth noting that although the government may not be able to compel organizations to accept members, it is not obliged to grant tax preferences to organizations that discriminate in ways that violate well-established public policy.

The Revised Model Act, following the Revised Model Business Corporations Act, does provide members with certain governance rights. For instance, fifty or 5% of the members (whichever is fewer) can bring suits on behalf of the nonprofit, and any class of members must be allowed to vote on certain changes to the organization's charter or bylaws that would disproportionately affect the membership rights of that class.⁵²

III. GOVERNANCE

A. Structures

1. Introduction and Overview

⁵¹ See REVISED MODEL NONPROFIT CORP. ACT §§ 6.01(b), 6.20(a) (1987). Even where this right is not codified, constitutional principles of freedom of association would probably require the same result. See *supra* Part II.B.

⁵² REVISED MODEL NONPROFIT CORP. ACT § 6.30 (1987).

While the tax status of a charity is a matter of federal law, its status as a legal entity, including issues of governance and accountability, are matters of state law.⁵³ Since a charity may be organized in any of the fifty States of the United States, and because it can be organized as a nonprofit corporation, a charitable trust or an unincorporated nonprofit association, there is an almost countless array of variables that come into play.⁵⁴

In spite of these variations, there are a number of common threads that weave through the structure and governance of these different types of organization and from state to state.⁵⁵ The governing body is always expected to use the charity's assets productively and in a manner consistent with the organization's charitable purposes. The governing body is considered to be a fiduciary, and those who serve on the governing body owe fiduciary duties to the charity. These principles are consistent from state to state and apply (albeit in slightly varied ways) to nonprofit corporations, charitable trusts, and unincorporated associations.

2. Governance of Different Types of Organization

Nonprofit corporations and unincorporated nonprofit associations are typically governed by a board of directors,⁵⁶ while charitable trusts are governed by trustees.⁵⁷

a. *Nonprofit Corporations*

Most charities in America today are organized as nonprofit corporations, and thus in this Report we will focus primarily upon the governance of nonprofit corporations.⁵⁸ A nonprofit corporation has two basic empowering documents, the "articles of incorporation,"⁵⁹ which create

⁵³ FREMONT-SMITH, *supra* note 8, 53–54.

⁵⁴ See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 717 (6th ed. 1992), [hereinafter HOPKINS, Sixth Edition].

⁵⁵ FREMONT-SMITH, *supra* note 8, app. at 476–517.

⁵⁶ See HOPKINS, Sixth Edition, *supra* note 54, at 719 ("If the corporate form is used, the governing instruments will be articles of incorporation and bylaws. An unincorporated organization will have articles of organization, perhaps a form of a constitution, and, undoubtedly, also bylaws.").

⁵⁷ ADLER, *supra* note 30, at 59; HOPKINS, Sixth Edition, *supra* note 54, at 719 ("If a trust, the basic document will be a declaration of trust or trust agreement.").

⁵⁸ FREMONT-SMITH, *supra* note 8, app. at 219.

⁵⁹ Terminology varies from state to state, and the "articles of incorporation" are sometimes called the "certificate of incorporation" or "charter." A charity comes into existence as a non-profit corporation when the articles of incorporation or equivalent document is filed with the secretary of state or other applicable

the organization as a legal entity, and the “bylaws,” which set forth the charity’s internal governance procedures.⁶⁰ Fremont-Smith explains, “The governance of charitable corporations is initially determined by the incorporators, who specify in the articles of organization the basic framework under which the corporation will operate. Aside from determining the charitable purposes, the most important decision will be whether control of the corporation is to be in the board of directors or whether it will be divided between directors and members.”⁶¹

b. *Trusts*

Among the types of unincorporated nonprofit legal organizations is the charitable trust.⁶² Beyond the common law definition of a private trust in which a trustee maintains and manages property for the benefit of the trustor’s named beneficiaries, the common law definition of a charitable trust adds the additional requirement that the trustee has a fiduciary obligation “to deal with the property for a charitable purpose.”⁶³ Because of the governing authority of the trustee to manage the assets held in the trust, a charitable trust gives rise to several administrative duties of the trustee including delegation,⁶⁴ keeping and rendering accounts,⁶⁵ and other duties.⁶⁶ The

state official in the state where the charity is being organized. *See* HOPKINS, Sixth Edition, *supra* note 54, at 719 (“The articles of organization should contain provisions stating the organization’s purposes; whether there will be members and, if so, the qualifications and classes thereof; the initial board of directors or trustee(s); the registered agent and incorporators (if a corporation); the dissolution or liquidation procedure; and the required language referencing the appropriate tax law (federal and state) requirements and prohibitions.”).

⁶⁰ “Depending on the corporate law of the state in which a particular charity is organized, some governance rules may appear in the articles of incorporation. In the typical charity, however, the procedural choices [applying to the charity] are found in the bylaws.” ADLER, *supra* note 30, at 60. Hopkins explains, “The bylaws may also contain the provisions of the articles of organization and, in addition, should contain provisions amplifying or stating the purposes of the organization; the terms and conditions of membership (if any); the manner of selection and duties of the directors or trustees, and officers; the voting requirements; the procedures for forming committees; the accounting period; any indemnification provisions; the appropriate tax provisions; and the procedure for amendment of the bylaws.” HOPKINS, Sixth Edition, *supra* note 54, at 720.

⁶¹ FREMONT-SMITH, *supra* note 8, at 159.

⁶² *See generally, id.* at 133–49.

⁶³ RESTATEMENT (SECOND) OF TRUSTS, § 348 (1957).

⁶⁴ A trustee had the ability to delegate certain administrative functions to other persons under the common law but could not delegate “acts which the trustee can reasonably be required to personally perform.” *See* RESTATEMENT (SECOND) OF TRUSTS, § 171. The preliminary draft of the Restatement (Third) of Trusts represents a refined definition of delegation as requiring the trustee to perform all duties “except as prudent person of comparable skill might delegate” RESTATEMENT (THIRD) OF TRUSTS, § 80 (Preliminary Draft No. 6, 2003).

governance of a charitable trust by a trustee as a fiduciary agent is not only limited to “negative restraints.”⁶⁷ A charitable trustee’s authority includes all “[a]dditional powers considered necessary and appropriate to the accomplishment of the trust purposes”⁶⁸ One difference between the governance of a charitable trust and a private trust is only a majority of trustees’ consent is required for the exercise of trust powers in a charitable trust.⁶⁹ Yet, despite minor differences, the governance of a charitable trust is substantially equivalent to the governance of private trusts under the common law.

c. Unincorporated Associations

At common law, a third form of charitable organization, termed an unincorporated association, exists.⁷⁰ Use of this form is rare because, like a partnership, members of the association bear personal responsibility for the liabilities of the association.⁷¹ That rule has been modified in eleven states who have adopted in full or in part the Model Unincorporated Nonprofit Association Act.⁷² This act provides unincorporated associations with legal entity status.

Associations are governed through a variety of organizational structures.⁷³ Under the Model Act, the only explicit governance provisions are in the definitions of the act.⁷⁴ A member “means a person who, under the rules or practices of a nonprofit association, may participate in the selection of persons authorized to manage the affairs of the nonprofit association or in the development of policy of the nonprofit association.”⁷⁵ Associations require two or more

⁶⁵ See FREMONT-SMITH, *supra* note 8, at 140–142.

⁶⁶ The second Restatement of Trusts details nine other duties including the duty to (1) administer the trust, (2) take and keep control of the property, (3) preserve the trust property, (4) enforce claims, (5) defend actions, (6) keep the trust property productive, (7) keep the trust property separate, (8) keep the trust property apart from the trustee’s own property, and (9) use care in certain banking decisions. RESTATEMENT (SECOND) OF TRUSTS, §§ 169, 175–80 (1957); FREMONT-SMITH, *supra* note 8, at 142.

⁶⁷ FREMONT-SMITH, *supra* note 8, at 143.

⁶⁸ *Id.*

⁶⁹ *Id.* at 146.

⁷⁰ *Id.* at 116.

⁷¹ *Id.*

⁷² *Id.* at 116 n.1.

⁷³ UNIF. UNINC. NONPROFIT ASS’N ACT, §1, 6A U.L.A. 657 (2003).

⁷⁴ *Id.* at 656.

⁷⁵ *Id.*

members.⁷⁶ “Persons” is defined in this act as “any individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.”⁷⁷

3. Electing Directors

In a for-profit corporation, the shareholders elect the directors. Because charities do not have shareholders, different mechanisms have been developed for the election of directors. Most states have three alternative methods of selecting directors: by vote of the members, by vote of the directors currently in office, and by appointment or designation. The bylaws of the nonprofit corporation will stipulate which method of electing directors will be used, and the details of how that method will operate.

a. *Election by Members*

In some nonprofit corporations, the bylaws stipulate that the charity’s members elect the directors. Who counts as a member and whether a member has voting rights is governed by the bylaws. Adler explains, “Typically, a member is a person who is affiliated with the corporation in some way (often by paying dues, but sometimes by being named as a member in the governing documents) and who has the right, under the charity’s governing documents, to participate in the election of directors.”⁷⁸ The applicable state nonprofit corporation statute governs voting procedures, with the goal of promoting fairness.⁷⁹ According to Fremont-Smith, “For the minority

⁷⁶ *Id.*

⁷⁷ *Id.* at 657.

⁷⁸ ADLER, *supra* note 30, at 60. Adler explains that “Membership structures may be complex, with multiple classes of members, each with different rights, or they may be simple. State law may confer additional rights on voting members, such as the right to inspect corporate records, to call special meetings of the members or the board, to bring issues before the board of directors by petition, and to communicate with other members on issues of concern to the membership. State law may also require the corporation to follow certain procedural safeguards when terminating a person’s membership. In general, however, membership is an internal matter.” *Id.* at 61.

⁷⁹ See ADLER, *supra* note 30, at 61 (“Most states allow members to vote at a meeting, by written ballot or by mail, as long as procedures are in place to ensure fairness. Members who elect directors typically also have the right to remove those directors from office. Some states also regulate the nominating process; California, for example, prescribes specific procedures for nonprofit corporations with more than 500 members and additional procedures where there are more than 5,000 members, all with the goal of promoting fairness.”).

[of charitable corporations] that do have members, in many instances the members and directors will be the same persons, and when they cease to hold one office, they also cease to hold the other.”⁸⁰

b. *Election by Existing Directors*

As an alternative, the bylaws may empower existing directors to elect their successors, usually by majority vote.⁸¹ According to Fremont-Smith, “[t]he majority of charitable corporations are governed by a self-perpetuating board of directors, often called trustees.”⁸²

c. *Appointment or Designation*

The articles of incorporation or bylaws may also designate particular individuals or organizations to appoint directors.⁸³ For example, the bylaws of some community foundations provide that the directors will be appointed by the heads of named civic institutions. In a family foundation, the bylaws may stipulate that the founder and primary donor has the authority to appoint directors during his or her lifetime, after which another mechanism is stipulated. When a for-profit corporation creates a nonprofit entity, the bylaws may authorize the governing body of the for-profit corporation to appoint directors of the nonprofit corporation.

4. Officers

⁸⁰ FREMONT-SMITH, *supra* note 8, at 159. “In those instances in which a charity has both members and directors who are not the same persons, the position of member and the powers that attach to that office are analogous to the position and powers of stockholders, except that the members have no financial interest in the assets or income of the corporation. The articles and by-laws will specify the terms of office and qualifications, if any, for the members, and any powers they may retain other than those granted by law, namely, the power to elect directors and to approve amendments to the by-laws.” *Id.*

⁸¹ Those who elect a director usually also have the right to remove that director from office. “State law usually does not prescribe nomination procedures, leaving it to the board itself to develop procedures that are appropriate in the circumstances. Election is generally by majority vote.” ADLER, *supra* note 30, at 61.

⁸² FREMONT-SMITH, *supra* note 8, at 159.

⁸³ See ADLER, *supra* note 30, at 61.

Under most state statutes, a nonprofit corporation must have a president, a secretary, and a treasurer.⁸⁴ The bylaws will stipulate whether or not officers must also be directors. Unless the bylaws state otherwise, officers are appointed by the directors.

