

2013 Columbia Law School Charities Regulation and Oversight Project
Policy Conference on
"The Future of State Charities Regulation"

The Fundamental Role of The States In Governance Issues

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INTRODUCTION

Attorneys General in every state have responsibility, on behalf of the public interest, to ensure that assets dedicated to charitable purposes are protected for those purposes. The Attorney General's duty arises from the responsibility of the parens patriae as representative of the indefinite members of the public – the public at large – who are the beneficiaries of property devoted to charitable purposes.² The Attorney General's enforcement power on behalf of the public interest in protecting charitable assets "extends to all assets dedicated to charitable purpose, regardless of the legal form – corporation, trust, or voluntary association – in which they are held."³ When governance failures threaten the stability of a charitable organization, or enable waste or diversion of its assets, the Attorney General is often the only party with standing to intervene.

The role of states, and particularly the role of Attorneys General, as parens patriae protectors of charitable assets, is essential. It is also a power that can be leveraged in positive ways to influence both the culture of how fiduciary responsibilities for charitable organizations are perceived, and the legal structure from which those responsibilities are assessed.

¹ Assistant Attorney General, State of Connecticut. Opinions expressed in this article are those of the author and do not represent positions or opinions of the Connecticut Attorney General or any other Attorney General, Assistant Attorney General, NASCO or NAAG. The author expresses sincere gratitude to the many Assistant Attorneys General and other officers in state charities regulatory offices who shared their expertise, materials, references, and stories with the author. Any errors in fact are entirely the responsibility of the author and should in no way reflect on those who shared information with the author. All representations in the article are those of the author and no other person or state official bears responsibility for any representation.

² See generally *Scott on Trusts*, Fourth Edition § 391.

³ Marion Freemont-Smith, *Governing Nonprofit Organizations*, The Belknap Press, 2004, pg 301; see also *Scott on Trusts*, Fourth Edition §§ 348.1 and 391.

I. THE LEADERSHIP CHALLENGE

The degree and effectiveness of resources and activities directed toward oversight of charitable assets by Attorneys General varies widely. Until the last decade, most Attorneys General focused more on solicitation of charitable funds under laws directed toward statutory consumer protection and criminal fraud laws, than on the underlying governance issues that are designed to protect the organization from fraud, waste, and other failures. There are multiple reasons for the focus on consumer laws, but among them is the fact that it is easier for Attorneys General to direct limited resources to the clearer definitions, mandatory disclosures, and bright lines of compliance or noncompliance with statutory registration and solicitation laws (now enacted in 40 states), than on the elusive determinations of whether breaches of fiduciary duties have compromised the integrity of a charitable organization and caused harm to its charitable purpose or mission.

In enforcement actions, the state's role is reactive only. The state, through the Attorney General, steps in after harm has occurred. The harm, when charitable institutions are compromised by neglect or bad conduct, undermines the public trust in charitable endeavor. It also undermines public trust in government, because government affords privileges to charitable endeavor through tax-exemption, and should prevent abuses that betray that privilege by wasting charitable assets or diverting them to private benefit. What is the Attorney General's role, as the agent for the state in the role of *parens patriae*, in the prevention of fiduciary and governance neglect and abuses? We have seen over the past decade of intense media attention that enforcement actions to correct harm that has already occurred has not been effective – or not effective enough -- in prevention of neglect or abuse. Governance failures have not abated, despite the promulgation of best practices during that period by possibly every state and national nonprofit professional association, and heightened scrutiny by Congress and the media.

What proactive role, in addition to the traditional role of enforcement after harm has occurred, should Attorney Generals play in effecting prevention of harm? What leadership should Attorneys General assume in effecting changes that will facilitate prevention of loss due to governance failures? –by offering and advocating for thoughtful legislation and regulations that will help to set standards without imposing undue burden on a charity, or otherwise resulting in more harm than good? --by affirmative outreach in the community to help convey the standards by which the community should expect all fiduciaries to operate?

An increasing number of states are directing resources to education about governance issues, often reaching out to the nonprofit sector to work with them on educational and other initiatives. Some states, however, continue to operate on the premise that the Attorney General's role is reactive only, limited to enforcement actions when legal violations have occurred and assets have been diverted from charitable purpose. In the latter states, there is sometimes a perception that working cooperatively with a charitable organization will compromise the Attorney General's ability to bring enforcement actions against that organization should legal violations occur. Too often, however, limiting activity to actions for violations of law is a default choice driven by the necessity of prioritizing allocation of limited resources, without the

ability to direct staff time to educational or outreach activities.

II. THE CONTEXT WITHIN WHICH THE LEADERSHIP CHALLENGE MUST BE MET

In Connecticut, we have experienced what the head of the CT Assoc. of Nonprofits called “a spate of bad media” in recent years about significant failures of charitable corporations. Some of those corporations were dissolved after egregiously poor management and lack of effective board oversight led to inability to continue operations. Some were reorganized with voluntary implementation of new governance and management procedures after theft or misappropriation of assets was discovered. In each instance, hundreds of thousands of charitable dollars were embezzled, otherwise misappropriated through self-dealing, or simply wasted by poor management practices. Each instance revealed that lack of effective board oversight, or failure to implement and follow good management and board oversight policies and practices had enabled the failure. The Advisory Committee on Tax Exempt and Government Entities stated in its 2008 Report that “[I]t is virtually tautological today that a significant failure by an organization is a failure of governance.”⁴

Governance failures have come under intense scrutiny by news media over the past decade, beginning with the collapses of the giant for-profit corporations Enron and Worldcom in 2001 and 2002. The scandals surrounding those collapses severely compromised public confidence in the reliability and trustworthiness of corporate boards, and the integrity of financial statements and disclosures. In 2002, journalists reporting on the corporate scandals broadened their investigations to the charitable sector. News media began exposing apparent self-dealing, excess compensation, and other questionable conduct that extended the decline of public confidence to the nonprofit sector.⁵ The lack of sensitivity to conflicts of interest and the importance of independent audits that had facilitated the collapse of Enron and other for-profit corporations appeared to have carried over to the governing culture of the nonprofit sector. Governing boards were perceived to have abdicated fiduciary responsibilities, and executive directors or other insiders were treating charitable organizations as private fiefdoms for personal benefit.⁶ In the wake of media attention on questionable practices by some charitable organizations, United States Senators Charles Grassley and Max Baucus convened hearings in the Senate Finance Committee in 2004 and 2005 to explore the need for reforms aimed at

