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Jurisdictional Boundaries: State/Federal, State/State Relationships

Strange Silence: Attorneys General Reaction to The Internal Revenue Service's Corporate Governance Initiative

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INTRODUCTION

These are hard times for charities, and regulators at all levels are not making it easier for nonprofits to perform their missions. Recent regulatory efforts, most notably the Internal Revenue's "Corporate Governance Initiative" (CGI), have caused a diversion of board and staff energies from mission attainment and fundraising to a focus on formalism and process, which may have little to do with preventing fraud or even improving governance.[1]

This paper argues that the CGI not only is flawed but also represents an improper preemption of state law.[2] *I believe attorneys general should consider this misguided effort's impact on the charities in their state and serve as a buffer, by pushing back against the IRS's suggestions, and attempt to ease the burdens for smaller charities, which I arbitrarily define as organizations eligible to file Form 990–EZ and below.*[3] *The paper also urges attorneys general to exercise regulatory prudence by channeling their limited enforcement resources into scrutiny of larger charities and areas of common abuse–such as nonprofits established by sitting legislators and certain social services organizations where private inurement often exists – instead of facilitating an elaborate and expensive reporting system that affects most charities, innocent of such activities.*[4]

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[1] A similar trend has occurred in business corporate law with the development of independent committees, special counsel, special financial advisors in the development of information chains and procedures. It remains to make debatable whether these process reforms have been successful.

[2] In *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 Va. Tax Rev. 545 (2010), I wrote about the improper preemption of state law by the CGI from the perspective of constitutional and administrative law. The discussion of the corporate governance initiative is adapted and abridged from that article.

[3] This includes organizations with gross receipts of $200,000 and total assets less than $500,000.

[4] *See for example*, Colin Moynihan, *Monserrate Receives 2-Year Sentence for Misuse of City Funds*, N.Y. Times, Dec. 12, 2012 at A32 (Lawmaker directs $100,000 from nonprofit into campaign work); Benjamin Weiser, Aaron Edwards & Colin Moynihan, *Convicted of Fraud, Councilman Loses Seat*, N.Y. Times, July 27, 2012 at A18 (City Councilman convicted of corruption scheme to funnel hundreds of thousands in city money to relatives through

The financial crisis of 2008 has not ended for the charitable sector. Major organizations continue to suspend operations, go into bankruptcy or just disappear. In the past year such well known institutions have ceased operations as Hull House in Chicago. At the same time there have been increasing calls for additional regulation of charities in the name of "good corporate governance."

Charity boards should be focusing on mission attainment, strategic planning and fundraising. Instead, at the insistence of the Internal Revenue Service and other regulators, their energies and resources have been spent in implementing a flawed and empirically untested Corporate Governance Initiative, which creates significant burdens on organizations and their boards, utilizing human and financial resources that could be better devoted elsewhere.

Charity fraud has always existed and certainly does so today.[5] *It is a crime, and as with child abuse, no one, but no one is in favor of wrongdoing by charities. Such misdeeds not only limit and loot the affected organizations, but tarnish the halo of the whole sector. The amount of such fraud is unknown. In New York there are over 50,000 charitable organizations. How many suffer from or engage in wrongdoing? Probably very few. Let's also admit that no attorney general can marshal the resources to effectively monitor the governance of the charities in its jurisdiction. The basic assumption of the Corporate Governance Initiative is that all charities are suspect of wrongdoing, but if they follow the Service's advice, it will stop.*

One of the difficulties in this area is that regulators have so many responsibilities apart from oversight of nonprofits. Within attorneys general responsibilities for charities are several important roles. As the primary state regulator and monitor of the charities in a jurisdiction, it is likely attorneys general consider themselves primarily as regulators. They also should be educators of the charities in their jurisdiction, a role played admirably by a few states with active charity bureaus. Another important role, when appropriate, should be to serve as a buffer to and coordinator of federal efforts at oversight. What has been puzzling to me has been the strange silence of attorneys general in their unwillingness to challenge this flawed IRS initiative that has little grounding in law or in experience. Attorneys general have worn their regulatory hats, but when it comes to the CGI, they resile from a buffering role, which increases the burdens on charities and allows a federal agency to improperly preempt traditional state responsibilities.

I. THE TRADITIONAL LOCUS OF NONPROFIT GOVERNANCE: STATE NONPROFIT CORPORATE CODES AND REGULATIONS

Nonprofit corporations, the predominant exempt organizational form, are primarily creatures of state law. Nonprofit corporate law, as its for-profit analogue, is a kind of constitutional law in that its dominant function is to regulate the manner in which a nonprofit

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network of nonprofit organizations he controlled); Sam Dolnick, *Halfway houses Prove Lucrative to Those at Top*, N.Y. Times, Dec. 30, 2012 at A1 (Nonprofit New Jersey halfway house operator pays chief $7 million over past decade, daughter, brother-in-law and son-in-law receive more than $2.5 million).

[5] In *The Faithless Fiduciary* (2010) I traced charity fraud in the Anglo-American world back to the founding in 1132 by a grandson of William the Conqueror of the St. Cross Hospital in Winchester, England, an almshouse.

corporation is constituted, to define the relative rights and duties of those participating in the organization and to delimit the powers of the organization in relation to the external world.[6]

Modern nonprofit corporate statutes are enabling acts, which make it easy for individuals to organize and operate organizations whether large or small. Some corporate statutory requirements are mandatory.[7] Some sections require organizations in formation to obtain certain approvals from state officials before corporate existence can commence.[8] Many more sections of a nonprofit corporate code are supplementary or gap-fillers, meaning they apply if internal corporate documents fail to resolve a disagreement.[9] Corporate certificates of incorporation, or the bylaws or resolutions create other corporate rules that have been determined by the members or the governing body as appropriate for that particular organization.

