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# The Things People Do When No One Is Looking: An Argument for the Expansion of Standing in the Charitable Sector

Joshua B. Nix

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**THE THINGS PEOPLE DO WHEN NO ONE IS LOOKING:  
AN ARGUMENT FOR THE EXPANSION OF STANDING IN  
THE CHARITABLE SECTOR**

JOSHUA B. NIX\*

I.	INTRODUCTION—THE OMNIPRESENCE OF CHARITABLE ORGANIZATIONS . . . . .	148
II.	WHO QUALIFIES FOR A TAX EXEMPTION AND WHY DOES THIS MATTER? . . . . .	151
III.	PUBLIC CHARITIES V. PRIVATE FOUNDATIONS . . . . .	154
	A. <i>An Overview of Private Foundations</i> . . . . .	154
	B. <i>Self-Dealing and Internal Revenue Code Section 4941</i> . . . . .	155
	C. <i>An Overview of Public Charities</i> . . . . .	156
	D. <i>The Limits of Internal Revenue Code Section 4958</i> . . . . .	157
IV.	NONPROFIT V. FOR-PROFIT—IDENTICAL OR FRATERNAL TWINS? . . . . .	157
	A. <i>The Business Judgment Rule</i> . . . . .	157
	B. <i>Nonprofit Boards</i> . . . . .	158
	C. <i>Members and Derivative Suits</i> . . . . .	161
	D. <i>I.R.C. Section 4958 v. I.R.C. Section 4941: Is There a Logical Basis for the Distinction?</i> . . . . .	163
V.	ENFORCEMENT PROBLEMS—WHO HAS STANDING TO SUE IN THE CHARITABLE SECTOR? . . . . .	164
	A. <i>What is Standing and Why Does it Exist? A Brief Overview</i> . . . . .	165
	B. <i>Just Who Does Have Standing to Sue in the Charitable Sector?</i> . . . . .	167
	C. <i>The Internal Revenue Service</i> . . . . .	167
	1. Form 990s . . . . .	168
	a. <i>Increased Financial Disclosure by Public Charities</i> . . . . .	169

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	b. Potential Side-Effects of Proposed Disclosure Reforms . . . . .	171
	2. Intermediate Sanctions . . . . .	172
	D. <i>Members of the Board</i> . . . . .	174
	E. <i>The State Attorney General</i> . . . . .	176
VI.	ENFORCEMENT SOLUTIONS—AN EXPANSION OF STANDING AS AN AGENCY SUPPLEMENT . . . . .	178
	A. <i>Special Interest Doctrine</i> . . . . .	178
	B. <i>The Inconsistency of the Special Interest Doctrine as a Means of Granting Standing</i> . . . . .	182
	1. The Irrebuttable Presumption of the Threat of Vexatious Litigation . . . . .	182
	2. Are Courts Determining Standing or Reviewing the Merits of a Claim? . . . . .	185
	C. <i>A Call for Legislative Action</i> . . . . .	186
	D. <i>Proposed Model Legislation</i> . . . . .	187
VII.	CONCLUSION . . . . .	191

## PART I: INTRODUCTION—THE OMNIPRESENCE OF CHARITABLE ORGANIZATIONS

H.L. Mencken once wrote, “Conscience is the inner voice that warns us somebody may be looking.”<sup>1</sup> In dealing with the nonprofit sector, and public charities in particular, the law has been reluctant to place too many burdens upon those who have fiduciary responsibilities to the organization. Instead, we have relied upon the conscience and integrity of those who head nonprofits to adhere to their duties and act in a manner that best serves the missions of their particular organizations. But are we ignoring human nature by placing too much faith in the executives and directors of nonprofit entities to do the right thing? In an area where funding for oversight agencies is inadequate and enforcement is sporadic, can conscience carry the day when no one is looking?

This article examines the doctrine of standing and how it has limited those who are able to sue to enforce the fiduciary obligations of charity insiders. The case is then made that more regulation without a means of enforcement is futile, and that a simple expansion of the doctrine of standing will ensure that more eyes are trained upon the actions of nonprofit directors

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<sup>1</sup> H.L. MENCKEN, A MENCKEN CHRESTOMATHY (1949).

and executives. In turn, such expanded oversight will increase compliance with the regulations that are already in place.

In today's world, tax-exempt charitable organizations of all shapes and sizes perform valuable functions upon which all members of our society have invariably depended at one time or another.<sup>2</sup> The mission statements of these various organizations are viewed as worthwhile, and our government rewards the existence and efforts of charities by conferring upon them tax-exempt status.<sup>3</sup> The justifications for the tax-exemption to charitable organizations have been many and hotly debated among legal scholars.<sup>4</sup> Regardless of the preferred rationale for the charitable exemption, the reality is that it is utilized by nearly 1.4 million nonprofit organizations each spring.<sup>5</sup> Yet, even this number fails to tell the whole story, as churches and other religious organizations that are also exempt from taxation are not included in this statistic.<sup>6</sup>

While charitable organizations perform a role that is essential to the well-being of our nation, the amount of money that the United States government is relinquishing as a result of the tax-exemption is staggering. The total revenue for organizations that claimed a tax-exemption in the year 1995 was equal to 12.4% of the gross domestic product of the United States.<sup>7</sup> This money, which is not paid to the government by way of taxation, is either lost at the expense of government programs or it is subsidized by the very citizens for whose benefit these charitable organizations were created. The purpose of the foregoing was not to suggest that a tax-exemption for charitable organizations is outdated or inefficient, but only to highlight the fact that reciprocity exists in the charitable sector. That is, while citizens benefit greatly from the existence of charities, so too do these organizations benefit from the charitable social contract that exists with the citizens.<sup>8</sup> As

<sup>2</sup> Section 501(c)(3) of the Internal Revenue Code defines a tax-exempt charitable organization as any organization that is operated exclusively for religious, charitable, scientific, literary or educational purposes or for the purpose of testing for public safety, fostering amateur sports competition or for the prevention of cruelty to children or animals. 26 U.S.C. § 501(c)(3) (2002).

<sup>3</sup> *Id.*

<sup>4</sup> See Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 U. FLA. L. REV. 419 (1998) (describing the author's theory of the exemption justification as one of risk compensation and comparing other explanations for the exemption). See also Michael J. Barry, *A Sensible Alternative to Revoking the Boy Scouts' Tax Exemption*, 30 FLA. ST. U. L. REV. 137 (2002).

<sup>5</sup> National Center for Charitable Statistics, *Number of Nonprofit Organizations in the United States 1996-2004*, at <http://nccsdataweb.urban.org/PubApps/profile1.php?state=US> (last visited Sept. 17, 2005).

<sup>6</sup> FRANCES R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶ 1.01, 1-2 n.2 (2002) (citing 1999 IRS Data Book, Publication 55b, Table 27).

<sup>7</sup> *Id.* at 1-2.

<sup>8</sup> The idea of the charitable social contract is that essentially "people are generally willing to

noted by Susan Gary, where public dollars support a charity instead of being collected from the charity as tax, then the public has an interest in ensuring that those dollars are spent on a public, rather than a private purpose.<sup>9</sup>

The focus of this article is on the interest of the citizens, who are the ultimate beneficiaries of charitable organizations, to be reassured that charitable organizations are being operated in a manner that is consistent with the fiduciary duties of charity directors and executives.<sup>10</sup> Specifically, when funds are diverted away from a charity's stated purpose and into the pockets of the directors and executives of that charity, who then has standing to bring suit on behalf of the public? Part II of this article will begin by providing an overview of charitable corporations in the United States and outline the characteristics necessary for an organization to qualify for tax-exempt status. Part III will then describe the distinction between private foundations and public charities, two kinds of organizations that fall under the umbrella of "tax-exempt charities." In Part IV, this article examines the law to determine what safeguards are in place to ensure that directors of both types of charities are faithful to their fiduciary duties and whether those safeguards are both adequate and consistent for each type of organization. In Part V, focus is shifted to the available enforcement mechanisms that exist both to prevent and punish the misconduct of charitable insiders and why those current mechanisms are insufficient to protect the public's interest in charity. In a final section, Part VI examines the inconsistent application of standing to the enforcement of charitable fiduciary duties. It is then suggested that an expansion of standing in the charitable realm by states' legislatures would better serve the goal of ensuring that charitable organizations are efficiently and responsibly managed.<sup>11</sup>

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'spend' through taxation in support of charitable activity which they would not support directly, because other taxpayers 'spend' reciprocally." Laura B. Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 IND. L.J. 201, 251 (1987-1988).

<sup>9</sup> Susan Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 617 (1999).

<sup>10</sup> This article will specifically deal with the dangers inherent when charitable fiduciaries violate their duty of loyalty to the organization by converting charitable funds for their own personal use. For a more detailed explanation of the trinity of duties (i.e. duties of care, loyalty, and obedience), see *id.* at 598-615.

<sup>11</sup> No suggestions of additional state driven regulatory means for ensuring charitable responsibility will be discussed in this paper. This article will instead concentrate on how an expansion of standing doctrine in the nonprofit sector could serve to change and make more efficient the internal governance of such organizations. For a discussion of regulatory changes that could increase charitable accountability, see generally Robert C. Degaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance*, 36 CATH. LAW 203 (1995) (suggesting the implementation of intermediate sanctions and an increase in the quality of public charity disclosure as possible solutions).

## PART II: WHO QUALIFIES FOR A TAX-EXEMPTION AND WHY DOES THIS MATTER?

In order for an organization to qualify for tax-exempt status under I.R.C. Section 501(c)(3), it must be an organization where “no part of the net earnings of [that organization] inures to the benefit of any private shareholder or individual.”<sup>12</sup> Obviously this definition is open to multiple interpretations, requiring more concrete definitions of its terms. The phrase “private shareholder or individual” is defined in the Internal Revenue Code (“Code”) as “persons having a personal and private interest in the activities of the organization.”<sup>13</sup> The Internal Revenue Service has defined “private shareholder or individual” to mean “persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities.”<sup>14</sup>

Stated broadly, nonprofit organizations are not barred completely from earning a profit, but are prohibited from distributing any of the profit earned to the individuals who are in a position to exercise control over the organization (i.e. members, directors, officers, or trustees).<sup>15</sup> This characteristic was first referred to by Henry B. Hansmann<sup>16</sup> as the “nondistribution constraint” and has led to many interesting issues regarding nonprofit enterprises that also engage in operating for-profit businesses or partner with such.<sup>17</sup>

Hansmann saw the nondistribution constraint not only as the reason for the existence of nonprofit organizations in a capitalistic society, but also as filling a consumer confidence gap left by capitalism.<sup>18</sup> That is, where for-profit companies, because of their endless pursuit of a more robust bottom-line, may not provide certain services and goods, nonprofit companies will provide such services exactly because the bottom-line is not a factor for consideration.<sup>19</sup> For example, suppose that a for-profit company were in charge of handling the disbursement of food and aid to the victims of the

<sup>12</sup> 26 U.S.C. § 501(c)(3) (2002).

<sup>13</sup> Treas. Reg. § 1.501(a)-1(c) (as amended in 1959).

<sup>14</sup> HILL & MANCINO, *supra* note 6, at 4-9 (citing to Gen. Couns. Mem. 39862 (Nov. 22, 1991)).

<sup>15</sup> Denise Ping Lee, *The Business Judgment Rule: Should it Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 929-30 (2003).

<sup>16</sup> Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

<sup>17</sup> For a more complete discussion of this issue, see Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 S.M.U. L. REV. 675 (2003).

<sup>18</sup> Hansmann, *supra* note 16, at 843-51.

<sup>19</sup> *Id.*

tsunami of December 2004<sup>20</sup> in Indonesia, Sri Lanka, and Thailand. This for-profit company would be torn between its duty to complete the work that it had begun in the region and the duty to the company's stockholders to provide a profit and strong quarterly earnings. Since very few consumers can be present to witness how much food or aid is being provided to those in need, there is the concern that the company's pursuit of increased profits will overtake its duty to disburse contributions. The nondistribution constraint allows for donors or contributors who cannot be in Southeast Asia to know that a nonprofit organization is disbursing all of the donations and aid that it possibly can to those in need because the company is barred from retaining any of the donations in order to make a profit. This in turn increases the public's confidence in nonprofit organizations and provides these organizations with their lifeblood - donations that support their respective causes.<sup>21</sup>

While tax-exempt charities have always been prohibited from distributing any of their assets to insiders or individuals in a position to exercise substantial control over the organization, we must ask, who guarantees that this does not happen? The measure of a lawful society cannot simply be whether or not laws exist to govern certain behaviors. It is clear that there must also be effective measures in place that enforce those laws. After all, a law rarely enforced is a law rarely followed.