5. Powers

a. *Administrative Powers of Directors*

Under U.S. law, a non-profit corporation, like a for-profit corporation, is considered to be a legal person, entitled to many of the constitutional protections that are afforded to persons, such as equal protection under the laws, and the right to not have liberty denied without due process of law. Fremont-Smith explains that “Corporations possess under law all the powers of a natural person that are reasonably necessary for the accomplishment of their proper purposes, with the exception of those specifically forbidden by statute, the federal and state constitutions, or the terms of their charters.”⁸⁵ The Revised Model Nonprofit Corporation Act states that a corporation “has the same powers as an individual to do all things necessary or convenient to carry out its affairs,” and then gives a nonexhaustive list of specific powers, including: to sue and be sued; to have and use a corporate seal; to make and amend by-laws; to acquire and deal freely with all types of property or interests in property, including the power to mortgage or pledge; to make contracts, borrow and secure property, and make loans other than loans to any director or officer; to act within or without the state; to elect or appoint directors, officers, employees, and agents and fix their compensation; to pay pensions; to make charitable donations; to establish conditions for admission of members, and impose dues or other fees on members; and to carry on a business.⁸⁶

The power to indemnify directors is treated somewhat differently in the Revised Model Act, where this power is granted in a separate section,⁸⁷ than it is in some other states, where “it is

⁸⁴ Other officers, such as vice presidents, are optional. If a corporation has both a chair and a president, the chair presides at meetings and the president is chief executive officer.

⁸⁵ FREMONT-SMITH, *supra* note 8, at 165.

⁸⁶ See FREMONT-SMITH, *supra* note 8, at 166 (citing REVISED MODEL NONPROFIT CORP. ACT § 3.02 (1987)).

⁸⁷ See REVISED MODEL NONPROFIT CORP. ACT, Part E (1987).

treated as an optional power that may be exercised only if it has been included in the corporation's articles or by-laws.”⁸⁸

Charitable organizations must not assert powers that are inconsistent with the organizations' tax-exempt purposes. Fremont-Smith explains that “[t]reasury regulations require that the articles of organization of a corporation seeking federal tax exemption contain no express powers that would allow the organization to engage to any substantial extent in activities that in themselves are not in furtherance of one or more exempt purposes. Furthermore, they warn that powers may not be granted that are inconsistent with the organization's exempt purposes.”⁸⁹

b. *Deviations from Original Charitable Purposes*

Under the equitable doctrine of *cy pres*, which originated in the eleventh century, a court is empowered to modify an organization's charitable purposes in a manner as close as possible to the donor's original intent, but only after three conditions have been met: “(1) there existed a valid charitable trust or corporation or a gift to be used for valid charitable purposes; (2) it was impossible or impractical to carry out the donor's original intention; (3) the donor had a general charitable intention, as well as the intention to benefit the particular charitable object he designated.”⁹⁰

6. Duties

As Adler explains, “[t]he directors of a nonprofit corporation are legally responsible for the corporation's actions and its omissions. At one time charities and their directors were immune

⁸⁸ FREMONT-SMITH, *supra* note 8, at 166 (citing the examples of Massachusetts and New York).

⁸⁹ *Id.*

⁹⁰ *Id.* at 173. Fremont-Smith explains that the “doctrine is now generally accepted as part of the common or statutory law of all of the states except Alaska, and North Dakota, although in Hawaii and Nevada it has been recognized only in dictum, while South Carolina uses the doctrine of ‘deviation’ in its stead. The doctrine has a basis in statutory law in thirty of these states.” *Id.* Section 67 of the Restatement (Third) of Trusts states a modern version of the doctrine. See RESTATEMENT (THIRD) OF TRUSTS, § 67 (2003). For a discussion of the application of the *cy pres* doctrine in the United States, see FREMONT-SMITH, *supra* note 8, at 174–86.

from suit under a legal doctrine known as charitable immunity, but that doctrine has long since vanished from nearly all states.”⁹¹

a. *Fiduciary Duties of Directors and Officers*

Directors and officers of nonprofit corporations, like directors and officers of for-profit corporations, are fiduciaries of their corporation and owe a variety of fiduciary duties to the corporation. These duties are complex and vary based upon the character of the entity, the character of the fiduciary, the character of the beneficiary, the character of the subject matter, and the nature of the relationship between the fiduciary and beneficiary. In general, directors owe a fiduciary duty of care and a fiduciary duty of loyalty to the corporation. The legal duties of directors and officers have been developed from the same fiduciary principles that apply to trustees, although fiduciary duties are generally considered to be of a higher magnitude in the trust context.⁹² In recent years, when dealing with directors of nonprofit corporations, courts have more often looked to the more lenient legal standards and case law governing the fiduciary duties of corporate directors than to case law and legal standards governing trustees.⁹³

i. The Duty of Care

⁹¹ ADLER, *supra* note 30, at 60.

⁹² See FREMONT-SMITH, *supra* note 8, at 199. Fremont-Smith notes that in earlier cases, “directors of all corporations were commonly said to owe a duty to the corporation as *cestui que trust* similar to that which a trustee owes to his beneficiary. Because business reality required that in some instances a director be allowed greater freedom than a trustee to deal with the corporation, particularly in making loans to assist the corporation, the rules were gradually relaxed.” *Id.* at 199–200.

⁹³ See *Id.* at 200. See *Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974) (the “Sibley Hospital” case, strongly endorsing the corporate standard to define fiduciary duties of loyalty and care). Soon thereafter, “New York and California adopted statutes containing narrowly defined standards of conduct for directors of nonprofit corporations, and in each case they codified the corporate standard. The Revised Model Nonprofit Corporation Act (RMNCA), promulgated by the American Bar Association in 1987, also adopted the corporate model.” FREMONT-SMITH, *supra* note 8, at 202. Harvey Goldschmid has noted that the fiduciary duties of nonprofit directors are more difficult to assess than directors of for-profit corporations. “For-profit directors and officers are principally concerned about long-term profit maximization. While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the

Fremont-Smith explains that “[t]he standard of care applied to directors of corporations has been described as that degree of care and diligence that ordinary prudent men, prompted by self-interest, would exercise under similar circumstances.”⁹⁴ This duty applies to all directors, regardless of whether they receive compensation or not.⁹⁵ Unlike trustees, who may be liable for ordinary negligence, directors of nonprofit corporations, like their for-profit counterparts, are liable only upon a showing of gross negligence.⁹⁶ Many states have enacted statutory provisions that are designed to limit the personal liability of volunteer directors and officers to third parties for violations of the duty of care.⁹⁷ While these statutes specifically shield from liability directors who fail to discharge their obligations as a director, provided that the standard of care is met, the effectiveness of these statutes is not yet clear.⁹⁸

Directors may be held accountable in court for the waste of charitable assets or the breach of their duty to the corporation. They are accountable for all aspects of the charity’s operations, including the investment of the charity’s assets, the management of the charity’s operations and the charity’s compliance with laws of general application (e.g., the labor and employment laws). Directors are allowed, and indeed encouraged, to delegate the management of these tasks to others; however, delegation does not excuse a director from ultimate responsibility.⁹⁹

The Business Judgment Rule: There was a time when it was unclear whether directors of nonprofit organizations would be held liable upon a showing of ordinary negligence, like trustees, or only upon a showing of gross negligence, like directors of for-profit corporations. Most states

nonprofit’s mission.” Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 639 (1998).

⁹⁴ FREMONT-SMITH, *supra* note 8, at 201. For a discussion of each of the components of this standard, see *id.* at 203–05.

⁹⁵ *See id.* at 201.

⁹⁶ *See id.* at 202; RESTATEMENT (SECOND) OF TRUSTS, § 174 (1957); *see also* Bennet B. Harvey, Jr., *The Public Spirited Defendant and Others: Liability of Directors and Officers of Non-for-Profit Corporations*, 17 J. MARSHALL L. REV. 665, 679 (1984).

⁹⁷ *See, e.g.*, CAL. CORP. CODE §§ 5047.5, 5239 (2004).

⁹⁸ *See* ADLER, *supra* note 30, at 62 n.194. Adler notes that these liability shields require a defendant to prove that he has satisfied the standard of care, and by their terms do not protect against violations of the duty of loyalty or other financial conflicts of interest. *Id.* For example, in California, a director who satisfies the standard of care “shall have no liability based upon any alleged failure to discharge the person’s obligations as a director, including . . . any actions or omissions which exceed or defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated.” CAL. CORP. CODE § 5231(c) (2004).

have looked to corporate law, rather than trust law, to determine the standard for evaluating alleged breaches of fiduciary duty. The “business judgment rule,” adopted from the for-profit corporation context, shields directors from most errors of judgment, as long as the directors act in good faith. The business judgment rule does not shield directors from liability based upon violations of the fiduciary duties of loyalty and good faith. The business judgment rule protects directors from errors of judgment or mistake so long as they act with reasonable skill and prudence. For example, one court described the business judgment rule as follows:

Directors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.¹⁰⁰

As a practical matter, if directors’ actions are not tinged by self-interest or disloyalty, they will be liable for their errors of judgment only if they are grossly negligent.

Director Inattention: Directors who are inattentive to their duties, and who have not consciously exercised judgment, will much less likely be shielded from liability by the business judgment rule, which requires directors to actually exercise judgment in order to receive the protections of the rule.¹⁰¹ Thus, director inattention is more likely to result in liability than director mistakes made after trying to make an informed judgment.

Reliance: Most state statutes explicitly allow directors to rely upon information and opinions presented by the charity’s officers and employees, as well as outside counsel and accountants and other outside experts.¹⁰² In order to rely upon such information, however, “[a]

⁹⁹ ADLER, *supra* note 30, at 60.

¹⁰⁰ Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981).

¹⁰¹ See FREMONT-SMITH, *supra* note 8, at 206–07.

¹⁰² See ADLER, *supra* note 30, at 62. In order to rely upon information supplied by others, two conditions must be met. “First, the director must reasonably believe that the provider of the information or advice is competent and reliable regarding the matter in question. Second, the director has a duty of reasonable inquiry; reliance is permitted only if the director ‘acts in good faith, after reasonable inquiry and without

director must ‘reasonably believe’ that the party on whom he is relying for information is competent or merits confidence”¹⁰³ In addition, “if the director has actual knowledge concerning the matter in question that makes reliance unwarranted,” or if a director did not actually rely upon such information, then the statutes will not offer protection.¹⁰⁴

Indemnification and insurance: Although there is no common law right of indemnification for corporate directors, most states also allow nonprofit organizations to indemnify their officers, directors, employees, and other agents, in which case the organization will reimburse them for the costs of defending themselves if they are sued for performing their duties for the organization, but these laws generally contain numerous exceptions designed to prevent abuse.¹⁰⁵ Some have viewed such provisions as part of a more general trend of relaxing the duty owed by fiduciaries of nonprofit organizations. According to Fremont-Smith, “[a]ccompanying this relaxation of the duties of care and loyalty was the adoption of statutes in a vast majority of the states authorizing charities to indemnify their directors and officers, to pay their legal fees, and to purchase liability insurance to cover claims against them.”¹⁰⁶

ii. The Duty of Loyalty

As Adler explains, “[t]he duty of loyalty requires a director to act in the charity’s best interests, even when there is a *conflict of interest* – that is, a situation where the charity’s interests and the director’s interests diverge.”¹⁰⁷ While nonprofit corporations are not forbidden from doing business with a director, special procedures must be taken to ensure that the transaction is really in the nonprofit corporation’s best interests.¹⁰⁸

knowledge that would cause such reliance to be unwarranted.” *Id.* (quoting CAL. CORP. CODE § 5231(b) (2004)). *See also* REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1987).

¹⁰³ FREMONT-SMITH, *supra* note 8, at 206; REVISED MODEL NONPROFIT CORP. ACT § 8.30(b) (1987); PRINCIPLES OF CORPORATE GOVERNANCE §§ 4.02–.03.

¹⁰⁴ FREMONT-SMITH, *supra* note 8, at 206.

¹⁰⁵ ADLER, *supra* note 30, at 62 n.195.

¹⁰⁶ FREMONT-SMITH, *supra* note 8, at 53.