⁴ See 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*, June 11, 2008, pg. 8. The Advisory Committee on Tax Exempt and Government Entities (ACT) is an organized public forum for discussion of relevant employee plans, exempt organizations, tax-exempt bonds, and federal, state, local and Indian tribal government issues. The ACT also enables the IRS to receive regular input on the development and implementation of IRS policy concerning these communities. ACT members present interested public's observations about current or proposed IRS policies, programs and procedures as well as suggest improvements. ACT members are appointed by the Department of the Treasury upon recommendation of the Commissioner of the IRS, and serve for two-year terms.

[http://www.irs.gov/Charities-&-Non-Profits/Advisory-Committee-on-Tax-Exempt-and-Government-Entities-\(ACT\)](http://www.irs.gov/Charities-&-Non-Profits/Advisory-Committee-on-Tax-Exempt-and-Government-Entities-(ACT))

⁵ See e.g. Stephanie Strom, *United Way Chief Urges Clean Sweep in Washington Office*, N.Y. Times, Aug. 23, 2002; Beth Healy et al., *Some Officers of Charities Steer Assets to Self*, The Boston Globe, Oct. 9, 2003.

⁶ See e.g. <http://www.finance.senate.gov/hearings/hearing/?id=48ca4cce-afe1-db95-0fcb-8ff9255e780a>

heightened transparency and integrity of governance for charitable entities. Congressional response to the Enron collapse had been swift. Congress enacted the American Competitiveness and Corporate Accountability Act, commonly known as the Sarbanes-Oxley Act, in 2002. The Act established requirements designed to ensure effective and independent audits of publicly-traded companies, and required implementation of whistleblower and document retention policies. No similar sweeping reform legislation followed the 2004 and 2005 Congressional hearings on the nonprofit failures. The Senate Finance Committee issued a draft paper calling for stronger nonprofit governance.⁷ But the intense media attention on abuses and the scrutiny of nonprofit practices by the Senate Finance Committee prompted nearly every nonprofit professional organization and many state Attorneys General to promulgate governance best practices, most of which incorporate provisions similar to those required for publicly-traded corporations by the Sarbanes-Oxley Act.⁸ The Internal Revenue Service (IRS) issued governance guidelines in 2008 and incorporated governance questions into the Revised 990 released in 2009, in an effort to direct attention to the importance of best practices and fiduciary integrity for public charities.⁹

In September 2004, Senators Grassley and Baucus asked Independent Sector¹⁰ to assemble an independent group of leaders from the charitable sector to consider and recommend actions to strengthen governance practices and accountability of charitable entities. The Panel on the Nonprofit Sector, convened by Independent Sector in response to the request of Senators Grassley and Baucus, provided recommendations to Congress in June 2005 for “a comprehensive approach to improving transparency and governance” of charitable organizations.¹¹ The recommendations focused on the need for independence of the nonprofit sector, standards for self-regulatory responsibilities, and educational responsibilities of the sector, and for effective but balanced government oversight that “should deter abuse without discouraging legitimate charitable

⁷ See Senate Finance Committee Staff Discussion Draft at <http://www.finance.senate.gov/hearings/testimony/2004test/06204stfdis.pdf>

⁸ See Francie Ostrower, *Nonprofit Governance in the United States, Findings on the Performance and Accountability from the First National Representative Survey*, The Urban Institute Center on Nonprofits and Philanthropy, 2007, pgs. 3-6, finding that even though the Sarbanes-Oxley Act has not been formally extended to nonprofits, many of its principles have been incorporated into best practices for nonprofits and have altered expectations and standards about nonprofit governance. See also Francie Ostrower and Marla J. Bobowick, *Urban Institute National Survey of Nonprofit Governance Preliminary Findings*, The Urban Institute Center on Nonprofits and Philanthropy, 2006. <http://cnp.urban.org>

⁹ See IRS Good Governance Practices, posted February 4, 2008, at http://www.irs.gov/pub/irs-tege/governance_practices.pdf; see <http://www.irs.gov/Charities-&-Non-Profits/2009-Form-990---Significant-Changes> re changes to Form 990, in particular Part VI; see also Grant Williams, *IRS Finalizes Form 990 for 2009*, Chronicle of Philanthropy, February 10, 2010.

¹⁰ Independent Sector is a coalition of approximately 600 national public charities, foundations, and corporate giving programs, collectively representing tens of thousands of charitable groups in every state. www.independentsector.org

¹¹ See Panel on the Nonprofit Sector, *Strengthening Transparency Governance Accountability of Charitable Organizations, a Final Report to Congress and the Nonprofit Sector*, June 2005 at https://www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf; the Panel submitted supplemental recommendations in 2006 at https://www.independentsector.org/uploads/Accountability_Documents/Panel_Supplement_Final.pdf.

activities.”¹² The Panel’s recommendations have been discussed, debated, critiqued, and alternatives offered, by commentators, scholars, government officials, and professional associations, bar associations, uniform law commissioners, and the nonprofit sector in the years since they were submitted to the Senate Finance Committee. Some have been implemented to some degree, such as regular reporting requirements to IRS for all public charities, including those with annual gross receipts under \$25,000.¹³