A consensus of criminologists now agree that where the goal is to deter criminal behavior, increasing the likelihood of a criminal's apprehension is a far more powerful deterrent than increasing the severity of punishment.<sup>22</sup> A nonprofit director or executive who breaches her duty of loyalty to the company by funneling resources into her own pocket is unlikely to be deterred from doing so if she is relatively certain that this malfeasance will go undetected.<sup>23</sup> It is essential that we provide more protections for nonprofit organizations so as to increase the public's confidence in these necessary entities and insulate them from the reach of the unfortunate state of human nature. To accomplish this goal, there must either be an increase of funding for agencies already charged with charitable oversight or the

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<sup>20</sup> For an account of this horrible natural disaster and its aftermath, see Associated Press, *Tsunami Death Toll Rises Above 150,000*, available at <http://abcnews.go.com/International/wireStory?id=395358> (last visited Sept. 7, 2005).

<sup>21</sup> See Hansmann, *supra* note 16, at 847.

<sup>22</sup> John C. Coffee, *Are We Really Getting Tough on White Collar Crime?*, 15 FED. SENT. R. 245 (2003).

<sup>23</sup> See Willard K. Tom & Chul Pak, *Toward a Flexible Rule of Reason*, 68 ANTITRUST L.J. 391, 400 (2000).

utilization of another set of eyes that can watch over nonprofit organizations and protect the public's interest in charity.

There has been a tremendous increase in the number of organizations applying for I.R.C. Section 501(c)(3) status over the last decade.<sup>24</sup> It is imperative that our ability to enforce the existing regulations that govern charities keeps pace with this rapid growth to ensure that nonprofits are fulfilling the purposes outlined in their respective articles of incorporation. Some commentators have proposed that the swift growth of the nonprofit sector has caught the state legislatures unprepared and that the existing laws are too permissive and in need of reform to bring them into conformity with one another.<sup>25</sup>

Once again, this article will center on the issue of standing and how an expansion of standing in the charitable realm would serve to advance the important goal of ensuring the fiduciary responsibility of nonprofit insiders. It is important that these insiders do not exceed the bounds of the law in their activities. This is essential not only for the financial well-being of the country that relieves charitable organizations of the burden of taxation, but also for the charitable industry as a whole. After all, a nonprofit relies on the public's confidence that the money donated to that organization will be used in a way that is consistent with the organization's stated purpose. The existence and subsequent exposure of scandals, such as the well-publicized Adelphi University fiasco<sup>26</sup> and the diversion of funds by United Way's President, William Aramony,<sup>27</sup> only serve to erode public confidence in the administration of charitable organizations and make donations less likely.<sup>28</sup> This article will now focus on the two largest categories of tax-exempt organizations, public charities and private foundations. It will outline the structure of these organizations and examine the existing regulations that serve to ensure the fiduciary responsibility of those in positions of power within those organizations.

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<sup>24</sup> Tax-exempt nonprofits organized under section 501(c)(3) of the Internal Revenue Code increased by 58.2% between 1989 and 1998 – far exceeding the growth rate of for-profit corporations over the same span. Lee, *supra* note 15, at 929.

<sup>25</sup> Lee, *supra* note 15, at 932.

<sup>26</sup> See JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 9-18 (1995 & Supp. 1998).

<sup>27</sup> Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 633-35 (1998).

<sup>28</sup> Mary Grace Blasko, Curt S. Crossley & David Lloyd, *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 39 (1993)[hereinafter Blasko].



### PART III: PUBLIC CHARITIES V. PRIVATE FOUNDATIONS

Both public charities and private foundations are tax-exempt organizations under Internal Revenue Code Section 501(c)(3).<sup>29</sup> In fact, all charitable entities are assumed to be private foundations unless they fall within one of the following four categories listed in Section 509(a) of the Internal Revenue Code:<sup>30</sup>

1. Organizations such as churches, schools, hospitals, governmental units and organizations supported by the general public and government (e.g., the American Red Cross).
2. Organizations that receive more than one-third of their support from gifts, grants, membership fees and admissions and less than one-third of their support from investment income (e.g. museums).
3. Organizations classified as public charities because their purpose is to support other public charities.
4. Organizations formed for the purpose of testing for public safety.<sup>31</sup>

#### A. *An Overview of Private Foundations*

Until 1950, the law made no distinction between private foundations and public charities.<sup>32</sup> However, in 1950, Congress recognized the need for more strict regulation of tax-exempt charities and enacted laws that listed prohibited transactions for tax-exempt organizations that, if engaged in, would result in revocation of the organization's tax-exempt status.<sup>33</sup> The organizations that are now listed in Section 509(a) as public charities<sup>34</sup> were exempt from these prohibitions because it was generally thought that these organizations were "not believed likely to become involved in any of these prohibited transactions."<sup>35</sup> This sentiment has shifted however, and today public charities are governed by limitations on prohibited transactions.<sup>36</sup>

<sup>29</sup> 26 U.S.C. § 501(c)(3) (2002).

<sup>30</sup> 26 U.S.C § 509(a) (2002). See also Gail D. Neuharth, *A Primer on Private Foundations*, 12-DEC PROB. & PROP. 33, 34 (1998).

<sup>31</sup> 26 U.S.C § 509(a) (2002).

<sup>32</sup> HILL & MANCINO, *supra* note 6, at 8-4.

<sup>33</sup> See also *id.* (explaining 1939 Code Sections 3813 and 3814, which later became 1954 Code Sections 503 and 504).

<sup>34</sup> Churches, educational organizations, hospitals, and publicly supported organizations. See § 501(c)(3), *supra* note 29 and accompanying text.

<sup>35</sup> HILL & MANCINO, *supra* note 6, at 8-4 n.3 (quoting from S. Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 CB 483, 511).

<sup>36</sup> See *infra* Part III.C.

Private foundations are typically created by a large endowment from either a wealthy individual or a corporation, and then funded by returns on investments of the organization.<sup>37</sup> Lack of reliance on public support and the fact that many private foundations remained under the control of their creators soon led to criticisms that these organizations were nothing more than a vehicle for the wealthy to be insulated from the burden of taxation under the guise of philanthropy. In response to these public concerns, Congress enacted the Tax Reform Act of 1969 in an attempt to limit the abuses within such organizations.<sup>38</sup> The Act imposed an excise tax on private foundations that participated in any of certain prohibited activities that Congress determined were the most susceptible to abuse.<sup>39</sup>

### B. *Self-Dealing and I.R.C. Section 4941*

As a result of Congress's perception of private foundations as difficult to monitor, the Tax Reform Act of 1969 sought to completely prohibit any direct or indirect transactions, which are known as acts of self-dealing,<sup>40</sup> between a private foundation and disqualified persons<sup>41</sup> or foundation managers.<sup>42</sup> The Code section that specifically addresses self-dealing, Section 4941, makes no distinction between a transaction that is "fair" or in the "best interests" of the private foundation and a transaction in which a disqualified person benefits from the transaction.<sup>43</sup> In other words, a

<sup>37</sup> David G. Samuels, *The Regulation of Private Foundations*, 217 N.Y.L.J. 1, 1 (1997).

<sup>38</sup> Degaudenzi, *supra* note 11, at 214-15. See also, HILL & MANCINO, *supra* note 6, at 10-3 (describing the purpose and effect of the Tax Reform Act of 1969).

<sup>39</sup> This article will focus primarily on the prohibition of self-dealing and how it impacts nonprofit organizations. For a more complete listing of the prohibited transactions that apply only to private foundations, see generally 26 U.S.C. § 4940 - § 4945.

<sup>40</sup> I.R.C. § 4941(d)(1) lists acts of self-dealing as between a disqualified person and a private foundation which includes any direct or indirect (A) sale or exchange, or leasing, of property; (B) lending of money or other extension of credit; (C) furnishing of goods, services, or facilities; (D) payment of compensation that is unreasonable; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; or (F) agreement by a private foundation to make any payment of money or other property to a government official. I.R.C. § 4941(d)(1)(A) (2002).

<sup>41</sup> A disqualified person is defined in I.R.C. § 4946 as any of the following: (1) a substantial contributor, defined as one who contributes more than \$5,000 to the foundation; (2) a foundation manager, defined as an officer director or trustee of the foundation or any individual with powers and responsibilities similar to those persons; (3) one who owns more than 20% of the voting power of a corporation; (4) a family member of any of the persons listed in 1-3 above; (5) a corporation, partnership, trust or estate in which persons named in 1-4 above own more than 35% of the voting power, profits, or interest; (6) a private foundation effectively controlled by the same person(s) who control the private foundation; and (7) a government official as defined in I.R.C. § 4946(c). I.R.C. § 4946(a)(1) (2002).

<sup>42</sup> HILL & MANCINO, *supra* note 6, at 10-3.

<sup>43</sup> I.R.C. § 4941 (2002).

disqualified person may not claim ignorance or propound that the questioned transaction was actually beneficial to the foundation as a defense to accusations of self-dealing. This new and elaborate regulatory regime established for private foundations in 1969 was groundbreaking in that it provided for penalties that could be assessed directly against the self-dealing disqualified person.<sup>44</sup> This allowed the government to punish the wrongdoer without having to punish the charity as a whole, which could have the unintended consequence of punishing the charity's beneficiaries.

In summary, I.R.C. Section 4941 imposes a high standard of fiduciary responsibility on any private foundation director or manager, or any other disqualified person. Excise taxes may be levied upon any individual who engages in a prohibited transaction regardless of the ignorance or subjective belief of the self-dealing disqualified person.<sup>45</sup> However, this standard is not applied to other tax-exempt organizations, namely public charities.<sup>46</sup>

### C. *An Overview of Public Charities*

An organization is classified as a public charity, rather than a private foundation, when it falls into one of the four categories of organizations listed in I.R.C. Section 509(a).<sup>47</sup> In general, public charities were not as strictly regulated as private foundations because they derived a significant amount of financial support from the public.<sup>48</sup> As a result, it was thought that they would be more accountable to the public and not require the strict oversight applied to private foundations.<sup>49</sup>

There are many reasons that a nonprofit organization would want to achieve public charity status instead of the default private foundation status, not the least of which is that all public charities are exempt from the more rigid regulations that are imposed on private foundations in Chapter 42 of the Code.<sup>50</sup> The most interesting of these for purposes of this discussion is the exemption from the rigid self-dealing regulations for private foundations.<sup>51</sup>

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> See *infra* Part III.C.

<sup>47</sup> See Neuharth, *supra* note 30, at 34.

<sup>48</sup> Degaudenzi, *supra* note 11, at 217.

<sup>49</sup> *Id.*

<sup>50</sup> I.R.C. § 4940 – § 4945 (2002). Restrictions that will not be discussed in this article are minimum distributions, excess business holdings, jeopardy investment, and taxable expenditure provisions. For a more in-depth discussion of these topics, see HILL & MANCINO, *supra* note 6, at Chapters 10-12.

<sup>51</sup> I.R.C. § 4941 (2002).

Until 1996, public charities were immune from any sanctions by the Internal Revenue Service other than complete revocation of tax-exempt status.<sup>52</sup> When Congress realized that this was too harsh a punishment because it served to vilify and destroy the public charity rather than punishing the individual who had engaged in the inappropriate self-dealing, a new piece of legislation was passed to cure the problem.<sup>53</sup> Internal Revenue Code Section 4958 was enacted in 1996 and provided for “intermediate sanctions” that would impose excise taxes on insiders who engaged in transactions that resulted in “excess benefits” to the insiders.<sup>54</sup>

#### D. *The Limits of I.R.C. Section 4958*

The regulations suggest a procedure whereby the organization can rely on a rebuttable presumption that the transaction is not an excess benefit transaction if: (1) its terms were approved by a board or board committee composed of individuals who have no conflict of interest; (2) disinterested board members relied upon comparable data; and (3) the board “adequately documented the basis for its determination.”<sup>55</sup>

As James Fishman correctly notes above, Section 4958 differs markedly from its counterpart rule dealing with private foundations, Section 4941. That is, while disqualified persons in private foundations are strictly prohibited from engaging in any of certain transactions with the organization, their counterparts that run public charities may engage in the same transactions so long as the transaction is approved by a disinterested board. But how disinterested do we want members of the boards of charities to be?

### PART IV: NONPROFIT V. FOR-PROFIT—IDENTICAL OR FRATERNAL TWINS?

#### A. *The Business Judgment Rule*

The mistaken analogy upon which much of the problem of enforcement in the charitable realm relies is that nonprofit corporations (public charities) are similar to for-profit corporations. While it is true that the two are similar

<sup>52</sup> Gary, *supra* note 9, at 632.

<sup>53</sup> See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 4958, 110 Stat. 1452, 1475-78 (1996).