¹⁰⁷ ADLER, *supra* note 30, at 63.

¹⁰⁸ *See, e.g.,* ADLER, *supra* note 8, at 63 (“For example, a charity may prefer to hire the lawyer who sits on its board of directors, not only because the lawyer knows the charity’s operations but because she is more likely to offer a significant discount because of her commitment to the organization. For this reason, neither

The Revised Model Nonprofit Corporation Act defines a director conflict of interest as a “transaction with the corporation in which a director of the corporation has a direct or indirect interest. Some states try to address potential conflicts of interest by limiting the percentage of board members who are compensated by the nonprofit organization, or who have family members who are compensated by the organization.¹⁰⁹ A more common approach is for state law to “prescribe a very specific set of procedures that must be followed if a director has a material financial interest in a transaction of a charity.”¹¹⁰ Under the RMNCA, a conflict of interest in a transaction is permissible if the material facts of the transaction and the director’s interest are disclosed or known to the disinterested members of the board, and the disinterested directors approve the transaction in good faith and in the reasonable belief that the transaction is fair to the corporation.¹¹¹

iii. Administrative Duties of Directors

Trustees and directors have a wide array of administrative duties, “including the duties to administer the trust according to its terms, take and keep control of property, preserve the property, enforce claims, defend actions, and make the trust property productive.”¹¹² Two administrative duties of directors of charitable organizations are of particular note.

First are duties with respect to delegation. As Fremont-Smith explains, “directors are permitted to delegate most management duties provided they retain general supervision over the

state nor federal law forbids charities to hire or contract with board members or other insiders for goods or services that the charity needs to carry out its public benefit activities. . . . Instead, federal tax law and the corporate laws of most states prescribe various procedures through which the directors with no financial interest in the transaction may review and approve a transaction with an insider if, on inquiry, the transaction is in the charity’s best interests.”)

¹⁰⁹ Adler cites California as an example of a state with such a prohibition, although she notes that such provisions are not widespread. *See id.*

¹¹⁰ *Id.* at 64. Adler explains further: “This law reaches direct transactions, such as when a charity employs one of its board members, and indirect transactions, such as the charity’s purchase of goods or services from a firm partially owned by a director.” *Id.* For example, in California such transactions are termed “self-dealing,” and are defined by statute. *See* CAL. CORP. CODE § 5233 (2004).

¹¹¹ REVISED MODEL NONPROFIT CORP. ACT § 8.32(b)(1) (1987). In the alternative, a transaction involving a conflict of interest can be cleansed by receiving the approval of the attorney general, or a court in an action where the attorney general is joined as a party. *Id.* § 8.32(b)(2).

¹¹² FREMONT-SMITH, *supra* note 8, at 165.

business. Directors may not, however, abdicate their duty to direct, and they may be chargeable with losses resulting from failure to participate.”¹¹³

Second are duties to keep and render accounts.

The Model Non-Profit Corporation Act did not require directors to make annual reports, although it specified that the corporation must keep correct and complete books and records of accounts and minutes of all its proceedings, and required that all books and records be open to inspection by any member or his agent or attorney, “for any proper purpose at any reasonable time.” The Revised Model Act retained this requirement but added a provision requiring the corporation to provide on demand from any member or director the latest financial statements, accompanied by a statement of either a public accountant or the president or chief financial officer affirming the reasonable belief that the records were prepared on generally accepted accounting principles and declaring the basis of any inconsistencies from accounts of prior years.¹¹⁴

iv. Reporting Requirements

There is considerable variation in state reporting requirements for charitable corporations. Fremont-Smith explains that in twenty-five states charitable corporations have a duty to report on the status of the corporation to state officials at certain intervals. “In fourteen states the report consists of information as to the location of the corporation and a list of its current officers or directors; in seven states it must contain financial information; and in four others, it consists of detailed financial reports submitted to the attorney general.”¹¹⁵ In twenty-five states and the District of Columbia there are no general reporting requirements for charitable corporations, but in thirty-nine states details of fundraising solicitations must be reported in detail.¹¹⁶

b. *Fiduciary Duties of Trustees*

While similar to the typical duties found in any fiduciary relationship, the fiduciary duties are of a “peculiarly intense degree in a trust.”¹¹⁷ The trustee’s duties in a charitable trust arise from both the terms of terms of the trust agreement and the common law principles that are

¹¹³ *Id.* at 162.

¹¹⁴ *Id.* at 163–64.

¹¹⁵ *Id.* at 173.

¹¹⁶ *Id.* See also *id.*, app. tbl. 1, cols. 6, 7, 15.

applied in all trust situations.¹¹⁸ Beyond the trustee's direct obligations as set out by the trustor in the trust instrument, a major duty of a trustee is to exercise prudence in the administration of the trust.¹¹⁹

c. Assessing the Magnitude of Duties and Breaches

In the United States, in order to determine the likelihood of legal liability for an alleged breach of fiduciary duty, one should engage in three related enquiries: First, focusing upon various factors and indicia that will help determine the magnitude of duty that arises within a particular relationship and context; second, evaluating various factors and indicia that will help judge the amplitude of the fiduciary's performance to determine the extent to which that conduct exceeded or fell short of the required level of performance; and third, if that conduct is found deficient, then measuring and fashioning the appropriate level of remedy that should be imposed to rectify the breach.

This approach to analyzing fiduciary duties is particularly helpful in several ways. It inherently recognizes that fiduciary duties are not created equal, and all breaches will not be regarded as equally harmful. As one court observed, "What would be slight neglect in the case of a quantity of iron might be gross negligence in the case of a jewel."¹²⁰ For example, from conducting this type of analysis we learn that courts are most likely to find liability in cases of duties of a high magnitude coupled with breaches of a high magnitude and an available appropriate remedy. Thus, for example, in cases involving directors of banks or other organizations where a fiduciary is responsible for the personal property of others, the degree of duty is

¹¹⁷ *Id.* at 187.

¹¹⁸ *Id.* at 188.

¹¹⁹ "The trustee is under a duty to the beneficiaries to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust; prudence requires the exercise of reasonable care and skill and of a degree of caution suitable to the particular trust's objectives, circumstances, and overall plan of administration." RESTATEMENT (THIRD) OF TRUSTS, § 77(1) (Preliminary Draft No. 6, 2003). If the trustee has skills that go beyond the "ordinary prudent person," the trustee has an obligation to utilize those additional skills for the benefit of the trust. FREMONT-SMITH, *supra* note 8, at 189.

¹²⁰ *Hun v. Cary*, 82 N.Y. 65, 71 (1880) (quoted by FREMONT-SMITH, *supra* note 8, at 201 n.66).

generally quite high.¹²¹ Conversely, if a low-degree duty is coupled with a low-degree breach and no appropriate remedy, courts are unlikely to find legal liability. Cases involving a high degree of duty and a low degree breach, or cases involving a low degree duty and an egregious breach will prove to be the most difficult situations to predict outcomes. This approach also enables us to focus upon the wide array of factors that courts look at in determining the magnitude of an alleged duty and the magnitude of an alleged breach of duty.

Magnitude of Duty: Courts look at four broad considerations in determining the magnitude of duty: (i) the characteristics of the parties, both the fiduciary¹²² and the beneficiary¹²³ in absolute as well as relative terms; (ii) the characteristics of the relationship;¹²⁴ (iii) the characteristics of the subject matter of the alleged breach,¹²⁵ and (iv) the underlying source of the legal action.¹²⁶ Many of these considerations exist on an observable continuum, with one end of the continuum corresponding to a higher degree of duty and the other end of the continuum corresponding to a lower degree of duty. It has sometimes been suggested that the magnitude of the duty of care owed by a director or officer of a nonprofit corporation should be lower than the magnitude of duty owed by a director or officer of a for-profit corporation, especially when the

¹²¹ See FREMONT-SMITH, *supra* note 8, at 201.

¹²² Relevant characteristics of the fiduciary include: the type of fiduciary; the level of qualifications and expertise; the amount of actual power or control entrusted; the degree of delegated fiduciary discretion; the dominance of one fiduciary over other fiduciaries; the amount of compensation received by a fiduciary; and other roles of the fiduciary.

¹²³ Relevant characteristics of the beneficiary include: the number and uniqueness of beneficiaries; the age of beneficiaries; the experience and sophistication of beneficiaries; and the vulnerability of the beneficiaries.

¹²⁴ Relevant characteristics of the relationship between the fiduciary and beneficiary include: the manner of formation of the relationship (including the timing of the relationship, the degree of formality in creating the relationship, the nature and degree of promises involved, names, titles and level of expectations, specificity of rights and duties of the fiduciary, attempts to contract away fiduciary duties, and whether the relationship resulted from real negotiation), as well as the history and duration of the relationship before the alleged breach (including the voluntariness and exclusivity of the relationship, whether it is reciprocal, and the relative power, sophistication, information, and control of the fiduciary and beneficiary), the degree and cause of reliance of the beneficiary upon the fiduciary, and the degree to which the interests of the fiduciary and beneficiary are aligned or conflict.

¹²⁵ Relevant characteristics of the subject matter include the significance of the event in question, the tangible and intangible amounts involved, the type of property involved, the type of stewardship involved, and the public importance of the event (visibility, attention, image and reputation of parties).

directors are volunteers serving for public spirited reasons and without compensation. While this attitude has been reflected in a few court decisions, “in the majority of cases the courts have imposed a high degree of care and a strict rule of loyalty, based on their belief that this was necessary in order to assure the preservation of funds held for the benefit of the general public rather than individuals.”¹²⁷

Magnitude of an Alleged Breach of Fiduciary Duty: After the magnitude of duty involved has been determined, the second step in analyzing the likelihood of liability for an alleged breach of duty is to compare the magnitude of those fiduciary duties against the level of performance. In assessing the magnitude of an alleged breach of duty, there are four general categories of considerations that courts take into account: (i) the character of the harm suffered;¹²⁸ (ii) the character of the fiduciary’s deliberative process;¹²⁹ (iii) the character of the fiduciary’s motives;¹³⁰ and (iv) the classification of the alleged breach of duty.¹³¹

¹²⁶ In general, actions under federal statutes will have higher degrees of duty compared with actions brought under state statutes, and actions brought pursuant to statutory enactment will carry higher degrees of duty than actions brought under the common law.

¹²⁷ FREMONT-SMITH, *supra* note 8, at 200. As far as liability to third parties goes, however, Congress has provided that directors and other volunteers can be held liable only for “willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer.” 42 U.S.C. § 14503(a)(3) (2000).

¹²⁸ Relevant considerations in assessing the character of the harm suffered include: the magnitude of the loss or harm (life, physical or emotional injury, wealth, number of people harmed, frequency of harm, and the duration of the alleged breach).

¹²⁹ Relevant considerations in assessing the character of the deliberative process include: the degree of diligence involved, both with respect to the length and seriousness of deliberations; whether relevant experts were consulted; the character (quality as well as quantity) of information upon which a decision was based; whether there was time to study and digest available information; whether a “due diligence” investigation was performed; the consistency and detail of fiduciary accounts and memory of decisionmaking; whether alternative courses of action were considered; and whether actions were taken to foreclose or preclude the consideration of alternatives.

¹³⁰ The character and nature of the fiduciary’s motives will often be relevant to an assessment of the magnitude of an alleged breach of fiduciary duty. Relevant considerations when assessing a fiduciary’s motives will include: whether the fiduciary acted based upon greed or other selfish motives; whether there was a conflict of interest, such as the opportunity for self-enrichment or seizing a corporate opportunity; whether the fiduciary was motivated by anger, hatred, jealousy, or animus; whether the fiduciary tried to hide or obfuscate his mistakes; whether the fiduciary was inappropriately risk-averse; and whether the fiduciary was careless or inattentive to his duties.