The governance abuses and failures continue, exacerbated by the economic downturn that began in late 2008. The debate about how to balance the tension between the nonprofit sector’s goal of independence and self-regulation, and government oversight that will effectively abate governance failures continues within the context of the potential for Congressional action and the ongoing attention of a 24-hour media cycle. Media commentary is becoming part of the debate. A headline in the October 28, 2012 issue of *The Chronicle of Philanthropy* announced that *Lack of Oversight of Charities Undermines Public Trust*. The article posits that nonprofit experts believe that lack of serious efforts to bolster the regulatory system that monitors the nation’s 1.1 million charities and foundations is undermining public trust in the charitable world.¹⁴ It is an important debate. The charitable world contributed \$804.8 billion to the U.S. economy in 2010, making up 5.5% of the country’s gross domestic product. There were approximately 300,000 more public charities and private foundations in 2010 than there in 2000, an increase of approximately 24%. Charitable contributions in 2011 totaled more than \$298 billion. In 2010, public charities reported \$2.7 trillion in assets, a 40% increase since 2000 and 17% increase since 2005. Private foundations held another \$621.7 billion.¹⁵ Cindy Lott, Lead Counsel for The Charities Regulation and Oversight Project of Columbia Law School’s National State Attorneys General Program,¹⁶ puts the importance into perspective, stating that the nonprofit world has become such a big economic engine – employing millions of people and handling billions of dollars – that it needs a strong regulatory regime to ‘protect the charities that are doing it right.’¹⁷

¹² *Id.*, 2005 Final Report, pg. 4. In October 2007, the Panel for the Nonprofit Sector published its own best practices guide: *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*.
<https://www.independentsector.org/principles>

¹³ See Sam unknown, *IRS Releases ‘E-Postcard’ for Small Charities*, *Chronicle of Philanthropy*, February 7, 2008; see also [http://www.irs.gov/Charities-&-Non-Profits/Annual-Electronic-Filing-Requirement-for-Small-Exempt-Organizations--Form-990-N-\(e-Postcard\)](http://www.irs.gov/Charities-&-Non-Profits/Annual-Electronic-Filing-Requirement-for-Small-Exempt-Organizations--Form-990-N-(e-Postcard))

¹⁴ See Suzanne Perry, *Lack of Serious Oversight of Charities Undermines Public Trust*, *The Chronicle of Philanthropy*, Oct. 28, 2012.

¹⁵ See Amy S. Blackwood et al., *The Nonprofit Sector in Brief 2012*, The Urban Institute
<http://www.urban.org/publications/412674.html>

¹⁶ The Charities Regulation and Oversight Project, sponsor of the Conference for which this article is drafted, was developed in 2004 and serves as vital resource for state Attorneys General in their oversight and enforcement of charitable interests, and for nonpartisan policy initiatives to improve regulatory practices in oversight of the charitable sector. See <http://web.law.columbia.edu/2013-charities-regulation-policy-conference/about>

¹⁷ As quoted in Suzanne Perry, *Lack of Serious Oversight of Charities Undermines Public Trust*, supra., *The Chronicle of Philanthropy*, Oct. 28, 2012.

III. LEARNING FROM COLLABORATION

While there has been no broad, sweeping new regulatory regime implemented for charities oversight over the past decade of intensified scrutiny and debate about regulation and governance failures, there have been developments nationally and among the states from which we can learn as we plan for development, promulgation, and facilitating implementation of standards, practices, and laws that will be effective in preventing governance failures.

In 2011, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved a Model Protection of Charitable Assets Act (MPOCAA).¹⁸ The NCCUSL drafting committee actively sought input from Attorneys General during the process of developing and drafting MPOCAA. This collaboration ensured that the drafting process was informed by the knowledge and experience of state officers who had long experience in protecting charitable assets, and ensured that the final result provided clarity for charitable organizations and their advisors, and enhanced and supported the responsibilities of state charities regulators.

The Model Act provides a basic framework for registration and reporting of charitable assets, and also identifies transactions and legal proceedings that require notice to the Attorney General, such as terminations, conversions, mergers, removal of assets from the state, or judicial proceedings involving a charitable entity or charitable assets. In addition, MPOCAA clearly articulates the role of the Attorney General in the protection of charitable assets.

The Model Act has yet to be introduced or adopted in any state, in part because many states have existing statutory or common law requirements for some or all of the provisions in MPOCAA.¹⁹ But the laws vary widely among the states and MPOCAA provides a useful model for statutory articulation of standards and Attorney General standing for those states that lack some or all of the statutory provisions articulated in the ACT. For those states that have little or no statutory support for the protection of charitable assets, MPOCAA provides an excellent basic statutory framework that informs those managing charitable assets and facilitates protection of those assets by state officials, a tribute to NCCUSL's efforts to seek input from the state officials responsible for ensuring protections.

NCCUSL also sought input from state Attorneys General in 2006, before approving and introducing the Uniform Prudent Management of Institutional Funds Act (UPMIFA).²⁰ UPMIFA is a revision of a uniform law that was introduced by NCCUSL in 1972 to provide statutory guidelines for management, investment and expenditures by charitable institutions from endowment funds. That the revised law introduced in 2006, UPMIFA, has now been adopted in all states except Pennsylvania²¹ is a tribute to the excellent organizational structure of NCCUSL and the respect the Conference has earned throughout the country.

The rapid adoption of UPMIFA by state legislatures prompted the Financial Accounting Standards Board to offer revisions to the generally accepted accounting principles (GAAP) for

¹⁸ See [http://www.uniformlaws.org/Act.aspx?title=Protection of Charitable Assets Act, Model](http://www.uniformlaws.org/Act.aspx?title=Protection%20of%20Charitable%20Assets%20Act,%20Model)

¹⁹ *Id.*

²⁰ See [http://uniformlaws.org/Act.aspx?title=Prudent Management of Institutional Funds Act](http://uniformlaws.org/Act.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act)

²¹ *Id.*

reporting endowment funds. In developing those revisions, FASB engaged state charities officials and practitioners in discussions about proposed GAAP changes related to UPMIFA. Those discussions helped ensure that audit reports would continue to provide governing boards with necessary information to manage permanently restricted gift assets in accordance with state laws.²²

In practice, we have learned in some states that UPMIFA presents questions for charitable institutions about how Attorneys General will enforce compliance with the Act.²³ Those questions could lead to differing interpretations that may need to be resolved by costly litigation.²⁴ To avoid that unfortunate result, we might learn from NCCUSL's and FASB's examples and bring together state officials and charitable institutions to better understand the questions and how they might be resolved before problems lead to litigation.²⁵ Collaboration and input from all parties with an interest in the protection of charitable assets results in better and more effective laws, accounting rules, and practice standards.