<sup>54</sup> Gary, *supra* note 9, at 632-33. 26 U.S.C. § 4958 (1996).

<sup>55</sup> James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 254 (2003).

in structure, the application of the business judgment rule to nonprofit directors is a perfect example of the old maxim that for every complex question there is an answer that is simple, elegant, and wrong.<sup>56</sup> The business judgment rule is a suit that just does not fit the executives of nonprofits.

The business judgment rule as applied in the for-profit realm allows those individuals who are in positions of power within the corporation to make decisions without being second-guessed by shareholders or the judiciary.<sup>57</sup> Any action of an executive of a for-profit company will be protected if the decision was made: (1) in good faith and without a conflict of interest; (2) on a reasonably informed basis; and (3) with a rational belief (connoting broad discretion and wide latitude) that the business decision is in the best interests of the corporation.<sup>58</sup>

The problem with the business judgment rule as applied to public charities is not the standard itself, but the fact that enforcement procedures that are available to assure stockholders that the directors of for-profit companies adhere to this standard are lacking in the nonprofit arena.<sup>59</sup> In the for-profit world, boards of directors and shareholders act as a check upon directors or chief executive officers of corporations that would seek to line their own pockets at the expense of the company. Boards and executives of for-profit companies are elected by the shareholders of that company and entrusted with running the company in a profitable manner. I.R.C Section 4958, as it applies to public charities, assumes that the boards and members of nonprofit corporations will act in the same manner to prevent any breach of fiduciary duty or misappropriation of funds by charity directors, but as we shall see, this is not necessarily the case.<sup>60</sup>

### B. Nonprofit Boards

The boards of directors of public charities are not analogous to their for-profit counterparts as effective checks upon motivated and overbearing nonprofit executives for many reasons. First of all, for-profit boards are elected by shareholders and well compensated to be independent when reviewing decisions that are purportedly in the best interests of the

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<sup>56</sup> Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV 307, 330 n.76 (1991) (quoting H.L. Mencken).

<sup>57</sup> Lee, *supra* note 15, at 945, 955.

<sup>58</sup> Goldschmid, *supra* note 27, at 643-44.

<sup>59</sup> For an extensive discussion of why the underlying purposes of the business judgment rule are inapplicable to nonprofit organizations, see Lee, *supra* note 15.

<sup>60</sup> See *infra* Part IV.C-D.

corporation.<sup>61</sup> In contrast, boards of nonprofit corporations are frequently self-perpetuating, which means that the directors are not subject to election and their terms are potentially of infinite duration.<sup>62</sup> As a result, these board members are likely to feel less responsibility for their actions since they are not accountable to a group of persons analogous to the shareholders of a for-profit company. Incompetent directors will also be difficult, if not impossible, to remove for the same reason . . . lack of accountability.<sup>63</sup>

Secondly, boards of nonprofits are also typically larger than their for-profit counterparts and are not usually compensated for their time.<sup>64</sup> Many members of nonprofit boards have jobs as executives in the for-profit world and serve on nonprofit boards as a status symbol rather than out of a genuine desire to further the goals of the charity.<sup>65</sup> As a result, they are often uninvolved, rarely attend meetings, and almost never concern themselves with oversight responsibilities.<sup>66</sup> The danger of larger boards, in addition to a lack of accountability, flows from two separate but closely related social psychological concepts called diffusion of responsibility and deindividuation.<sup>67</sup>

The core principle of diffusion of responsibility is that people are more likely to acquiesce to the will of the group or just “go along” instead of asserting their individual thoughts or feelings in situations where there is a lack of individual accountability.<sup>68</sup> Generally, subjects in experiments designed to study this concept have said that they failed to voice their concerns or act when in a large group because they assumed that if a problem existed, someone else would take care of it.<sup>69</sup> Deindividuation is a related concept that was first studied by Festinger, Pepitone and Newcomb in 1952<sup>70</sup> and deals with the phenomenon that individuals who are in a large group tend to lose their personal identities and do things that are inconsistent with their self-identified personalities. Larger groups, of which an individual is a part, give that individual anonymity and also allow them

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<sup>61</sup> Lee, *supra* note 15, at 950.

<sup>62</sup> *Id.* at 932.

<sup>63</sup> *Id.* at 950.

<sup>64</sup> *Id.* at 950-51.

<sup>65</sup> Goldschmid, *supra* note 27, at 633.

<sup>66</sup> *Id.*

<sup>67</sup> See *Social Influence – Diffusion of Responsibility*, <http://www.cultsock.ndirect.co.uk/MUHome/cshtml/socinf/diffusion.html> (last visited Sept. 7, 2005).

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> L. Festinger, A. Pepitone, & T. Newcomb, *Some Consequences of Deindividuation in a Group*, 47 *JOURNAL OF ABNORMAL AND SOCIAL PSYCHOLOGY*, 382-89 (1952).

to share the blame, reducing the sense of individual responsibility.<sup>71</sup> Nonprofit boards that are especially large and consist of persons who have other responsibilities and duties at for-profit companies are very likely to allow themselves to be dominated by a motivated board member with an agenda.

To see these social psychological concepts at work in the larger board rooms of nonprofit entities, one need look no further than the scandal involving United Way of America and its President, William Aramony. In late 1991, Mr. Aramony was indicted and ultimately convicted for using United Way funds for personal perquisites such as “limousines and transatlantic flights on the Concorde.”<sup>72</sup> In addition, Aramony used his position to “reward friends and family members with jobs, board memberships, and consulting contracts.”<sup>73</sup>

The actions of William Aramony were abhorrent, but the question that should be asked is why none of the more than 30 members of the United Way board of directors stepped in to prevent Aramony from looting the charity? As is the case with many nonprofit boards, many of the members of the board of United Way were also successful businesspeople who played large roles in the successes of their for-profit employers.<sup>74</sup> These were intelligent people who knew the difference between right and wrong and presumably understood from their collective business experience what the role of a board member of a company entailed. So what could explain their lack of action and passivity when so much evidence of wrongdoing was right at their fingertips? The Report to the Board of Governors of United Way of America stated that the board only met only twice a year and always approved Aramony’s requests for separately incorporating United Way functions.<sup>75</sup> Soon after, the board subsequently lost control and supervision over the separate corporations.<sup>76</sup> Perhaps the members of the United Way board simply did not pursue their responsibilities at United Way with the same vigor that they pursued their exploits in their for-profit companies. Or, perhaps they fell victim to diffusion of responsibility and assumed that if a problem existed, someone else would say something, and since nobody had complained, everything must be all right. Whatever the reason for the

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<sup>71</sup> See ChangingMinds.org, *Deindividuation*, <http://changingminds.org/explanations/theories/deindividuation.htm#Research> (last visited Oct. 1, 2005).

<sup>72</sup> Goldschmid, *supra* note 27, at 633-34 (citing THE PHILANTHROPY MONTHLY (Dec. 1991 and Jan.-Feb. 1992)).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 634.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

shirking of their duties, a passive and complacent board can be a nightmare to the nonprofit system that lacks the other forms of enforcement that are present in the for-profit world.<sup>77</sup>

Consuelo Kertz challenges whether the boards of nonprofits can ever truly be independent in the way that for-profit boards are expected to be in order to protect the company.<sup>78</sup> She states that “board membership often consists of the executive’s friends and cronies, and there is often reciprocity—individuals sitting on one another’s boards.”<sup>79</sup> As should be evident, boards of nonprofit corporations are not nearly the check on executive action as are their counterparts in the for-profit world. Nonprofit board members who are not compensated, elected, or involved with the charity out of a genuine desire to ensure that the organization is responsibly run can become so disinterested that the more appropriate terms to describe them are uninformed and complacent. Without an active board of directors to check a motivated executive, the standard established in I.R.C. Section 4958 that a transaction is presumptively reasonable if approved by the board of directors becomes strikingly ineffective. Where boards acquiesce in their responsibility to monitor the activities of a director, the danger of misappropriation grows exponentially, especially in light of the fact that nonprofit corporations lack shareholder equivalents that would serve as a further check on a dominant director of a public charity.<sup>80</sup>

### C. *Members and Derivative Suits*

For-profit directors are also monitored by shareholders that have the ability to institute shareholder derivative suits in order to sue a director on behalf of the corporation.<sup>81</sup> Charities do not have shareholders, but some charitable corporations have members with the power to elect directors and these members have been seen as analogous to shareholders in for-profit

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<sup>77</sup> This author is pleased to report that the Senate Finance Committee has recently published a list of proposed reforms in the area of tax-exempt organizations. Included within these proposals was a suggested reform of nonprofit board composition that would limit boards to “no less than three members and no greater than fifteen.” This could likely serve to increase individual accountability of board members and, in turn, strengthen the first line of defense against misappropriation of charitable assets. William Josephson, *The Senate Finance Committee Staff Discussion Paper*, 144 PLI/NY 141, 155 (2004).

<sup>78</sup> Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 855 (1997).

<sup>79</sup> *Id.*

<sup>80</sup> Blasko, *supra* note 28, at 54.

<sup>81</sup> Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP L. 655, 670 (1998).



corporations.<sup>82</sup> The analogy is not perfect, as nonprofit corporations have the power to determine the terms on which membership is offered or whether they will have members at all.<sup>83</sup>

Denise Ping Lee also notes that even when a nonprofit corporation does have members, those members do not have a direct financial stake in the organization as do shareholders of for-profit companies.<sup>84</sup> As a result, any money that would be recovered through a lawsuit would be given back to the nonprofit, and so a member has little incentive to sue due to her lack of personal financial interest in that organization.<sup>85</sup> While it is certainly true that a member who initiates a lawsuit to enforce the charitable responsibilities of an organization does not stand to gain financially from such an action, can it be said that financial gain is the sole motivating factor behind a suit such as this? Often a member of a charity may want to see that the charity continues to maintain a presence in his or her community because it breathes life into a deteriorating neighborhood. Certainly, this has a value all its own that cannot be measured in terms of dollars and cents. Can we truly argue that a plaintiff who stands to receive an award of money damages is more interested in the litigation for standing purposes than one whose overall quality of life stands to be affected by an adverse decision of a charity? In *Young Men's Christian Association of the City of Washington v. Covington*,<sup>86</sup> ("Y.M.C.A.") the court ruled that where a charity has membership defined by a process that includes filling out an application, having that application approved, and paying dues, then that member has a "special interest"<sup>87</sup> and has standing to sue to enforce the charitable obligations of the organization.<sup>88</sup> While this is certainly an encouraging decision, the fact is that the Y.M.C.A. case is the exception and not the rule in the world of charitable organizations. Very few charities have a system where individuals can become members through an application process that would enable a court to view them as having an interest in the organization beyond that of the general public.

The simple fact is that if the members in the Y.M.C.A. case had not paid dues to the organization, it is highly unlikely that they would have been found to have an interest in the activities of the charity. So how can we reconcile this with the fact that donors to a charity are routinely denied

<sup>82</sup> Blasko, *supra* note 28, at 54.

<sup>83</sup> Lee, *supra* note 15, at 934.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> 484 A.2d 589 (D.C. 1984).

<sup>87</sup> See discussion *infra* Part VI.A.

<sup>88</sup> Y.M.C.A., 484 A.2d at 591-92.

standing?<sup>89</sup> Must the determination of standing turn on an individual donating money to the organization and also reaping a benefit from the same? The standard for determining standing seems at best overly discretionary and at worst arbitrary. For purposes of this section, it suffices to note that most charities do not have voting members who are analogous to for-profit shareholders, even in states that would authorize such members to bring suit to enforce the charitable obligations of the organization.<sup>90</sup>

*D. I.R.C. Section 4958 v. I.R.C. Section 4941: Is There a Logical Basis for Such a Distinction?*

The intermediate sanctions codified in Section 4958 that apply to public charities were an excellent idea and a reform that was badly needed. However, those sanctions are useless when they exist in a system that is void of any enforcement mechanisms that are equivalent to those in the for-profit world. Without interested boards of directors or shareholders that will vigorously defend the interests of the organization, who is left to ensure that transactions between executives and the public charities that they oversee are in fact fair? If we conclude that oversight is lacking in the nonprofit field generally, then why is there a difference between the self-dealing regulations applied to private foundations and those applied to public charities?

One of the more convincing arguments that public charities should not be completely prohibited from acts of self-dealing is that smaller public charities have a greater financial need to be able to rely on beneficial transactions by those who would be otherwise considered insiders.<sup>91</sup> While private foundations are often more financially stable since they are typically created by one significant endowment, small public charities that depend upon public support for survival may find themselves in a situation where an insider or disqualified person can provide real estate, goods, or services at a cost that is below fair market value.<sup>92</sup>

Deborah DeMott favors the ability of small public charities to be free of the strict prohibitions of private foundations, but argues that the standard of

<sup>89</sup> See *infra* note 99 and accompanying text.

