

## THERE OUGHT TO BE A LAW: THE DISCLOSURE FOCUS OF RECENT LEGISLATIVE PROPOSALS FOR NONPROFIT REFORM

DANA BRAKMAN REISER\*

In response to news of scandals in nonprofit organizations large and small, prestigious and obscure, states and the federal government have begun to tout legislative solutions to the perceived nonprofit accountability gap.<sup>1</sup> These legislative reform initiatives have been linked, by their proponents and by commentators, to the federal Sarbanes-Oxley Act (“Sarbanes-Oxley” or “the Act”) passed in response to Enron and the other major for-profit scandals of the early 2000s.<sup>2</sup> One can obviously link the two sets of

\* Associate Professor of Law, Brooklyn Law School; J.D., Harvard Law School; B.A., University of Pennsylvania. I am indebted to the Brooklyn Law School Summer Research Program and the able research assistance of Libby Bakalar, Matthew Kelly, Yuliya Levitan, and Joan Robinson. I appreciate the comments and suggestions of Evelyn Brody, Harvey Dale, Marion Fremont-Smith, Claire Kelly, Jeff Reiser, Richard Schmalbeck, and Norm Silber. I am also grateful for the feedback I received from the other participants and attendees at the Chicago-Kent College of Law Symposium, *Who Guards the Guardians?: Monitoring and Enforcement of Charity Governance*, and the participants in the Brooklyn Law School Junior Faculty Workshop Series. Any remaining errors are, of course, my own.

1. See, e.g., S. 4836-B, 226th Leg., Reg. Sess. (N.Y. 2004) [hereinafter N.Y. Senate Bill]; Office of the Massachusetts Attorney General Tom Reilly, An act to Promote the Financial Integrity of Public Charities: Draft 1.0, available at <http://www.providers.org/Charities%20Fin%20Integrity%20Legis%20Jan%202004.pdf> [hereinafter Mass. Draft Leg.]; see The Nonprofit Integrity Act, 2004 Cal. Stat. ch. 919 (as signed by governor Sept. 29, 2004), available at [http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1251-1300/sb\\_1262\\_bill\\_20040930\\_chaptered.pdf](http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_bill_20040930_chaptered.pdf) [hereinafter Cal. Act]; STAFF OF SENATE COMM. ON FIN., 108TH CONG., STAFF DISCUSSION DRAFT (2004), available at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf> [hereinafter White Paper].

2. See, e.g., Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer Proposes Reforms of State Corporate Accountability Laws (Jan. 23, 2003) (on file with author) [hereinafter N.Y. AG Press Release]; Press Release, California Office of the Attorney General, Attorney General Lockyer Unveils Reforms to Toughen Nonprofit Accountability, Fundraiser Controls: Audit, Disclosure and Compensation Provisions Seek to Protect Charities and Donors 1 (Feb. 12, 2004) (describing the AG’s reform proposal and its imminent introduction by state Senator Sher), available at <http://caag.state.ca.us/newsalerts/2004/04-018.htm> [hereinafter Cal. AG Press Release]; Office of Massachusetts Attorney General Tom Reilly, An Act to Promote the Financial Integrity of Public Charities: Summary of Draft 1.0, at 1, available at [http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/Mass\\_AG.Act\\_to\\_promote\\_fin\\_integ\\_pub\\_charities.pdf](http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/Mass_AG.Act_to_promote_fin_integ_pub_charities.pdf) (last visited Feb. 24, 2005) [hereinafter Mass. AG Summary]. See generally Michael Anft & Grant Williams, *States Propose New Accountability Regulations for Nonprofit Groups*, CHRON. PHILANTHROPY, Aug. 19, 2004, at 8; Michael Anft & Grant Williams, *Redefining Good Governance*, CHRON. PHILANTHROPY, Aug. 19, 2004, at 6. But see ALLIANCE FOR NONPROFIT GOVERNANCE, CONFERENCE REPORT, CHANGING NONPROFIT ACCOUNTABILITY: HOW WILL IT AFFECT YOUR ORGANIZATION? (Sept. 24, 2003) (quoting from AG Spitzer’s remarks at this conference, in which he criticized “the metaphor that we have applied Sarbanes-Oxley to the nonprofit sector. It’s not an appropriate metaphor.”), available at <http://www.angonline.org/2003summary.pdf>. The Sarbanes-Oxley Act was enacted in the summer of 2002, on the heels of several major corporate and accounting scandals. See Sarbanes-Oxley Act of

reforms in terms of timing, as the first of the legislative proposals for non-profit reform surfaced just a few months following the passage of Sarbanes-Oxley.<sup>3</sup> More interesting, however, is the substantive link between these two sets of reforms, particularly their shared emphasis on a disclosure model of regulation. This Article explores this disclosure focus of recent legislative proposals for nonprofit reform and evaluates the ability of disclosure-based reforms to improve nonprofits' accountability, either alone or in concert with other regulatory approaches.

Part I chronicles this most recent chapter in the long, but often meager, history of nonprofit enforcement. It begins by describing the first foray into nonprofit reform legislation "adopting reforms similar to those enacted by the federal Sarbanes-Oxley law," spearheaded by New York Attorney General Eliot Spitzer and his Charities Bureau.<sup>4</sup> In addition, it offers background on the similarly comprehensive draft legislation released by Massachusetts Attorney General Tom Reilly, and on some of the more limited proposals under review in other states. This Part also introduces the nascent but sweeping federal agenda for nonprofit legislative reform recently publicized by the U.S. Senate Finance Committee. Although this federal reform project is only at the discussion stage, the current information publicly available suggests that over 200 separate legislative reforms may be under consideration.<sup>5</sup> It is impossible to predict the ultimate path these reform efforts will take. Part I concludes by reporting the current state of their evolution.

Part II highlights the disclosure focus of each of these efforts at nonprofit legislative reform. Two disclosure-focused techniques, again with obvious links to Sarbanes-Oxley, particularly stand out. First, there have been proposals at both the state and federal levels that would require officers to certify the accuracy and reliability of organizational reports or filings.<sup>6</sup> Second, virtually all of the recent proposals share an emphasis on auditing, either as part of a comprehensive agenda or as a standalone reform.<sup>7</sup> In addition to these recurrent ideas, various other state and federal

2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

3. See N.Y. AG Press Release, *supra* note 2, at 1 (announcing New York's effort in January 2003).

4. See Memorandum from the Attorney General of New York, Eliot Spitzer, to the New York State Senate and Assembly and Program Bill #02-03 (on file with author).

5. See White Paper, *supra* note 1; see also Brad Wolverton, *Rethinking Charity Rules: Senate Panel Offers 200 Ideas for Revising Nonprofit Regulation*, CHRON. PHILANTHROPY, July 22, 2004, at 31 (noting that the White Paper listed over 200 reform ideas).

6. See *infra* Part II(A).

7. See *infra* Part II(B).

proposals also rely on disclosure mechanisms.<sup>8</sup> In all of these proposals, legislative drafters' faith in the ability of disclosure to improve nonprofit accountability is evident.

Next, the Article questions the assumption that disclosure-focused reforms will be effective. Part III argues that for legislation adopting disclosure-based reforms to improve nonprofit accountability, the reforms must either improve nonprofit behavior, facilitate enforcement in the nonprofit sector, or both. A combination of factors will make it difficult for disclosure-based reforms such as officer certification and increased auditing to improve the behavior of nonprofit organizations and actors. These factors include the duplicative nature of some of the suggested reforms, their assumptions about nonprofit compliance, and the costs of their implementation. Part III also considers the potential for currently proposed disclosure-based reforms to facilitate enforcement by regulators or others. Unfortunately, significant resource and structural issues unique to the nonprofit context also will make it difficult for many of these reforms to improve nonprofit accountability by facilitating enforcement.

