



EMERGING Nonprofit *and* Foundation Enforcement Issues

By Terry M. Knowles

THE GROWTH IN THE NUMBER, ASSETS, AND revenues of U.S. nonprofits and foundations has intensified the issue of how much government regulation is needed and how to do it. While the vast majority of charitable organizations operate in a legal and ethical manner, a small minority of bad actors attracts public attention and ultimately leads to demands for new laws and increased scrutiny by the Internal Revenue Service and state charity officials. This article examines some of the key areas of ongoing nonprofit regulation, as well as emerging trends confronting government officials.

Ongoing Regulatory Issues

Responsibility for the regulation of the nonprofit sector is divided between the Internal Revenue Service on the federal level and various regulatory offices on the state level. While the IRS and state charity officials can share a limited amount of information, federal law prevents the IRS from communicating information pertain-

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ing to the federal investigation of a nonprofit organization to state charity officials. This often impedes the ability of state officials to investigate allegations of illegal behavior in their own states. S.2020 as presently drafted would eliminate this barrier, by allowing states to obtain information from the IRS vital to the efficient regulation of the sector and the protection of charitable assets by state charity officials.

Charitable Organization Registration and Electronic Filing

Organizations raising funds in more than one state frequently complain about the multiplicity of laws, regulations, forms, fees, and levels of scrutiny at the local, county, state, and federal levels. Since each state debates, amends, and enacts its own laws, not much progress has been made in adopting a uniform system of enforcement. The resulting maze of regulatory requirements is not easily understood by even the most seasoned nonprofit boards. Attempts by state charity regulators to develop uniform laws and some joint projects have met with limited success. For example, although the National Association of Attorneys General and the National Association of State Charity Officials drafted A Model Act Concerning the Solicitation of Funds for Charitable Purposes in 1986, few states have adopted it.

A uniform system of electronic filing would be a welcome benefit to both sides of the reporting and registration process. For the 39 state charity offices that require registration, (the following states do not require registration: Idaho, Montana, Wyoming, Nevada, South Dakota, Nebraska, Texas, Iowa, Indiana, Vermont, and Hawaii)¹, it would reduce or eliminate the avalanche of paper submitted by nonprofit organizations. For charities that solicit on a nationwide basis, it would reduce the high cost, in time and money, of multi-state filing requirements.

Although electronic filing for nonprofits is preferred, very few states have implemented the process. The Independent Sector Panel on the Nonprofit Sector recommended that Congress mandate and fund the creation of a single-point electronic, uniform registration and reporting system at the federal level, while permitting states to retain their leading role in regulating and enforcing charitable solicitation laws under an updated Model Charitable Solicitation Law²,

but this recommendation is bogged down with the rest of the Senate Finance Committee's charitable reforms and incentives. In the meantime, the IRS and the National Center for Charitable Statistics are working with state charity officials in the development of e-filing solutions and at least two states, Colorado and Pennsylvania, have implemented electronic filing systems.

Fundraising/Revenue-Raising Activity

Regulators are finding that the dramatic increase in nonprofit organizations and greater competition for donations creates great pressure to obtain those donations and can lead to an "ends justifies the means" fundraising culture. Some nonprofits, frustrated by declining contributions and increasing financial obligations, have stretched the truth in their appeals, adopting alternative names or "alter-egos" for their organizations to attract new donors. Programs that purport to help veterans, firefighters and police, and children with terminal illness evoke particularly strong emotions from donors. Nonprofits with missions unrelated to these causes are sometimes tempted to try and capture more donations by creating programs that mimic these popular causes; in some cases, the dollars raised do not benefit any of these causes. Although state regulators are experienced in the investigation and prosecution of alleged fraud in telephone and mail solicitation, the Internet has presented a new set of challenges.

Among these challenges for state charity officials is the matter of donations made to foreign nongovernmental organizations. American donors have a long tradition of contributing to the welfare and development of communities abroad, and as the costs of global communication drop, charitable activity and solicitation are less constrained by national borders. Given the size of state charity regulators' budgets for international travel (zero), the ability of a regulator to investigate allegations of misdirected charitable money originating in a distant geographic location is limited.

Allegations that American charities and donors have funneled money to entities engaged in terrorist activities abroad have prompted greater state and federal scrutiny. It is therefore imperative that state and federal regulators continue to work together to address these oversight challenges. The National Association of State

Charity Officials first addressed this issue in 2001 with the adoption of The Charleston Principles: Guidelines on Charitable Solicitations Using the Internet.³ While the Principles were a good first step, much more needs to be done to protect the giving public from fraudulent online appeals.

Emerging Issues

Sarbanes-Oxley: Enhanced Annual Reporting and Audit Requirements. For many years IRS Form 990 served not only as the informational return used by the IRS to monitor tax-exempt organizations, but also as a state financial statement and public disclosure document. While perjury penalties may be imposed for filing a fraudulent return, state regulators have not found that this is an adequate deterrent to the growing number of charities that file inaccurate, incomplete, misleading, or even fraudulent returns.

The financial collapse of Enron and Tyco, the arrest of high-ranking corporate officers, and the alleged complicity of a major accounting firm in a cover-up led Congress to pass the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley sought to increase the accuracy of financial statements and accountability of publicly traded corporations by requiring:

- CEO/CFO certification of financial statements,
- a ban on personal loans to officers and directors,
- the prohibition of certain non-audit services for accounting firms,
- mandated audit committees,
- increased disclosure requirements,
- whistleblower protection, and
- increased civil and criminal penalties for corporate fraud.