<sup>90</sup> Gary, *supra* note 9, at 626.

<sup>91</sup> See Goldschmid, *supra* note 27, at 647-48 (explaining that a complete prohibition against self-dealing transactions for nonprofit corporations would be too inflexible and would prove both impractical and counterproductive). *Contra* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 569 (1981) (arguing for a "flat prohibition against all self-dealing transactions involving controlling persons in nonprofit organizations").

<sup>92</sup> Gary, *supra* note 9, at 635; see also Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 144 (1993).

review is too lax.<sup>93</sup> She proposes that a self-dealing transaction should be voidable unless the proponent can affirmatively show that the transaction was, in fact, fair at the time that it was completed.<sup>94</sup> DeMott additionally proposes that larger public charities who are at least as financially stable as most private foundations should be subject to the strict prohibitions against interested transactions that are found in Section 4941.<sup>95</sup> This would certainly deal with the deferential standard of judicial review of such challenged transactions under the business judgment rule. Unfortunately, what truly seems to be lacking in the field are the enforcement mechanisms to prevent unfair transactions in the first place. After all, while it is important to be able to punish a self-dealer once he or she is in court, the charitable industry as a whole would benefit more by a system that could get more self-dealers into court in the first place.

#### **PART V: ENFORCEMENT PROBLEMS—WHO HAS STANDING TO SUE IN THE CHARITABLE SECTOR?**

As we have seen, charitable corporations are often compared to for-profit companies in applying a “reasonableness” standard to determine whether a particular transaction was an act of self-dealing. Courts have applied the business judgment rule to directors of nonprofits even though so many of the market restraints on for-profit companies are lacking in the charitable sector (i.e. interested boards of directors, shareholders, etc.).<sup>96</sup> In the absence of such safeguards acting as a check on a director’s power, how can we be sure that nonprofit corporations are functioning efficiently and using charitable donations in a manner consistent with the organization’s stated purpose? The answer is that we cannot, and where internal measures to assure compliance with the law are lacking, as is the case with nonprofit corporations, external enforcement measures must be relied upon to protect the public’s interest in charity.

In this section, we will first briefly examine the doctrine of standing and how this judicially-created doctrine serves to sharply limit those who may bring an action for breach of fiduciary duty against a charity or a charitable director or executive. Next, we will take a closer look at those parties who are generally entrusted with the responsibility of bringing an action to

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<sup>93</sup> DeMott, *supra* note 92, at 143.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> For some decisions by courts applying the corporate business judgment rule standard to directors of nonprofits, see *Stern v. Lucy Webb Hayes Nat'l Training Sch. For Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974); and *Auerbach v. Bennett*, 47 N.Y. 2d 619 (1979).

enforce the charitable fiduciary responsibilities of a nonprofit. It will become evident that there are significant problems with relying on these parties to oversee the quickly increasing number of charitable entities in this country. Budgetary restraints have tied the hands of governmental entities charged with the oversight of nonprofits and the enforcement of charitable laws, and action needs to be taken to supplement the efforts of these overburdened oversight entities.

A. *What is Standing and Why Does it Exist? A Brief Overview*

The judicially created concept of standing is built around the singularly important Constitutional notion of separation of powers.<sup>97</sup> The judicial power of the United States after *Marbury v. Madison*<sup>98</sup> was seemingly limitless, and standing doctrine ensures that the judiciary does not intrude upon or second guess the policy making roles of the representative branches of the government. The doctrine embraces several judicially self-imposed limitations on a court's ability to reach judgment in certain cases.<sup>99</sup> Such limitations include: (1) a general prohibition on a litigant's raising another person's legal rights; (2) a rule barring adjudication of generalized grievances that should be addressed to the representative branches of government; and (3) a requirement that a plaintiff's complaint fall within the zone of interests protected by the law invoked.<sup>100</sup> "In essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues."<sup>101</sup> Justice Scalia summarized the three elements necessary for a particular plaintiff to have standing as:

- 1) The plaintiff must have suffered an "injury in fact" - an invasion of a legally protected interest which is (a) concrete and particularized, and (b) "actual or imminent, not 'conjectural' or 'hypothetical.'"
- 2) There must be a causal connection between the injury and the conduct complained of—the injury has to be "fairly...traceable to the challenged action of the defendant, and not...the result [of] the independent action of some third party not before the court."

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<sup>97</sup> *Allen v. Wright*, 468 U.S. 737, 752 (1984).

<sup>98</sup> 5 U.S. 137 (1803).

<sup>99</sup> *Allen*, 468 U.S. at 751.

<sup>100</sup> *Id.*

<sup>101</sup> *Warth v. Seldin*, 422 U.S. 490, 498 (1975).

- 3) It must be “likely,” as opposed to merely “speculative,” that the injury will be “redressed by a favorable decision.”<sup>102</sup>

For the purposes of our discussion, the “injury in fact” requirement is the most interesting.<sup>103</sup> Very few citizens are recognized by courts as having such a personal interest in a charitable organization that any malfeasance by that organization would give rise to an injury in fact and consequently, standing. Even donors and beneficiaries, who are more closely tied to and interested in the charitable organization than are members of the general public, have been denied standing to sue<sup>104</sup> unless they can demonstrate that they have a “special interest” in the charity.<sup>105</sup> In addition, statutory construction of various states’ nonprofit corporation acts by courts have led to peculiar results in various cases. For instance, at least one court has ruled that ousted minority directors of a nonprofit may not sue on behalf of the charity to enforce the fiduciary responsibilities of charitable executives.<sup>106</sup>

The restriction of standing doctrine in the area of enforcing the fiduciary duties of charity insiders has been justified as serving the purpose of protecting the charities from “vexatious litigation” that could occur if members of the general public were granted the ability to act as champions of the public good.<sup>107</sup> The general idea is that if charities or their directors were subject to suits by the general public, then charitable resources that were intended to further the mission of the organization would be diverted to defend those actions.<sup>108</sup> But is this the case? Would the virtual floodgates

<sup>102</sup> Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-61 (1992).

<sup>103</sup> For a discussion of the evolution of standing doctrine and the requirement of an “injury in fact”, see Kristen M. Shults, *Friends of the Earth v. Laidlaw Environmental Services: A Resounding Victory for Environmentalists, its Implication on Future Justiciability Decisions, and Resolution of Issues on Remand*, 89 GEO. L.J. 1001, 1008-11 (2001).

<sup>104</sup> Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995 (Conn. 1997) (stating that a donor may not institute an action against a donee to force the use of the funds as was agreed. Only the Attorney General has standing to enforce the restriction on the gift); Russell v. Yale Univ., 737 A.2d 941, 946 (Conn. App. Ct. 1999) (holding that alumni of the university lack standing as donors of unrestricted charitable gifts to their alma mater). *Contra In re Milton Hershey Sch.*, 867 A.2d 674, 689-691 (Pa. Commw. Ct. 2005) (holding that members of alumni association of charitable school had a special interest in the school and so had standing to seek rescission of an agreement between the Office of the Attorney General and the charitable trust company); *In re Estate of Smithers*, 760 N.Y.S.2d 304 (N.Y. Sur. Ct. 2003) (holding that the widow of a deceased donor had standing to enforce the terms of the charitable gift to a hospital).

<sup>105</sup> See discussion *infra* Part VI.A.

<sup>106</sup> See *infra* Part V.D.

<sup>107</sup> Hooker v. Edes Home, 579 A.2d 608, 612 (D.C. Ct. App. 1990).

<sup>108</sup> Blasko, *supra* note 28, at 42 (recounting a telephone conversation with Catherine Wells, Prof. of Law, University of Southern California, Former Member, Nat’l Comm. of Charity Info. Officers (Jan. 15, 1992)).

of litigation be opened such that litigation would drown the effective functioning of charitable entities in our country if standing were expanded? Or could the result be somewhat less chaotic and perhaps even beneficial to the country and the charitable industry? We will revisit this question after outlining those who are today recognized by the courts as having standing to bring an action to enforce the fiduciary duties of a charitable organization.<sup>109</sup>

### B. *Just Who Does Have Standing to Sue in the Charitable Sector?*

Standing doctrine in the nonprofit arena have led nonprofit fiduciary duties to be referred to as “legal obligation[s] without legal sanction[s].”<sup>110</sup> So whose job is it to protect the public’s interest in charity? There are generally three groups or agencies that have been consistently granted standing to sue a self-dealing director of a charity: (1) the Internal Revenue Service; (2) other board members who question the appropriateness of the actions of a dominant director; and most importantly (3) states’ attorneys general.

This section will review each of these groups and discuss whether these groups are a sufficient means of enforcement, either alone or in conjunction, for assuring that nonprofit boards and directors are fulfilling their fiduciary duties to the public. In Part VI, we will discuss how courts have begun to retreat from rigid application of the doctrine of standing when a plaintiff has a “special interest” in the charitable organization and just what classes of individuals have been identified by courts as having such an interest. This article then argues that a further expansion of standing through legislation could serve to better assure compliance with existing regulations by making prosecution of charitable executives who violate their fiduciary duties more certain.

### C. *The Internal Revenue Service*

We have previously discussed I.R.C. Section 4941 and Section 4958, two of the Internal Revenue Service (“IRS”) regulations that serve to define the boundaries within which fiduciaries of both private foundations and public charities may act.<sup>111</sup> Traditionally, states’ attorneys general have been the

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<sup>109</sup> For a discussion of the implications of expanding standing in the charitable sector, see *infra* Part VI.B.1-D.

<sup>110</sup> Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465-66 (1996).

<sup>111</sup> See *supra* notes 40-44, 55, 91-95 and accompanying text.

primary protectors of the public's interest in charity and, as such, are responsible for oversight of nonprofit organizations.<sup>112</sup> However, due to a lack of resources at the disposal of attorneys general,<sup>113</sup> the IRS has become the primary regulator of nonprofit behavior.<sup>114</sup> In this section, we will outline the steps taken by the IRS to ensure that nonprofit entities in this country are complying with the law. The possibility of reform to the existing charitable oversight system of the IRS and criticisms of such reforms are analyzed in an attempt to strike a balance between forcing compliance with existing regulations while avoiding the imposition of too many administrative requirements on smaller nonprofits with limited resources.

## 1. FORM 990S

Every organization that has gross receipts exceeding \$25,000 and is exempt from federal income tax must file an information return called a Form 990 each year with the IRS.<sup>115</sup> Congress recently imposed a requirement that an organization must provide its Form 990s for the most recent three years upon request by any member of the public who wishes to inspect them.<sup>116</sup> The motivation behind this Congressional action was that increased accessibility to nonprofit tax returns would increase compliance with existing IRS regulations governing those entities.<sup>117</sup> It is difficult to say if members of the public have taken advantage of the opportunity to review the 990s of nonprofit entities over the last nine years. What is certain is that if the public does not inspect these forms, it is unlikely that the IRS will be able to do so either.

The IRS' Form 990s reveal limited, but important information about the nonprofits who file with the IRS.<sup>118</sup> Unfortunately, very few of the Form 990s are actually reviewed due to the declining ratio of IRS staff to nonprofit entities applying for tax-exempt status each year.<sup>119</sup>

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<sup>112</sup> John Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 ST. MARY'S L.J. 243, 244-45 (2004).

<sup>113</sup> See discussion *infra* Part V.E.

<sup>114</sup> U.S. Gov. Accountability Office, Report No. GAO-02-526, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities* (2002) [hereinafter GAO Report].

<sup>115</sup> See Treas. Reg. § 1.6033-2 (as amended in 1995).

<sup>116</sup> See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996) (July 30, 1996).

<sup>117</sup> See *id.*

<sup>118</sup> John F. Coverdale, *Preventing Insider Misappropriation of Not-For-Profit Health Care Provider Assets: A Federal Tax Law Prescription*, 73 WASH. L. REV. 1, 15 (1998).

<sup>119</sup> *Id.*

For instance, in the year 2001, 58,938 applications were received requesting that the entity receive tax-exempt status under 501 (c)(3). Of those 10,548 were disposed of because the applicant did not submit a fee, did not submit all documents, or the application was withdrawn. Of the 42,366 complete applications submitted, only 58 were denied! From 1996 through 2001, the number of Form 990 annual returns filed with the Service increased by twenty-five percent (286,000) while the number examined dropped fifteen percent (to 1237). The percentage of charities examined annually has fallen from .73 in 1998 to .43 in 2001. The reasons for the decline are: changing Service priorities for other taxpayers, declining resources, and shifting of agents from examinations to cope with the increased number of applications.<sup>120</sup>

As we have seen, the Form 990 was intended to increase the public's access to nonprofit financial records and the accountability of the organizations that file these informational returns. Yet, it is becoming apparent that the IRS is ill-equipped to handle the sheer volume of 990s that must be reviewed each year. The danger of the public perceiving IRS review as a rubber-stamp to nonprofit entities is very real and has the potential to negatively affect charitable contributions if the public ultimately concludes that a lack of governmental oversight may lead to misconduct that could go undiscovered.