Every corporate code includes some rules that are essentially needlepoint, in that they facilitate paper shuffling in the creation, registration and dissolution of corporations.[10] Other rules define the very nature of the nonprofit corporation. The non-distribution constraint, which prohibits the distribution of dividends, income or profit to members, directors or employees is one such rule.[11]

Beyond certain fundamental mandates, state nonprofit statutes do not prescribe specific corporate governance approaches. In most jurisdictions, nonprofit governance procedures are matters of internal organizational decision.[12] Nonprofit corporate statutes promote flexibility, so

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[6] Cf. Melvin Aron Eisenberg, The Structure of the Corporation 1 (1976). *See also*, James J. Fishman & Steven Schwarz Nonprofit Organizations: Cases and Materials 125-126 (4th ed. 2010).
[7] *See*, N.Y. Not-for-Profit Corp. L. § 405("after the corporate existence has begun, an organization meeting…shall be held…,") Model Nonprofit Corp. Act § 205(a) or "A corporation shall not have stock or shares certificates for stock or for shares.…" *Id.*at § 501; Model Nonprofit Corp. Act § 603.
[8] N.Y. Not-for-Profit Corp. L. § 404; Model Nonprofit Corp. Act § 1.20(a)(1) requires or permits filing in the office of the secretary of state.
[9] Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 Mich. L. Rev. 999, 1001 (1982). Thus, a quorum for a members' meeting is a majority of the total votes entitled to be cast, unless the organization selects a higher or lesser number. *See*, N.Y. Not-for-Profit Corp. L. § 608. A reduction in the quorum requirement is limited to not less than one hundred votes or one-tenth of the total number of votes entitled to be cast, whichever is lesser. *Id.* at § 608(b); Model Nonprofit Corp. Act § 7.26.
[10] Ellman, *supra* note 9 at 1002. These rules include the method by which the certificate is filed, agents for service of process are selected. *See,* N.Y. Not-for-Profit Corp. L. §§ 403, 305; Model Nonprofit Corp. Act § 1.20.
[11] *See*, N.Y. Not-for-Profit Corp. L. § 515(a) ("A corporation shall not pay dividends or distribute any part of its income or profit to its members, directors or officers."); Model Nonprofit Corp. Act § 6.40.
[12] New Hampshire offers the broadest prescriptions for governance structure. A charitable nonprofit corporation must have at least five voting members, who are not of the same immediate family or related by blood or marriage. No employee of a charitable nonprofit corporation shall hold the position of chairperson or presiding officer of the board. N.H. Rev. Stat. Ann. §292:6-a. Maine and California require a majority of a nonprofit corporation's directors be financially disinterested. Cal. Corp. Code § 5227; Me. Rev. Stat. Ann. Tit. 13-B, § 713-a(2). A few states have adopted certain Sarbanes-Oxley type provisions, typically the requirement of an audit committee if the organization reaches a certain level of revenues. *See,* Wash. Rev. Code. § 19.09.540. California requires charities with gross revenues of $2 million or more to prepare independent audits for and establish and maintain an audit committee. Cal. Gov't. Code §12586(e)(1), (e)(2). Executive compensation must be reviewed and approved by the governing board to ensure the payment is "just and reasonable." Cal. Gov't. Code § 12586(g); Model Nonprofit Corp. Act §§ 16.01, 16.20-21 requires keeping of corporate records, such as minutes of meetings and appropriate accounting records, but does not require an audited financial statement.

that differing organizations can have different structures, which are most useful and efficient for a particular activity.[13]

The approach of state corporate law to corporate governance is very different from that of the CGI. For example, with very few exceptions state nonprofit corporate codes do not require an organization to have a conflict of interest policy.[14] Nonprofit corporate statutes deal with interested transactions, but the focus is upon whom has the burden of proof to show the transaction was fair to the organization at the time it was entered into.[15] Under state law, whether an organization adopts a conflict of interest policy is within the discretion and judgment of the board. State regulators' primary concerns have been in the areas of charitable solicitation, fraud, and breach of fiduciary duties.

II. THE CORPORATE GOVERNANCE INITIATIVE

The Internal Revenue Service's Corporate Governance Initiative proceeds from a different vantage point, the assumption its recommendations will assist tax compliance and improve the governance and fiduciary behavior of nonprofits and their boards.

The Service has five points of contact with exempt organizations: 1) creating standards for exemption; 2) determining exemption; 3) examining of exempt organizations or in other compliance initiatives; 4) in Form 990 reporting of annual activities and finances; and 5) education and outreach activities.[16] In each of these areas the Service has introduced corporate governance overtones and standards.

A. Corporate Governance Questions in the Application for Tax exemption under I.R.C. §501(c)(3).

Form 1023 was revised extensively in 2004 and now includes questions about the applicant's adherence to "best practices," which are identified by the Service as conflicts of interest and compensation policies.[17] These are "recommended" but not officially required to

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[13] In Ellman's words: "…a corporate code [is] a means by which to facilitate activity…Even though it may have a number of mandatory rules, therefore, the corporation code is not regulatory in its essential purpose. Instead, we use the code to create a legal structure that is useful as a vehicle for a particular type of legitimate activity…[E]very group of individuals pursuing a lawful activity should be able to find a form of organization that meets its needs: an organization whose defining rules fit the group's *raison d'etre,* whose gap-filling rules tend to meet the participants' expectations, and whose value-based rules help to protect both the participants and third parties from abuses of the organizational form." Ellman, *supra* note 9 at 1004.

[14] Arizona requires a nonprofit corporation to have a conflict of interest policy. Ariz. Rev. Stat. §10-3864. A few jurisdictions require health care organizations to or other specialized organizations to have conflict of interest policies. *See*, Ark. C. §20-46-304 (Community health centers); R.I § 27-19.2-4 (nonprofit hospitals in accord with IRS guidelines); Ct. Gen. Stat. §36A-454b (Credit Unions).

[15] Cal. Corp. Code § 5233; N.Y. Not-for-Profit Corp. L. § 715; Model Nonprofit Corp. Act § 8.60.

[16] Advisory Committee on Tax Exempt and Government Entities, *The Appropriate Role of the Internal Revenue Service With Respect to Tax exempt Organization Good Governance Issues* 29 (June 11, 2008) available at 2008 T.N.T. 114-24.