Although Sarbanes-Oxley was designed to address problems among for-profit entities, many states are generalizing the need for governance and accounting reforms and enacting some Sarbanes-Oxley-like provisions to increase regulation of the nonprofit sector. The most common elements among the states include new auditing requirements, increased board oversight and legal responsibility for financial statements, mandated audit committees, whistleblower protection, and mandated conflict of interest policies. California's Nonprofit Integrity Act of 2004⁴ is an example of this trend.

Charitable Trust Issues

Monitoring the proper use of charitable funds sitting in thousands of separate trusts and endowments is one of the earliest common law responsibilities of state attorneys general. Fiduciary duties of care and loyalty and the attorney general's authority to enforce those standards have evolved through statutory and case law in the United States over a period of many decades, but now some of the fund holders trustees and endowment managers are questioning these standards.

Corporate fiduciaries, the academic community, and charities holding large endowment funds have begun to challenge the usefulness of these standards as well as the role of the attorney general as the guardian of the public interest in charitable trusts. The Uniform Trust Code and proposed amendments to the Uniform Management of Institutional Funds Act (now the Uniform Prudent Management of Institutional Funds Act) illustrate the profound changes now currently under discussion in the trusts and estates area of the law. Central to the debate are issues concerning the definition of endowment funds, fiduciary duties, investment standards, legal standing, and the delegation of trustee authority in both private and charitable trusts. The following three proposals, if implemented, have the potential to change state oversight and regulation of charitable trusts:

How can the value of endowment funds be preserved? A current draft amendment to the Uniform Management of Institutional Funds Act (UMIFA), if adopted, will eliminate the concept of "historic dollar value" as it relates to permanently restricted funds.⁵ While public charities and private foundations currently holding endowment funds are permitted to adopt a spending policy to be applied against capital appreciation, they are also required to maintain the original amount of each institutional fund. The UMIFA drafting committee is proposing this change to permit endowment managers greater flexibility in the development of investment policies and in the shaping of asset allocation models. While this amendment may benefit large, sophisticated institutions, state charity officials will need to insure that smaller, less sophisticated organizations and their boards understand that the elimination of the historic dollar value requirement does not transform the

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legal definition of their endowment fund from permanently restricted to unrestricted.

Fiduciary duties: Who is responsible? The Uniform Trust Code⁶ was adopted by the National Conference of Commissioners on Uniform State Laws in 2000, and since that time 15 states have adopted their own versions of the Code (Alabama, Arkansas, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Utah, Virginia, and Wyoming). Section 808 of the Uniform Trust Code permits the creator of a trust to delegate or direct certain powers over the management and investment of the trust to an individual or individuals who are not serving in the capacity of trustee. These “trust protectors” and “trust advisors” often have the authority to override decisions made by the trustee and may or may not be classified as “fiduciaries.” Permitting the fragmentation of authority poses a significant challenge for state regulators who want to determine which party has the legal responsibility in cases of mishandled or misappropriated charitable assets.

Who can enforce a charitable donation? Section 405 (c) of the Uniform Trust Code states: “The settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust.”⁷ This particular change has great significance for the regulation of charitable trusts. Traditionally the attorney general has represented the public interest in enforcing the terms of a charitable trust while settlors, their children, and other interested parties lacked the standing to intervene in these cases or to initiate an enforcement action independently. The Uniform Trust Code as written extends standing to include the settlor and others, noting: “The grant of standing to the settlor does not negate the right of the state attorney general or persons with special interests to enforce either the trust or their interests.”⁸ While the attorney general is still a necessary party to these enforcement actions, the AG’s office will no longer have exclusive jurisdiction to institute litigation against trustees for alleged failure to carry out the terms of a restricted trust.

Eternal Vigilance: The Price of Liberty

As the number of charitable organizations continues to grow and the issues surrounding the sector become more complex, the supervision,

administration, and enforcement of charitable trusts and nonprofit organizations by state charity officials will continue to be challenging for even the most experienced regulator. However, if the public’s trust and confidence in the nonprofit sector is to be sustained and charitable assets used as they are intended for the public benefit, state regulators must find new ways to meet this challenge.

New Hampshire’s first Director of Charitable Trusts summarized the importance of this duty as follows:

“One absolute need stands out—it is the need for a regular form of constant public supervision over the administration of charitable funds to the end that the community, the municipality, and charities in general might receive the fullest possible measure of social benefits intended by philanthropists for their fellow citizens.”⁹

Endnotes

1. The following states do not require registration: Idaho, Montana, Wyoming, Nevada, South Dakota, Nebraska, Texas, Iowa, Indiana, Vermont, and Hawaii. The Unified Registration Statement Multi-State Filer Project: www.multistatefiling.org/index.html#yes_states
2. Independent Sector Panel on the Nonprofit Sector. *A Final Report to Congress and the Nonprofit Sector*, June 2005.
3. See www.nasconet.org/Charleston%20Principles,%20Final.pdf
4. See http://ag.ca.gov/charities/publications/nonprofit_integrity_act_nov04.pdf
5. www.law.upenn.edu/bll/ulc/umoifa/feb2006draft.htm
6. www.law.upenn.edu/bll/ulc/uta/2005final.htm#TOC1_67
7. Ibid.
8. Ibid.
9. Attorney General Ernest R. D’Amour’s address to the National Association of Attorneys General, 1946.

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