¹³¹ The manner in which an alleged breach of fiduciary duty is classified will often have an enormous effect on whether a breach of duty will be found. Not all breaches of fiduciary duty are viewed as being equally egregious. Most notable is the distinction between malfeasance (affirmative misconduct) and nonfeasance (failure to act appropriately). In general, a court is more likely to find liability for fiduciary conduct that can

Availability of an Appropriate Remedy: The third step in an analysis of the likelihood that a fiduciary will be found liable for a breach of fiduciary duty focuses on determining the availability of an appropriate and meaningful remedy.¹³² There is a wide array of remedies that are imposed in cases involving breaches of fiduciary duty. Similar to breaches, potential remedies seem to exist in an informal hierarchy based upon the degree of burden or magnitude of penalty placed upon the fiduciary to remedy his breach of fiduciary duty.¹³³

In general, courts reserve the most severe penalties for instances of high magnitude breaches of high magnitude duties. So, for example, imprisonment, decertification, and punitive damages will normally be reserved for severe breaches of serious duties. On the other hand, a remedy such as requiring an accounting or requiring a full disclosure will be more common in situations involving lower degree violations of lower degree duties. If a severe penalty is sought, a court will most likely require proof of a high magnitude breach and a high magnitude duty. If an appropriate remedy does not seem to exist, this will decrease the likelihood that a court will find a breach of duty.

B. Accountability

1. Overview of Duties and Responsibilities of Governing Bodies

US charities are accountable to their donors, the government, and the community in which they exist.¹³⁴ Accountability occurs in three phases: at formation, throughout operation,

fairly be characterized as malfeasance as opposed to nonfeasance. Thus there is something of an informal hierarchy of alleged breaches of duty, based upon the nature of the breach, with fraud at the top of the list of seriousness and prudence at the bottom.

¹³² It might seem that the remedy would only become a focus of consideration after a determination has been made that liability should attach, but in a number of cases it appears that courts consider whether a remedy is available as part of their determination of whether liability should exist at all. This might be in part because a court may be reluctant to find liability when an appropriate remedy does not seem to exist. On the other hand, if there is an available and obvious remedy to an alleged breach, this may actually increase the likelihood that a court will find that there has been a breach of duty.

¹³³ At the bottom of the hierarchy would be the requirement to give an accounting, followed in roughly ascending order by disclosure, disgorgement, recession, restitution, actual damages, an injunction, specific performance, removal from office, punitive damages, decertification, and imprisonment.

¹³⁴ ADLER, *supra* note 30, at 65.

and at termination.¹³⁵ Of note in the formation stage is the secretary of state who accepts or rejects a nonprofit corporation's articles of incorporation.¹³⁶ As well, the corporation is responsible for adopting bylaws.¹³⁷ During operation of the charity, the state attorney general "is empowered to supervise and regulate charities."¹³⁸ Charities are responsible for filing reports with the attorney general on a regular basis that are open to the public.¹³⁹ The IRS, a federal organization, provides an element of accountability as well.¹⁴⁰ The IRS maintains accountability through annual returns, audits, and the assessment of penalties and fines.¹⁴¹ Finally, upon dissolution the charity must take steps to ensure that its assets continue to serve its charitable purposes; some states require dissolving charities to notify the attorney general of their disposition of assets, giving the attorney general a chance to object.¹⁴²

2. Fiduciary Duties of Governing Bodies

The fiduciary duties of directors and officers for nonprofit corporations and of trustees are discussed in Part III.A.6.a of this Report.

3. Conflicts of interest and self-dealing

The doctrine of conflicts of interest and self-dealing stem from the duty of loyalty owed by the directors of a nonprofit corporation (or the trustees of a trust) to its charitable beneficiaries.¹⁴³ Section 8.31(a) of the Revised Model Nonprofit Corporations Act defines a conflict of interest as, "A conflict of interest transaction is a transaction with the corporation in which the director of a corporation has a direct or indirect interest."¹⁴⁴ Similarly, in the case of private foundations, tax law defines self-dealing as conducting certain transactions with

¹³⁵ *Id.*

¹³⁶ *Id.* at 66.

¹³⁷ *Id.*

¹³⁸ *Id.* at 68.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 68–70.

¹⁴² *Id.* at 71.

¹⁴³ See FREMONT-SMITH, *supra* note 8, at 215.

¹⁴⁴ REVISED MODEL NONPROFIT CORP. ACT § 31(a) (1987).

individuals defined as “disqualified persons.”¹⁴⁵ Disqualified persons are generally those with an interest in the corporation.¹⁴⁶ Traditionally, a transaction between a director and the corporation were banned.¹⁴⁷ However, the United States has modified that rule, at least for corporations, and made such dealing subject to a “fairness test” which permits certain transactions if a disinterested majority of the board approves the transaction and the contract itself is fair.¹⁴⁸ Some states, including Delaware, still apply the more strict prohibitions on all self-dealing to trustees, at least in the absence of contrary provisions in the trust instrument.¹⁴⁹ In the case of private foundations, the federal tax code has returned to the strict prohibition on self-dealing, imposing a tax of 5% of the transaction’s total value on the self-dealer, a 2.5% tax on foundation managers who knowingly participate without reasonable cause, and a 200% tax on any failure to undo the transaction promptly.¹⁵⁰ States have responded by categorically prohibiting private foundations from self-dealing in forty-eight of fifty states.¹⁵¹

Section 4958 also contains a softer restriction on self-dealing by public charities. That section does not categorically prohibit such transactions, because of the awareness that many public charities benefit from transactions with friendly directors, who will often provide services below market rates that would be too expensive for the charity to obtain any other way. However, if a public charity makes a bargain with a disqualified person that favors the disqualified person, the excess benefit conferred on the disqualified person is subject to a 25% tax, a 200% tax if it is not corrected promptly, and a 10% tax on foundation managers who participated in the transaction willfully or without reasonable cause.¹⁵² If the disinterested

¹⁴⁵ Basically, “disqualified persons” include substantial contributors and directors or other managers of a foundation, as well as these persons’ family members and other persons that have substantial holdings in, or are partially owned by, other disqualified persons. For more detail, see ADLER, *supra* note 30, at 30.

¹⁴⁶ *Id.* at 29.

¹⁴⁷ See FREMONT-SMITH, *supra* note 8, at 215.

¹⁴⁸ *Id.*

¹⁴⁹ See *Stegemeier v. Magness*, 728 A.2d 557 (Del. 1999) (describing the difference between trust and corporate standards).

¹⁵⁰ I.R.C. § 4941 (2000).

¹⁵¹ FREMONT-SMITH, *supra* note 8, at 267.

¹⁵² I.R.C. § 4958 (2000).

members of the board approve the transaction in advance, documenting a reasonable basis for believing the price paid to be fair, a presumption arises that the disqualified person has not been unduly favored.¹⁵³

4. Enforcement/Standing to Sue

At state common law, the attorney general is granted almost exclusive authority to sue to enforce charitable assets.¹⁵⁴ “Members of the general public, unless they can show a specific beneficial relationship to a charity are not permitted to call charitable fiduciaries to account.”¹⁵⁵ Similarly, because they do not generally experience concrete injury when an organization is recognized as charitable and granted corresponding tax benefits, third parties attempting to enforce the federal tax laws almost always lack standing to sue.¹⁵⁶ Thus, to a large extent, private parties lack the ability to enforce state or federal charity law in court.

5. Enforcement in History and Practice

It is difficult to quantify the amount of wrongdoing in the nonprofit sector. Critics complain that all but a handful of states have failed to police fiduciary behavior, and the IRS has been the default mechanism for correcting wrongdoing.¹⁵⁷ One recent study found that between 1995 and 2003 there were 152 organizations whose fiduciaries were accused of criminal or civil wrongdoing.¹⁵⁸ Given that there are more than 1.4 million charitable organizations in the United States, this might create an impression that serious wrongdoing is relatively rare, but it may also

¹⁵³ Treas. Reg. § 53.4958-6 (2004).

¹⁵⁴ *Id.* at 448.

¹⁵⁵ *Id.*

¹⁵⁶ FREMONT-SMITH, *supra* note 8, at 422–23. In general, a plaintiff has “standing to sue” (that is, the plaintiff is allowed to complain of a defendant’s actions) in federal courts only when the plaintiff has suffered a concrete injury in fact; the injury is fairly traceable to the defendant’s conduct; and the injury is redressable by the courts. State courts follow analogous principles, although they vary in the details.

¹⁵⁷ *Id.* at 13. Marilyn Phelan and Robert Desiderio have stated that “The Requirements set out in the Internal Revenue Code to maintain tax exempt status and to avoid penalty taxes often have the effect of imposing more exacting standards of conduct on directors and trustees than those imposed by state legislature or by the courts.” MARILYN E. PHELAN AND ROBERT J. DESIDERIO, *NONPROFIT ORGANIZATIONS LAW AND POLICY* 93 (2003).

¹⁵⁸ FREMONT-SMITH, *supra* note 8, at 14.

indicate that underreporting is widespread and that privacy provisions in state and federal laws prevent an untold amount of wrongdoing from coming to light.¹⁵⁹

Anecdotally, the perception is that for the most part charitable organizations comply with the law. However, occasionally there are flagrant abuses that attract the attention of the general public and lead to specific anti-abuse legislation. For instance, concern over the extravagantly high salaries some charities were paying to high-ranked employees led in 1996 to the excess benefit transaction rules discussed above in the self-dealing rules. Today, stories about abuses by organizations that technically qualify as public charities but have many of the features of private foundations have led to proposals of tightening the definition of public charity, or simply forcing all public benefit organizations to abide by the same strict self-dealing rules that currently apply only to private foundations.¹⁶⁰

At the same time federal tax law has been creating new mechanisms for enforcement, the traditional mechanisms (private lawsuits in state courts) have in some ways weakened. “Both Congress and the states adopted a vast number of statutes protecting charity volunteers from suit. Taken together, these measures created an environment in which it would be nearly impossible to hold a charitable fiduciary liable for breach of duty except in the most egregious circumstances, often only if criminal behavior were involved.”¹⁶¹

6. Self-Regulation of Charitable Organizations

One reason that abuses remain fairly isolated is that for a variety of reasons, the U.S. charitable sector engages in substantial amounts of self-regulation. Partly, this is because forced disclosure makes it important for charities to maintain high standards of performance if they are to remain competitive for funding. In addition, the large number of legitimate organizations have every interest in maintaining the general reputation of the sector by stopping abuse. It is therefore

¹⁵⁹ *Id.*

¹⁶⁰ See *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities Before the Senate Comm. On Finance*, 108th Cong. (2004) available at <http://finance.senate.gov/sitepages/hearing062204.htm>.

common to develop policies and best practices that make abuse more difficult long before such practices are legally required. Large grantmakers often can impose standards on the charities they fund that are at or above those mandated by law. Moreover, the sector has a long tradition of working with the government to make sure that abuses are curbed in ways that do not stifle legitimate activity. For example, the government is now considering its proposal to tighten the self-dealing rules, and it is also considering imposing investigatory requirements on international grants to make sure they do not inadvertently support terrorism.¹⁶² In both cases, the government has asked for comments and feedback from the charitable sector as to the possible advantages and disadvantages of these actions.

7. Monitoring Charitable Organizations by Private Sector Organizations

“The growth of the charitable infrastructure has been accompanied by growth in the number of organizations that monitor, promote, or study the sector.”¹⁶³ As of January 2003 there were seventy-two institutes and research centers devoted to the sector.¹⁶⁴ Many of these organizations publish reports or host websites providing information about the nonprofit sector.¹⁶⁵

IV. DISSOLUTION, WINDING UP, AND LIQUIDATION OF ASSETS

A. Voluntary Dissolution

Generally, the directors of a nonprofit corporation can dissolve it by majority vote at a meeting of which all the directors had proper notice. If the organization has members, they may also have to approve the dissolution, perhaps by a two-thirds vote. (Indeed, in California, the members can dissolve the nonprofit even without the directors’ approval.¹⁶⁶) After dissolution, the corporation continues in existence for a certain time, during which it attempts to locate

¹⁶¹ FREMONT-SMITH, *supra* note 8, at 53.

¹⁶² *See infra*, Part VI.B.