Bearing in mind the limits of disclosure reform, Part IV offers suggestions for legislators as they continue to consider such proposals: (1) invigorate enforcement and (2) increase education and training. Legislatures should increase funding for state and federal regulators currently facing vastly inadequate resources to meet their nonprofit enforcement responsibilities. Further, legislatures should support education and training efforts to teach nonprofit fiduciaries and employees the skills they need to self-regulate and self-police. Disclosure-based reforms should be viewed as a useful adjunct to fully funded governmental enforcement and knowledgeable, effective internal monitoring, and should be adopted only when they will serve this purpose. Advances in disclosure technology, especially electronic filing, should be pursued to enable regulators to do more with less and to use disclosures to target investigation and prosecution. Moreover, to the extent their costs are not prohibitive, reforms that focus on guiding the process of disclosure creation should be favored over those that primarily increase disclosure outputs.

The Article concludes that the ability of disclosure-based reforms to enhance nonprofit accountability may be overstated, but can be improved if legislatures recognize the limits of the for-profit analogy and refashion their reforms to complement enforcement. With many proposals for nonprofit reform still at an early stage, this kind of realignment remains possi-

8. *See infra* Part II(C).

ble, if reformers are willing to support this more appropriate regulatory approach.

### I. RECENT LEGISLATIVE PROPOSALS FOR NONPROFIT REFORM

The recent crop of nonprofit reform proposals demonstrates a commitment to a disclosure model of regulation worthy of discussion and analysis. Before beginning this exploration and critique, it is necessary to provide a short history of their introduction and evolution.

#### A. *The States Move First*

The proposal publicized by New York Attorney General (“AG”) Eliot Spitzer was the first of this new group of legislative reform efforts. AG Spitzer announced his proposal in January 2003, as an effort to protect consumers from fraud perpetrated by “not-for-profit entities that have custody of billions of dollars in charitable funds” by “strengthen[ing] state laws to protect . . . donors.”<sup>9</sup> Shortly thereafter, the AG’s proposal was drafted into a bill proposing officer certification mandates, enhanced auditing requirements, and several other changes to the state’s Not-for-Profit Corporation Act,<sup>10</sup> and was introduced in the New York State Senate.<sup>11</sup> The scope of this initial version generated some alarm among members of New York’s nonprofit community,<sup>12</sup> and the bill was soon amended to

9. N.Y. AG Press Release, *supra* note 2, at 1.

10. See N.Y. Senate Bill, *supra* note 1. One part of the AG’s proposal, its overhaul of the state’s regime for handling self-dealing transactions in nonprofit corporations, also was introduced in separate bills in the state legislature in 2004. See S. 7219A, 226th Gen. Assem., Ann. Sess. (N.Y. 2004); A. 11292A, 226th Gen. Assem., Ann. Sess. (N.Y. 2004).

11. At the request of the Attorney General, the bill was introduced in the state Senate by Senator Leibell on April 23, 2003. It was referred to the Committee on Corporations, Authorities and Commissions. See S. 4836, 226th Gen. Assem., Ann. Sess. (N.Y. 2003). See generally Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303 (describing and analyzing the original version of the New York bill).

12. See *Sarbanes-Oxley for Nonprofits*, N.Y. NONPROFITS (Nonprofit Coordinating Comm. of N.Y.) Aug. 2003 (describing how amendments had addressed many of the nonprofit community’s concerns regarding the legislation initially proposed), available at <http://www.npccny.org/info/gti10.htm>; Fred Stokeld, *Bill to Apply Sarbanes-Oxley to New York Nonprofits Revised*, 100 TAX NOTES 753 (2003) (similar); Jay Dismukes, *Attorney General’s Office Discusses Proposed Nonprofit Legislation*, TRUSTED PROF., Apr. 2003 (raising nonprofit accounting professionals’ concerns with regard to the lower financial triggers in the original version), available at <http://www.nysccpa.org/trustedprof/archive/0403/1Tp2a.htm>; Simon Eskow, *Charities Bureau Hosts Symposium on Reform*, TRUSTED PROF., June 2003 (reporting announcement by New York’s AG that it would raise financial triggers in an amended bill), available at <http://www.nysccpa.org/trustedprof/archive/0603/1Tp6a.htm>.

address many of their concerns.<sup>13</sup> The amended Senate bill remained in committee through the end of the 2004 session,<sup>14</sup> as did a companion bill introduced in the New York State Assembly.<sup>15</sup> These bills (the “New York Proposals”) were the most comprehensive and formalized state proposals for nonprofit legislative reform for two years.

The New York AG’s Charities Bureau announced an ambitious new legislative agenda in March 2005.<sup>16</sup> Among other proposals, this agenda includes two bills revising the AG’s earlier proposals for nonprofit legislative reform.<sup>17</sup> These bills (the “Revised New York Proposals”) retain much of the substance and a fair amount of the text of their predecessors. Yet, the Revised New York Proposals do represent significant improvements, in some ways along the lines this Article advocates. At this initial phase of their development, it is difficult to predict the fate of these new bills, but they surely merit continuing observation.

In late 2003, Massachusetts AG Tom Reilly made public a draft of a bill containing provisions quite similar to the early New York Proposals. Soon after, AG Reilly announced plans to file this bill with the state legislature to enhance the financial accountability of the nonprofit sector.<sup>18</sup> This bill also met with resistance from the nonprofits it would regulate.<sup>19</sup> The

13. The bill was amended in various respects and referred back to the committee on June 10, 2003; it was reassigned there at the opening of the new Senate session on January 7, 2004. *See* S. 4836-A, 226th Gen. Assem., Ann. Sess. (N.Y. 2003).

14. The amended bill, S. 4836-A, was amended again on June 16, 2004, and recaptioned S. 4836-B. *See* N.Y. Senate Bill, *supra* note 1. The only change made by this amendment was to move the effective date from January 1, 2004 to January 1, 2005. *Compare id.*, with S. 4836-A, 226th Gen. Assem., Ann. Sess. (N.Y. 2003).

15. *See* A. 10239, 226th Gen. Assem., Ann. Sess. (N.Y. 2004). The Assembly bill is true companion legislation, tracking precisely the language of its Senate bill counterpart. Therefore, future references cite to the Senate version only.

16. *See* Office of New York State Attorney General, *Charities Bureau 2005 Legislative Proposals*, at <http://www.oag.state.ny.us/charities/legislation.html> (last visited Mar. 8, 2005). At the time this Article was finalized, the AG’s office had just released its proposed bills to the legislature and the public. Before the state legislature can take action on them, they will have to be sponsored and formally introduced, and reviewed by the committees to which they will be referred.

17. *See* Attorney General’s Legislative Program, Program Bill 68-05, at [http://www.oag.state.ny.us/charities/char\\_pdf/ag68-05.pdf](http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf) (last visited Mar. 8, 2005) [hereinafter N.Y. AG Program Bill 68-05]; Attorney General’s Legislative Program, Program Bill 65-05, at [http://www.oag.state.ny.us/charities/char\\_pdf/ag65-05.pdf](http://www.oag.state.ny.us/charities/char_pdf/ag65-05.pdf) (last visited Mar. 8, 2005) [hereinafter N.Y. AG Program Bill 65-05].