IV. STATE INITIATIVES, LEADING BY ACTION

There have been significant developments in many states over the past decade related to legal requirements for, or enforcement of, governance standards. In 2004, California enacted the Nonprofit Integrity Act, which imposes detailed governance and reporting obligations on charities with operations in California, regardless of the state of incorporation or formation. The obligations include an annual compensation review and appointment of an audit committee for those charities that have gross revenues of \$2 million or more.²⁶ At least ten other states have registration and reporting requirements for all charities and/or charitable trusts, as well as registration and reporting requirements for all persons and charities who engage in charitable solicitations.²⁷ Disclosures under registration and reporting laws serve as key tools by which states can identify potential problems and often prompt corrective steps before a serious or chronic failure or violation occurs.

V. LESSONS FROM A CASE STUDY: NEW HAMPSHIRE

²² See generally http://www.fasb.org/pdf/fsp_fas117-1.pdf

²³ In Connecticut, legal representatives for Yale University initiated discussions with the Attorney General's Office about questions concerning application of UPMIFA in the management of hundreds of restricted purpose endowment funds donated to the University over a period of three hundred years. Yale was one of many charitable institutions in the State that contacted the Attorney General with questions and concerns about managing institutional funds under UPMIFA after it was enacted into law in the State.

²⁴ Attorneys General welcome opportunities to work cooperatively with charities to resolve questions and problems when they do arise, to provide guidance or to work cooperatively to provide greater clarity and consistency in what constitutes compliance with fiduciary responsibilities in managing charitable assets.

²⁵ In New Hampshire, Dartmouth and Phillips Exeter Academy each initiated discussions with the Attorney General about their many old restricted endowment funds. Over a period of a year, each institution, working cooperatively with the Attorney General's Office, was able to modernize its respective restricted funds under the provisions of UPMIFA through a combination of judicial and non-judicial actions.

²⁶ Cal. Gov. Code Sections 12585-86, 12599; see generally *Nonprofit Integrity Act of 2004* <http://ag.ca.gov>

²⁷ See Marion Freemont-Smith, *Governing Nonprofit Organizations*, The Belknap Press, 2004, pg 55.

New Hampshire has proposed legislation in the 2013 session to require mandatory board training for any charitable organization receiving more than \$250,000 from the state or federal government. A recent unfortunate board failure has heightened the likelihood that the legislature will adopt the proposed requirement and enact it into law. In mid-December, 2012, New Hampshire Attorney General Michael Delaney filed an emergency petition for a court order to suspend the powers of the board of a \$23 million social service agency and appoint a special trustee to take charge of the organization. The organization, a Community Action Agency providing vital services in the State,²⁸ was suddenly unable to make payroll in December and in danger of financial collapse.

The organization had received unqualified audits and filed 990s which indicated a financially stable organization. It was one of the largest human service agencies in New Hampshire. Its failure would leave hundreds of individuals in the poorest area of the state without vital services including fuel assistance, Meals on Wheels, and health-related assistance for children and adults. The court granted the Attorney General's petition and immediate failure was averted by pledges from several New Hampshire foundations to ensure services were not suddenly terminated in mid-December.

In the weeks since the Special Trustee took charge, it has become apparent that the 15-member board of the organization was completely disconnected and disinterested, the staff routinely overspent budgets, the executive director hired eighteen months ago has no nonprofit experience, and when a particular program ran out of money the program manager simply "borrowed" from another account even if that account was restricted. While the legislation to require board training was proposed before this egregious failure came to light, in the wake of the facts being uncovered about the near collapse of this important charitable organization, it is expected to be enacted: the Board of this organization would have been required to undergo training under the proposed legislation.

The failure of the New Hampshire Community Action Agency may be more broadly instructive as we consider regulatory measures that can be effective in preventing governance failures. New Hampshire is a small state with approximately 9000 nonprofits and charitable trusts. The Attorney General's office has been innovative and intensely engaged with the nonprofit community over the past decade in developing educational materials and programs, and participating in training for nonprofit board members, volunteers and staff. Programs begun in 2003 were intended to increase accountability of charitable organizations without enacting legislation. The initiatives to achieve this goal were undertaken by the Attorney General's Office

²⁸ Community Action Agencies are nonprofit public and private agencies established under the Economic Opportunity Act of 1964 to fight America's war on poverty. Community Action Agencies are in every state and some territories of the United States.

http://www.communityactionpartnership.com/index.php?option=com_content&task=view&id=21&Itemid=50

The near-collapse of the New Hampshire community action agency in December would have rendered a crisis in the communities that it serves. The New Hampshire Department of Health and Human Services out-sources the delivery of all social services through contracts to community nonprofits such as Community Action Agencies.

New Hampshire is one of only two states that does not have a sales or income tax.

in cooperation with the New Hampshire Charitable Foundation, the state's largest foundation and a leader in the nonprofit sector in the State.

The cooperative initiatives became one of four representative case studies in a 2006 publication sponsored by The Council on Foundations and the Forum of Regional Associations of Grantmakers: *The Value of Relationships Between State Charity Regulators and Philanthropy*.²⁹

[I]n 2003, as national media and legislative scrutiny of the sector increased, some alarm bells went off for [New Hampshire Charitable Foundation] President Lewis Feldstein. "I was especially concerned about avoiding unnecessary state legislation, and trying to see if we could distinguish New Hampshire from the national concerns around these issues," he explains.³⁰

The Director of the Attorney General's Charitable Trusts Unit at the time, Assistant Attorney General Michael DeLucia, shared Feldstein's concerns about increasing accountability and his preference for avoiding legislation. DeLucia had just written an article about the implications for the charitable sector of the Sarbanes-Oxley Act:

[DeLucia] noted that the legislation did not have much of a direct impact on charities, "but it has become shorthand for 'How can we have better board governance.' In the nonprofit sector, the issue is much broader: How can we make our charities more transparent and regain the public's confidence in them?"³¹ "How do we achieve excellence without more legislation?"³²

Terry Knowles, then Registrar of the Attorney General's Charitable Trusts Unit and President of the National Association of State Charity Officials, was hearing increasing complaints about the number of charities not appearing to be properly governed and managed.