#### A. INCREASED FINANCIAL DISCLOSURE BY PUBLIC CHARITIES

One question that we should ask with regard to the Form 990s is, if there were sufficient numbers of IRS employees to review all of the 990s, would that solve the problem? Many commentators have suggested that the problem with the Form 990s lies not simply in the fact that they are scantily reviewed, but also in the fact that even if reviewed, the 990s would not be useful because charities often misrepresent information, or worse, fail to provide the required information at all.<sup>121</sup>

This is not to suggest that where errors appear on Form 990s, they are always indicative of charities intentionally misleading the government and the public because they have something to hide. On the contrary, a lack of

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<sup>120</sup> Fishman, *supra* note 55, at 265-66 (summarizing findings listed in GAO Report, *supra* note 109, at 20-23).

<sup>121</sup> Degaudenzi, *supra* note 11, at 221.



conformity in accounting standards between organizations contributes to different charities using different methods of calculations when accounting for expenses.<sup>122</sup> This flexibility in accounting methods has led to charities erroneously reporting fundraising and general expenses as program expenses on their Form 990s.<sup>123</sup> Whether such errors are innocent mistakes because the organization is small and ill-equipped to handle complex accounting issues, or the errors are intentional and an attempt to make the charity appear more efficient in an age of more accessible tax returns, the problem is equally grave. The Form 990 is an all too brief statement of information that is compiled by a variety of differing methods. This makes it very difficult to decipher these forms and discover any questionable accounting or out-and-out fraud by the organization.

In response to a report issued by the General Accounting Office to Congress, which highlighted the fact that similarly situated charities can file very different Form 990s due to the previously mentioned problems,<sup>124</sup> the Senate Finance Committee has proposed Sarbanes-Oxley<sup>125</sup> type legislation for nonprofit entities.<sup>126</sup> The proposed reforms would: (1) require enhanced and itemized disclosure on annual 990s;<sup>127</sup> (2) require the signature of the charity's chief executive officer under penalty of perjury that the organization put in place processes that will ensure that the organization's tax return complies with the mandates of the IRS and is both accurate and complete;<sup>128</sup> and (3) promulgate standards for the filing of Form 990s and increase penalties for failure to timely file in accordance with such standards.<sup>129</sup> Certainly these reforms will serve to provide more information about nonprofit entities to both the IRS and to the public for review, but are they the answer? Will these Sarbanes-Oxley type reforms serve to increase compliance with the existing regulations of charitable organizations, or like the business judgment rule, are they a for-profit solution that does not easily translate to a nonprofit problem? As is always the case in life, the critics are not at a loss for words.

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<sup>122</sup> Kertz, *supra* note 78, at 861-62.

<sup>123</sup> *Id.* (citing a report by Baruch College). See also Gary, *supra* note 9, at 641.

<sup>124</sup> GAO Report, *supra* note 109.

<sup>125</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18 U.S.C.).

<sup>126</sup> Josephson, *supra* note 77, at 149-53.

<sup>127</sup> *Id.* at 152.

<sup>128</sup> *Id.* at 150.

<sup>129</sup> *Id.* at 150-51.

## B. POTENTIAL SIDE-EFFECTS OF PROPOSED DISCLOSURE REFORMS

Critics of the disclosure and accountability reforms proposed by the Senate Finance Committee note that these changes will likely increase operating costs of charities which will cause the charity to appear less efficient.<sup>130</sup> In addition, it may dissuade competent and talented individuals from pursuing a career in the nonprofit sector due to a simple application of cost/benefit analysis.<sup>131</sup>

We must remember that in deciding to whom to donate funds, contributors often look to an organization's annual report to get an indication of what percentage of funds are used for the organizations stated purpose.<sup>132</sup> Enacting reforms that increase the operating costs of charitable organizations may have the unintended effect of making it more difficult for charities to obtain significant donations because contributors may feel that their money is not being directed to the purpose for which they intended.<sup>133</sup> There is yet another serious problem to be considered when increasing the operating costs of charities; while many large charities will be able to easily bear the costs of such a change, the majority of charities in this country are not on par with the Red Cross<sup>134</sup> and have very small amounts of both human and monetary resources. Increasing the amount of paperwork and administrative duties of nonprofits may have a disproportionate impact on smaller charities, which will cut what the staffs of such organizations could accomplish in charity work.<sup>135</sup>

Imposing reforms that will provide for criminal liability for directors and board members may also have the effect of diverting competent individuals from the nonprofit sector to the for-profit sector.<sup>136</sup> For-profit executives are much more generously compensated than are executives and directors who have chosen to work in the charitable sector.<sup>137</sup> Most executives of

<sup>130</sup> Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1319 (2003).

<sup>131</sup> *Id.* at 1316-17.

<sup>132</sup> *Id.* at 1319-20. See also [www.give.org](http://www.give.org).

<sup>133</sup> *Id.*

<sup>134</sup> More than a million Red Cross volunteers and 35,000 employees annually mobilize relief to families affected by more than 70,000 disasters. See <http://www.redcross.org/aboutus> (last visited September 17, 2005).

<sup>135</sup> Steven Renaldi, *Too Many New Reporting Rules Could Hurt Michigan Nonprofits*, *The Detroit News*, Sep. 17, 2004, available at 2004 WLNR 16230314.

<sup>136</sup> David W. Barrett, *A Call for More Lenient Director Liability Standards for Small Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 970 (1996).

<sup>137</sup> *Id.*

nonprofits are hired for their extensive knowledge of the field and not for their financial prowess or accounting skills.<sup>138</sup> Adding more responsibility and the possibility of criminal liability to an already underpaid position (as compared to their for-profit counterparts) is only likely to convince qualified candidates for charitable executive positions to pursue other opportunities. Where these candidates engage in any sort of cost-benefit analysis, they will be led to the inexorable conclusion that they would be better off in the for-profit world where the compensation is more reflective of the liability and effort of the job.<sup>139</sup>

While some accountability and disclosure reform is certainly necessary in the nonprofit sector, it would be dangerous to be too hasty in importing for-profit solutions such as Sarbanes-Oxley type legislation to the nonprofit field without considering all of the possible negative implications of such action. Criminal liability for nonprofit executives and directors goes too far and could, in the long run, cause charitable organizations to be less productive due to less qualified individuals being at the helm of such entities. Additionally, there are very few rules and regulations in any field that apply across the board. While increased disclosure and accountability is a necessary reform, more thought needs to be devoted as to how such regulations could be applied even-handedly so that smaller nonprofits are not spending a larger percentage of their overhead on administrative tasks. Such a result would only cause a public perception of inefficiency and a possible reduction in donations. In addition to disclosure and accountability requirements, the IRS has also provided penalties that can be assessed directly against a self-dealing charity executive in order to avoid punishing the organization as a whole.<sup>140</sup>

## 2. INTERMEDIATE SANCTIONS

Earlier sections of this article discussed Congress' attempt to punish wrongdoers at the heads of public charities without also having to punish the organization itself and the beneficiaries of that organization's mission.<sup>141</sup> The intermediate sanctions legislation passed by Congress in 1996 does have bite when applied to a disqualified person who participates in an excess

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<sup>138</sup> Renaldi, *supra* note 135.

<sup>139</sup> Szymanski, *supra* note 130, at 1317.

<sup>140</sup> 26 U.S.C. § 4958.

<sup>141</sup> See discussion *supra* Parts III.C-D, IV.D.

benefit transaction,<sup>142</sup> but just how often is Section 4958 enforced against charitable fiduciaries?

In the first seven years of the existence of intermediate sanctions through Section 4958, the insiders of only two organizations had taxes imposed upon them under that legislation.<sup>143</sup> Does this suggest that public charity insiders are conforming to the demands of the law or that there are enforcement problems with I.R.C. Section 4958 that are not present with its private foundation counterpart, I.R.C. Section 4941? The idealist smiles at the former, while the realist acknowledges the latter. The inherent problem in dealing with these two pieces of legislation as equals is that Congress has chosen to deal with public charities and private foundations in two very different ways.<sup>144</sup>

I.R.C. Section 4941 is a blanket prohibition on all transactions by any private foundation insider with his or her organization.<sup>145</sup> This provides objective, and easily identifiable behavior that, if engaged in, will subject the insider to intermediate sanctions.<sup>146</sup> Legislation with this type of objective criteria can be seen as self-executing in that a few largely publicized cases will be sufficient to bring the rest of the industry into compliance.<sup>147</sup> This is a reasonable assumption given the ease with which violations of Section 4941 can be identified. After all, a transaction either took place or it did not, there is no reasonableness standard against which to measure the actions of an insider of a private foundation. Some commentators have argued that Section 4958, as applied to public charities, will be self-executing in the same way,<sup>148</sup> but their analysis of the situation seems to have omitted the problem of proof.

Unlike the rigid but objective transactional rules for private foundations, Section 4958 imposes a reasonableness standard into the equation.<sup>149</sup> In

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<sup>142</sup> Coverdale, *supra* note 118, at 13-14.

An excess benefit transaction triggers an initial tax on the disqualified person equal to twenty-five percent of the excess benefit. . . . By the earlier date on which a notice of deficiency with respect to the initial tax is mailed or the initial tax is assessed, the excess benefit transaction must be 'corrected.' If not corrected within that time, a tax equal to two hundred percent of the excess benefit is imposed on the disqualified person.

*Id.*

<sup>143</sup> Fishman, *supra* note 55, at 267 (referring to the Bishop Estate in Hawaii and a medical organization in Mississippi where family members and directors had to return \$5.2 million in assets).

<sup>144</sup> See discussion *supra* Part III.D.

<sup>145</sup> 26 U.S.C. § 4941.

<sup>146</sup> *Id.*

<sup>147</sup> Coverdale, *supra* note 118, at 14.

<sup>148</sup> BRUCE R. HOPKINS & D. BENSON TESDAHL, INTERMEDIATE SANCTIONS: CURBING NONPROFIT ABUSE 44 (1997).

<sup>149</sup> See discussion *supra* Part III.D.

other words, an insider of a public charity is only subjected to intermediate sanctions when it can be shown that the transaction in question was not reasonably fair, taking into account the particular facts and circumstances.<sup>150</sup> John Coverdale argues that the reasonableness standard militates strongly against Section 4958 being self-executing in the same manner as Section 4941 because it is “notoriously difficult to determine fair-market value in complex transactions involving multiple assets, including intangibles such as goodwill and going concern value.”<sup>151</sup> As such, it is less likely that Section 4958 will force compliance with its demands in the absence of some real threat and presence of a viable system of enforcement. Unfortunately, as we have seen, the IRS’ budget is failing to even keep pace with inflation, to say nothing of the rapid growth of nonprofit entities that are applying for tax-exempt status each spring.<sup>152</sup> It seems apparent that, at least as far as Section 4958 and the Internal Revenue Service are concerned, the urgent need in this area of law is for assistance in the realm of enforcement and not more regulation. So if the IRS is failing to keep up with the rapid growth of nonprofit entities in this country and is having difficulty enforcing its regulations, then who else is left with standing to enforce the duties of charitable fiduciaries?

#### D. *Members of the Board*

Any member of the board of a nonprofit entity has standing to bring suit on behalf of the entity against another director who has breached his fiduciary obligation to the charity.<sup>153</sup> Our discussion has already reviewed in some detail how nonprofit boards are ill suited to act as checks on the actions of dominant directors or executives.<sup>154</sup> However, there is another piece of the puzzle that should be examined. Whether or not a director or board member has standing to sue on behalf of the nonprofit corporation for the actions of a self-interested executive or director is often a question of statutory interpretation by the courts.<sup>155</sup> This can result in rather bizarre

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<sup>150</sup> See discussion *supra* Part III.D.

<sup>151</sup> Coverdale, *supra* note 118, at 14.

<sup>152</sup> Fishman, *supra* note 55, at 265-66.

<sup>153</sup> *Id.* at 258.

<sup>154</sup> See discussion *supra* Part IV.A-B.