[17] The pre-2004 version of Form 1023, revised in September 1998, had general questions about the organization's governing body, its charitable activities and sources of funding.

obtain exemption**,** but it would be a reckless charity to ignore the Service's suggestions.[18] None of these recommendations are generally required under state law. Nor has Congress mandated the adoption of specific governance practices as a condition of tax exemption. However, governance issues have appeared in IRS rulings in the healthcare area and as a condition for exemption of healthcare organizations, because of their substantial regulation by federal and state authorities. Governance standards also have been required for approval of tax exempt credit counseling agencies, organizations frequently found to engage in abusive practices. There have been denials of recognition of exemption of other organizations, based on faulty governance structures.

The question is not whether good governance is desirable. Of course it is. But, has the IRS identified appropriate indicators of that behavior, and does the Service have the authority and expertise to demand such steps as it recommends? The instructions to Form 1023 explain that though a conflict of interest policy is recommended but not required "by adopting the sample policy or a similar policy, you will be choosing to put in place procedures that will help you avoid the possibility that those in position of authority over you may receive an inappropriate benefit." [19] There is no empirical data that validates this statement. The Service's comment that the conflict of interest policy is recommended is countered by the unspoken implication that if the organization does not have one, it will become victim to or subject to interested inappropriate insider transactions. There is also the implication that when the exemption application is reviewed, the Service will take a negative view of the policy's absence. In fact, the Service has denied applications for exemption based on the corporate governance structure of organizations that did not follow its "recommendations.[20]

B. Corporate Governance Questions in the Form 990 Annual Information Return.

The revised Form 990 Annual Information Return, effective beginning with the 2008 fiscal year, contains many questions concerning corporate governance issues. Some derive from Congressional legislation, such as that which added Section 4958 to the Internal Revenue Code, the so-called Intermediate Sanctions legislation.[21] Those questions dealing with potential of

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[18] Two areas relating to public charities where Congress has required certain corporate governance practices is with excess benefit transactions under I.R.C. § 4958) and mandating the public availability of Forms 1023 and 990. This is in marked contrast to the strict confidentiality relating to other tax return information. Advisory Committee *supra* note ,16 at 29-30.

[19] Instructions for Form 1023, Part V, question 5a, p. 9. Question 5a deals with whether the organization has adopted a conflict of interest policy consistent with the sample IRS conflict of interest policy in Appendix A of the instructions. If the answer is no, then there are two follow-up questions that force the applicant to go back to--what else, but a conflict of interest policy. What procedures will you follow to assure that the person who has a conflict of interest will not have influence over you for setting their own compensation and what procedures will you follow to assure that persons who have a conflict will not have influence over you regarding business transactions. Questions 5b and 5c.

[20] Many of the denials are listed in *Stealth Preemption, supra* note at 562-563.

[21] *See,* I.R.C. § 4958, which introduced excise taxes for excess compensation and other private inurement. § 4958(c)(1); Treas. Reg. § 59.4958-4(a)(1),(2). This section creates a framework for penalizing transactions characterized as excess benefits to insiders. An "excess benefit transaction" is any transaction in which an economic benefit is provided by an exempt organization directly or indirectly to or for the use of any person in a position to exercise substantial influence over the organization, if the value of the benefit exceeds the value of consideration received by the organization for providing the benefit. I.R.C. § 4958(c)(1); Treas. Reg. § 59.4958-4(a)(1),(2). Examples of excess benefit transactions are unreasonable compensation or below market loans to an organization's

excess benefit transactions under I.R.C. § 4958 relate directly to tax compliance and are appropriate.

The Service also has made several pronouncements on the participation of charities in joint ventures, and the Form 990 has questions that reflect corporate governance concerns and relate to the compatibility of joint ventures between nonprofit and for-profit entities.[22] The questions assist the Service in assuring that Congressional intentions are achieved and assist enforcement, and are reasonable efforts to ensure compliance with the Internal Revenue Code. Whether or not the legislation has achieved its goals, Congress has spoken, and the questions relating to compensation are within the Service's authority.

Other questions, more attenuated to tax law compliance, place new and undefined burdens on organizations. They concern the independence of directors, conflicts of interest, disclosure policies, related party transactions and general issues of corporate governance that have little relationship to tax law compliance. These questions diverge from the approach of state corporate law, which offers an organizational flexibility the Service seems not to recognize.

1. *Conflicts of Interests/ Transactions with Interested Persons*

Revised Form 990 creates the concept of "interested person," which has several meanings, depending on the context in which transaction takes place. Transactions with interested persons must be become part of the process of informing the appropriate organizational authority of conflicts of interest.[23] Such transactions include business transactions with interested persons, [24] loans to or from interested persons, and grants or other assistance provided to interested persons. The meanings are complicated and detailed.[25] Relationships between directors, trustees, officers and key employees must be disclosed.[26]

The Form 990 and instructions imply that conflicts of interest are substantively wrong. The Service does not recognize that under state law conflicts of interest are matters of procedure, relating to the burden of proof for showing whether the interested transaction was fair or not. So long as the fact of a conflict of interest and the material terms of the interested transaction are

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executives. The "Intermediate Sanctions" name refers to the intermediate penalty of an excise tax on the insider, who receives an excess benefit for the organization's executives. Prior to the legislation, all the Service could do was to revoke the charity's exemption, a penalty so draconian that it was rarely invoked. The intermediate sanction is an excise tax on the insider, who received the excessive benefit and the organization's executives who authorized it. The law of unintended consequences applies to the requirements of I.R.C. § 4958 that organizations determine comparable salaries of individuals in other organizations of their size, when determining compensation. This has placed *upward* pressures on nonprofit salaries.

[22] *See*, Rev. Rul. 98-15, 1998-1Cum. Bull. 718; Rev. Rul. 2004-51, 2004-22 I.R.B. 974; St. David's Health Care System v. U.S. 349 F.3d (5th Cir. 2003). The Joint venture question asks whether the organization invested in, contributed assets to, or participated in a joint venture or similar arrangement with a taxable entity during the year; and, if yes, whether the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements. Form 990, Part VI, questions 16a, 16b.

[23] Conflicts should be listed on Schedule L.