[Knowles] was also beginning to fear a renewal of past patterns of foundations behaving like private entities that don't see the need to be accountable to the public. "Many foundations are slipping back into that era of privacy, thinking that, 'It's nobody's business what we're doing,' and that can only hurt foundations."³³

So in 2003, the New Hampshire Foundation and the Attorney General's Office convened a 21-member Excellence in Nonprofit Governance working committee of nonprofit and philanthropic leaders. The Committee developed a checklist for state and federal legal requirements for a New Hampshire charity and a template for a series of legal workshops to provide in-depth information to nonprofits on meeting their legal requirements. They published

²⁹ David Biemesderfer and Andras Kosaras, *The Value of Relationships Between State Charity Regulators & Philanthropy*, Council on Foundations and Forum of Regional Associations of Grantmakers, 2006 at <http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/06AGreportfull.pdf>

³⁰ *Id.*, Part Three, pg. 33

³¹ *Id.*

³² *Id.*, pg. 33, pull quote

³³ *Id.*, pg. 33.

a nonprofit guidebook for New Hampshire charities, and developed best practices programs to be disseminated as a primary resource for nonprofits throughout the state.³⁴

It was a model of a program designed to establish a culture of voluntary accountability in the state's nonprofit sector. But the failure of the Community Action Agency also makes it a cautionary tale that, perhaps, conveys a lesson about the prudence of carefully considered legislation to support or reinforce voluntary or self-regulatory good intentions, or to provide legal guidelines and standards for voluntary compliance.

The Attorney General's Office first offered the mandatory board training legislation last year. There was opposition to the proposed training mandate from the nonprofit sector in 2012 and the bill was tabled. The sector did not want a legal requirement that its board members and staff be informed about best practices and fiduciary responsibilities, even though infrastructure and developed training programs already existed in the programs and workshops currently offered by the New Hampshire Foundation and the New Hampshire Center for Nonprofits.³⁵ The legislation was prompted by the Attorney General's involvement with triage or dissolutions for dozens of small nonprofits after the economic crisis began in 2008. The nonprofits had been essential providers of social services in their respective communities.³⁶ The Attorney General's Office believed that many of the dissolutions that followed the economic crisis (3 to 4 per week at the peak of the crisis in 2009) could have been avoided if the organizations had been better informed about governing options, or had knowledge of available resources for assistance and guidance. It was obvious that, however well-intentioned, the attempt at voluntary training and self-regulation through promulgation of the materials and programs developed in 2003 in the Excellence in Nonprofit Governance project, the training and materials were not reaching board and staff members in many of the nonprofits where they were most needed.

VI. A COMPREHENSIVE PROGRAM TO RESTORE PUBLIC TRUST: NEW YORK

In 2011, New York Attorney General Eric Schneiderman convened a Leadership Committee for Nonprofit Revitalization with 32 nonprofit leaders from across the state and charged them with developing proposals that would reduce outdated and costly regulatory burdens on nonprofits, while strengthening governance and accountability. On February 16, 2012, Attorney General Schneiderman unveiled the Committee's Report and announced his intention to implement

³⁴ Id., Part Three, pgs. 33-37.

³⁵In 2009, New Hampshire received an American Resources and Recovery Act grant (ARRA) that was directed toward training for capacity building and technical assistance for small community and faith-based nonprofits that were providing essential social services in a region of the state that was hit hardest by the economic crisis. (See endnote 28.) The New Hampshire Center for Nonprofits and the Attorney General's Division of Trusts were designated to develop the project and provide the training and technical assistance to faith-based and secular small nonprofits that were experiencing a 25-40% increase in demand for services. The ARRA materials and ongoing programs offered by the New Hampshire Center for Nonprofits provide a second body of training resources, in addition to those developed with the New Hampshire Foundation in the Excellence in Nonprofit Governance project

³⁶The New Hampshire Department of Health and Human Services out-sources the delivery of all social services through contracts to community nonprofits such as Community Action Agencies. See endnote 28.

the recommendations, including proposing legislation, the Nonprofit Revitalization Act,³⁷ to implement recommended reforms to New York’s nonprofit laws.³⁸ The recommendations included comprehensive reform to New York’s nonprofit laws and two bold proactive initiatives designed to improve nonprofit governance in partnerships between the Attorney General’s Charities Bureau and the New York nonprofit community.³⁹ Both recommended initiatives were launched that same day by Attorney General Schneiderman and partners in the nonprofit community.⁴⁰

A. *New York On BOARD*⁴¹

The Attorney General’s Office will partner with the Association for a Better New York (ABNY) to develop a director recruitment initiative to fill the growing gap between the need for talented individuals to fill positions on nonprofit boards and the pool of those willing to serve. This disparity between demand and supply is not unique to New York.⁴² Attorney General Schneiderman’s Leadership Committee, however, recognized that in New York, “home to the broadest spectrum of industry in the world,” there is an “enormous opportunity to reach beyond traditional sources and attract a larger, broader and more diverse pool of directors.” Working with the business community, ABNY and the Attorney General’s Office will develop “pipelines for recruiting the next generation of board leaders,” by obtaining commitments from businesses to encourage their employees to serve on nonprofit boards. Five major New York employers had already committed to serve as a steering committee with ABNY to develop the program at the time Attorney General Schneiderman unveiled it in February 2012. The plan for the program includes development of a database to match nonprofits with board members who have relevant skills and backgrounds.⁴³

B. *Directors U*

For the second new initiative launched last February, the Attorney General’s Office coordinated with a consortium of academic institutions, including Cornell, Columbia, NYU, Yale and many others, to provide training to nonprofit directors that is free or of minimal cost and easily accessible.⁴⁴ Schneiderman said that “Directors U will create an online library of seminars and materials covering a full range of nonprofit subjects, which will be supplemented by a series of live, in-person trainings.”⁴⁵ The Leadership Committee reported to the Attorney General that providing directors with a substantive knowledge base alleviates unfounded fears

³⁷ Changes recommended by the Leadership Committee were included in the Attorney General’s Nonprofit Revitalization Act. The Bill was proposed in 2012 but was not passed by the legislature.