<sup>155</sup> See *Lundberg v. Coleman*, 60 P.3d 595, 598-99 (Wash. Ct. App. 2002) (stating that the Washington Legislature has granted shareholders of for-profit companies the right to bring derivative actions on behalf of the corporation. The fact that that same Legislature did not adopt the section of the Revised Model Nonprofit Corporation Act that would grant members and directors of nonprofits standing to bring derivative suits indicates its intent to reject such a provision or right).

outcomes, such as in the case of *Morris v. Thomas*.<sup>156</sup> In *Morris*, the court stated that a plain reading of the North Carolina Nonprofit Corporation Act required that two ousted members of a charity's board of directors be denied standing because they did not institute the derivative action while they were still members of the board.<sup>157</sup> This would seem to allow a situation where board members could conspire to oust other members in a sort of nonprofit hostile takeover. On its face, this ruling seems to further weaken our faith in the ability of boards of directors to ensure that charitable obligations are being fulfilled. After all, if dissenting board members can simply be ousted and replaced when they refuse to go along with the will of the majority, then how strong will they be willing to fight against a course of action that they feel is not in the best interests of the charity?

A quick review of the implications of the *Morris* decision will lead to the conclusion that something in the system broke down. As a point of review, it seems to be agreed that we want boards of directors to review suggested courses of action of the organization to be sure that those actions are in the charity's best interests. However, if a member of the board objects to a course of action as not in the best interests of the charity, then he or she can be ousted and replaced by the other self-interested board members. If the ousted board member then files a derivative action on behalf of the charity the next day, or even later that same day, the result is that he or she will be denied standing because they were not on the board when the action was filed. Does this system maximize the role of boards of directors as watchdogs of charitable efficiency? The plaintiffs in the *Morris* case similarly argued to the court that this result was not logical.<sup>158</sup> While the court seemed to be sympathetic to the arguments of the plaintiff, it stated that it was the job of the North Carolina Legislature to alter a statute that does not conform with public policy, and until that time, the court is bound by the plain wording of the statute.<sup>159</sup> The court also noted that the attorney general of the state has standing to protect the public's interest in charity and investigate any allegations of wrongdoing.<sup>160</sup> In the next section, the

<sup>156</sup> 589 S.E.2d 419 (N.C. Ct. App. 2003).

<sup>157</sup> *Id.* at 422-23. *But cf.* *Richelieu v. Kirby*, No. 157001, 1999 WL 262444 (Va. Cir. Ct. 1999) (holding that the Virginia Nonstock Corporation Act did not prohibit former members and directors of a charity from instituting a derivative action where there were allegations that the corporation had acted *ultra vires* or of willful misconduct on the part of officers and directors. The case was dismissed on the grounds that Virginia law requires that a demand be made upon the charity to bring such an action before it is independently filed. Here, no demand was made upon the respondents to bring an action on behalf of the Humane Society and so the case was dismissed).

<sup>158</sup> *Morris*, 589 S.E.2d at 423.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

effectiveness of states' attorneys general in relation to charitable enforcement will be discussed.<sup>161</sup>

There are many problems with relying upon the members of boards of directors of charities to act as a check upon a director or directors who are motivated by self-interest. States' Nonprofit Corporation Acts vary from state to state<sup>162</sup> and often sharply limit the circumstances under which a board member may bring an action on behalf of the charitable organization. On one end of the spectrum, there is the statutory road blocking of board members who are acting as we would want them to in adhering to their fiduciary obligations to the public, while on the other end, we have disinterested board members who either through complacency or outright indifference are not nearly the check on executive action as are their for-profit counterparts. In either instance, we would do well to remember that the existence of a nonprofit board of directors is not the equivalent check on executive action as it is in the for-profit realm, and more needs to be done to ensure that the public's interest in charity is safeguarded.

#### E. *The State Attorney General*

In every state, state attorneys general are entrusted with the responsibility of safeguarding the public's interest in charity either by statute or by common law.<sup>163</sup> In theory, they are to oversee all charitable activities within their state and have standing to sue a charity insider for any breach of fiduciary duty. On its face, this would appear to have the matter settled; that the attorney general will handle any suits that need to be instituted against charities or their directors and executives within that state.

The difficulty with relying on the attorney general to investigate and correct any wrongdoings of charities is threefold. First, the attorneys general of the respective states are woefully understaffed, particularly in the charitable sectors.<sup>164</sup> Hand-in-hand with the first problem is the fiscal

<sup>161</sup> See *infra* Part V.E.

<sup>162</sup> Twenty-nine states have adopted all or part of the Revised Model Nonprofit Corporation Act of 1987. For an in depth discussion of how various states have approached the problem of whether to use corporate law or trust law to deal with charitable organizations, see Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Nonprofit Health Care Enterprise*, 5 YALE J. HEALTH POL'Y, L. & ETHICS 1 (2005).

<sup>163</sup> Vinson, *supra* note 112, at 244-45 (2004). See also Gary, *supra* note 9, at 622.

<sup>164</sup> Gary, *supra* note 9, at 623 (reporting that a 1994 study of attorneys working in the charitable sections of states attorneys general offices found that Connecticut had four attorneys working in the division, Massachusetts had seven and New York had seventeen. Many other states, however, had one assistant attorney general supervising the nonprofit sector as only one part of his or her assignment. Hawaii reported .5 attorneys working with charities, and many states do not list any attorneys specifically

difficulties facing almost all state governments. Due to budgetary constraints, the effectiveness of the attorney general is sporadic at best.<sup>165</sup> This results in a large number of charitable abuses falling through the cracks, as the attorney general is forced to selectively prosecute only the worst cases of abuse based upon the amount of money involved, the size of the organization, the impact on the public, and the egregiousness of the conduct.<sup>166</sup> Each year in the United States, eighty thousand new companies petition the government for a tax-exemption as a Section 501(c)(3) organization.<sup>167</sup> Budgetary constraints are simply not allowing states' attorneys general to keep pace with the ever growing class of entities that claim a tax-exemption as charitable organizations each year. Lastly, while a lack of resources may prevent an attorney general from prosecuting a case, so too may a conflict of interest in a particular case. It must be remembered that attorneys general are political officials and they may not want to drag the name of a prominent citizen through the mud in a charitable investigation.

While the states' attorneys general are an indispensable cog in the machinery of charitable enforcement, it is all too evident that they are overburdened as it is and unable to keep up with the rapid growth of organizations in the charitable sector. Professor Harvey Dale has commented,

Government regulators (and most particularly attorneys general, to whom the law confides the principle role in policing charities) tend to allocate their scarce regulatory resources to other more politically potent portions of their domains. In most states, the Charity Bureau of the Attorney General is inactive, ineffective, overwhelmed, or some combination of these.<sup>168</sup>

Some have suggested that private parties could serve as a needed supplement to the authority of the attorney general,<sup>169</sup> but this would be a

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assigned to charitable matters). For more statistical information on the shortage of assistant attorneys general assigned to charitable matters see *Number of Full-Time Equivalent (FTE) Attorney Positions by Selected Practice Areas: "Public Protection"* (Nat'l Ass'n of Attorneys General), 1997, at 18, 20 [hereinafter "Public Protection"].

<sup>165</sup> *Public Protection*, *supra* note 164, at 39.

<sup>166</sup> *Id.* See also, Gary *supra* note 9, at 623.

<sup>167</sup> HILL & MANCINO, *supra* note 6, ¶ 1.01, 1-2.

<sup>168</sup> Fishman, *supra* note 55, at 268 (quoting from Peter Swords, *Nonprofit Accountability: The Sector's Response to Government Regulation*, 25 EXEMPT ORG. TAX REV. 413, 419 n.17 (1999)).

<sup>169</sup> See Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 91, at 607. See also Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1431 (1998) (stating that "attorneys general rarely pursue their rights with the same zeal that private parties exhibit").



delicate balance because, as previously noted, the courts have an interest in limiting the class of persons who may institute an action against a charity so that such organizations are not subjected to “vexatious” or “harassing” litigation.<sup>170</sup> Therein lies the question; how do we at once protect charitable organizations from constant attack in the courts, but also provide assistance to the existing state and federal enforcement agencies that are already overburdened, underfunded and understaffed?

#### **PART VI: ENFORCEMENT SOLUTIONS: AN EXPANSION OF STANDING AS AN AGENCY SUPPLEMENT**

Much of our time thus far has been devoted to examining the regulations and agencies that are in place to ensure that directors of charitable organizations comply with the law. We have seen the shortcomings of these safeguards and have reached the point at which criticism must end and innovation must begin. By now it is apparent that there are only two feasible solutions to increasing enforcement in the realm of charitable fiduciary law. We must either increase funding for agencies, such as the IRS and state attorneys general, that are charged with the oversight of nonprofit entities, or we must supplement their efforts by expanding the class of persons who are able to institute an action against the director of a charity on behalf of the public in order to enforce their fiduciary responsibilities. Unfortunately, pinning our hopes on the former is likely to lead only to disappointment, as both federal and state budgetary constraints make it extremely unlikely that charitable enforcement sectors will be given priority over other more politically pressing concerns. That being the case, we must try to strike the delicate balance between providing sufficient oversight of nonprofit organizations to force compliance with existing law while still protecting these valuable entities from harassing and vexatious litigation. First, let us look at how courts have begun to recede from the rigid application of standing doctrine in certain circumstances and allow others who meet certain criteria to challenge the actions of charitable organizations.

##### *A. Special Interest Doctrine*

While the attorney general has traditionally enjoyed her role as *parens patriae*,<sup>171</sup> or the exclusive protector of the public’s interest in charity, the

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<sup>170</sup> Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 91, at 607.

<sup>171</sup> *In re Milton Hershey School*, 867 A.2d 674 (Pa. Commw. 2005).

courts have not entirely turned a blind eye to the realities of our legal world. Over time, both state and federal courts have begun to recognize the political and fiscal restraints that often tie the hands of state attorneys general and prevent them from policing violations of nonprofit organizations in the way that they would like. One judicially created solution to the problem of inadequate charitable enforcement at the state level has been to relax the traditionally rigid standing requirements for plaintiffs through the special interest doctrine.<sup>172</sup>

Special interest doctrine originated in the area of private trusts where beneficiaries were typically a smaller and more easily identifiable group than is the case with larger public charities.<sup>173</sup> While trustees have generally been considered to have standing to sue in both the area of private trusts and the charitable sector, beneficiaries in the charitable sector have had a much more difficult road to travel when trying to enforce the duties of a nonprofit organization.<sup>174</sup> This is because it is often the case that the class of beneficiaries of a given charitable organization is a shifting class; that the group is too large and amorphous to have a clearly defined interest in the operation of the charity.<sup>175</sup>

The overarching theme of special interest doctrine is that the plaintiff in question must have an interest that is distinct from that of the public at large.<sup>176</sup> Certainly, the appeal of expanding the special interest doctrine from private trust law to the area of charitable enforcement has merit for the simple fact that it is likely to eliminate the harassing and vexatious litigation of charitable entities that opponents to expanded standing in the charitable sector predict. This is because a plaintiff who has a "special interest" in the efficient and lawful operation of the charity in question is presumably seeking to uphold the best interests of both the charity and the likely beneficiaries of such.<sup>177</sup>

In order to determine whether a given plaintiff has the requisite special interest in a charity such that they should be granted standing to sue, courts

<sup>172</sup> For a more in depth discussion of special interest doctrine and how it has been applied in various cases see Blasko, *supra* note 28, at 61-67.

<sup>173</sup> *Id.* at 59.

<sup>174</sup> Gary, *supra* note 9, at 618.

<sup>175</sup> Students of a university are a prime example of a large and amorphous group of beneficiaries who have been identified as lacking the requisite "special interest" to be granted standing to sue. See *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819); *Russell v. Yale Univ.*, 737 A.2d 941, 942 (Conn. App. Ct. 1999). *But cf.* *Jones v. Grant*, 344 So.2d 1210 (Ala. 1977) (stating that a student body, faculty and staff had standing to institute a class action against a college, its president and board of directors for misuse of federal and church funds).

<sup>176</sup> *Hooker v. Edes Home*, 579 A.2d 608, 609 (D.C. 1990).

<sup>177</sup> Blasko, *supra* note 28, at 61.

have utilized a five-factor test. The elements of the test include the following:

- (1) the nature of the benefited class and its relationship to the charity;
- (2) the extraordinary nature of the acts complained of and the remedy sought;
- (3) the state attorney general's availability and effectiveness to enforce the trust;
- (4) the presence of fraud or misconduct on the part of the defendants; and
- (5) subjective and case-specific circumstances.<sup>178</sup>

However, for purposes of determining standing, at least one court has noted that little weight, if any, should be accorded to either the nature of the acts complained of or the presence of fraud or misconduct on the part of the defendants.<sup>179</sup> The underlying rationale of this assertion is that if courts were to allow allegations of grave misconduct to confer standing on individuals, this would undermine the purposes of limiting standing in order to protect trustees from vexatious litigation.<sup>180</sup> Where acts of serious misconduct have occurred, the attorney general should be sufficient to enforce the rights of the public.<sup>181</sup> As such, the attorney general's availability and effectiveness is a more important factor for consideration.<sup>182</sup> In their 1993 article, Blasko, Crossley, & Lloyd agreed that attorney general effectiveness is a key factor.<sup>183</sup> There, the authors noted that "[i]n those jurisdictions where the attorney general is heavily involved in charities regulation, courts generally will take a dim view of private parties attempting to step into the attorney general's role to seek enforcement of charitable fiduciary duties."<sup>184</sup>

While the availability of the attorney general is an important factor for consideration by the courts, perhaps the most important consideration is the

<sup>178</sup> *Id.* See also RESTATEMENT (SECOND) OF TRUSTS § 391.