¹⁶³ FREMONT-SMITH, *supra* note 8, at 469.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *See* CAL. CORP. CODE §§ 6610, 8610 (2004).

creditors and settle claims with them. Once adequate provision has been made for creditors, the assets may be distributed according to organization's articles, bylaws, and any specific plan adopted as part of the decision to dissolve. A growing number of states require charities to notify the attorney general of their proposed dissolution, giving the attorney general the chance to protest the dissolution in court if the action violates the charity's governing documents or is inconsistent with the charity's purposes.¹⁶⁷ Such rules often apply equally to other ways of discontinuing the charity's operation, such as mergers or sales of substantially all of a charity's assets.

Whether the trustees can dissolve a trust voluntarily, and how they must distribute its proceeds, depends on the intent of the founder as manifest in the trust instrument.¹⁶⁸ Thus, if the founder's will was that the trust use its assets to maintain a separate orphanage, the trustees cannot ordinarily choose to deviate from that intent by donating the trust assets to another orphanage, even if they think doing so would be the most efficient way of caring for orphans. Of course, if modification is necessary because unforeseen circumstances have made it impossible to carry out the trust as originally designed, the trustee may petition the court to apply *cy pres* doctrine to modify the trust's purposes or allow the dissolution.

Because most states do not distinguish between mutual benefit and public benefit nonprofits, they do not generally impose any restriction on distributions to members at dissolution. Laws that distinguish between the two types of nonprofit generally require that public benefit organizations distribute their assets to other public benefit organizations, although the Revised Model Act appears to impose that requirement only as a default if the organization's bylaws do not specify an alternative distribution.¹⁶⁹ Trust law is also flexible with respect to distribution; a trust instrument can provide that assets will be used for charitable purposes

¹⁶⁷ See REVISED MODEL NONPROFIT CORP. ACT § 14.03(a)–(b) (1987).

¹⁶⁸ FREMONT-SMITH, *supra* note 8, at 136.

¹⁶⁹ REVISED MODEL NONPROFIT CORP. ACT § 14.06(a)(6) (1987).

permanently or only for a certain time or until some specified event occurs, at which time the assets will be transferred to someone else.¹⁷⁰

At first glance, it might seem a major shortcoming that U.S. law does not categorically prohibit public benefit nonprofits and trusts from distributing their assets to members or other insiders on dissolution. However, it must be remembered that as a precondition for obtaining the special tax advantages available to charitable organizations, every organization must irrevocably commit in its articles of incorporation that its assets will continue to be used for charitable purposes, and not be distributed to its members, founders, or other insiders. Thus, the United States approach maximizes the flexibility of the nonprofit and trust forms, while still ensuring that no special benefits will be paid to organizations that are not permanently public benefit. An organization is free to operate for private benefit during its lifetime or on dissolution, but if it does so, it will forego the advantages reserved for organizations with assets permanently dedicated to charitable purposes.

B. Involuntary Dissolution

Involuntary dissolution as it is normally conceived can be accomplished only by the courts. Most states allow courts to dissolve a corporation if it is shown that it has obtained its corporate charter through fraud, that it has abused or exceeded its authority on an ongoing basis, or (in the case of public benefit organizations) that it is misapplying or wasting the charitable assets or has become unable to accomplish the charitable purpose. Courts do not have the power to consider such questions *sua sponte*; a party with standing, typically the attorney general, must petition the court to dissolve a nonprofit corporation. In such proceedings, courts often have other remedies available to them.¹⁷¹ When dissolution is necessary, courts generally apply so-

¹⁷⁰ See RESTATEMENT (SECOND) OF TRUSTS § 401 (1957). Such conditional terminations of the trust are generally construed strictly, and may be void if the event in question may not happen for many years. See *id.*

¹⁷¹ See *infra* Part V.D.

called *cy pres* principles to keep the dissolved corporation's assets in use for a purpose as near as possible to the original charitable purpose.

A nonprofit corporation may also be dissolved involuntarily on various administrative grounds. For instance, if its articles state that it had a limited duration, then it will be dissolved at the end of that period. Similarly, failure to file regular reports, pay applicable fees and franchise taxes, or maintain a current registered agent may lead to administrative dissolution. Under the Revised Model Act, the Secretary of State (or whoever incorporates nonprofits) has the authority to dissolve a corporation on these grounds after providing the nonprofit with notice and a chance to cure the defect. Even after the nonprofit is dissolved, it has two years to correct the violation, after which its legal personality is reinstated as if it had never been dissolved. Administrative dissolutions are appealable to the courts.

V. REGULATION

As we noted at the outset of this overview, United States charity law is fundamentally devoted to a dual attitude toward charity. On the one hand, charitable assets are to be used for public purposes and to lighten the burdens of government. In the act of donation, the donor irrevocably cedes full control over assets that were previously his alone; the government acquires a corresponding interest in how those funds are used. But while charities are thought to do the government's work, they are not its tools; rather, the United States remains committed to the idea that the public interest is best furthered by a regime in which private individuals and groups have wide latitude in choosing what causes they will support and what methods they will employ in doing so. The United State remains fundamentally committed to the idea that the public interest is served best when private citizens are able to choose the aims, organizations, and methods that they will support. This dual attitude toward charity, which sees charity as both public and private, is nowhere more clearly to be seen than in the regulatory framework for charitable organizations.

A. Regulatory Authorities

1. The Attorney General

It is typically said that the state attorneys general have primary authority to regulate charities. That is true, but it misses an important respect in which the role of the attorney general is different from that of an ordinary regulator. To see this requires a little more background in the principles of trust law that provide the basis for the attorney general's authority.

An essential feature of the private trust is that there must always be a beneficiary of the trust who can sue in court to enforce the trust if the trustee fails to perform adequately. But while the beneficiary may petition the judiciary to keep the trustee from abusing the trust reposed in her, what the courts will enforce is the will of the trust's creator—not the will of the beneficiary. Indeed, one principal use for the trust is to allow the trustee to exercise paternalistic control over the beneficiary's assets, precisely because the creator of the trust doubts the beneficiary's ability to manage those assets himself. In this sense, the paradigmatic beneficiary is the small child not yet ready to take responsibility for his own affairs; in the end, it is the court, not the beneficiary, who is in the position of superiority with respect to the trustee.

Charitable trusts (and charitable corporations) do not usually have definite beneficiaries to enforce the trust. Instead, the attorney general of each state stands in as the representative of the trust's (or corporation's) charitable beneficiaries. That position both authorizes an attorney general's intervention and limits his powers. For just like any private beneficiary, the attorney general has no right to direct how the trust funds are used on behalf of the public he represents. Rather, he can only petition the courts to intervene; they, in turn, can usually intervene only when the trustee violates the terms of the trust or breaches his fiduciary duties. The mere fact that a trustee pursues a particular charitable purpose in a way the attorney general believes is deeply mistaken is not enough to justify intervention. (As noted above, the doctrine of *cy pres* provides a limited exception in cases where the trust purposes become impossible; but even then, the court will try to change the charitable purposes or other terms of the trust as little as possible.)

It is worth noting that the original donor also has limited control over the trust. Having parted with the trust property, the donor generally has no further standing to intervene if the trustee's methods are not to her liking. Thus, the donor has initial control over the charitable purposes but not, as donor, ongoing control over the charity's methods for furthering those purposes. The attorney general has ongoing rights to intervene in the public interest, but they are circumscribed by the terms of the donor's initial disposition. These limits on both sides help to keep the charitable sector from collapsing into either the private sector or the government. As readily appears, a central bulwark of these limits is the separation of the would-be regulator (the attorney general) from the power to regulate (which resides in independent courts).

But although it is essential that the attorney general's enforcement power be limited, there is no requirement that it be ineffective. Rather, proper regulation of the charitable sector depends on attorneys general exercising their properly channeled oversight authority to stop the abuses that inevitably occur. Unfortunately, many state attorneys general have not had adequate methods for gathering information about the charitable sector that would allow them to identify, and complain about, abuses. They are frequently understaffed and have many other responsibilities to attend to besides the regulation of charities.¹⁷² And because attorney general is an elected post, the attorney general is likely to concentrate on high-profile cases that will catch the public eye, whereas the usual case of diverted charitable resources is not exactly glamorous. The result has been that in many states, the attorney general has exercised little or no oversight over the charitable sector, leaving regulation of the sector to the Internal Revenue Service.¹⁷³

States have taken various measures to fill this regulatory vacuum. A few have enacted the Uniform Supervision of Trustees for Charitable Purposes Act, which requires all charitable trustees (and, although this is less clear, corporate directors) to register with the state attorney general's office (so that it is at least aware of the charities under its jurisdiction). The act also

¹⁷² FREMONT-SMITH, *supra* note 8, at 445.

¹⁷³ *Id.* at 443.

empowers the attorney general to investigate potential wrongdoing, among other things by calling witnesses and demanding the production of relevant documents.¹⁷⁴ To some extent, attorneys general are benefiting from better information even without legislative intervention, as many begin to take advantage of the increased online availability of charities' reports to the IRS. Some states have targeted potentially abusive transactions more directly, requiring notice to the attorney general, and perhaps court approval, before dissolutions, mergers, or conversions to for-profit status can occur.¹⁷⁵ Others have allowed other private parties in addition to the attorney general to sue misbehaving charitable trustees or directors.¹⁷⁶

Some such improvements are undoubtedly useful. Most fundamentally, it must be recognized that the charitable sector has expanded a great deal over the last decades, and as a result, states may need to devote more resources to their oversight. However, none of these changes should impact the fundamental structure of U.S. charity regulation, which does not allow the government to force charities to further its own vision of the public good. In this regard, it must be remembered that when attorneys general are given broader powers, they, no less than private trustees, can succumb to the temptations of putting private interests ahead of the overall public good. For instance, a state attorney general is sometimes more concerned with protecting the interests of her own state than she is with protecting the public at large. As a result, a trustee may rightly believe that the charitable assets would best be used in another state, only to have the move blocked by a parochial attorney general.¹⁷⁷ An attorney general needs adequate resources to serve as an effective check against charitable trustees' and directors' abuses, but not so much power that she needs to be checked herself.

¹⁷⁴ *Id.* at 317.

¹⁷⁵ *Id.* at 320–21; *see supra* Part IV.B.

¹⁷⁶ For instance, a handful of states have passed the Uniform Trust Code (2001), which changes the traditional rule that the creator of a trust cannot sue to enforce it. FREMONT-SMITH, *supra* note 8, at 339. This is in recognition that at a practical level, the person who has created the charity will usually be particularly interested in making sure it serves its intended purpose.

2. The Internal Revenue Service

Because it is the gatekeeper for federal tax exemption, which requires an analysis not only of governing documents but of past and future operations and budgets, the IRS starts out with far more information about a new charity than state regulators are likely to have. Although it, too, is overworked, it has substantial resources and experience to devote to auditing charities. Moreover, its power to terminate tax exemption gives it a powerful tool for encouraging compliance. Perhaps in part because of the lack of state-level enforcement, the past forty years have seen the introduction of several federal tax mechanisms for enforcing duties that were traditionally the domain of state law.

B. Licensing and Governmental Approvals

It is impossible to list all of the kinds of operation that may be subject to special licensing requirements under various state laws. Most states require nonprofit corporations to remain licensed to do business with the state authority responsible for business licensing generally. In addition, schools are often subject to special licensing requirements and to supervision by state education authorities. Health care organizations, day care centers for children, and nursing homes for the elderly are among the other types of organization that commonly must obtain special approval.

C. Reporting

The dual focus of the United States system is also reflected in its reporting regime. Our system is one in which charities have an obligation not only to the government but also to their private contributors to carry out their stated purposes properly. Reporting requirements thus have a twofold purpose. On the one hand, they enable the government to ensure that charities continue to merit the various advantages that they have received because of their publicly beneficial activities. But on the other, they help to guarantee an effective market for contributions, one in which potential contributors have ready access to key facts about potential donees. A primary

¹⁷⁷ *Id.* at 446-47.

purpose of this sort of public disclosure is to encourage self-regulation by charities. For example, given the reality that many other charities will be competing for the same donations, charities must think twice about how much they spend on officers' salaries and other administrative expenses; even if these are not so egregious as to justify legal sanctions, they may make a charity an unattractive vehicle for philanthropy relative to one that directs resources toward its charitable purposes more efficiently.