18. Mass. AG Summary, *supra* note 2.

19. *See* Michael Rezendes & Sacha Pfeiffer, *Legislation Eyed to Fight Abuses at Foundations*, BOSTON GLOBE, Mar. 1, 2004, at A1 (reporting the comment by a Boston attorney that “adding new laws that will substantially burden existing charities is not the way to deal with the wayward few”); Tom Witkowski & Jill Lerner, *AG Mulling Sarbanes-like Rules for State Nonprofits*, BOSTON BUS. J., Feb. 27, 2004 (reporting concerns of the Massachusetts nonprofit community), at <http://www.bizjournals.com/boston/stories/2004/03/01/story3.html?t=printable>; Massachusetts Council of Human Service Providers, Inc., *Attorney General Legislation Comments* (listing various concerns regarding the AG’s proposed legislation held by the Council and its members), at

bill never was introduced in the state legislature, and plans for introducing this or a similar bill no longer appear on the AG's legislative agenda.<sup>20</sup>

The California legislature entertained and ultimately enacted a non-profit reform bill on a speedy schedule after its introduction in February 2004 on behalf of AG Bill Lockyer.<sup>21</sup> While this new statute does contain disclosure enhancements and auditing requirements for nonprofit organizations generally, these elements appear in a sea of reforms to the state's charitable solicitation laws.<sup>22</sup> Again, perhaps in response to the concerns raised by the nonprofit community,<sup>23</sup> the bill was amended several times before being passed by both houses of the state legislature.<sup>24</sup> The governor signed it into law in late September 2004, and it went into effect January 1, 2005.<sup>25</sup>

Commentators and the press often have referred to the New York, Massachusetts, and California efforts as Sarbanes-Oxley legislation for nonprofits,<sup>26</sup> and some reports have so characterized legislation proposed in other states.<sup>27</sup> A review of state legislative activity reveals, however, that

<http://www.providers.org/Attorney%20General%20Legislation%20comments.pdf> (last visited Feb. 24, 2005).

20. See Office of the Massachusetts Attorney General Tom Reilly, *Legislative Initiatives* (mentioning only two current AG legislative reform initiatives relevant to nonprofit organizations, Senate Bill 159, a bill to clarify and enhance penalties for theft of the identity of a charity, and House Bill 557, a bill to require regulatory review of major asset transfers between nonprofit organizations), at <http://www.ago.state.ma.us/sp.cfm?pageid=1679> (last visited Feb. 24, 2005).

21. The Nonprofit Integrity Act, S. 1262, 2003–2004 Leg. Sess. (Cal. 2004) (version introduced in California Senate on Feb. 13, 2004), available at [ftp://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1251-1300/sb\\_1262\\_bill\\_20040213\\_introduced.pdf](ftp://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_bill_20040213_introduced.pdf); see also Cal. AG Press Release, *supra* note 2, at 1 (describing the AG's reform proposal and its imminent introduction by Senator Sher).

22. See Cal. Act, *supra* note 1, *passim*.

23. See Todd Wallack, *Nonprofits Fight Tougher Disclosure Rules*, S.F. CHRON., June 24, 2004, at C3 (reporting that despite changes addressing some concerns of the nonprofit community, various nonprofit groups remained opposed to the California Senate bill); Melanie Payne, *Bill Would Order Audits for Charities*, SACRAMENTO BEE, Feb. 13, 2004 (reporting similar concerns in response to the California Senate bill), available at <http://www.sacbee.com/content/business/v-print/story/8259982p-9190611c.html>.

24. See S. 1262, 2004 Leg., 2003–2004 Sess. (Cal. 2004) (version passed by California Senate on May 25, 2004), available at [ftp://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1251-1300/sb\\_1262\\_bill\\_20040524\\_amended\\_sen.pdf](ftp://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_bill_20040524_amended_sen.pdf); S. 1262, 2004 Leg., 2003–2004 Sess. (Cal. 2004) (version passed by California Assembly on August 25, 2004), available at [http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1251-1300/sb\\_1262\\_bill\\_20040823\\_amended\\_asm.pdf](http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_bill_20040823_amended_asm.pdf).

25. See Cal. Act, *supra* note 1.

26. See Anft & Williams, *States Propose New Accountability Regulations for Nonprofit Groups*, *supra* note 2, at 8; Anft & Williams, *Redefining Good Governance*, *supra* note 2, at 6; Jessi Hempel & Amy Borrus, *Now the Nonprofits Need Cleaning Up: Cozy Boardrooms at Colleges and Charities Face Increasing Government Scrutiny*, BUS. WEEK, June 21, 2004, at 107; Stephanie Strom, *Questions About Some Charities' Activities Lead to a Push for Tighter Regulation*, N.Y. TIMES, Mar. 21, 2004, at A23; Bill Barnhart, *Non-Profits Review Tried-and-True*, CHI. TRIB., June 22, 2003, § 5, at 3.

27. See, e.g., Rachel Emma Silverman, *Charities Start to Grade Themselves*, WALL ST. J., Aug. 18, 2004, at D1 (noting the current legislative reform efforts in New York and California and stating that "many more [states] are considering such measures"); National Council of Nonprofit Associations,

other states' proposals do not match the scope of those in New York and Massachusetts.<sup>28</sup> The California enactment is of considerable size, but most of its contents are addressed to the state's charitable solicitation regime. New Hampshire adopted legislation in 2004 increasing the scope of the financial reporting required of financially large charitable organizations.<sup>29</sup> Other recent state bills, however, narrowly address only charitable solicitation reform,<sup>30</sup> regulate only a confined subset of nonprofit organizations,<sup>31</sup>

*State Governance Proposals and Bills—2004* (described by NCNA's website as compiling state nonprofit governance reforms proposed "[i]n the wake of Congress' passage of the Sarbanes-Oxley Act"), at [http://www.ncna.org/\\_uploads/documents/live//State%20governance.doc](http://www.ncna.org/_uploads/documents/live//State%20governance.doc) (last updated Oct. 1, 2004) [hereinafter NCNA Compilation]; PATRICE A. HEINZ, ALLIANCE FOR CHILDREN & FAMILIES (MILWAUKEE, WIS.), RESPONDING TO THE SARBANES-OXLEY ACT OF 2002: THE FINANCIAL REPORTING PRACTICES OF NONPROFITS 9 (2003) (mentioning the interest of AGs in Ohio and Minnesota in pursuing such legislation as well), available at [http://www.alliance1.org/Home/SOX\\_final\\_8-03.pdf](http://www.alliance1.org/Home/SOX_final_8-03.pdf).