[24] Business transactions include but are not limited to contracts of sale, lease, license, and performance of services, whether initiated during the organization's tax year or ongoing from a prior year. Business transactions also include joint ventures, whether new or ongoing, in which the profits or capital interest of the organization and the interested person each exceeds 10%. Form 990 Instructions, Glossary.

[25] There are differing requirements for organizations that file the Form 990–EZ. Listing of interested transactions provides increased transparency to the financial workings of the organization.

[26] Form 990, Part VI, Question 2.

disclosed, and the transaction is fair to the nonprofit at the time it is entered into, a conflict of interest is not a wrong as the IRS's approach and language implies.

Obviously, in light of the IRS's focus at the application for exemption stage, in the Form 990 and as a primary focus during examinations, an organization must have a conflicts of interest policy. For smaller organizations with limited resources, interested transactions may be a necessity. They may be the only way to gain access to sources of credit, services or assistance.[27] As a result of the implications in IRS publications, many organizations to their detriment will be reluctant to engage in a perceived conflict of interest, because prospective donors, who view the Form 990 and see lists of interested transactions will have an unfavorable reaction. It is important for attorneys general to educate charities and the public that not all conflicts are bad, that there is nothing wrong with such transactions if they benefit the organization, there is disclosure and the transaction is fair to the corporation.

2. Independence of Directors

Revised Form 990 introduced the category of "independent" voting members, directors or trustees.[28] There are three tests of independence: 1) the member was not compensated as an officer or other employee of the organization or of a related organization; 2) the member did not receive total compensation or other payments exceeding $10,000 during the organization's tax year from the organization or from related organizations as an independent contractor, other than reimbursement of expenses under an accountable plan or reasonable compensation for services provided in the capacity as a member of the governing body; and 3) neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported on the Form 990 for the organization's tax year.[29] Donors, no matter how much they contribute are considered independent.

Though the Service does not explain why an independent board is important or require a specific number of directors to fit in that category, in an educational outreach publication,

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[27] According to the Urban Institute which sponsored the most extensive survey of nonprofit governance, there are substantial interested transactions between board members and organizations. Perhaps most surprisingly, larger organizations, those with more than $10 million in annual expenses were more likely to engage in interested transactions. The survey reported that a majority obtained goods or services at below market cost. Francie Ostrower, Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study, 8 (The Urban Institute 2007) available at http://www.urban.org/UploadedPDF/411479_ Nonprofit_ Governance.pdf. Among organizations that did not engage in transactions with board members 75% said they did not have a conflicts disclosure policy. Undoubtedly, that figure has changed in light of the CGI, but it suggests such a policy may not really be needed.

[28] *Id*. at Question 1b.

[29] It would be reported on Schedule L. A member of the governing body is not considered to lack independence merely because of the following circumstances: 1) the member is a donor to the organization, regardless of the amount of the contribution; 2) the member has taken a bona fide vow of poverty and either (A) receives compensation as an agent of a religious order or a 501(d) religious or apostolic organization, but only under circumstances in which the member does not receive taxable income (see, e.g., Rev. Ruls.77-290, 80-332); or (B) belongs to a religious order that receives sponsorship or payments from the organization which do not constitute taxable income to the member (the "religious exception" referred to above); or 3. the member receives financial benefits from the organization solely in the capacity of being a member of the charitable or other class served by the organization in the exercise of its exempt function, such as being a member of a section 501(c)(6) organization, so long as the financial benefits comply with the organization's terms. Form 990 Instructions, Part VI. Outside counsel may not in some circumstances qualify for consideration as an independent director.

"Governance and Related Topics- 501(c)(3) Organizations," it suggested that a non-independent board wouldn't represent the public interest and would increase the likelihood for insider transactions. The statement does not explain why independence will cure that and whether independent boards have shown more probity.[30]

Under state corporate law, the independence of a majority of nonprofit board members has been required in very few jurisdictions.[31] Professor Dana Brakman Reiser, who is participating in this conference, has questioned the usefulness of the concept of independence in the nonprofit context given the broader goals of improving nonprofit governance and strengthening the nonprofit sector.[32] Interested directors may be the most committed to the organization's goals. Many medium and smaller nonprofits have extreme difficulty in recruiting board members. It may be that interested, non-independent directors are the only source. In the for-profit sector, independence of some board directors has been required by the stock exchanges,[33] and for audit committees under Sarbanes-Oxley.[34] However, the validity of the benefits of board independence in the for-profit context is questionable at best. Empirical studies have shown little correlation between board independence and increase in firm value.[35] I am aware of no empirical studies relating to the impact of good nonprofit governance on mission outcome. One can only conclude that the Service's push for board independence, as with so much of its corporate governance initiative, represents wishful thinking.

3. Documentation Run Amok

Many nonprofit organizations are more informal in adherence to procedures than their for-profit counterparts.[36] This results from inadequate staff resources or a lack of in-house or permanent outside counsel. The Service favors a more bureaucratic approach. It requires contemporaneous documentation of meetings, not only of the board--standard procedure for all

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[30] http://www.irs.gov/pub/irs-tege/governance_practices.pdf. The publication states: "Irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships. The Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets. The Internal Revenue Service also reviews whether an organization has independent members, stockholders, or other persons with the authority to elect members of the board or approve or reject board decisions, and whether the organization has delegated control or key management authority to a management company or other persons." *Id.* Independent boards have been a focus of importance to the Service in the healthcare area and a requirement for § 501(c)(3) exemption for credit counseling organizations, I.R.C. § 501(q)(1). Both have been a source of abusive practices and Congressional concern.

[31] *See*, Cal. Corp. Code § 5227(a); Me. Rev. Stat. Ann. Tit 13-B, § 713-A(2); N.H. Rev. Stat. § 292:6-a; N.D. Cent. Code § 10-33-27(2); Vt. Stat. Ann. Tit. 11B, § 8.13(a).

[32] Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 Ford. L. Rev. 795, 797-798 (2008). Professor Brakman Reiser also concludes that director independence makes a relatively limited contribution in addressing real accountability issues facing nonprofit organizations. *Id.* at 832.