³⁸ See Press Release, February 16, 2012, *A.G. Schneiderman Announces Bold Plan to Revitalize And Reform New York’s Nonprofit Sector* at <http://www.ag.ny.gov/press-release/ag-schneiderman-announces-bold-plan-revitalize- and-reform-new-yorks-nonprofit-sector>

³⁹ See *Revitalizing Nonprofits Renewing New York*, Leadership Committee for Nonprofit Revitalization Report to Attorney General Eric T. Schneiderman, February 16, 2012 [http://www.ag.ny.gov/sites/default/files/NP%20Leadership%20Committee%20Report%20\(2-16-12\).pdf](http://www.ag.ny.gov/sites/default/files/NP%20Leadership%20Committee%20Report%20(2-16-12).pdf)

⁴⁰ See Press Release, February 16, 2012, *supra.* (footnote 38).

⁴¹ *New York on BOARD (Building Oversight, Awareness, Resources and Depth)*

⁴² See Boardsource, *Nonprofit Governance Index 2010*, at 33 (2010) <http://www.boardsource.org/governance/>

⁴³ See *Revitalizing Nonprofits Renewing New York*, *supra.*, pgs. 29-31.

⁴⁴ See *Revitalizing Nonprofits Renewing New York*, *supra.*, pgs. 32-33.

⁴⁵ See Press Release, February 16, 2012, *supra.* (footnote 38).

about personal liability that may deter board service and pointed out that: “Even sophisticated and experienced directors must learn nuances of nonprofit laws and practices . . . [and] become familiar with state law fiduciary obligations and federal tax exemption requirements, as well as evolving standards of governance best practices.”⁴⁶ A certification program to recognize directors who have completed training programs will be part of the effort to broaden the base of knowledgeable directors.⁴⁷

C. Implementation of Reforms to State Contracting Processes

Delays and inefficiencies in state contracting in many states, including New York, impose crippling financial and operational burdens on nonprofits that contract with the states as providers of essential human services. The Leadership Committee proposed implementing reforms for these crippling burdens in New York by creation of an Office of Contracting Reform and Accountability (OCRA). The OCRA would take responsibility for implementing recommendations made in 2010 by the State Comptroller for expediting and simplifying state contracting processes. The Leadership Committee followed the example of a number of other states⁴⁸ by recommending also that the Governor appoint a Nonprofit Liaison, an individual with significant authority whose role would be as point-person and troubleshooter for nonprofits within government.⁴⁹

D. Updating and Simplifying Regulatory Procedures

New York’s nonprofit laws had not been comprehensively assessed and updated for decades. The Leadership Committee’s recommended changes focused on eliminating outdated and burdensome regulatory requirements, such as permitting electronic notices of board meetings (replacing a requirement that notices be mailed), simplifying the process for forming a nonprofit, and replacing pre-approvals with notice requirements.

The Attorney General’s launch of electronic filing for nonprofits last December corresponds with recommendations of the Leadership Committee to utilize technology to make it easier for nonprofits to file annual financial reports and enable enhanced public access to information about nonprofits.⁵⁰

E. Clarifying Fiduciary Responsibilities in Governance Matters

Leadership Committee recommendations related to fiduciary responsibilities are aptly titled “Enhancing Governance and Maintaining the Public Trust.” The recommendations merit serious consideration in all jurisdictions. They address two of the most commonly reported governance problems throughout the country: excess executive compensation and ineffective audit processes. Recommended new statutory provisions would delineate standards and process for meeting the

⁴⁶ See *Revitalizing Nonprofits Renewing New York*, supra., pg. 32.

⁴⁷ See *Revitalizing Nonprofits Renewing New York*, supra., pg. 32-33.

⁴⁸ Connecticut Governor Dannel Malloy, soon after assuming office in 2011, created a cabinet-level position for a Nonprofit Liaison, the first at that level in the country. The first directive to the Liaison was to communicate directly with nonprofit providers and make recommendations to the Governor for reforms to improve Connecticut’s partnership with the nonprofit sector. Initial steps to expedite state contracting processes were implemented in 2011 while a cabinet of nonprofit leaders convened by the Nonprofit Liaison and the Governor prepared more comprehensive recommendations for reform. Those recommendations are expected to be released in February 2013

⁴⁹ See *Revitalizing Nonprofits Renewing New York*, supra., pgs. 10-17.

⁵⁰ *Id.* at pgs. 18-22.

existing requirement in New York law that nonprofits pay “reasonable compensation” that is “commensurate with services performed.” New provisions would require that independent directors make an “annual affirmative determination” of the reasonableness commensurate with services performed. The criteria directors must consider in making annual affirmative determinations are specified in the recommended new law, including total compensation and benefits, relative comparability data, qualifications and performance, payments or benefits from other entities, and budgetary challenges and the corporation’s overall financial position. The Leadership Committee also recommended requirement for contemporaneous documentation of the affirmative determination by the board, and justification of the board determination, to approve the compensation. It was also recommended that nonprofits that utilize outside compensation consultants must adopt policies and procedures governing consultants’ selection and retention, and oversight of their work.⁵¹

The Leadership Committee also recommended new guidance and requirements for a governing board’s responsibilities in overseeing the external financial audit process.⁵² Independent directors on the Board or a committee of independent directors would have a legal requirement to perform the function of an audit committee, and the audit committee functions and criteria for independence would be set forth in the proposed new statutory requirements. In addition, boards would be required to adopt audit oversight charters that prescribe the statutory requirements and criteria for independence.⁵³ Like New Hampshire’s proposal for legislation to require mandatory board training for nonprofits that receive significant government funds, the Leadership Committee’s proposed new statutory requirements are directed toward correcting conduct for which voluntary self-regulation has been inadequate. The requirements do not impose objectionable or unreasonable burden on nonprofits because they reflect best practice standards that nonprofits should be practicing anyway (other than the cultural aversion to being required to do what we would otherwise be willing to do). Coupled with training and model policy documents easily accessible by every nonprofit, through Director U, this collaboration of nonprofit and state initiative has created a much clearer path for compliance, making compliance easier. The collaboration has also resulted in more tools for better enforcement by the state, through action by the Attorney General, when compliance fails.