<sup>179</sup> Robert Schalkenbach Found. v. Lincoln Found., Inc., 91 P.3d 1019, 1026 (Ariz. Ct. App. 2004).

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> Blasko, *supra* note 28, at 70.

<sup>184</sup> *Id.* In re Clement Trust, 679 N.W.2d 31, 35 (Iowa 2004) (denying partial standing to the beneficiaries of a charitable trust who had unsuccessfully attempted to have the Attorney General of Iowa challenge the actions of the trustees).

exact nature of the complaining party's relationship to the charity.<sup>185</sup> In order to be granted standing to challenge the actions of a charity, a plaintiff or class of plaintiffs must show that their interest in the charity is "distinct from that of members of the public at large."<sup>186</sup> Courts require such a specially defined interest in the charity in order to reduce the likelihood of subjecting charitable organizations and trustees to suit when they make decisions with which members of the public are displeased.<sup>187</sup> An oft cited example of a plaintiff who was denied standing to bring an action against the trustees of a foundation because he lacked a special interest in the trust is *Kania v. Chatham*.<sup>188</sup> In *Kania*, a candidate for an undergraduate scholarship brought an action seeking removal of the trustees of a private foundation for their decision to deny him a scholarship.<sup>189</sup> The student asserted that he had a special interest in the execution of the trust because he was a "potential beneficiary" of the trust.<sup>190</sup> This, the court stated, was fatal to his case because a plaintiff who brings an action on the basis of a special interest in a charitable trust must have a more definite interest than simply being a potential beneficiary subject to the discretion of the trustees.<sup>191</sup> Here, we see again the concept of the business judgment rule being applied to charitable organizations.<sup>192</sup> Courts simply do not want the unpleasant task of second-guessing the discretion and judgment of charitable executives and trustees.

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<sup>185</sup> *Clement Trust*, 679 N.W.2d at 37-38 (stating that individuals must show that they have a special or definite interest in the trust or are entitled to receive a benefit before they will be granted standing); *Hooker v. Edes Home*, 579 A.2d 608, 614 (D.C. 1990) (holding that a class of potential beneficiaries may have standing to enforce a charitable trust where the class is "sharply defined and its members are limited in number").

<sup>186</sup> *Hooker*, 579 A.2d at 609.

<sup>187</sup> *Blasko*, *supra* note 28, at 74.

<sup>188</sup> 254 S.E.2d 528 (N.C. 1979). *See also* *Warren v. Bd. of Regents of the Univ. Sys. of Ga.*, 544 S.E.2d 190, 193 (Ga. Ct. App. 2001) (holding that "those who enjoy the status of beneficiaries only when selected by the trustees are generally held to have no right to initiate a suit for the enforcement of a charitable trust").

<sup>189</sup> *Kania*, 254 S.E.2d at 529.

<sup>190</sup> *Id.* at 530.

<sup>191</sup> *Id.* The idea that a "potential beneficiary" can never have a special interest in the execution of a trust was rejected in *Hooker*, 579 A.2d at 608, 614, in favor of a view that potential beneficiaries can have a special interest in enforcing a trust if "the class is sharply defined and its members are limited in number."

<sup>192</sup> *See* discussion *supra* Part IV.A.

B. *The Inconsistency of the Special Interest Doctrine as a Means of Granting Standing.*

In examining how courts have relaxed the standing requirements for plaintiffs in the charitable arena through the use of the special interest doctrine, it becomes apparent that various courts are engaging, at least in some sense, in a balancing test. On one side of the equation, we have the interest in ensuring that charitable organizations are adhering to the existing laws that govern them. On the other side, there is a strong interest in not subjecting charities to lawsuits which could deplete valuable resources that were intended for the entity's stated charitable purpose. To assure the efficient functioning of the charitable system in this country, both the public at large and the charitable industry have a strong interest in both sides of the equation.<sup>193</sup>

For all of the successes of the use of special interest doctrine by courts to supplement the efforts of agencies charged with charitable enforcement, the inconsistency with which the doctrine is applied across the country is staggering. As previously stated, the five-factor test listed in the Restatement<sup>194</sup> and the Blasko article<sup>195</sup> is at best a guideline for courts that may choose to place more emphasis on one factor over another to reach a desired result.<sup>196</sup> As would be expected of such a situation, factually similar cases have produced different outcomes, with some plaintiffs being granted standing to bring suit while other similarly situated plaintiffs are turned away.<sup>197</sup>

## 1. THE IRREBUTTABLE PRESUMPTION OF THE THREAT OF VEXATIOUS LITIGATION

If courts are truly engaged in balancing the public's interest in charitable compliance with the laws and the charitable entity's interest in not being subjected to harassing and vexatious litigation, how is one to measure each

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<sup>193</sup> A vicious cycle can be seen appearing here where the donating and benefiting public certainly does not want a charity constantly subjected to the threat of litigation. However, without the deterrent effect of the threat of litigation, how can the public be assured that charities are adhering to the laws they are to follow? Additionally, the charitable industry has a strong interest in reducing lawsuits, while also complying with the law so as to avoid the appearance of impropriety that may serve to deter the public from donating money to their charity.

<sup>194</sup> RESTATEMENT (SECOND) OF TRUSTS § 391.

<sup>195</sup> Blasko, *supra* note 28, at 61.

<sup>196</sup> See *supra* notes 179-184 and accompanying text.

<sup>197</sup> See *supra* note 104 and accompanying text.

side of the equation? The threat of harassing and vexatious litigation as the by-product of a particular lawsuit is immeasurable. In the hands of a court that is simply unwilling to grant standing to an interested party for whatever reason, this unquantifiable factor can be assigned infinite weight in the balancing of public and charitable interests. It is beyond dispute that opening the door to any member of the public to challenge the actions of a charity is unwise. But what of those whose knowledge and insight into the functioning of the challenged organization place them in a unique position to bring the organization back into conformity with its stated charitable mission? Would expanding standing in the charitable realm actually lead to the downfall of the industry and force nonprofits to battle constant lawsuits as doomsday theories have warned? We can see an analogy, although an imperfect one, when we look to the history of standing in administrative proceedings.<sup>198</sup>

In the case of *Office of Communication of the United Church of Christ v. Federal Communications Commission*,<sup>199</sup> members of the listening public sought standing to intervene in a license renewal proceeding of a Mississippi television station that they charged with discrimination and promotion of segregationist views.<sup>200</sup> The Federal Communications Commission ("FCC") denied standing to the listening public due to rigid adherence to a requirement that an intervenor suffer a direct and economic injury in order to have standing.<sup>201</sup> In addition, the FCC argued that was the "prime arbiter of the public interest" and that it could effectively represent listener interests without the aid and participation of listener representatives.<sup>202</sup> The view of the FCC here can be seen as analogous to the court's view of the role of the attorney general as *parens patriae*, or the sole protector of the public interest in charity. Both agencies are entrusted with protecting the interests of the general public in their respective areas of law.

The Court of Appeals for the District of Columbia Circuit in *Church of Christ* took a very functionalist and liberal view of the role of the FCC. That court noted that practical circumstances necessitated an expansion of standing that would not require an economic injury to intervene in a

<sup>198</sup> It is acknowledged that standing to intervene in an administrative proceeding, such as a licensing, is not an exact analogy to standing to bring an action in an Article III judicial proceeding. This section is only meant to illustrate that reformation in a given area of law will not always result in catastrophic failure of the system. Those who felt that expanding the class of persons who were entitled to participate in administrative proceedings would overburden the administrative system have not seen their fears borne out.

<sup>199</sup> 359 F.2d 994 (D.C. Cir. 1966).

<sup>200</sup> *Church of Christ*, 359 F.2d at 997-98.

<sup>201</sup> *Id.* at 1000.

<sup>202</sup> *Id.* at 1003.

licensing proceeding.<sup>203</sup> “The Commission of course represents and indeed is the prime arbiter of the public interest, but its duties and jurisdiction are vast, and it acknowledges that it cannot begin to monitor or oversee the performance of every one of thousands of licensees.”<sup>204</sup> The court then continued,

The theory that the Commission can always effectively represent the listener interests in a renewal proceeding without the aid and participation of legitimate listener representatives fulfilling the role of private attorneys general is one of those assumptions we collectively try to work with so long as they are reasonably adequate. When it becomes clear, as it does to us now, that it is no longer a valid assumption which stands up under the realities of actual experience, neither we nor the Commission can continue to rely on it. . . .<sup>205</sup>

The court in *Church of Christ* noted that the limited staff and resources of the FCC made it impossible for that agency to oversee all licensees.<sup>206</sup> It further realized that some mechanism was necessary to protect the legitimate interests of the public that could not be served by the FCC.<sup>207</sup> As a result, the court rejected the “‘oft-expressed fear’ that a ‘host of parties’ will descend upon [the agency] and render its dockets ‘clogged’ and ‘unworkable.’”<sup>208</sup> and stated that “[t]he fears of regulatory agencies that their processes will be inundated by expansion of standing criteria are rarely borne out.”<sup>209</sup>

At this point, it seems necessary to reiterate that the discussion of the *Church of Christ* case is not meant to be a perfect analogy to standing in the context of Article III jurisprudence. Instead, it is offered as an example of how traditional notions of the role of an agency, whether the FCC, the IRS, or states’ attorneys general, can become outdated by the realities of the impossible tasks laid before them. Just as the Court of Appeals for the D.C. Circuit recognized that it was unrealistic to think that the FCC could

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<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.* at 1003-04.

<sup>206</sup> *Church of Christ*, 359 F.2d at 1005.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* at 1004.

<sup>209</sup> *Id.* at 1006. The court here notes that restraining factors such as the expense of participation in the administrative process will often keep those with even a large economic interest in the proceeding from participating.

adequately protect listener interests by monitoring all of its many licensees, the rapid growth of nonprofit entities in this country is quickly making oversight by understaffed agencies a daunting task.<sup>210</sup>

The Internal Revenue Service and the Charitable Divisions of States' Attorneys General are diligently working to win as many battles as possible. Yet, fiscal realities have predetermined that they will lose the war unless others are allowed to aid them in their fight to protect the public's interest in charitable functioning. Now is the time to carefully expand standing in the charitable sector and challenge the indefinable and immeasurable prediction that harassing and vexatious litigation will ensue. This author suggests that few individuals will be in a position to have sufficient knowledge regarding the operations of a particular charity to bring a claim for malfeasance or breach of fiduciary duty. For those with such information, carefully drafted legislation will prevent harassing lawsuits by precisely defining which persons have standing to bring a claim and the strict procedures that must be followed in order to do so.

## 2. ARE COURTS DETERMINING STANDING OR REVIEWING THE MERITS OF A CLAIM?

It seems as though many courts may not be determining if the plaintiff has standing to have the court reach the merits of their claim as much as they are evaluating the merits of the claim to see if they want to grant standing. Many courts seem to be asking the singular question; is this the type of harassing and vexatious litigation that standing doctrine in the charitable realm is designed to prevent?<sup>211</sup> Other courts have skewed the question so as to ask if the plaintiff at hand is likely to bring vexatious litigation against the charity.<sup>212</sup> Whether or not a certain party would be likely to institute harassing litigation against a particular charity becomes more a matter of subjective assessment by the judge and less a decision based upon the objective factors listed in the special interest test.<sup>213</sup>

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<sup>210</sup> See discussion *supra* Parts V.C, V.E.

<sup>211</sup> *Hooker v. Edes Home*, 579 A.2d 608, 616-17 (D.C. 1990) (granting standing to limited class of beneficiaries in part because "the interest here is to vindicate a collective interest in the continued availability of that benefit—an interest affected by a proposed exercise of discretion that will change the nature of the institution—the prospect of recurrent, vexatious litigation is minimal.").

<sup>212</sup> *In re Milton Hershey School*, 867 A.2d 674, 690-91 (Pa. Commw. Ct. 2005) (stating that "[f]urthermore, the risk of vexatious or unreasonable litigation by the Association if virtually non-existent in this case.").