[33] *See*, N.Y. Stock Exchange Listed Co. Manual ¶¶ 303A.01-07.

[34] Sarbanes-Oxley Act of 2002, § 301;15 U.SC.A. § 7201 et seq.

[35] Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance* 27 J. Corp. L. 231 (2002); Kathleen M. Boozang , *Does An Independent Board Improve Nonprofit Corporate Governance?*, 75 Tenn. L. Rev. 83 (2007). Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for the Policymakers Too*, 22 Ga. St. U. L. Rev. 521 (2005); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2005).

[36] This is outside of hospitals, universities and major cultural and social services organizations.

organizations--but also of committees authorized to act on behalf of the governing body.[37] Such documentation may be common practice for larger nonprofits. Smaller organizations often conduct committee meetings informally. It can become a burdensome commitment of staff time to take and prepare minutes of all actions taken, particularly at the committee level.

4. Document Retention and Destruction Policy

Another question inquires whether the organization has a written document retention and destruction policy.[38] Presumably, this is derived from the Sarbanes-Oxley legislation that makes it a crime to alter, cover up, falsify or destroy any document or prevent its use in a federal investigation or bankruptcy proceeding.[39]

There is nothing in state law that requires an organization to have a retention or destruction policy, though statutes require organizations to prepare and produce documents.[40] Best practices and the ease of storage of digitalized documents encourage the implementation of such a policy. An organization should retain essential governance documents, business records, minutes, financial reports and items related to tax exempt status, but why this is a concern of the Service is mystifying. The Form 990 is a matter of public record, and presumably a permanent record.

5. Board Review of Form 990

Another question, with no grounding in federal tax or state nonprofit law, asks about the board's *process* [emphasis added], if any, it uses to review the Form 990.[41] If no review was conducted, the organization must so state.[42] This question seems derived from section 906 of

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[37] Form 990, Part VI, Question 8. Documentation of meetings and actions. Answer "Yes" to lines 8a and 8b if the organization contemporaneously documented by any means permitted by state law every meeting held and written action taken during the organization's tax year by its governing body and committees with authority to act on behalf of the governing body (which ordinarily do not include advisory boards). Documentation permitted by state law may include approved minutes, strings of e-mails, or similar writings that explain the action taken, when it was taken, and who made the decision. This requirement does not include advisory bodies. For this purpose, contemporaneous means by the later of (1) the next meeting of the governing body or committee (e.g., approving the minutes of the prior meeting), or (2) 60 days after the date of the meeting or written action. If "No," explain in Schedule O the organization's practices or policies, if any, regarding documentation of meetings and written actions of its governing body and committees with authority to act on its behalf. Presumably, this would include executive committees, which generally act for the board between meetings of the full board.

[38] Form 990, Part VI, line 14.

[39] *See* Sarbanes-Oxley Act of 2002 § 802(a), 18 U.S.C. § 1519-20 (Supp. II 2002) (imposing criminal sanctions for altering or destroying documents in federal investigations *See, infra* for a discussion of Sarbanes-Oxley and nonprofits. While that section of the federal statute deals with organizations under federal investigation, the Service has adapted it to encourage a document retention policy. Such policies identify the record retention responsibilities of staff, board members or outsiders, such as accountants and counsel, for maintaining and documenting the storage and destruction of an organization's documents and records.

[40] *See,* N.Y. N-PCL §§ 519 (annual report of directors), 520 (reports of corporation).Model Nonprofit Corp. Act. § 16.01. The Model act requires a nonprofit corporation to keep as permanent records, minutes of all meetings of its members, board of directors and a record of all actions taken by committee. The Act does not require minutes of committee deliberations. A nonprofit corporation must maintain appropriate accounting records.

[41] Form 990, Part VI, line 10. "Governing Board Review of Form 990."

[42] The organization is asked to respond 'yes' only if a copy of the organization's final Form 990, including required schedules, as ultimately filed with the IRS, was provided to each voting member of the governing body of the organization, whether in paper or electronic form, prior to its filing with the IRS. The organization must also describe in Schedule O the process, if any, by which any of the organization's officers, directors, trustees, board committee members, or management reviewed the prepared Form 990, whether before or after it was filed with the

Sarbanes-Oxley, which requires the chief executive officer and chief financial officer of public companies to certify financial reports.

The Form 990 is a complicated and time-consuming document to understand, let alone review. To expect board members to become familiar with the intricacies of the form creates a real burden on directors and consumes their valuable time that could be otherwise expended in more worthwhile activities, such as fundraising and strategic planning. One of the consequences of this initiative will be to increased the already difficult burden of finding board members willing to serve.[43]

6. Whistleblower Policies.

A whistleblower policy encourages staff and volunteers to feel free to come forward with good faith credible information about illegal practices or violations of adopted organizational policies and assures that the organization will protect the individual from retaliation. The policy is supposed to identify those staff or board members or outside parties to whom such information can be reported.[44] For a large nonprofit, a hospital or university, that policy makes sense. In a smaller organization where there are few staff, the reality is that a good faith effort which is incorrect may make it impossible for the individual to continue and the organization's dynamics to work as it should.[45]

C. The Specter of Sarbanes-Oxley (SOX)

In the aftermath of the collapses of Enron, Worldcom and Arthur Andersen, Congress passed the American Competitiveness and Corporate Accountability Act of 2002, known as the Sarbanes-Oxley Act ("SOX").[46] One of the strangest reactions to the pressures for nonprofit

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IRS, including specifics regarding who conducted the review, when they conducted it, and the extent of any such review. If no review was conducted, the organization must so state. The instructions give the following example, which seems to put organizations that don't have a substantial board process at a disadvantage: "The return preparer e-mails a copy of the final version of the Form 990 to each board member before it was filed. However, no board member undertakes any review of the form either before or after filing. Because a copy of the final version of the return was provided to each voting member of the organization's governing body before it was filed, the organization may answer "Yes" even though no review took place. The organization must describe its Form 990 review process (or lack thereof) in Schedule O.

[43] The 2007 study by the Urban Institute found that 70% of nonprofits surveyed stated it was difficult to find board members; 20% said it was very difficult. Ostrower, *supra* note 27 at 16.