F. New Tools for Policing Self-Dealing

An additional set of recommended new statutory provisions that would give the Attorney General more power to bring judicial actions to challenge interested-party transactions should also receive serious considerations in all jurisdictions. Nonprofits boards would be required to adopt conflict of interest policies, and procedures for implementing them. Besides the requirements currently common in corporate statutes for full disclosure to the board of the material terms of a conflict of interest and recusal of the interested board member, the board would also be required to make an affirmative determination that a transaction with an interested person is fair and reasonable before it can be approved. The Leadership Committee recommended that the law

⁵¹ *Id.* at pgs. 23-25

⁵² New York law requires charities that raise more than \$250,000 per year to have external financial audits. See Exec. Law § 172-b; 13 NYCRR 91.5(c)(3)(ii).

⁵³ See *Revitalizing Nonprofits Renewing New York*, supra., pgs. 25-26.

apply to key employees as well as directors and officers. In addition, nonprofits with employees would be required to adopt whistleblower policies providing for reporting of potential illegality and prohibiting intimidation and retaliation to protect employees who make such reports.⁵⁴

A recommended new provision that a nonprofit's chief executive and other compensated employees are prohibited from serving as board chair arises from the not uncommon struggle to maintain proper balance between board oversight and deference to management, particularly when an executive is the organization's founder and maintains disproportionate influence over board decision-making. The Leadership Committee pointed out that restoring the proper balance of power requires a cultural shift that is not achievable through statutory change alone, but that the legal requirements can set the tone and make clear that management is accountable to the board. The Committee also recommended a new legal requirement that boards have policies on board independence, including whether the CEO and other compensated employees may serve on the board and whether they have voting rights, the circumstances in which recusal from board deliberations and voting is required, the percentage of the board that must be independent, and criteria for determining independence.⁵⁵

G. Envisioning the Nonprofits of Tomorrow

The Leadership Committee Report concludes with a recommendation that the Attorney General's Office continue the new partnership with the nonprofit sector that was begun with this effort, and develop a blueprint of vision and strategy that can be a national model for collaborative and innovative reform for the future. Working together, "the nonprofit sector and government can direct resources and craft policy more strategically and thoughtfully."⁵⁶

VII. MEETING THE CHALLENGE OF LEADERSHIP

Marion Fremont-Smith said in 2003: "The fact that the number of criminal cases far exceeded those involving breach of fiduciary duty can be attributed to the preponderance of regulatory tools to correct criminal behavior and the greater funding of state and federal agencies prosecuting crimes. . . states have neither the funds nor the personnel to pursue cases of this nature."⁵⁷ I would add that states lack adequate tools – statutory standards -- to bring effective breach of fiduciary duty actions.

Fiduciary duties under trust law are clear. A trustee's duty runs solely and absolutely to the charitable beneficiary or charitable purpose to which the trust assets are directed. While the same premise applies to all assets dedicated to charitable purpose, as charitable corporations became more complex in structure and operation (hospitals being the classic example), courts began applying the more lenient fiduciary standards applicable to for-profit corporations to charitable corporations. By the end of the twentieth century those more lenient standards for the duties of care and loyalty had been incorporated into the Revised Nonprofit Corporation Act and

⁵⁴ *Id.* at pgs. 26-27.

⁵⁵ *Id.* at pg. 28.

⁵⁶ *Id.* at pg. 34.

⁵⁷ Marion Freemont-Smith, *Governing Nonprofit Organizations*, supra.,pg 14.

adopted in some form into many state corporate statutory schemes.⁵⁸

Analysis of duty of care for for-profit corporations is, generally, the degree of care and diligence that an ordinary man acting in self-interest would exercise in similar circumstances. Statutes allow directors to rely on reports prepared by other directors, employees or outside professionals, and courts often apply the business judgment rule to analysis for charitable corporations. The duty of loyalty for many conflict of interest transactions may be overcome by disclosures and abstentions from voting on conflicted transactions, as may be provided in statutes or corporate governing documents. The analysis of whether breach of duty rises to the level of liability becomes intensely fact-specific and slippery in determining whether neglect, waste, conflict of interest or corruption of mission is mitigated by these safe haven defenses. The focus of analysis shifts from the conduct in relation to the duty owed to the charitable mission, to the conduct in relation to permissible mitigating protections provided in statutes or governing documents. The duty owed to charitable mission and protection of charitable assets has become perverted to a secondary consideration.

The recommendations of the New York Leadership Committee for Nonprofit Revitalization to incorporate best practice policies and procedures into law as statutory standards for issues that have become chronic governance failures gives clear direction to nonprofit directors, to Attorneys General, and to the courts.

VIII. REPRESENTATIVE STATE ENFORCEMENT ACTIONS

Attorneys General remain diligent in actions to intervene when charitable assets are wasted or diverted to personal benefit. New York recently announced a \$5.5 million settlement for self-dealing by the founder and president of a nonprofit that is the largest supplier of student housing in New York City, other than the colleges themselves. \$1 million of the settlement will be paid by the board of the nonprofit. The investigation revealed that the board members had breached their fiduciary duties by approving the founder's self-dealing without proper diligence and oversight. All board members are barred permanently from serving on nonprofit boards in New York.

In Tennessee, the Attorney General successfully brought multiple actions to remove and replace the entire boards of several nonprofits and then, in conjunction with new boards, pursued successful claims against for-profit companies for unfair dealings and transactions with the nonprofits. In 2009, one such claim ultimately resulted in a payment of approximately \$40 million to the nonprofit. Two other similar actions currently pending will result in payment of \$20 – 30 million to each of two nonprofits, if successful.

In 2009, the Colorado Attorney General was successful in a lawsuit against the Colorado Humane Society for waste and misuse of charitable assets. Colorado also intervened to remove the board chair of a cemetery association that had been run by the same chairperson for 40 years and who had engaged in conflict of interest transactions and other inappropriate conduct. The action helped to prompt enactment of a new law requiring greater transparency for cemetery

⁵⁸ See generally Marion Fremont-Smith, *Governing Nonprofit Organizations*, supra., Chapter 4.

associations, including opening board meetings to the public.