<sup>213</sup> See *supra* note 178 and accompanying text. While it is true that the fifth factor in the test is "subjective and case-specific circumstances," giving this factor too much weight would obviate the need for the other factors. The factors of the test listed in Restatement (Second) of Trusts § 391 should be



The more relevant question that should be answered by a court is whether granting standing to the party before it will open the door to harassing litigation by creating precedent for other similarly situated persons. The former, and more subjective, question seems to turn standing doctrine on its head by giving judges the power to choose from among similarly situated plaintiffs as to who will be allowed to bring their claim. One New York court has even distorted charitable standing doctrine to the point where it was suggested that if an individual brings a claim against a charity without the possibility for pecuniary gain, then they should be granted standing.<sup>214</sup> While this abbreviated analysis certainly simplifies the job of the courts in determining whether a plaintiff has standing, it is seemingly miles away from the five-factor test that has been traditionally used to determine a special interest to bring a claim in the interests of a charity.<sup>215</sup> After all of this, how can we reach a solution where parties interested in the effective functioning of a charitable organization can clearly understand their rights under the law by ensuring that standing to enforce charitable responsibilities is either granted or denied on a more consistent basis?

### C. *A Call for Legislative Action.*

The foregoing discussion should not be interpreted as a hostile attack on courts who have relaxed the rigid standing requirements to allow interested parties to challenge the possible misconduct of charitable fiduciaries or entities. Certainly, this article argues in favor of a revised system that will permit interested parties to be able to initiate such challenges. However, while consistency may be “the hobgoblin of little minds,”<sup>216</sup> a judicial system that lacks consistency in an area of law demands guidance and reform. As the law exists today, an interested party and his or her lawyer may have a

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used to evaluate the interested party's relationship to the charity so that the court can determine if that party will be a motivated and interested party; this is the primary purpose of the doctrine of standing. Allowing courts to use subjective feelings about the complaining party or a class of claims generally to deny standing invites inconsistency. As well, it works to defeat the purpose of the special interest doctrine by ignoring the complaining party's interest in the charity and placing emphasis on whether or not the judge feels that the party may have an ulterior motive.

<sup>214</sup> *Smithers v. St. Luke's-Roosevelt Hosp.*, 281 A.D.2d 127, 138-39 (N.Y. App. Div. 2001) (stating, “Moreover, the desire to prevent vexatious litigation by ‘irresponsible parties who do not have a tangible stake in the matter and have not conducted appropriate investigations’ has no application to Mrs. Smithers either. Without possibility of pecuniary gain for himself or herself, only a plaintiff with a genuine interest in enforcing the terms of a gift will trouble to investigate and bring this type of action.”).

<sup>215</sup> See *supra* note 178 and accompanying text.

<sup>216</sup> Ralph W. Emerson, *Self-Reliance* in RALPH WALDO EMERSON 131,137 (R. Poirier ed., 1990).

hard time knowing whether they will have standing to bring their charitable claim until a judge rules on the matter.

It is entirely necessary and appropriate for state legislatures to respond to the charitable enforcement problem that exists within all fifty states by supplementing the efforts of overworked and underfunded states' attorneys general with a precisely defined category of persons who may challenge the actions of a charitable fiduciary. The special interest doctrine was seen by courts as a way of alleviating the problem of selective charitable enforcement, but the application of this doctrine has fallen short of being a consistent solution. When judicially created doctrines can be easily manipulated to create wildly inconsistent results for similarly situated parties, it is the legislature's duty to announce the public policy so as to provide guidance that will bring such cases into conformity with one another. In the next section, model legislation is proposed that would codify the spirit and purposes of the special interest doctrine while at the same time providing more defined criteria for determining standing so as to eliminate subjective merit-based evaluations by courts.

#### *D. Proposed Model Legislation*

The Model Legislation that follows should be viewed as a rough guideline for state legislatures who recognize that the charity sections of their respective attorney generals' offices are overburdened. Now is the time to institute a system whereby interested citizens, who have a stake in a charitable organization, can be proactive in ensuring that such organization is conforming to the dictates of the law. Legislation by state policy makers will serve to guide courts as to what procedures must be followed by complainants in order to preserve a charge. Additionally, the new law will help to specifically define those who are entitled to bring a charge due to a special interest in the charity or unique circumstances that would lead them to have knowledge of the operations of the charity beyond that of a member of the general public.

It is true that any new legislation must carefully balance the need for more rigorous enforcement in the charitable sector with the need to shelter charities from frivolous lawsuits. In striving to achieve such a balance, careful statutory drafting is necessary such that strict adherence to procedural guidelines is required and any charging party who obtains legal counsel will be aware, prior to the filing of a formal complaint, whether a court will recognize that they have standing to enforce the charitable duties of the organization.

**THE NONPROFIT RESPONSIBILITY ACT**

It shall be the public policy of this state that efficient and lawful charitable functioning through the enforcement of the laws governing nonprofit entities be a priority for courts faced with such cases. The procedures set forth in the following sections for the filing of a charge against a charitable organization with the State Attorney General or the filing of a formal complaint after Attorney General review are to be strictly adhered to by presiding courts. The failure of a charging party to timely file a charge with the Attorney General, or complaint with the court, shall result in dismissal of such party's complaint.

(1) **Definitions:**

- (a) **“Charge”**—Informal allegation of misconduct on the part of a charitable organization or insider that is filed with the charitable division of the Office of the Attorney General. Such allegation must be supported by particular facts including, but not limited to:
- (i) the specific acts of misconduct that are alleged;
  - (ii) the party or parties alleged to have committed the misconduct;
  - (iii) the date or approximate date of the alleged misconduct;
  - (iv) the personal knowledge upon which the allegations are based; and
  - (v) the charging party's relation to the nonprofit organization in question.
- (b) **“Interested Party”**—Any person who possesses knowledge or has an interest in a particular charity beyond that of the general public. Such parties should include, but are not limited to:
- (i) employees of the charity;
  - (ii) former employees of the charity;
  - (iii) any member or former member of a board of directors, whether compensated or serving on a volunteer basis;
  - (iv) members of the nonprofit organization;
  - (v) beneficiaries of the nonprofit's mission who have been identified for receipt of charitable action; and
  - (vi) donors who had conditioned their donation upon an action subsequently not undertaken by the nonprofit organization.

The word “identified” in subsection (1)(b)(v) of this statute should not be interpreted to mean “identified by name.” Rather, a beneficiary qualifies as an interested party within the meaning of that subsection if such beneficiary is a member of a group or class of citizens that have been targeted for receipt of charitable funds or action.

- (c) “Formal Complaint” or “Complaint” – Civil action filed by the Office of the Attorney General or the charging party with the court after a reasonable investigation by the Attorney General has been undertaken and a decision of action made by that Office.
  - (d) “Discovery”—As used in subsection (3) of this statute, discovery on the part of the charging party shall be construed to mean actual knowledge of misconduct and not “knew or should have known” of the misconduct.
- (2) The sections of this statute shall apply in all cases involving allegations of fraud, malfeasance, misappropriation of funds, breach of fiduciary duty, or any other act of self-dealing by a private foundation or public charity insider within the meaning of such terms as used by the Internal Revenue Code.
- (3) Where any interested party, as defined in subsection (1) of this statute, alleges misconduct on the part of a nonprofit organization or insider of such organization, a charge of charitable misconduct must be filed with the State Attorney General within 90 (ninety) days of the incident of misconduct or within 90 (ninety) days of the discovery that misconduct has occurred.
- (4) Upon the filing of a timely charge, the charitable division of the Office of the Attorney General shall conduct a reasonable investigation into the facts upon which the allegations of misconduct were based. Such investigation shall conclude within 180 (one-hundred eighty) days with a finding by the Office of the Attorney General. At or before the conclusion of the 180-day investigation period, the Attorney General shall send to the charging party a brief finding of fact and a notice of recommended action in any of the following forms:
- (a) *Attorney General Intervention*—The Office of the Attorney General has investigated the facts and has determined that there is cause for the filing of a formal complaint. Such complaint will be filed by the Office of the Attorney General against the alleged offender(s) within a timeframe to be determined by that agency.

- (b) *Attorney General Nonintervention*—The Office of the Attorney General has investigated the facts and has determined that there is cause for the filing of a formal complaint. Such formal complaint will not be filed by the Attorney General, but may be filed by the charging party within 90 (ninety) days of the receipt of this notice.
  - (c) *Finding of No Cause*—If at the conclusion of a reasonable investigation, the Office of the Attorney General finds that there is no cause for the filing of a formal complaint of misconduct against the nonprofit organization or organization insider based upon the facts, such shall be communicated to the charging party. At such point, the charging party may still file a formal complaint with the court subject to the restrictions of subsection (6) below.
- (5) Where a charging party receives a notice of nonintervention pursuant to subsection (4)(b) of this statute, the Office of the Attorney General shall be copied on all filings to the court of both the plaintiff and defendant. Further, the Office of the Attorney General retains the right to intervene in the proceeding at any stage of the litigation, and for either party, in the event that it is determined that intervention is in the public interest.
  - (6) Upon the filing of a formal complaint by either the Office of the Attorney General or the charging party, the notice of recommended action of the Attorney General shall be attached to the formal complaint for review by the court. Where the Attorney General has made a finding of no cause and a charging party has proceeded with the filing of a formal complaint against the nonprofit organization or insider without any new evidence or extraordinary circumstances, such may be grounds for a dismissal of the case and assessment of attorney's fees against the complaining party at the discretion of the presiding judge.
  - (7) *Standing*—Upon the filing of a charge with the Office of the Attorney General, such Office will review the charging party's relation to the nonprofit organization in question to determine if they are an interested party within the meaning of subsection (1)(b). In the case of a notice of recommended action pursuant to subsection (4)(b) of this regulation, the Attorney General's assessment that the charging party is an interested person shall be determinative and binding on the courts. In no circumstance may a party who has been granted the right to sue by the Office of the Attorney General upon a finding of charitable misconduct have his or her case dismissed for lack of standing. This subsection is

inapplicable to a finding of no cause notice of recommended action in subsection (4)(c).

- (8) Damages—In all cases that fall under this statute, any claim for damages shall be paid directly to the charitable organization and not to the charging or complaining party. This subsection does not apply to requests for injunctive relief by a charging party.
- (9) In any case where the complaint of a charging party leads to a recovery of misappropriated funds by a charitable organization, whether by way of settlement or judgment, the original charging party is entitled to receive the lesser of an amount equal to 5% (five percent) of the misappropriated funds or \$1,000 (one thousand dollars).
- (10) Attorney's Fees—In any case where an interested party has been granted a right to sue upon a finding of cause but nonintervention by the Office of the Attorney General, the attorney of the charging or complaining party is entitled to reasonable fees and costs associated with the action where damages are assessed against a party charged with misconduct. Where such party is found by a judge or jury to be innocent of any wrongdoing or misconduct, fees shall be paid to the charging or complaining party's attorney by the charging or complaining party.

## VII. CONCLUSION

The preceding Model Legislation is not a panacea, but it would alleviate many of the problems of charitable enforcement that exist today. While some may read the foregoing and feel that it only requires more work from an already overburdened state agency; that is not the case. The preceding legislation grants to states' attorneys general the power to allow interested parties of a charity to reduce their workload. Any state's Office of the Attorney General can choose to pursue only those charges where it is determined that there is cause for filing a formal complaint, but where the original charging party is not an interested party within the meaning of the statute. In all other situations, the Office of the Attorney General can simply oversee the case and intervene only if it determines that such intervention is necessary to protect the public's interest in charity.<sup>217</sup>

As the law exists today, there are very few individuals who have standing to enforce the fiduciary obligations of a nonprofit director or executive. The agencies that are entrusted with this monumental task, namely state

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<sup>217</sup> See Model Legislation § 5.

attorneys general and the IRS, are overburdened and underfunded to the point where a supplement to their efforts is badly needed. Various courts have attempted to fill the enforcement void in the charitable sector by relaxing traditional standing requirements through use of the special interest doctrine. However, these decisions have been marred by inconsistency and unpredictability to the point that a new, legislative solution is required. State legislatures must heed the call and resolve the confusion that exists as to how and when an interested party seeking to enforce the fiduciary obligations of a charitable executive is entitled to have his or her case heard on the merits.

Nonprofit entities are an invaluable part of our efficient capitalistic machine and serve to supplement the efforts of the government by providing services which are essential to the well-being of all citizens. That being said, the potential for abuse within the system is overwhelming because the checks that exist to restrain for-profit executive action lack nonprofit equivalents and enforcement by designated agencies is sporadic. Everyone affiliated with the nonprofit industry wants to ensure that charitable entities are not subjected to harassing and vexatious litigation. We cannot reach this goal by simply turning our heads and looking the other way, nor can we truly rely on the integrity and conscience of nonprofit fiduciaries to force them into compliance with the law when no one is looking.