28. A search of recent legislative proposals and enactments yielded what might broadly be termed nonprofit legislative reform efforts in at least eighteen states. See S.B. 532, 2004 Leg., Reg. Sess. (Ala. 2004); S.B. 1066, 46th Leg., 1st Reg. Sess. (Ariz. 2004); H.B. 2514, 46th Leg., 1st Reg. Sess. (Ariz. 2004); S.B. 1193, 46th Leg., 1st Reg. Sess. (Ariz. 2004); Cal. Act, *supra* note 1; H.B. 5014, 2005 Gen. Assem., Jan. Sess. (Conn. 2005); S.B. 396, 2004 Gen. Assem., Feb. Sess. (Conn. 2004); S.B. 1035, 2003 Gen. Assem., Jan. Sess. (Conn. 2003) (original version), available at <http://www.cga.ct.gov/2003/tob/s/2003SB-01035-R00-SB.htm>; H.B. 5313, 2004 Gen. Assem., Feb. Sess. (Conn. 2004); S.B. 2839, 22d Leg., Reg. Sess. (Haw. 2004); H.B. 2453, 80th Gen. Assem., 1st Reg. Sess. (Iowa 2004); S.B. 2274, 80th Gen. Assem., 1st Reg. Sess. (Iowa 2004); L.D. 1691, 121st Leg., Reg. Sess. (Me. 2004) (codified in ME. REV. STAT. ANN. tit. 9 §§ 5003–18 (West 2004)); Mass. Draft Leg., *supra* note 1; H.B. 4234, 183d Gen. Ct., 2d Ann. Sess. (Mass. 2004); S.B. 1115, 92d Leg., Reg. Sess. (Mich. 2004); H.B. 1769, 83d Leg., Reg. Sess. (Minn. 2004); S.B. 1780, 83d Leg., Reg. Sess. (Minn. 2004); H.B. 514, 2004 Leg., Reg. Sess. (Miss. 2004); H.B. 1408, 158th Leg., Reg. Sess. (N.H. 2004) (codified in N.H. REV. STAT. ANN. §§ 7:28, 7:32 (2004 Supp.)); N.Y. AG Program Bill 68-05, *supra* note 17; N.Y. AG Program Bill 65-05, *supra* note 17; N.Y. Senate Bill, *supra* note 1; S. 7219, 226th Gen. Assem., Ann. Sess. (N.Y. 2004); A. 11292, 226th Gen. Assem., Ann. Sess. (N.Y. 2004); A. 8568-B, 226th Gen. Assem., Ann. Sess. (N.Y. 2004); S.B. 153, 125th Gen. Assem., Reg. Sess. (Ohio 2003); H.B. 1019, 187th Gen. Assem., Reg. Sess. (Pa. 2003); H. 7962, 2004 Gen. Assem., Jan. Sess. (R.I. 2004); 2004 R.I. Pub. Laws 330 (signed July 2, 2004); H.B. 3061, 115th Gen. Assem., 1st Sess. (S.C. 2003); H. 724, 2004 Gen. Assem., Reg. Sess. (Vt. 2004); W. VA. CODE ANN. § 12-4-14 (West 2004). However, only the Massachusetts Draft Legislation, the New York Proposals, and, to a lesser degree, the Revised New York Proposals provide a comprehensive set of reforms clearly patterned on Sarbanes-Oxley. Most of the other legislation is more limited in scope or offers reform proposals unlinked to the federal Act. Legislation considered in Alabama and enacted by the Iowa legislature would broadly address nonprofit legal issues, but are adoptions of the Uniform Trust Code and Revised Model Nonprofit Corporation Act, respectively, and thus do not suggest innovative or Sarbanes-Oxley-linked reforms. See S.B. 532, 2004 Leg., Reg. Sess. (Ala. 2004); H.B. 2453, 80th Gen. Assem., 1st Reg. Sess. (Iowa 2004); S.B. 2274, 80th Gen. Assem., 1st Reg. Sess. (Iowa 2004).

The National Council of Nonprofit Associations ("NCNA") provides a useful compilation of state legislative reform proposals linked with Sarbanes-Oxley, including many of the proposals listed here, on its website. See NCNA Compilation, *supra* note 27.

29. See H.B. 1408, 158th Leg., Reg. Sess. (N.H. 2004) (codified in N.H. REV. STAT. ANN. § 7:28(III-a–III-b)) (requiring charitable organizations with over \$1 million in revenue, gains, or other support to submit audited financial reports to the state AG along with their annual filings, and demanding filing charitable organizations with more than \$500,000 in such support to submit unaudited financial reports).

30. See, e.g., S.B. 1066, 46th Leg., 1st Reg. Sess. (Ariz. 2004); H.B. 2514, 46th Leg., 1st Reg. Sess. (Ariz. 2004); S.B. 1115, 92d Leg., Reg. Sess. (Mich. 2004).

or impose new requirements only on organizations receiving or using public funds.<sup>32</sup> While certainly not equivalent in coverage to the comprehensive New York or Massachusetts efforts, these more limited proposals do often introduce and rely on disclosure mechanisms, and will be discussed when relevant.

### B. *The U.S. Senate Shows Interest*

In the summer of 2004, the U.S. Senate began to show renewed interest in nonprofit regulation as well.<sup>33</sup> The Senate Finance Committee held a hearing on June 22 captioned “Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities.”<sup>34</sup> In connection with this hearing, the Committee released a bipartisan staff discussion draft (the “White Paper”) describing myriad potential charity reform proposals, which would, if enacted, be implemented through the tax code.<sup>35</sup> Less than two weeks after the public hearing, Senate Finance Committee Chairman Charles Grassley issued a press release soliciting comments on the White Paper and announcing an invitation-only Charitable Governance Roundta-

31. See, e.g., 2004 R.I. Pub. Laws 330 (signed July 2, 2004).

32. See, e.g., S.B. 153, 125th Gen. Assem., Reg. Sess. (Ohio 2003); H. 724, 2004 Gen. Assem., Reg. Sess. (Vt. 2004); W. VA. CODE ANN. § 12-4-14 (West 2004).

33. Prior to the hearing held in June 2004, the last time the U.S. Congress undertook significant revisions to the regulation of tax-exempt entities was in 1996, when it enacted new excise tax remedies to be levied upon insiders involved in self-dealing transactions with their tax-exempt public charities or social welfare organizations. See 26 U.S.C. § 4958 (2000) (imposing the so-called “intermediate sanctions”). See generally BRUCE R. HOPKINS, *THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS* (2003) (offering a comprehensive guide to the intermediate sanctions regulatory regime). The last truly expansive effort at reform in this area may well have been in 1969, when Congress enacted a series of new provisions targeting perceived abuses by private foundations.

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

35. The legislative proposals discussed in this Article variously address their reforms to nonprofit corporations, charities, tax-exempt organizations, and other legal categories within the nonprofit sector. In part, this is an outgrowth of the body of law each seeks to reform. For example, while the New York efforts would reform only its statutes relating to not-for-profit corporations, the federal proposals would revise the federal tax code’s regulation of tax-exempt organizations. Charity denotes a group both more and less inclusive than either of these terms. It refers to a group’s charitable mission, regardless of whether it is formed as a corporation, trust, or unincorporated association and regardless of whether it is tax exempt. These categories can impact whether specific reforms apply to a particular organization. See *infra* note 53. However, the analysis of the disclosure focus of the proposals presented here rarely hinges on this categorization. Thus, for ease of reference, this Article generally will discuss the proposals holistically, as nonprofit reforms with an impact on nonprofit organizations and the nonprofit sector.

Other papers within this symposium offer helpful analysis of the many consequences of these categories. See, e.g., Evelyn Brody, *Charity Governance: What’s Trust Law Got to Do with It?*, 80 CHI.-KENT L. REV. 641 (2005) (analyzing the impact of legal form of organization on the substance of nonprofit law); Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613 (2005) (addressing the overlapping regulatory and enforcement capacities of state AGs and the IRS).



ble discussion of its proposals.<sup>36</sup> Many groups and individuals submitted comments, and the Roundtable was held at the Senate on July 22, 2004.<sup>37</sup>

The White Paper addresses many tax-specific abuses, but it also responds to general concerns about fraudulent practices and lackadaisical oversight by nonprofit directors, officers, and managers. In this latter sense, the federal and state reform initiatives share many similar substantive aims. The breadth of the reform proposals and tactics described by the White Paper dwarfs even the sweeping New York and Massachusetts initiatives. Yet, the federal proposals share with their state counterparts a strong commitment to disclosure-based reform. The proposals contained in the White Paper also obviously rest on the assertion that new *legislation* is the cure for failures of monitoring and enforcement in the nonprofit sector, a position shared by state legislatures and attorneys general pressing nonprofit reform.

The ultimate shape the Senate's nonprofit reform efforts will take remains uncertain. Early on, Chairman Grassley stated that his Committee was unlikely to bring forward a single reform bill encompassing all or most of its proposals,<sup>38</sup> and the Committee provided few signals as to its priorities.<sup>39</sup> In late September 2004, Chairman Grassley and Ranking Member Max Baucus asked Independent Sector, a nonprofit umbrella group, "expeditiously" to convene a panel to analyze proposals for nonprofit reform on the federal level, and to make final recommendations on their adoption by

36. See Press Release, U.S. Senate Committee on Finance, Senator Chuck Grassley, Chairman, Grassley Announces Charitable Governance Roundtable, Solicits White Papers for Discussion (July 2, 2004), available at <http://finance.senate.gov/press/Gpress/2004/prg070204.pdf>.