Very recently, the Oregon Attorney General settled a significant breach of fiduciary duty case with the religious organization Sikh Dharma. The case demonstrates the sometimes complicated dilemma of distinguishing issues about religion and the extent to which the state can be involved. The State joined with private plaintiffs, a group of adherents to Sikh Dharma, who believed assets of their community were being sold out from underneath them. The assets included significant business holdings that had been donated by adherents, including a natural food company and a security firm. Investigation revealed that substantial assets were transferred to an insider for less than fair market value.

IX. EDUCATION AND TRAINING

Many Attorneys General Offices conduct training programs and educational conferences for nonprofits. New York is among the most active and has produced multiple publications dealing with various governance issues. Those materials will form the basis for many of the Director U training programs. Colorado, California, Hawaii, Massachusetts, Michigan, Nebraska, New Hampshire, New Mexico, Oregon and Ohio are among the other states most active in training and educational outreach, and most of those states work cooperatively with nonprofit organizations in their respective states to conduct the programs and produce materials. The states identified and a few others provide governance information on the Attorney General's website, such as best practices, or links to other sources for best practices and other governance resources.

The Ohio Attorney General's charities unit trained nearly 3,000 board members and volunteers in 2012 in workshops throughout the state. Ohio also produces a quarterly newsletter for the nonprofit sector and presents a webinar each month with an overview of board governance issues, often developed from suggestions received from its Charitable Advisory Council. The Charitable Advisory Council is made up of leaders from the nonprofit community. The Attorney General's collaborative relationship with the Charitable Advisory Council is similar to that of New York's with the Nonprofit Leadership Committee, but on an ongoing basis rather than for a single (very large!) purpose as in New York. Besides the monthly webinars, Ohio now is developing a series of prerecorded webinars on governance that will be accompanied by supplemental materials, enabling boards to watch together or as individuals at their own convenience.

X. ELECTRONIC REGISTRATION AND REPORTING

Last year, Ohio launched mandatory electronic filing for charities registration and annual reporting requirements. It has been well received and the Attorney General's office believes it will have a significant impact on enhancing attention to governance and fiduciary responsibilities. Beth Short, Assistant Attorney General in the Charities Unit: "This [electronic

filing] will provide us with data that we never had before that we can crunch in various ways to identify red flag organizations, etc. Also for the first time, the public can get information online about registering charities. The charitable community is aware of the impact that this type of increased transparency and visibility can have on them and their efforts.”

Six other states have electronic filing for charities, each on a state specific website. Some of the other 33 states with registration and annual reporting requirements enter basic data from filings into databases, and enable the public to search those databases from state-specific websites. Many still maintain registration and annual reporting data in paper files.

XI. NASCO'S⁵⁹ PROPOSED UNIFIED ELECTRONIC REGISTRATION SYSTEM

Eleven states -- California, Illinois, Alaska, Colorado, Connecticut, Hawaii, Massachusetts, Michigan, Mississippi, Missouri, and New Hampshire (the pilot states) -- are working together with the Urban Institute and the Columbia Law School Charities Project to develop a unified electronic registration system that will bring the efficiencies and advantages of electronic charities registration and reporting to all states, all charities, and the general public. The proposed Unified Registration System will allow nonprofit organizations and their professional fundraisers to comply with every state's registration requirements at one online location (Singlepoint Website). Unified registration will eliminate many of the costly inefficiencies of complying with the disparate rules of the forty states that currently require charities registration—a process that now requires a multiplicity of forms, duplication of data entry, a mix of electronic and paper submissions, and confusion (or varying requirements) about what attachments are required by which state in order to register and meet annual reporting requirements.

On the proposed Singlepoint Website, a charity or its professional fundraiser will select each of the states in which they need to register and then complete the necessary registration requirements for those states efficiently and without duplication. The Singlepoint system will be integrated with Urban Institute's 990-Online filing system so that charities that elect to file their federal 990 at the same time they complete electronic state registration will realize maximum efficiency and cost savings in meeting annual state and federal government reporting requirements. NASCO hopes to launch the website within three years and anticipates that all 40 states that have charities reporting requirements will join the Singlepoint Website with five to ten years, bringing together at that point the wealth of data collected by the states at one easily accessible location.

The website will have a search feature on the home page that will enable the public to make more informed choices about charitable giving by providing quick and easy access, for the

⁵⁹ The National Association of State Charities Officials (NASCO) is a coalition of all State officials who have enforcement and oversight responsibilities for charitable assets, including all Attorneys General and those Secretaries of State and other State agencies that manage registration requirements for charities or those who solicit for charitable purposes. NASCO is closely affiliated with the National Association of Attorneys General (NAAG).

first time, to the wealth of public information available in state registration filings. NASCO will make the data available to academics for analysis that is anticipated to facilitate more timely and effective policy making for the nonprofit sector. The system also will enable state charities officials to direct their increasingly limited resources away from the registration process and towards their fundamental role of preventing fraud and misuse of charitable funds.

CONCLUSION

The economic crisis and lingering recession have placed tremendous stress on nonprofits and increasing demand for the important public services they provide. These conditions have also heightened the importance of maintaining the integrity of the nonprofit sector. Ongoing budget crises continue to limit the resources that the states, who have primary enforcement responsibility for the protection of charitable assets, can dedicate to the essential task of ensuring the integrity of the nation's 1.1 million charities and foundations.

In these difficult circumstances, leadership, collaboration and innovation must come from all sectors of society. Government, both state and federal, should continue to leverage its enforcement powers judiciously to support measures to enhance fiduciary responsibility and good governance. An investigator recently boasted to the head of the government regulatory agency for which he worked about the large number of violations he had investigated and taken action against over the last year. The response from the agency head was: "We will have done our job when there are no violations to investigate." As state charities regulators, our goal for charities should be the same: We will have done our jobs when governance failures and misappropriation of charitable assets are rare.