[44] Instructions for Form 990 Part VI Governance, Management, and Disclosure, Line 13 and 14. Whistleblower and document retention policies.

[45] *Cf*.Bohatch v. Butler & Binion, 977 S.W.2d 543, 548 (Texas 1998),[Justice Hecht, concurring: "I have no trouble justifying a 500-partner firm's expulsion of a partner for reporting overbilling of a client that saves the firm not only from ethical complaints but from liability to the client. But I cannot see how a five-partner firm can legitimately survive one partner's accusations that another is unethical. Between two such extreme examples I see a lot of ground."].

[46] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). The legislation *inter alia* requires corporate boards to have audit committees consisting of independent directors, mandates the creation of effective financial reporting systems, and requires chief executives and chief financial officers of publicly listed companies to personally certify the validity of their corporation's financial statements and that they validly represent the financial condition of the company.

accountability has been the willingness of many charities to embrace Sarbanes-Oxley reforms voluntarily as a statement of improved governance, transparency and accountability.[47]

It is ironic that SOX has such an influence on the nonprofit sector, for it primarily applies only to the one half of one percent of all for-profit corporations that are publicly listed. The statute generally does not apply to nonprofits, nor was it intended for application to the nonprofit sector. As Senator Paul Sarbanes, the cosponsor of the legislation commented, Sarbanes-Oxley "was not designed for non-profits, and the two worlds are clearly different."[48]

SOX has come under substantial criticism for its cost of implementation as well as its underlying assumptions, whose validity have been questioned.[49] A very few jurisdictions, most notably California, have enacted legislation with SOX-type requirements for nonprofits,[50] and the Panel on the Independent Sector's project on Principles for Good Governance and Ethical Practice has incorporated some SOX-type recommendations.[51]

The nonprofit sector is far more structurally diverse than the for-profit organizations to whom SOX applies. For the business corporation, financial performance and protection of investors is of primary importance. The primary goal of charitable organizations is fulfillment of mission, a very different function. The Service's Corporate Governance Initiative seems not to realize this difference. The Urban Institute Study urges caution before adopting practices from other sectors–wise advice.[52]

The CGI's "recommendations" are expensive for organizations to introduce, and as the Service admits, are not required by the Internal Revenue Code. Because the Service's initiative is couched in the guise of questions on the Form 990 that must be answered and will be observed by the public, an organization is virtually required to answer in the way the Service suggests. These questions diverge from the approach of state corporate law, which offers an organizational flexibility the Service seems not to recognize.

The structure of the questions creates a catch twenty-two. It is the tax form equivalent of "have you stopped beating your wife?" If the organization says "no" to one of the practices or policies the Service recommends, it better have a good reason because that response also become

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[47] Almost half of nonprofit organizations responding to a survey said they made changes in their operations as a result of SOX. Grant Williams, *Accountability Law Spurs Charities to Make Changes,* Chron. Phil. Nov. 24, 2004 available at http://philanthropy.com/premium/articles/v17/i04/04002905.htm. *See*, Drexel University, Drexel Trustees Adopt the Sarbanes-Oxley Act on Governance and Auditing Practices, Feb. 26, 2003 Press Release *available at* http://www/drexel.edu/dateline/default.pl.

[48] Senator Paul S. Sarbanes, *Sarbanes-Oxley and Ethical Principles of Corporate Behavior*, Address at Drexel University's Bennett S. Lebow College of Business Lecture Series, *available at* http:// www.lebow.drexel.edu/events/sarbanes/sarbanesspeech.pdf (May 14, 2004) *cited in* Carl Oxholm III, *Sarbanes-Oxley in Higher Education: Bringing Corporate America's "Best Practices" to Academia*, 31 Journal of College and University Law, 351, 360 (2005). Two sections of SOX theoretically could apply to a nonprofit organization as they are amendments to the federal criminal code, one concerns document destruction in the course of a federal investigation. *See* Sarbanes-Oxley Act of 2002 § 802(a), 18 U.S.C. § 1519-20 (Supp. II 2002) (imposing criminal sanctions for altering or destroying documents in federal investigations); *id.* § 1102, 18 U.S.C. § 1512(c) (Supp. II 2002). The other prohibits retaliation against whistleblowers that report federal offenses. *Id. at* 1513(e). For most nonprofits, the danger of violating these provisions is minimal.

[49] Clark, *supra* note 35 and Romano, *supra* note 35.

[50] California Nonprofit Integrity Act of 2004, Cal. Govt. Code § 12586.

[51] Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations, Appendix 5. Board Source & Independent Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, 2003.

[52] Ostrower, *supra* note 27 at 22.

publically available information on Schedule 0. The organization that does not yield to the IRS view of good corporate governance is asking for trouble. One can only wonder what prospective donors, who view the Form 990, will think of positive answers to some of these questions and negative responses to others.

III. DISCLOSURE TO THE PUBLIC

In marked contrast to the confidentiality of other tax documents, Congress, in a continuing effort to make exempt organizations more accountable, has enacted and expanded a variety of public disclosure and inspection requirements that apply to both the Internal Revenue Service and the organization.[53] Most importantly, the annual information returns are available over the Internet.[54]

As the law requires organizations provide public access to certain documents, a question in the Form 990 inquiring whether and how documents that the Code requires public disclosure are made available to the general public is appropriate.[55] However, another question that asks the organization to describe in Schedule O whether (and if so, how), the organization makes its governing documents, conflict of interest policy, and financial statements available to the public is not.[56] Neither federal tax law nor most state nonprofit laws require such documents be made publicly available, unless they are included in a form that is publicly available. This erodes the idea that charities are private organizations and possess any rights of privacy.[57]

Because it is publicly available over the Internet, the Form 990 is a charity's most important document. It has become an organization's window onto the world, and the world's window into the organization. The transparency forced by the Form 990 may mislead the public. If an organization fails to follow the Service's template or has no independent directors or engages in interested transactions, it may indicate to laypeople that there is something suspicious or improper about the charity.