37. See Press Release, U.S. Senate Committee on Finance, Senator Chuck Grassley, Chairman, Grassley Announces Participants, Releases White Papers for Charitable Governance Roundtable (July 21, 2004) (listing presenters and providing links to their submissions), available at <http://finance.senate.gov/press/Gpress/2004/prg072104d.pdf>. The discussion included brief presentations from representatives of various parts of the nonprofit sector, as well as academics and attorneys, and then proceeded to a general question and comment session. See Fred Stokeld, *EO Repts Respond to Finance Draft of Charity Reform Proposals*, 45 EXEMPT ORG. TAX REV. 321 (2004) (describing the session and reporting comments of various participants).

38. See Stokeld, *supra* note 37, at 322 (reporting Chairman Grassley's prediction that comprehensive legislation is unlikely).

39. See Press Release, U.S. Senate Committee on Finance, Senator Chuck Grassley, Chairman, Grassley Advances Crackdown on Car, Intellectual Property Donation Abuses (Oct. 6, 2004) (reporting the inclusion in a near-final conference report of a provision intended to prevent abuse of deductions available to taxpayers who donate cars and intellectual property to charity), available at <http://finance.senate.gov/press/Gpress/2004/prg100604d.pdf>; Fred Stokeld, *Finance Staffer Praises Proposed EO Reforms*, 104 TAX NOTES 471 (2004) (reporting a staffer's comment that the Committee would pursue proposals over the next year "as it gets comfortable with them," though a proposal addressing donor-advised fund reforms was likely in the near future).

spring 2005.<sup>40</sup> The Panel on the Nonprofit Sector, organized by Independent Sector in response to this request, released its Interim Report to the Senate Finance Committee and the public on March 1, 2005,<sup>41</sup> and has promised a Final Report later this spring.<sup>42</sup> Upon receipt of this Interim Report, Senator Grassley announced that he hoped to hold a hearing on these issues in the spring of 2005.<sup>43</sup>

\* \* \*

Virtually all of the current legislative proposals for nonprofit reform remain in early form. Only time will tell whether these reform rumblings will lead to substantial legislative changes. Still, their reliance on improving disclosure as a preferred tactic is evident and persistent, and should be analyzed as a potential new starting point for regulatory thinking about nonprofit reform. The remainder of this Article will explore these disclosure-based reform techniques and will consider whether and how they can successfully be adapted to the unique context of the nonprofit sector.

## II. THE FOCUS ON DISCLOSURE

Throughout the recent state and federal proposals for nonprofit reform, legislatures have embraced a disclosure model of regulation. This focus on disclosure takes several forms, and the individual proposals differ widely in their details. Two major categories of these disclosure-based reform measures, however, echo through various proposals. First, New York, Massachusetts, and federal proposals have all at times included requirements that nonprofit officers certify the accuracy and reliability of

40. See Letter from Senators Charles E. Grassley & Max Baucus, Chairman and Ranking Member of the U.S. Senate Committee on Finance, to Diana Aviv, President and CEO of Independent Sector 2 (Sept. 22, 2004), available at <http://philanthropy.com/free/update/2004/09/finance.pdf>.

41. See PANEL ON THE NONPROFIT SECTOR, INTERIM REPORT PRESENTED TO THE SENATE FINANCE COMMITTEE (Mar. 1, 2005), at <http://www.nonprofitpanel.org/interim/PanelReport.pdf> [hereinafter NONPROFIT PANEL INTERIM REPORT]. In January 2005, the staff of the congressional Joint Committee on Taxation issued a report recommending many changes to improve compliance with federal tax law and reform tax expenditures. See STAFF OF THE JOINT COMM. ON TAXATION, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Jan. 27, 2005), at <http://www.house.gov/jct/s-2-05.pdf> [hereinafter Joint Committee Report]. The Joint Committee Report addresses myriad issues and includes a lengthy section of recommendations relating to exempt organizations. See *id.* at 220–332. In addition to proposing some novel changes, its recommendations echo and amplify several suggestions first made in the White Paper. See *id.*

42. See Press Release, Independent Sector, Independent Sector Convenes National Panel on Nonprofit Sector, (Oct. 12, 2004), at [http://www.nonprofitpanel.org/press/Independent\\_Sector\\_Convenes.html](http://www.nonprofitpanel.org/press/Independent_Sector_Convenes.html).

43. See Press Release, U.S. Senate Committee on Finance, Statement of Senator Chuck Grassley, News Conference with the Panel on the Nonprofit Section, Mar. 1, 2005, at <http://finance.senate.gov/press/Gpress/2005/prg030105.pdf>.

their organizations' reports.<sup>44</sup> Second, proposals in various states and in the White Paper would mandate increased use and oversight of disclosure auditing.<sup>45</sup>

The appeal of the disclosure model of regulation also can be seen in federal and state proposals that extend beyond deployment of these two common disclosure-based reform tactics. The White Paper contains a series of reform initiatives aimed at increasing the quantity of disclosures that tax-exempt nonprofit entities are required to produce.<sup>46</sup> It also would charge the IRS with introducing an electronic filing system to help tax-exempt filers and regulators better manage disclosed information.<sup>47</sup> In addition, a few recent state proposals also have adapted disclosure mechanisms to address traditional nonprofit enforcement priorities.<sup>48</sup> This Part will describe the use of each of these techniques in recent legislative proposals for nonprofit reform and will demonstrate their common focus on disclosure.

#### A. Officer Certification

Officer certification requirements are perhaps the reforms most frequently associated with Sarbanes-Oxley and post-Enron for-profit corporate reform.<sup>49</sup> Pursuant to the Act, the SEC promulgated regulations obliging top officers of publicly-traded companies to sign their financial reports, certifying the accuracy of the information these reports contain and the reliability of the means used to create and maintain that information.<sup>50</sup> The efficacy of for-profit officer certification has been the subject of some controversy among commentators,<sup>51</sup> but the assumption behind this re-

44. See *infra* Part II(A).

45. See *infra* Part II(B).

46. See, e.g., White Paper, *supra* note 1, at 1, 9–10 (proposing new mandatory quinquennial filings to retain exempt status and the addition of new categories of disclosure on existing annual informational returns).

47. See *id.* at 9.

48. See *infra* Part II(C).

49. See, e.g., William Donaldson, *Price of Change Will Pay Off in Long Term*, BANKER, Nov. 2003, at 16; Steven Marlin, *Absolutely Accountable*, INFORMATIONWEEK, Oct. 6, 2003, at 51; see also Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1200 (2003) (describing the function of the “highly publicized certification of the financial statements required of the chief executive officer and chief financial officer”).

50. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a)(1)–(3), 116 Stat. 745, 777 (codified at 15 U.S.C. § 7241 (2000)) (instructing the SEC to require certification that the signing officer has reviewed the report, the report does not contain material untruths, misstatements, or omissions, and the financial information in the report “fairly present[s] in all material respects the financial condition and results of operations of the issuer”); 17 C.F.R. § 240.13a-14 (2004) (promulgating these regulations).

51. See, e.g., Lisa M. Fairfax, *Form over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1 (2002);

quirement is obvious. It presumes that officer certification will improve the accountability of publicly-traded companies because officers required to sign will take personal responsibility for ensuring accurate and complete disclosures, backed by reliable internal controls.<sup>52</sup> Further, these more accurate disclosures will be available for the SEC and investors to use to prosecute perceived errors and abuses by the disclosing companies.