Most charities and social welfare organizations, along with many other organizations, are required to file an informational report known as "Form 990" with the IRS each year.¹⁷⁸ There is a limited exception for churches and for schools and certain public charities with less than \$5,000 in gross receipts. Because the purpose of reporting is to provide information not only to the government but equally to donors, these documents are public, and a charity must provide copies to any individual who requests them. Most are now available online.¹⁷⁹ The reports are quite detailed, describing such aspects of the charity's finances as its net asset position, sources of funding, revenue, and expenses. Among the other information to be disclosed is the compensation received by officers and directors, as well as by the organization's five highest-paid employees and five highest-paid independent contractors; information about any political, lobbying, or unrelated business activities; a summary of the organization's activities for the year; any unreported changes in the organization's governing documents; and information about other affiliated taxable or tax-exempt entities.¹⁸⁰ In addition, private foundations must provide information relating to any investment income, excess business holdings, self-dealing transactions, or jeopardizing investments.¹⁸¹ Fines for failure to file are \$20 per day (up to a

¹⁷⁸ I.R.C. § 6033 (2000).

¹⁷⁹ One commonly-used third-party provider of online reports is <http://www.guidestar.com>.

¹⁸⁰ For a complete copy of Form 990 (the form that all 501(c) organizations must file), see ADLER, *supra* note 30, app. E.

¹⁸¹ For a complete copy of Form 990-PF (the report private foundations must file), see *id.* app. F.

maximum of \$10,000 or 5% of gross receipts); for organizations with gross receipts of more than \$1,000,000, the fines are increased to \$100 per day and a total of \$50,000.¹⁸²

Many states also require annual filings from charities. Most of these have moved toward simplifying charities' reporting obligations by requiring the same information that the IRS requires, or even just requiring that a copy of the federal Form 990 be filed with the state attorney general or secretary of state. They may also require additional information; Massachusetts, for example, requires more detailed disclosure of contributions, payments to affiliates, self-dealing transactions, executive compensation, etc. It also requires audited financial statements for organizations with gross revenues above \$250,000.¹⁸³

In addition to these general filing requirements, a strong majority of states impose special registration and disclosure requirements on charitable solicitations aimed at the general public.¹⁸⁴ Although there are substantial differences in these regulations from state to state, their general purposes are to make sure that charities are truthful in their solicitations, and that noncharities cannot fraudulently raise funds by claiming that donations will be used for charitable purposes. While the Supreme Court has held that charitable solicitations cannot be banned solely because a high percentage of the revenues go to fundraising costs rather than to the organization's charitable purposes,¹⁸⁵ many states still require charities to make available information about how much of the funds will go to fundraising costs rather than directly to charitable purposes.¹⁸⁶ Charitable solicitation laws commonly exempt churches, accredited universities, organizations that solicit funds only from their members, and organizations that have annual revenues below a threshold amount.¹⁸⁷

¹⁸² I.R.C. § 6652(c) (2000).

¹⁸³ See FREMONT-SMITH, *supra* note 8, at 316, 357.

¹⁸⁴ See BRUCE R. HOPKINS, *THE LAW OF FUNDRAISING* § 3.1 (3d ed. 2002).

¹⁸⁵ *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980); HOPKINS, *supra* note 184, § 3.9.

¹⁸⁶ HOPKINS, *supra* note 184, § 3.9.

D. Enforcement

The courts have traditionally had broad powers to correct abuses involving charitable trusts, ranging from the power to remove a director or enjoin certain actions to the power to freeze certain assets or dissolve the charity outright. When directors or trustees have caused losses to a trust through their own negligence or gross neglect, a court can force them to reimburse the charity out of their own pockets; if they breach their duty of loyalty by making a personal profit at the trust's expense, the court can force them to repay the profits. The attorney general, trustees, and sometimes members can request such intervention, but they must first establish that such intervention is warranted. In addition, trustees could historically seek instructions from the court to verify *ex ante* whether a particular course of action would be consistent with their legal obligations.

The range of enforcement options available to the IRS was for many years much more limited. The lines defining the charitable sector—between fair compensation to insiders from excessive private benefit, between policy-related education and propaganda, between incidental and substantial business purposes—are not sharp ones. However, faced with difficult borderline cases, the Service was often faced with a seemingly black-and-white choice as to whether the organization fell within the definition of a charitable organization (in which case there was no penalty) or whether it did not (in which case, the loss of its exemption would likely be its death sentence). Paradoxically, the very strictness of this sanction may have led to underenforcement, since it was difficult to justify such harsh treatment of organizations that were, after all, only a shade worse than other organizations that received no penalty. Another problem with an enforcement regime that focused on the entity's tax exemption is that in many cases, it did not properly penalize the real wrongdoers. Often abuses are not the fault of the charity itself but rather of the particular individuals who have benefited at a charity's expense. Because charitable

¹⁸⁷ *Id.* § 3.5.

organizations do not belong to private parties, dissolving a charity or stripping its tax exemption altogether primarily harms the public purposes that it was designed to support, without effectively punishing the individual or individuals responsible for the abuse.

The solution to this problem has been the adoption of various “intermediate sanctions”—that is, a set of excise taxes that can be imposed in addition to, or in lieu of, revoking an organization’s exemption. Strictly speaking, the term “intermediate sanctions” is used to refer to a particular set of sanctions enacted in 1996.¹⁸⁸ Section 4958 is typical. It applies when a public charity enters a self-dealing transaction which confers “excess benefits” on an insider—that is, the charity provides something to the insider worth more than what the insider provides to the charity. When such a transaction occurs, section 4958 imposes a 25% tax on the excess benefit against the person who receives it. Moreover, if the excess benefit transaction is not corrected in a timely fashion, an additional 200% tax is imposed. Furthermore, if one of the public charity’s managers participated in an excess benefit transaction willfully or without reasonable cause, an additional 10% tax (up to a maximum of \$10,000 per transaction) is imposed personally on the manager.

This general pattern—imposing a tax on the guilty party, a tax on knowing or careless managers, and an additional tax for failing to correct the violation quickly—has been applied in many other contexts. A similar regime is used to tax an organization’s political campaign expenditures.¹⁸⁹ In addition, a number of similar regimes regulate many potential violations by private foundations, including the failure to make required distributions,¹⁹⁰ a private foundation’s self-dealing transactions,¹⁹¹ a private foundation’s risky investments that could jeopardize its purpose,¹⁹² a private foundation’s excessive business holdings,¹⁹³ and a private foundation’s

¹⁸⁸ I.R.C. §§ 4955, 4958 (2000).

¹⁸⁹ *Id.* § 4955.

¹⁹⁰ *Id.* § 4942.

¹⁹¹ *Id.* § 4941.

¹⁹² *Id.* § 4944.

¹⁹³ *Id.* § 4943.

lobbying, noncharitable, or insufficiently supervised expenditures.¹⁹⁴ By holding out the possibility of sanctions not only against the organization and other wrongdoers but also against managers whose neglect allows the violation, these rules increase directors' and trustees' incentives to take their monitoring responsibilities seriously.

VI. FOREIGN ORGANIZATIONS

A. Registration

Before foreign organizations can conduct activities in any particular state, they (like organizations formed in another state of the United States) must apply for a license to conduct business in that state. This is generally a simple process that involves providing the name and address of an agent within the state and paying a modest fee. Foreign organizations can also apply to the IRS for recognition as charitable or social welfare organizations under section 501(c)(3)-(4) of the Internal Revenue Code. However, although such organizations are exempt from tax, contributions to foreign entities are not tax-deductible (at least in the absence of a special treaty providing otherwise). This limits the value of obtaining recognition as a tax-exempt entity, especially since a foreign organization, once registered, may be obliged to file annual reports until it no longer qualifies for exemption.

B. Foreign grants

Although the IRS has expressed some doubt about the matter, its current position is that foreign funding may be treated like U.S. federal or state government funding for purposes of determining whether an organization is publicly supported. (That is, while most donations are counted as public support only to the extent that they do not exceed 2% of total support, government grants are considered public support in their entirety.)

Given the international character of much of United States philanthropy, however, the more important issue for U.S. charities (and the foreign charities they assist) is not the conditions

¹⁹⁴ I.R.C. § 4945.

for receiving foreign grants, but on making foreign grants. In general, an entity organized under the laws of a state or the federal government can qualify as a public benefit organization, and in particular, can qualify to receive tax-deductible contributions, even if it conducts its charitable activities abroad rather than domestically. However, the domestic organization must have real discretion in how to use the funds; if it is found to be merely a conduit for donations to a foreign charity, then donations will not be tax-deductible.

Domestic organizations must also ensure that money given to a foreign organization will, in fact, be used for their charitable purposes. In this regard, public charities are subject to a fairly flexible standard: they must maintain sufficient discretion and control to assure that the funds are properly used. Generally, this means that a public charity should make sure that the law governing the foreign entity, its governing documents, or the grant itself, legally binds the foreign entity to use the funds for the appropriate charitable purposes. Of course, in systems where the organization or the government can easily redirect charitable assets, it may be difficult or impossible to gain that assurance.

Private foundations are subject to a more onerous burden. A private foundation must generally exercise “expenditure responsibility” over grants to foreign organizations unless it makes a good-faith determination that those organizations are the equivalent of U.S. public charities. In reaching that determination, the organization can rely on a current affidavit from the foreign organization. However, making the equivalency determination can be difficult, particularly when the foreign organization can qualify as a public charity equivalent only by meeting the support test (in which case it has to gather and report a large amount of data about its support history over the previous four years).

Finally, the U.S. has various laws that restrict certain kinds of donations to designated nations. In the wake of September 11, these were supplemented to add a prohibition against providing funds to certain individuals and groups thought to be associated with terrorism. The Treasury Department has issued nonbinding guidelines suggesting procedures that international

grantmakers should follow in order to minimize the possibility of charitable grants being diverted to terrorist organizations.¹⁹⁵ The guidelines recommend gathering a great deal of information about potential grantee organizations, including their names, their key employees, the organizations to which they subcontract or make grants, and what financial institutions hold their funds. Grantmakers should also obtain copies of governing documents and other filings by the foreign grantees. They should then compare the obtained information against U.S. lists of suspected terrorists and terrorist organizations to verify that there are no connections. The U.S. organizations should also see that recipient organization implements procedures to minimize the risk of their funds being diverted. While grantmakers have criticized these rules for requiring more information than is reasonably obtainable in many countries, and for failing to recognize that not all international grants pose the same risks of diversion,¹⁹⁶ it is not yet clear what steps along these lines charitable organizations should take. The resulting uncertainty has the potential to discourage grantmakers from making grants, particularly to obscure charities in high-risk areas. However, it is worth noting that even after an attack on the scale of September 11, the U.S. government has gone no further than to suggest that charities adopt certain safety protocols in their own grantmaking. There is absolutely no suggestion, for instance, of requiring the charities to submit proposed international grants to government review.

¹⁹⁵ See U.S. Department of the Treasury Antiterrorist Financing Guidelines: *Voluntary Best Practices for U.S.-Based Charities*, available at <http://www.treas.gov/press/releases/docs/tocc.pdf>.

¹⁹⁶ See Thomas Silk, *Corporate Philanthropy and Law in the United States: A Practical Guide to Tax Choices and an Introduction to Compliance with Anti-Terrorism Laws*, 6 INT'L J. NOT-FOR-PROFIT L., available at http://www.icnl.org/JOURNAL/vol6iss3/ar_silk.htm; Council on Foundations, Comments on U.S. Department of the Treasury Antiterrorist Financing Guidelines: *Voluntary Best Practices for U.S.-Based Charities*, available at http://www.cof.org/files/Documents/Legal/Treasury_Comments_06.03.pdf.