Surprisingly, many more organizations file the full Form 990, than is necessary. When the revised Form 990 was first filed in 2009 for the 2008 fiscal year, an IRS official stated approximately 66 percent of tax-exempt organizations that filed the redesigned Form 990, could have filed the Form 990–EZ. By contrast, for the 2007 tax year, 20 percent of exempt organization filers filed a Form 990 when they could have filed the old Form 990–EZ.[58] In the

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[53] *See,* Fishman & Schwarz, *supra* note 6, at 573-576. The Service must make available for public inspection at the National Office and the appropriate field offices Forms 990 and approved applications for exemption. I.R.C. § 6104(a)(1)(A), (b). Trade secrets and information that would adversely affect national defense are exempt from disclosure, as is the schedule of major contributors that is required as an attachment to the Form 990. I.R.C. § 6104(a)(1)(D),(b). All organizations exempt from tax under § 501(c) or § 501(d) must make available for inspection their application for exemption, along with all supporting documents, and their annual informational returns for the most recent three years.

[54] *See,* http//www.Guidestar. org.

[55] Form 990, Part VI, question 18.

[56] *Id.* at question 19.

[57] *See* generally Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy?* 85 Chi-Kent L. Rev. 571 (2010).

[58] Simon Brown, - *Most Eos That Filed The New Form 990 Could Have Filed The 990–EZ, Says IRS Official*, 64 Exempt Org. Tax Rev. 570 (2009). Seventy percent of the redesigned Forms 990 that were filed were completed by

Fall 2012 Statistics of Income Bulletin, there was an increase of Form 990 filings from fiscal 2008 to fiscal 2009 of 9.1%. In contrast the number of Form 990–EZ filings fell by 4.8%.[59] This is the reverse of what one might expect.

I believe there are at least three reasons for the increase in percentage of Form 990 filings by organizations that could have filed the 990–EZ. Charities feel that if they file the full Form 990, donors and the IRS will think better of them, sort of a Kosher or Halal seal of approval. Second and perhaps most important, states that accept the Form 990 for satisfaction of filing of a financial return may not accept the Form 990–EZ. Third, accountants push the filing of the 990 as it is more complex (and lucrative) to prepare than the 990–EZ.[60]

Here is an area where attorneys general could provide a real service to charities by forcefully encouraging them to file within their appropriate category. One solution to this issue would be to exempt some of the corporate governance reporting from public availability, while requiring the charity to complete the current form. Regulators can do what they will with the information filed, but it will no longer mislead the public and unfairly prejudice the organization.[61] There is precedent for this approach as the schedule of major contributors that is required as an attachment to the Form 990 is exempt from public disclosure.[62]

IV. THE IMPACT OF THE CORPORATE GOVERNANCE INITIATIVE

The Corporate Governance Initiative preempts state sources of nonprofit corporate law, eroding a traditional area of state interest, expertise, and control. This occurs not as a result of Congressional legislation, agency regulation, court decision, or federal agency statements, but through formal and informal pronouncements that have the effect of superseding state laws and practices. The CGI supersedes the proper role and responsibility of charities' governing bodies to choose the governance practices and policies most appropriate to that organization given its size, purposes and expertise.

It also hinders and undermines states' roles as laboratories of innovation introducing new social, economic and legal experiments.[63] State approaches to nonprofit corporate law differ

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paid information return preparers and 57 percent of the Forms 990–EZ filed were completed by paid return preparers.

[59] Paul Arnsberger, Nonprofit Charitable Organizations 2009, 32 SOI Bulletin 169-171 (Fall 2012), available at http://www.irs.gov/uac/SOI-Tax-Stats-Fall-Bulletin-2012. . In 2008, 148, 821 form 990s were filed; in 2009 162, 421. In 2008 166,363 Form 990–EZs were filed; in 2009, 158, 370. In 2009 as part of the phase in of the new forms, the maximum gross receipts were less than $200,000 and the total assets had to be below $1.25 million.

[60] As of November 15, 2008, 70 percent of the redesigned Forms 990 that were filed were completed by paid information return preparers and 57 percent of the Forms 990–EZ filed were completed by paid return preparers. Brown, *supra* note 60.

[61] *See,* Evelyn Brody, *Sunshine and Shadows on Charity Governance as a Regulatory Tool*, 12 Fla. Tax Rev. 183, 189 (2012).

[62] I.R.C. § 6104(a)(1)(D),(b).

[63] New State ice Co. v. Liebmann, 285 U.S. 262, 311 (1932)(Brandeis,J., *dissenting*) ("There must be power in the states and the nation to remold, through experimentation, our economic practices and institutions to meet changing social and economic needs… It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

substantially.[64] Under state nonprofit law organizations have a wide range of permissible and suitable governance practices to choose from. In contrast the CGI suggests a one size fits all approach which constricts an organization's freedom to create the structure that best meets its needs. The IRS recommendations are not default rules, which organizations can supersede if they think another rule is more favorable. They replace state rules and practices. If these rules, mandatory in all but name, are flawed and burdensome, the organization and its beneficiaries lose.[65]

Though the Service suggests its governance principles are only recommendations, underneath those mild words lurks the inference of command. The Service's power and the fear it engenders make its recommendations prescriptive. Charities are under enormous pressure to comply. These governance issues are present at every stage of a charity's life cycle: formation, recognition of exemption, the auditing process and filing annual information returns. Failure to follow the IRS's recommendations may antagonize the Service, state charity officials, donors, charity rating agencies, or just plain gadflies.

Officers and board members of nonprofits have been misled into adopting procedures and policies that provide no aid to the organization or to regulators. A responsible board is in the best position to determine what should be good governance for a particular organization. The Corporate Governance Initiative places unnecessary burdens and expenses on charities. It reflects an unwarranted belief in the benefits that transparency and increased disclosure bring. One should not forget that disclosure comes with a cost to comply borne by the organization. Every additional cost in time and money diverts the organization's human and financial resources away from achieving its charitable mission.[66]

The Service's bureaucratic focus is on meetings, minutes, discussions of policy and documentation, which conflicts with the mission driven activities that so enrich our diverse nonprofit sector. This burden may be a mere cost of business for larger organizations—hospitals, educational institutions or major social services organizations, but for many nonprofits the time to complete the form and to design and actually implement the policies contained consumes substantial financial resources as well as time better spent on charitable activities.