New York was the first to adapt the officer certification mechanism to the nonprofit environment. This adaptation was relatively simple. New York law already required nonprofits to produce various kinds of internal and external reports;<sup>53</sup> the New York Proposals simply added a requirement that officers of incorporated nonprofits must certify the accuracy and reliability of the internal reports their corporations must produce. The main innovation in New York's adaptation was that the certification requirements varied, depending on the size of a nonprofit's assets or revenues.<sup>54</sup> For larger nonprofit corporations, the New York Proposals applied the Sarbanes-Oxley accuracy and reliability certification requirements virtually intact. The relevant provision required the president or CEO, as well as the treasurer or CFO, to sign these internal reports, verifying the truth of the information disclosed, the reliability of his or her nonprofit's internal controls, and that the officer has disclosed any deficiencies of these controls and any relevant frauds to appropriate parties.<sup>55</sup> In financially smaller nonprofit corporations, only a looser accuracy certification would be required, obliging the signing officer merely to verify that he or she has reviewed the report and believes it fairly presents the financial position and operations of

Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 1003–05 (2003).

52. President George W. Bush's statement accompanying his signature of the Sarbanes-Oxley Act also highlighted this role of the certification requirement. See President's Statement on Signing the Sarbanes-Oxley Act of 2002, 38 WEEKLY COMP. PRES. DOC. 1286 (July 30, 2002) ("The legislative purpose of sections 302, 401, and 906 of the Act, relating to certification and accuracy of reports, is to strengthen the existing corporate reporting system . . .").

53. Nonprofits incorporated under the state's Not-For-Profit Corporation Act must produce internal reports, "verified" by their officers, directors, or a financial professional. See N.Y. NOT-FOR-PROFIT CORP. LAW § 519(a) (McKinney 2001). Regardless of their form of organization, nonprofits that hold charitable assets or that solicit charitable contributions are required to file annual reports with the state attorney general. N.Y. EST. POWERS & TRUSTS LAW § 8-1.4(d), (f), (r) (McKinney 2001) [hereinafter N.Y. EPTL]; N.Y. EXEC. LAW § 172-b (McKinney 2001). However, the charitable solicitation regulation regime does exempt some rather broad categories of nonprofits from this requirement. See, e.g., N.Y. EXEC. LAW § 172-a(1), (2)(a), (2)(g) (exempting religious organizations and many educational institutions from filing requirements).

54. See N.Y. Senate Bill, *supra* note 1, § 1(d); see also Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205, 250–58 (2004) (providing a comparison of the language employed by the New York Proposals and the Sarbanes-Oxley Act).

55. See N.Y. Senate Bill, *supra* note 1, § 1(e)(1)–(4).

his or her organization.<sup>56</sup> The New York Proposals specifically declined to create any new private rights of action against signing officers based on their verifications.<sup>57</sup>

Despite the New York AG's continuing commitment to enacting legislation to curb financial frauds in nonprofit organizations, his early enthusiasm for officer certification has cooled. The AG's legislative agenda for nonprofit reform, as announced in March 2005, no longer includes accuracy or reliability certification requirements.<sup>58</sup> The Revised New York Proposals do still attempt to ensure that nonprofits have adequate internal financial controls, but use a more direct route to accomplish this goal. In a new section, one of the AG's new bills would affirmatively mandate the establishment and maintenance of such controls by all nonprofit corporations, regardless of size.<sup>59</sup> The Revised New York Proposals may mean officer certification is unlikely to become law in that state. Yet, the original New York Proposals' officer certification mechanism remains relevant, as it has been and will remain an important model for other reform drafters.

The Massachusetts Draft Legislation imposes an officer certification requirement quite like that of the early New York Proposals, but it requires certification of annual financial reports filed by all public charities with the state AG, rather than only internal reports of nonprofit corporations.<sup>60</sup> Again, this legislation provides differing levels of certification, depending on the size of a nonprofit's assets, revenues, or both.<sup>61</sup> Officers of larger organizations must certify both the accuracy and reliability of their reports, including the existence and sufficiency of internal controls, and various internal disclosures.<sup>62</sup> For smaller organizations, officers again need only certify to accuracy, making general statements that they are familiar with and trust the reports filed.<sup>63</sup> Although it too declines to authorize new private rights of action against certifying officers, the Massachusetts draft

56. *Id.* § 1(d). Private foundations would be subject to slightly different reporting requirements, *id.* § 1(f), and nonprofits that neither hold charitable assets nor engage in charitable solicitation would be entirely exempt from these enhanced verification provisions, *id.* § 1(e)(5).

57. *See id.* § 1(h). Although no new private causes of action are provided, the New York Proposals would add to AGs' potential enforcement actions the right to sue officers in situations of "persistent" failures in reporting, in addition to the "willful" failures the AG may sue to address under current law. *See id.* § 2. They also contain explicit authorization for the AG to seek such officers' removal in court. *See id.*

58. *See* N.Y. AG Program Bill 68-05, *supra* note 17; N.Y. AG Program Bill 65-05, *supra* note 17.

59. *See* N.Y. AG Program Bill 68-05, *supra* note 17, § 6.

60. *See* Mass. Draft Leg., *supra* note 1, §§ 2(3)–(4).

61. *See id.* § 2.

62. *See id.* § 2(4).

63. *See id.* § 2(3).

does include a list of punishments the AG might pursue against officers who make false certifications, including civil penalties and removal.<sup>64</sup>

The federal White Paper also includes an officer certification proposal. Due to the Senate Finance Committee's (and the federal government's) limited jurisdiction in the field of nonprofit legislation, this proposal appropriately focuses its certification approach on IRS filings required of organizations granted exemption from federal income taxation.<sup>65</sup> The Committee's proposal would oblige the CEO or equivalent officer of a tax-exempt entity to sign the entity's annual informational return—the Form 990—and by doing so to make two declarations. First, the CEO would make an attestation of accuracy, declaring that he or she has been reasonably assured of the accuracy and completeness of the Form 990.<sup>66</sup> Second, the CEO's signature would act as a reliability certification, reporting that he or she has established “processes and procedures to ensure” compliance with federal tax law.<sup>67</sup> Unlike the proposed state officer certifications and some of the White Paper's own reform ideas in other areas, the White Paper makes no distinction between CEOs' certification responsibilities in large and small entities.<sup>68</sup> Furthermore, it contemplates that “additional penalties could be brought against a CEO who signs the return,” presumably based on its inaccuracy.<sup>69</sup>

64. *See id.* § 5.

65. Both the states and the federal government exercise regulatory authority over nonprofit organizations. State attorneys general typically are charged with the responsibility to supervise charitable assets and have standing to enforce the duties of nonprofit fiduciaries. The federal Internal Revenue Service polices tax-exemption and deductibility of contributions, tax benefits available to eligible nonprofit organizations and their donors. Although the state and federal spheres of authority are distinct in concept, in practice their enforcement initiatives can overlap. This description is necessarily simplified. For in-depth discussions of the roles of the states and the federal government in regulating charities, see MARION FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* 301–427 (2004) and Silber, *supra* note 35.

66. *See* White Paper, *supra* note 1, at 8. The Panel on the Nonprofit Sector convened by Independent Sector (the “Nonprofit Panel”) also has recommended an accuracy certification requirement. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 20 (recommending an IRS requirement that the highest ranking officer of a tax-exempt organization should sign its annual informational return and “attest to the accuracy and completeness of its contents”).

67. *See* White Paper, *supra* note 1, at 8. Although the Nonprofit Panel has not recommended a reliability certification requirement, its recent Interim Report does note that reviewing the adoption and implementation of internal financial controls is an important component of audit oversight. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 20.

68. *See* White Paper, *supra* note 1, at 8. The Nonprofit Panel also recommends broad application of its accuracy certification requirement to all organizations required to file the Form 990 series returns. However, in its prefatory discussion of the guiding principles to improve accountability and governance of charities, it notes that “[l]awmakers must consider the range of organizations to which regulations may apply, and must refrain from adopting regulations where the costs of demonstrating compliance outweigh the benefits gained.” *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 16.