VII. MISCELLANEOUS

A. Mergers

In general, it is quite simple to execute a merger. One simply files articles of merger with the state secretary of state (or other registering body). Thereafter, only the surviving entity continues to exist, and it takes all of the assets and liabilities of the merged entities. Assuming that the new organization results from the merger of a charitable organization and continues to meet all the requirements of 501(c)(3) of the Code, the merger will not threaten its tax exemption. One potential problem with mergers is that the charitable assets could be diverted to private purposes (if the resulting organization is not charitable) or to different public purposes. To prevent this, twenty-eight states categorically prohibit charities from merging with for-profit entities.¹⁹⁷ Some states (particularly those that have distinguished between public benefit and mutual benefit nonprofits) impose checks on charitable mergers. Other states impose various conditions that must be satisfied before such a merger can be consummated. For instance, New York requires court approval prior to such a merger, and California requires at least twenty days' notice to the attorney general (who could presumably bring suit to enjoin the merger if it threatened to divert assets from charitable purposes).¹⁹⁸ The Revised Model Act does not require court approval when one public benefit corporation merges into another. However, mergers into mutual benefit corporations or for-profit companies must be approved in advance by the courts unless (1) the attorney general is given notice; (2) the merger is approved by a majority of directors who will not become insiders in the resulting organization; and (3) assets worth at least as much as the predecessor public benefit corporation are made available to the organizations that would have received its assets had it dissolved.¹⁹⁹

¹⁹⁷ FREMONT-SMITH, *supra* note 8, at 319.

¹⁹⁸ 2 MARILYN PHELAN, *NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS* § 15:01 nn. 3, 16 (2004).

¹⁹⁹ REVISED MODEL NONPROFIT CORP. ACT § 11.02 (1987). The statute also requires court or attorney general approval if the members of the public benefit organization receive some benefit as a result of the merger. *Id.* § 11.02(c).

B. Rules for Investment

The dominant trend in United States law has been to recognize that there is no list of permissible investments that can fit the needs of every organization and every situation. Therefore, rather than limiting trustees and directors to certain kinds of investments, United States law has focused on the requirement that they exercise due care in choosing investments. Some states have in the past adopted statutes limiting trustees' authority to invest in any but the most conservative investments (presumably because they believed a trustee's fundamental duty was to preserve, rather than to increase, trust assets). Similarly, courts interpreting common-law trust standards sometimes arrived at inflexible rules against particular investments such as junior mortgages or risky new companies. However, these approaches have come under heavy attack in recent years. The emerging consensus is that the "legal list" approach overlooks the lessons of modern portfolio theory, which teaches that the prudence of an investment cannot be evaluated in isolation; even superficially risky investments may form an appropriate part in an overall well-diversified portfolio.²⁰⁰ Moreover, even when legal lists have been in force, the law has recognized the need to customize; such lists have almost always been enacted as defaults which could be modified by contrary directions in an organization's governing documents.

Section 4944 of the Internal Revenue Code imposes a special tax on private foundation investments that jeopardize their charitable purposes. The tax is 5% per year of the amount invested, and an additional tax of 25% is due if the investment is not corrected promptly. No type of investment is *per se* improper; here again, the question is whether a given investment was reasonable under the circumstances.

C. Investment Abroad

Investments abroad, like other investments, are entirely permissible, subject only to the general standards requiring that investment decisions be reasonable.

²⁰⁰ See RESTATEMENT (THIRD) OF TRUSTS § 227 (2003).

D. Political and Legislative Activities

The United States shares the commonly-held view that direct intervention in a political campaign is not a charitable activity. Accordingly, charitable organizations and social welfare organizations are categorically prohibited from engaging in such activity. Whether they should be able to engage in legislative activities is a more complicated question. On the one hand, the United States recognizes that individuals and associations of individuals have a right to express their views on political candidates and legislation. The exercise of that expressive right, as an essential precondition for our republican form of government, is to be encouraged. Moreover, one of the benefits of a vibrant civil sector is that different organizations gain experience with different ways of dealing with various social problems, allowing the government to learn from civil sector successes and failures in developing its own programs. It is difficult to harness the experience of charitable organizations, though, if they are forbidden from speaking on the subject of legislation. On the other hand, a principal justification for the tax benefits provided to charitable organizations is that their activity lightens the burdens of government. To the extent that charities serve their purposes not by conducting charitable activity themselves but by seeking to convince the government to do so, this justification breaks down.

The upshot of these competing concerns is a compromise regime which is perhaps the principal reason for the existence of two separate categories of public benefit organization under the federal tax code. Charitable organizations under section 501(c)(3) of the Code, which are eligible for tax-deductible contributions, must not have any substantial part of their activities devoted to influencing legislation; social welfare organizations—which are not eligible for those tax-deductible contributions but are still exempt from income tax—can engage in unlimited lobbying activity, so long as it is related to their social welfare purpose.

Because education is recognized as an important charitable purpose, even the restriction on lobbying by 501(c)(3) organizations must be construed narrowly, lest educational organizations be restricted to teaching subjects that have no relevance to policy questions facing

the government. The restriction has therefore been interpreted to apply only when the organization (1) contacts, or urges the public to contact, members of the legislature regarding a specific legislative proposal; or (2) advocates the adoption or rejection of specific legislation.²⁰¹ The law preserves government's ability to benefit from nonprofits' experience by (1) allowing nonprofits to *respond* to legislative requests for their views; (2) allowing them to provide nonpartisan analysis on general policy questions; and (3) allowing some amount of lobbying as issues come up, so long as they do not become a substantial part of the organization's activities.²⁰²

Because the line between substantial and insubstantial activities is not a precise one, charitable organizations historically could not take advantage of their permission to conduct "insubstantial" lobbying activities without running the risk of losing their tax exemption. That changed in 1976, when Congress allowed charitable organizations to elect to apply a very specific expenditure test in lieu of the vague "insubstantial part" test.²⁰³ Electing organizations may spend a certain percentage of their overall purpose-related expenditures on lobbying²⁰⁴; that percentage depends on the size of the organization, ranging from 20% for small organizations to slightly more than 5% (but no more than \$1,000,000) for large organizations. Appeals to the public to contact their legislator(s) (known as grass-roots lobbying) are subject to a separate cap one-fourth the size of the restriction on direct lobbying.²⁰⁵

Finally, it should be born in mind that although the United States has a complex set of rules governing legislative and political activities, the rules are not designed to prohibit any of those activities. Rather, they are geared to encourage groups to conduct their lobbying activities

²⁰¹ See HOPKINS, *supra* note 7, § 20.2(b).

²⁰² See *id.* § 20.4(a).

²⁰³ I.R.C. § 501(h) (2000).

²⁰⁴ For purposes of the expenditure test, the definition of lobbying and its exclusions are spelled out somewhat more precisely than they are on the traditional definition of lobbying. See HOPKINS, *supra* note 7, §§ 20.2(c), 20.4(b).

²⁰⁵ I.R.C. § 4911(c)(3)–(4) (2000). For a more detailed look at the rules governing lobbying, see ADLER, *supra* note 30, ch. 5.

and political activities using separate entities, thus allowing the federal government to make sure that tax benefits designed for one class of activity are not diverted to another.

VIII. TAX LAWS

A. Tax Exemptions

1. Federal Income Tax

Public benefit organizations (both charitable organizations and social welfare organizations), like numerous other kinds of nonprofit organization, are generally exempt from federal income tax, with certain limited exceptions. Most organizations must apply to the Internal Revenue Service to be recognized as tax-exempt. The exception to this rule is that churches generally are presumed tax-exempt even without registering with the IRS. As noted above, to qualify as a public charity or social welfare organization, an organization must (1) be organized and operated exclusively for an appropriate public benefit purpose; (2) not allow private inurement to insiders; (3) serve a class large and indefinite enough that the operations do not produce any substantial private benefit; and (4) abide by the restrictions on political activity and (for charitable organizations) lobbying.

2. State and Local Income Tax

Because of the substantial administrative savings involved, most states base their income tax exemption on the federal exemption. In states like Delaware, obtaining an IRS determination letter automatically exempts the organization from state income tax. In other states like California, the state tax exemption closely tracks the federal tax exemption, but the organization must still separately petition the state for tax-exempt status.²⁰⁶ Other states vary their definitions slightly. For instance, Montana's exemption does not appear to include athletic organizations or organizations that test for public safety.²⁰⁷ In New York, an IRS determination of exemption

²⁰⁶ CAL. REV. & TAX CODE § 23701(d), (f) (2004).

²⁰⁷ MONT. CODE ANN. § 15-31-102(1)(d) (West Supp. 2004).

raises a presumption of exemption from the corporate franchise tax, but that presumption can be rebutted.²⁰⁸

3. Sales Tax

While VAT is quite uncommon in the United States, most states do impose some sort of sales (turnover) tax. There is wide variety in the nature of exemptions granted for charitable purposes. As in other areas, the law is generally designed to provide benefits to nonprofits without giving them an unfair advantage when they engage in business similar to for-profit companies. Thus, New York exempts any 501(c)(3) organization from sales tax, but specifically excludes sales made through a store, restaurant, or parking facility.²⁰⁹ California exempts certain kinds of goods and services (for instance, meals provided to students and certain periodicals produced by nonprofits) from the tax,²¹⁰ and also exempts nonprofits engaged in poverty relief from tax on purchases of items donated to the poor, and on sales made to the poor.²¹¹ Similarly, Massachusetts exempts charitable organizations so long as the items sold are used to further the organization's charitable purposes.²¹² Alabama takes a different approach, specifically legislating a list of specific organizations that are free from the tax.²¹³

4. Property Tax

States commonly provide for property tax exemptions for certain charitable organizations. Often, the property is not exempt unless it is both owned by a charitable organization and used for the organization's charitable purposes. Thus, if a charity rents property to others in order to generate income for its activities, the property will frequently be taxable. As in other areas of state law, the state law definition of charity may vary somewhat from the federal definition. For instance, although the IRS has recognized that providing housing and services for

²⁰⁸ BJORKLUND, *supra* note 50, § 14-5(a).

²⁰⁹ *Id.* § 14-6(b), (d).

²¹⁰ 2 ADVISING CALIFORNIA NONPROFIT CORPORATIONS § 7.28 (Michael C. Hone et al. eds., 1984)

²¹¹ CAL. REV. & TAX. CODE § 6375 (2004); CAL. CODE REGS. tit. 18 § 1570 (2004).

²¹² MASS. GEN. LAWS ch. 64H § 6(e) (2003).

²¹³ ALA. ADMIN. CODE r. 810-6-3-.07.05 (2003).

the elderly is always charitable even if the elderly served are not poor or sick, some states have disagreed. In addition, relying on the theory that tax-exempt entities should relieve some burden from the taxing authority, several states have conditioned property tax exemptions on the charity devoting at least a portion of its resources to furthering charitable purposes *within the state*. However, the Supreme Court has held one such law unconstitutional because by discriminating against out-of-state charity, it impermissibly infringed Congress's exclusive authority to regulate commerce between the states.²¹⁴

5. Customs, Duties, and Excises

Certain limited exemptions exist under federal law for particular types of charities. For instance, certain educational institutions are exempt from retail excise taxes on diesel fuels and special motor fuels, and the manufacturers' excise taxes on many specific articles; they, along with health care organizations, are also exempt from the communications tax.²¹⁵

B. Deductibility of Contributions

Generally, contributions to domestic 501(c)(3) charitable organizations are deductible.²¹⁶ Corporations can deduct contributions of up to 10% of their income each year. An individual can generally deduct contributions to public charities of up to 50% of income; there is a lower limit of 30% on contributions to private foundations. In addition, contributions of property other than cash are generally valued not at their current value, but at their "basis" (usually the cost at which the donor acquired them). Contributions of property to public charities may also be valued at basis if their use is not related to a charitable purpose or if they have been held for a year or less.²¹⁷ Bequests to charitable organizations are also deductible, and are not subject to the same rules and percentage limits that govern other contributions.²¹⁸

²¹⁴ *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).

²¹⁵ 2 ADVISING CALIFORNIA NONPROFIT CORPORATIONS, *supra* note 210, § 7.29.

²¹⁶ I.R.C. § 170 (2000); HOPKINS, *supra* note 7, § 3.2(b). The exception is organizations that test for public safety. *Id.*

²¹⁷ For a more complete explanation of these rules, see ADLER, *supra* note 30, at 11.

²¹⁸ *See* I.R.C. § 2055(d) (2000).

C. Endowment issues

Investment income (for example, interest, dividends, rent, and royalties) is not generally taxable to public benefit organizations. And except for the general requirement of prudence in investing charitable assets, organizations are free to have controlling ownership interests in for-profit corporations. (Of course, owning and managing a for-profit business unrelated to one's charitable purpose must not be a substantial purpose of a public benefit organization.)