V. ATTORNEYS GENERAL AND THE CORPORATE GOVERNANCE INITIATIVE: RECOMMENDATIONS

[64] *Compare*, Cal. Corp. Code § 5233 *with* N.Y. Not-for-Profit Corp. L. §715. (Interested transactions); Cal. Corp. Code §§ 5111, 7111, 9111; Ill. Comp. Stat. ch. 805, § 105/103.5; N.Y. Not-for-Profit Corp. L. § 201 (classification of nonprofit corporations). A few jurisdictions have introduced a new form of eleemosynary organization, the low profit limited liability company (L3C), that may become an attractive alternative form of nonprofit organization.

[65] A similar argument has been made by Judge Easterbrook concerning federal regulation of corporate governance of public corporations. *Cf.* Frank Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 Va. L. Rev. 685, 692-698 (2009).

[66] Dana Brakman Reiser, *There Ought to be a Law*, 80 Chi.-Kent L.Rev. 559, 596-597 (2005). Under the IRS's own estimates, the time needed to gather information and to prepare the form requires weeks, and the estimate seems to assume than an individual will complete it. *See*, Instructions for Form 990 Return of Organization Exempt from Income Tax 40 (2009).

The CGI has been assisted by the silence of state charity officials. In contrast to the aggressive defense of state interests in environmental, products liability and other issues, states' attorneys general and charity officials have been quiescent about this federal incursion. Attorneys general are in a peculiar position. Historically, there was little cooperation between state and federal charity regulators. The Service zealously protected the confidentiality of documents entrusted to it, and federal tax law imposed strict limits on what the Service could disclose about charities to state regulators.

This changed with the passage of The Pension Protection Act of 2006, which enabled increased cooperation and disclosure between state charity regulators and the Service.[67] Does this explain the reluctance to criticize the Service? Can one expect attorneys general to bite the hand that feeds them evidence? That seems a too simplistic and cynical explanation. It may be that attorneys generals have not really focused on the issues raised herein.

Attorneys general should recognize the administrative burdens on charities presented by the CGI and conduct a serious cost/benefit analysis of the value of these governance mandates and the probability that fraud will be prevented by their implementation. Even if the CGI's template reduces some fraudulent activity, the charitable sector is too diverse to warrant one approach.

Basically I am recommending that attorneys general remember their responsibilities ancillary to enforcement, education as well as well as the preservation of their jurisdiction's approach in structuring and regulating nonprofit entities. From an educational point of view they should inform charities and the public of the differences between appropriate and inappropriate conflicts of interest. Almost all fiduciaries of charities are honest and want to do what is right. Attorneys general have more than enough to do by focusing on the larger organizations in areas where fraud and misdealing are common.

If organizations do not reach the 990 level, they need not have the same governance complexity of larger ones. Attorneys general should urge organizations that are eligible to file the Form 990–EZ to do so, and encourage their states to accept that form as a recognized financial report. Until there is some empirical verification that the principles and recommendations of the CGI actually improve corporate governance, they should resist the governance suggestions for charities eligible to file the 990–E Z.

Forms 990 and 1023 are under periodic review by the Service, and attorneys general should become the leading voice in that discussion. Attorneys general should encourage differing levels of governance complexity.

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[67] P.L. 109-280 (2006), *adding* I.R.C. § 6103(p)(4). This section provides that upon written request by an appropriate state officer, the secretary of the Treasury may disclose : a notice of a proposed refusal to recognize or a notice of a proposed revocation of tax exemption of a § 501(c)(3) organization; the issuance of a proposed deficiency of tax imposed under I.R.C. § 507 or the names, addresses, and taxpayer identification numbers of organizations that have applied for § 501(c)(3) recognition; and returns and return information disclosed by in the process of seeking or losing exemption. This disclosure may be used in civil administrative and civil judicial proceedings pertaining to the administration of state laws regulating tax exempt status, charitable trusts, charitable solicitation and fraud. There are limitations on use of this information and penalties for unauthorized use. *See*, Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006*, 328-329 (JCX-38-06, August 3, 2006). The legislation enables state regulators to request tax information to enable them to prosecute wrongdoing, without a resource consumptive initial investigation.

The Advisory Committee on Tax Exempt and Government Entities, hardly a group hostile to the Service, rightly notes "Effective governance likely is much more a question of attitude of responsibility of those in charge than adoption of specific policies and practices."[68] The governance recommendations are not in Service's area of expertise. Nor is there any empirical validation that they will improve tax compliance. Attorneys general can best instill that attitude of responsibility through education.

Marion Fremont-Smith, a former assistant attorney general and participant in this conference and a wise and experienced observer of the nonprofit sector, has commented: "We have anecdotes of what fails, but no evidence of what works."[69] Attorneys general can assist in minimizing some aspects of the CGI, and serve as the most important voice in convincing the Service to lessen its impact on some of the charities affected by it.

The fact remains that in a time when many charities are struggling to survive and maintain their level of activity, when there are pressures to reduce administrative expenses, the Corporate Governance Initiative is an unwelcome, unnecessary distraction. It increases administrative costs, diverts boards and staff from the focus on the charity's mission, and has no verified relationship to tax compliance.

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[68] Advisory Committee, *supra* note 16 at 46. The Advisory Committee goes on to say "Specific governance practices should be mandated only in rare and limited circumstances and should not be a per se prerequisite for granting exemption or examination of information returns. Best practices is an open issue depending on size, expertise and area of the sector. There is no empirical proof that an adherence to a particular governance practiced will lead to a better outcome in performance of the organization's mission or probity." *Id.* at 48. It adds there is no empirical verification of the IRS's assumptions, nor any verified link, beyond the most trivial, between the IRS's version of good corporate governance and better tax compliance. In fact, there is no agreement as to what good governance is in the nonprofit sector. *Id.* at 35.

[69] *Id*. at p. 15 n.39.