69. *See* White Paper, *supra* note 1, at 8. Rather than suggesting new penalties to be imposed on organization managers, the Nonprofit Panel advocates greater enforcement of existing penalties for

### B. Auditing

Those drafting recent legislative proposals for nonprofit reform also demonstrate a striking faith in the ability of well-monitored outside auditors to improve the quality of nonprofit disclosures. One may trace some roots of this reliance on auditors and audit committees to the Sarbanes-Oxley Act, which adds new requirements for service on public company audit committees<sup>70</sup> and assigns new responsibilities to audit committee members.<sup>71</sup> However, in the context of publicly-traded companies, audited financial reports were a requirement long before the Enron and other scandals of 2001,<sup>72</sup> and audit committees became mandatory in order for companies to list their shares on major national exchanges beginning in 1999.<sup>73</sup> In the nonprofit context, as indeed in the non-publicly-traded company context, this level of auditing sophistication often cannot be assumed. Therefore, the proposed nonprofit auditing reforms start at a more basic level.

The auditing proposals separate into two basic categories: (1) initial demands for the production of audited financial reports or requirements that other, previously unaudited documents now be audited, and (2) mandates that organizations establish mechanisms for audit oversight. The New Hampshire and California enactments require high revenue nonprofits to begin producing audited annual financial reports.<sup>74</sup> In addition, California's legislation compels nonprofit corporations of a requisite size to establish

officers' failures to file accurate and complete returns. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 20.

70. See Sarbanes-Oxley Act § 301(3)(A)–(B); see also *id.* §§ 201, 204 (imposing significant new limitations on auditors as well).

71. See, e.g., *id.* § 202.

72. See Securities and Exchange Commission, Regulation S-X, 17 C.F.R. §§ 210.3-01 to 210.3-20 (2004) (describing the financial statements to be filed annually with the SEC by issuers and generally requiring these statements to be audited).

73. See New York Stock Exchange, Listed Company Manual § 303.01(A) (mandating that all listed companies have a qualified audit committee), at <http://www.nyse.com/lcm/107841-6930873.html?enable=section&snumber=3&ssnumber=303.00> (last modified Dec. 20, 1999); The Nasdaq Stock Market, Marketplace Rule 4350(d) (imposing a similar requirement for Nasdaq issuers), at [http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=4&FileName=/nasd/nasd\\_rules/Rules-oftheAssociation\\_mg.xml#chp\\_1\\_4\\_15](http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=4&FileName=/nasd/nasd_rules/Rules-oftheAssociation_mg.xml#chp_1_4_15); see also J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE § 11A.03[3], at 11A-21 & n.90 (3d ed. 2004) (describing these developments).

74. See Cal. Act, *supra* note 1, § 7(e)(1) (limiting application of this requirement to organizations “that receive[] or accrue[] in any fiscal year gross revenue of two million dollars (\$2,000,000) or more”); H.B. 1408, 158th Leg., Reg. Sess. (N.H. 2004) (codified in N.H. REV. STAT. ANN. § 7:28(III-a–III-b)) (requiring charitable organizations with over \$1 million in revenue, gains or other support to submit audited financial reports to the state AG along with their annual filings).

audit committees.<sup>75</sup> Oftentimes, New York and Massachusetts law already requires the organizations regulated under their reform proposals to produce audited reports; their proposals would retain these requirements.<sup>76</sup> Proposals in these states also would compel large nonprofits to create audit committees and assign to them specific supervisory responsibilities.<sup>77</sup> The state proposals requiring the establishment of audit committees all use similar language to set qualifications for participation that prohibit financial entanglement between committee members and their organizations.<sup>78</sup> Each also tasks these committees with selecting outside auditors, setting their compensation, and monitoring their performance.<sup>79</sup>

75. Cal. Act, *supra* note 1, § 7(e)(2) (imposing an audit committee requirement on charitable corporations with gross revenue of \$2,000,000 or more in any fiscal year).

76. Massachusetts imposes an audit requirement on all nonreligious public charities, even if they do not solicit contributions. *See* MASS. GEN. LAWS ANN. ch. 12 § 8F (West 2004) (requiring those public charities that must file annual reports to the AG and that receive more than \$100,000 in gross support and revenue during a fiscal year to submit an audited financial statement together with this annual report, although public charities receiving between \$100,000 and \$500,000 are permitted to substitute a CPA's review report). The Massachusetts proposal actually would decrease the number of charities subject to its audit requirement by raising the threshold at which audited reports must be submitted to the AG from \$500,000 to \$750,000 in annual receipts. *See* Marion R. Fremont-Smith, *Pillaging of Charitable Assets: Embezzlement and Fraud* 27 (2004) (unpublished manuscript on file with author) (describing this ironic turn of events). During its 2004 session, the Massachusetts legislature presumably agreed some relief from the requirement was necessary; it raised the trigger from \$250,000 to \$500,000 without the involvement of the AG. *See id.*

New York's existing audit requirement is limited in application to nonprofits that engage in solicitation of charitable contributions from the public. *See* N.Y. EXEC. LAW § 172-b(1), (2) (McKinney Supp. 2004) (requiring those nonprofits that must register under its charitable solicitation law to file annual audited financial reports if they receive gross revenue and support in excess of \$250,000 annually or if they use professional fundraisers; nonprofits receiving in excess of \$100,000 must file a CPA's review report). Several other states also impose audit requirements on soliciting charities earning significant revenues. *See, e.g.,* ARK. CODE ANN. § 4-28-403(b)(1) (Lexis 2001) (demanding inclusion of audited financial statements in annual filings by soliciting charities with gross revenues in excess of \$500,000); R.I. GEN. LAWS ANN. § 5-53.1-4(a) (2004) (requiring organizations registered to solicit charitable contributions to file annual audited financial statements with the state if they have annual gross income of more than \$500,000).

77. *See* Mass. Draft Leg., *supra* note 1, § 3 (requiring audit committees in nonprofit corporations with at least \$750,000 of gross revenue and support in any fiscal year); N.Y. Senate Bill, *supra* note 1, § 4(g)(1) (imposing an audit committee requirement on nonprofit corporations whose financial reports are audited by a certified public accountant, that have at least \$3 million in assets, or that receive at least \$1 million in gross revenue and support in any fiscal year, unless their articles of incorporation or bylaws prohibit it). The Revised New York Proposals retain the auditing proposals of their predecessors virtually intact. *See* N.Y. Program Bill 68-05, *supra* note 17, § 3(g). The only substantive difference is a change in the trigger point at which nonprofit corporations are instructed to appoint an audit committee. *Compare* N.Y. AG Program Bill 68-05, *supra* note 17, § 3(g)(1) (using a \$2 million revenue trigger), *with* N.Y. Senate Bill, *supra* note 1, § 4(g)(1) (using a \$1 million revenue or \$3 million asset trigger).

78. *See* N.Y. AG Program Bill 68-05, *supra* note 17, § 3(g)(3); N.Y. Senate Bill, *supra* note 1, § 4(g)(3); Mass. Draft Leg., *supra* note 1, § 3(3); Cal. Act, *supra* note 1, § 7(e)(2).

79. *See* Cal. Act, *supra* note 1, § 7(e)(2) (requiring the audit committee to recommend auditor engagements and compensation to the full board and to oversee auditor performance); Mass. Draft Leg., *supra* note 1, § 3(2) (making audit committee members "directly responsible for the appointment, compensation, and oversight" of independent auditors and accountants); N.Y. AG Program Bill 68-05, *supra* note 17, § 3(g)(2) (similar); N.Y. Senate Bill, *supra* note 1, § 4(g)(2) (similar).