Because of a perception that private foundation managers were using private foundation assets to hold stock in and maintain control of businesses—sometimes for noncharitable purposes—Congress has enacted special limits on private foundations' ability to accumulate substantial holdings in business companies. In general, a private foundation, together with its “disqualified persons” (basically, insiders) may own no more than 20% of any business corporation. If a third party effectively controls the business, this limit is increased to 35%. Notwithstanding these rules, a private foundation may generally hold 2% of a company's stock without triggering the excess business holding rules. In addition, the rules do not apply at all to businesses related to the organization's exempt purposes or to companies that derive 95% or more of their income from passive sources.²¹⁹

D. Commercial/Business/Economic Activities

As a general matter, state nonprofit laws provide corporate powers broad enough to include engaging in business activity. Historically, trust law has been more restrictive, assuming in the absence of specific authorization from the trust's creator that the trust should obtain income only through passive investment.²²⁰ However, well-designed trust instruments can easily surmount this difficulty.

Federal tax laws recognize that economic activities can be both an important source of funding for nonprofits and an important means by which they further their charitable services.

²¹⁹ See I.R.C. § 4943 (2000); ADLER, *supra* note 30, at 33–34.

²²⁰ RESTATEMENT (SECOND) OF TRUSTS § 230, cmt. m.

Public benefit organizations under sections 501(c)(3) and (4) of the Code are therefore allowed to engage in business activities, so long as they do not cause the organization to violate the fundamental rule that they not have any substantial purpose or activity other than their charitable one.²²¹ That is, any business activity must be insubstantial in nature or incidental to the organization's charitable purposes. This standard is not a clear one, and no single approach to determining substantiality has emerged to clarify it.

If the business activity furthers the charitable purposes, it will normally be unproblematic, even if it is a substantial amount of the organization's overall activity.²²² For instance, a charitable theater company could receive substantially all of its income from selling tickets to its performances; although this is technically business activity, it obviously furthers its charitable mission. However, some courts have held that even program-related business activity may be impermissible if it is conducted in an overly commercial way. That is, if an organization conducts its business activities in much the way similar for-profit organizations would, courts are more likely to decide that generating a profit, rather than the activity that generates the profit, has become a substantial purpose of the organization.²²³

When the business does not further the charitable purposes (except by providing income), the IRS and the courts frequently look to the percentage of expenditures or time devoted to that activity, and the percentage of an organization's revenue that it produces, to determine whether it is substantial.²²⁴ Percentages of around 30% have been held to disqualify an organization for exemption. However, sometimes the IRS and the courts consider whether the unrelated business activity is commensurate with the charitable activity. These courts will uphold an exemption even if substantially all of an organization's income comes from unrelated sources, so long as the charitable activity is substantial enough in comparison to the business activity that it appears the

²²¹ See HOPKINS, *supra* note 7, § 26.1.

²²² *Id.*

²²³ See *id.* at ch. 25.

²²⁴ *Id.* § 26.1.

business activity is being engaged in simply as a means of sustaining the charitable activity²²⁵. On the other hand, if the income from the activity were merely being accumulated, it might seem less like an incidental part of an overall charitable mission, and more like a substantial additional purpose in its own right.

These standards have the drawback that they are quite vague and carry the possibility of a severe sanction (loss of tax exemption) if an organization should stray too far over the difficult-to-discern line between permissible and impermissible business activity. However, this drawback is somewhat ameliorated by the fact that an organization can always avoid the risk of being found too commercial by conducting business activities through a taxable subsidiary.²²⁶ Although this adds organizational complexity, the business activities of a subsidiary are not generally attributed to the charitable parent.

Even if the organization conducts unrelated business activities itself instead of through a taxable subsidiary, income from that activity is subject to tax. This rule has been in place since 1950 and reflects Congress's desire to prevent nonprofits from conducting operations indistinguishable from for-profit operations while gaining an unfair competitive advantage from tax exemption. To be exempt from tax, a business activity must be "substantially related" to the organization's purposes, which the regulations have interpreted to mean that the conduct of the business activity itself, and not just the income it produces, must have a "causal relationship" to and "contribute importantly to" the fulfillment of the charitable purposes.²²⁷ To the extent that the business activity is more than reasonably necessary to further those purposes, it will be taxable. The more "commercial" the activity appears to be in its methods and purpose, the more likely it will be considered unrelated business income.

Several limitations on the definition of unrelated business activity are worth noting. First, the business activity must be a trade or business, which means it must be engaged in with

²²⁵ *Id.*

²²⁶ *Id.* § 27.1(b).

the goal of producing a profit, and must be somewhat more active than routine investment of assets. In addition, it must be regularly carried on, so that an occasional bake sale or other fundraising event will not constitute a taxable unrelated business. The Code also specifically excludes many forms of passive investment income,²²⁸ as well as sales of donated items and businesses in which substantially all of the labor is provided by volunteers.²²⁹

E. Reporting

See above, section V.C.

F. Miscellaneous

1. Administrative Expenses

The United States has not imposed a fixed percentage of expenses that may be used for administration, perhaps recognizing that the amounts needed for administration or fundraising are likely to vary depending on the kind of activity and the stage in an organization's development. However, charitable organizations have to disclose how much they spend on administration under federal tax law, and often state charitable solicitation laws require such disclosure. This allows the public to decide whether to contribute to an organization with high administrative expenses, without unduly constraining activities that naturally generate such expenses.

While there is no fixed cap on compensation for directors, officers, or employees of charitable organizations, if compensation is unreasonably high given the prevailing rate for the services in question, it can be considered an excess benefit transaction subject to intermediate sanctions, or even impermissible private inurement or private benefit disqualifying the organization from exemption.

2. Accounting Rules

Nonprofits follow many of the same accounting principles that govern for-profit companies. However, in the last decade or so, the Financial Accounting Standards Board (FASB)

²²⁷ Treas. Reg. § 1.513-1(c)(2) (1983).

²²⁸ I.R.C. § 512(b) (2000); HOPKINS, *supra* note 7, § 27.1.

has acted to implement some specialized standards.²³⁰ While an exhaustive treatment of accounting differences is impossible here, the general point is that the information most relevant to for-profit accounting is only marginally important for nonprofits. For-profit accounting properly focuses on net earnings, so that potential investors can readily obtain an accurate sense of how profitable a company is. How the company generates those profits is, in a sense, secondary. By contrast, a nonprofit's donors are normally more concerned with how the organization's money is spent and ensuring that it has adequate assets and cashflow than they are with the rate at which it is accumulating profit. In addition, nonprofits frequently have to manage funds from various donors, some of which will be earmarked for certain purposes, or for permanent investment. Thus, the FASB has required nonprofits to report their aggregate assets and liabilities, together with any change in net assets, and also to report separate subtotals for unrestricted funds, temporarily restricted funds, and permanently restricted funds. Expenses should also be sorted into functional categories (charitable program, management, fundraising, etc.).²³¹ Standards are also evolving to guarantee uniform treatment of transactions unique to nonprofits, for example, gifts to one nonprofit for the benefit of another, a pledge to give money at a later time, or the valuation of volunteer services.²³²

IX. COMPLIANCE

See above, Sections III.B.5-7.

X. GOVERNMENT FUNDING & PRIVATIZATION

While the United States legal system is structured in part to facilitate private parties joining together to pursue charitable ends independently from the government, in practice

²²⁹ I.R.C. § 513(a)(1) (2000).

²³⁰ See Ronald F. Ries & Ian J. Benjamin, *Accounting for Nonprofits*, in 2 MASSACHUSETTS NONPROFIT ORGANIZATIONS § 13-1 to -4 (1998).

²³¹ See *id.* § 13-4 to -5.

nonprofits often work closely with various governmental units and agencies. Indeed, as the government has expanded its provision of social services, in many cases it has chosen to provide those services by contracting with nonprofits. This may be due, in part, to the common, though not universally held, American sentiment that private actors are more likely to be effective than government bureaucrats.²³³ Whatever the reasons, the result has been a system in which nonprofits are major providers of various social welfare functions, and at least in certain fields, have become increasingly dependent on the government for their support. In 1996, the government provided roughly 36% of all revenue for nonprofits; fees for services constituted another 54% of revenues, with private contributions responsible for only 10%.²³⁴ These figures may actually understate government support for the sector, since many health care, child care, and other service organizations collect revenues by charging fees to clients who, in turn, are reimbursed or subsidized by the government.²³⁵ On the other hand, these figures do not take into account one of the most substantial forms of private contribution to charity: volunteer labor. It should be also stressed that the trend toward greater government support has not affected all charitable organizations equally; religious organizations depend overwhelmingly on private donations for their support, and in fact receive more than half of all private contributions annually.²³⁶ Similarly, government support accounts for only 14% of revenues for cultural and artistic organizations.²³⁷

During the 1980s, the federal government cut back its spending in areas such as social services. The nonprofit sector made up the shortfall largely by increasing their income from fees

²³² *Id.* § 13-6 to -7.

²³³ LESTER SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 62-63 (1999).

²³⁴ *Id.* at 37.

²³⁵ Kirsten A. Grønbjerg & Steven Rathgeb Smith, *Nonprofit Organizations and Public Policies in the Delivery of Human Services*, in *PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA* 139, 149-50 (1999).

²³⁶ SALAMON, *supra* note 233, at 152-53.

²³⁷ *Id.* at 37.

and economic activities; private donations did not grow nearly as quickly.²³⁸ Some worry that this shift to dependence on fees has forced the charitable sector to shift attention away from the most needy beneficiaries in favor of those who can afford their services.²³⁹

Privatization of various new and old government functions continues to be a common proposal in the United States. However, there is still a significant amount of disagreement about when it is a good idea. Proponents argue that nongovernmental organizations are less constrained by government bureaucracy and more able to tailor their services to local needs; critics worry that privatization will decrease public accountability in the provision of social services and perhaps compromise the independence of the nonprofit sector.²⁴⁰

XII. CONCLUSIONS

As this Report has demonstrated, The United States laws governing nonprofits have in many cases developed in response to specific situations and problems that may or may not be unique to its context. It is worth reviewing a few of the noteworthy features of U.S. law for comparison with other regimes:

- 1. Separation of tax benefits from the right to form a legal person and operate.** For the most part, an organization's classification for federal tax purposes does not depend on the type of legal entity chosen at the state level. An organization can easily form and operate even if it fails to qualify for tax benefits.
- 2. More than one tax-privileged status.** Even noncharitable organizations and social welfare organizations qualify for tax exemption; charitable organizations in the narrow sense are the only ones that can receive tax-deductible donations.

²³⁸ *Id.* at 69–71.

²³⁹ *Id.* at 72.

²⁴⁰ *See generally* Martha Minnow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1229 (2003).

3. **Regulating through disclosure.** Instead of setting limits on administrative expenses or other expenses, U.S. law regulates indirectly by forcing public disclosure of an organization's features and activities. This allows donors to make informed decisions, and allows the need to compete in the market for donations to spur self-regulation.
4. **Varying degrees of regulation for different classes of charity, with differences based not on formal legal features but on features that indicate a greater possibility for abuse.** Because private foundations are particularly likely to be controlled by one particular donor, the U.S. has applied a variety of special rules to them that it has not applied more widely.
5. **Availability of a wide range of sanctions.** The tax code's excise taxes on abuses (fines levied on the organization, the improperly benefited party, or the managers who knowingly allowed the abuses) provide an alternative to the ultimate sanction of tax-exemption revocation. This allows regulators to calibrate sanctions to the severity and nature of the offense.
6. **Limited authority of regulators to affirmatively direct use of charitable funds (rather than check abuses).**

The charitable sector in the United States is constantly evolving, giving rise to new and innovative ways of tackling social problems—and occasionally new and innovative schemes for abusing the nonprofit form. Current problems to be faced include the danger of funds being diverted to terrorism and the need to curb abuses associated with a few specific types of charity. Doubtless, the charitable sector and the government will continue to work closely together in order to address these problems in a way acceptable to both.