The federal proposal also invokes auditing solutions, although it again concentrates on requirements for tax forms and filings. It would require an independent auditor to review all Form 990 submissions for conformity with the standards for such filings; it also would require tax-exempt entities to submit these auditor reports to the IRS along with their annual filings.<sup>80</sup> In addition, the federal proposal mandates a sliding scale of audit requirements for the financial reports of organizations above some minimum asset size<sup>81</sup> and auditor rotation at least every five years.<sup>82</sup> Rather than assigning audit oversight responsibilities to an audit committee, the White Paper charges the board of each tax-exempt organization with the responsibility to “review and approve the auditing and accounting principles and practices used in preparing the organization’s financial statements and [to] retain and replace the organization’s independent auditor.”<sup>83</sup> In addition to issuing this governance mandate, the federal proposal requires that each exempt entity confirm its board’s compliance with it on the Form 990.<sup>84</sup> Unlike the state proposals and some other proposals in the White Paper, this governance mandate and certification is not keyed to asset or revenue size. But, the drafters note that “[r]elaxation of certain of these rules might be appropriate for smaller tax exempt organizations.”<sup>85</sup>

New legislation in several other states also would require subsets of nonprofit organizations to begin producing audited financial reports. However, one should not overstate the importance of these bills as evidence of a sea change in nonprofit regulation. These mandates are not linked to general nonprofit accountability reforms. They do not apply to all nonprofit or tax-exempt organizations, or even to all incorporated nonprofits or non-

80. See White Paper, *supra* note 1, at 9. The White Paper also proposes that these audit reports should be maintained as public documents. See *id.* at 9, 10–11.

81. See *id.* at 9 (requiring independent audits of the financial statements of tax-exempt organizations with greater than \$250,000 in gross receipts and review of these statements by a CPA for organizations with gross receipts of greater than \$100,000 but less than \$250,000). The Nonprofit Panel recommends somewhat higher triggers for requiring audited financial statements. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 23 (recommending that exempt filers with \$2 million or greater annual revenues be required to obtain audited financial reports and file them along with their Form 990 series returns and that filers with annual revenues between \$500,000 and \$2 million should be required to obtain an independent public accountant’s review of their financial statements).

82. White Paper, *supra* note 1, at 9. Although the Nonprofit Panel agreed that nonprofits can sometimes benefit from auditor rotation, and that large organizations should consider the practice, it did not view an auditor rotation mandate as appropriate legislation. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 25.

83. White Paper, *supra* note 1, at 12. In its Interim Report, the Nonprofit Panel expressed its view that audit oversight “is a critical responsibility of the board of directors,” but did not approve of legislation mandating the form this oversight should take. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 31.

84. White Paper, *supra* note 1, at 13.

85. *Id.*

profits of a requisite size. For example, recent amendments to Maine's charitable solicitation registration law add it to the growing list of states requiring organizations registered to engage in such solicitations to include an audited financial statement in their annual applications for renewal.<sup>86</sup> Proposed legislation in Ohio would require organizations that receive more than \$500,000 of government funds in any calendar year to obtain an independent audit and file an audit report with the legislative arm of the government entity from which the funds were received.<sup>87</sup> These proposals are part of more standard state regulation of the financial practices of organizations that hold donated or public funds, but they do reflect a now-familiar focus on auditing to produce better nonprofit disclosures.

### C. *Other Disclosure-Based Reforms*

Various state and federal proposals for nonprofit legislative reform also place a strong focus on disclosure in areas that extend beyond officer certification and auditing requirements. The White Paper includes a series of proposed reforms that would increase the quantity of information that tax-exempt organizations must provide to the IRS regarding their practices, relationships, and activities. It also endorses electronic filing for Forms 990 and proposes authorization to fund its implementation.<sup>88</sup> A few recent examples of state legislative reform also include disclosure requirements that go beyond officer certification and auditing requirements. These efforts tend to use disclosure to target or strengthen traditional areas of nonprofit regulation.

The very first proposal the White Paper advances would increase the volume and frequency of disclosures by tax-exempt entities by imposing a new layer of periodic filing requirements. On each fifth anniversary of an organization's initial qualification for exemption, it would be required to file "such information as would enable the IRS to determine whether the organization continues to be organized and operated exclusively for . . .

86. See ME. REV. STAT. ANN. tit. 9 § 5004(4) (as amended March 2004).

87. See S.B. 153, 125th Gen. Assem., Reg. Sess. § 9.23(C)-(D) (Oh. 2003-2004). A legislative initiative in Vermont and a recent enactment in West Virginia also address the issue of nonprofits' accountability for public funds they receive. See H. 724, 2004 Gen. Assem., Reg. Sess. (Vt. 2004) (requiring a public official, the auditor of accounts, "to collect and review biennially audits or financial statements" of nonprofit organizations receiving government funds, for report to the state legislature); W. VA. CODE ANN. § 12-4-14 (West 2004) (enacted in 2004 to add penalties for noncompliance to existing mandate that organizations receiving \$15,000 or more in state funds or grants must file CPA-conducted audits of disbursements of funds with the legislature).

88. See White Paper, *supra* note 1, at 9, 10-11; see also *infra* text accompanying notes 159-161, 167-168 (describing the White Paper's plans to fund its e-filing and other initiatives).

exempt purposes.”<sup>89</sup> The White Paper suggests that such filings would include some materials readily available to many organizations, such as current copies of the organization’s governing documents and financial statements.<sup>90</sup> However, it also would demand that tax-exempt entities submit various organizational policies and a detailed narrative about the organization’s practices, which many nonprofits would have to produce specially for this purpose.<sup>91</sup> This information would be used in at least two ways. It could be used by the IRS at its discretion to review the continued validity of the organization’s exemption, and it would be made publicly available.<sup>92</sup>

The White Paper also seeks to increase the depth of disclosures demanded of tax-exempt entities by expanding the existing Form 990. One proposal would require new attachments to the Form 990 to disclose relationships among exempt and non-exempt organizations, transactions between such entities, and insider transactions of various kinds.<sup>93</sup> Another proposal would expand the Form 990 to require larger exempt organizations to include detailed descriptions of their annual performance goals and measurements for meeting such goals in current and future years.<sup>94</sup> The White Paper explains that expanding the coverage of this publicly available form will “assist donors to better determine an organization’s accomplishments and goals in deciding whether to donate, and not [to provide] a point of review by the IRS.”<sup>95</sup> The federal proposals also emphasize the need for Forms 990 from all exempt organizations to include accurate financial and

89. White Paper, *supra* note 1, at 1. Failure to comply with this quinquennial filing requirement would result in loss of exemption. *Id.* The Nonprofit Panel did not address this proposed new filing requirement in its Interim Report, but expressed its intent to do so in the future. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 51–52.

90. *See* White Paper, *supra* note 1, at 1.

91. *See id.*

92. *Id.*

93. *Id.* at 9–10. The Nonprofit Panel has noted the “need for revision and reform of the Form 990 series returns to ensure accurate, complete, timely, consistent and informative reporting” and signaled its intent to provide guidance on revisions to these forms in a future report. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 22.

94. White Paper, *supra* note 1, at 10 (suggesting application of this requirement only to those tax-exempt entities over \$250,000 in gross receipts). The Nonprofit Panel reserved the question of performance data disclosure for its next phase of work. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 52.

95. White Paper, *supra* note 1, at 10.

other disclosures<sup>96</sup> and back up their new requirements for disclosure to the IRS with increased penalties.<sup>97</sup>

In addition to these provisions increasing the disclosure outputs that tax-exempt entities must prepare and file, the White Paper proposes a substantial innovation in the IRS' system for managing the documents it receives. First, it would authorize the IRS to mandate that tax-exempt entities file electronically.<sup>98</sup> In addition, the White Paper instructs the IRS to prepare itself to receive and capture electronically-filed information on a swift timetable and to coordinate with state officials to share information and simplify reporting.<sup>99</sup> The IRS just last year began to accept electronic Forms 990 and other disclosure documents filed by tax-exempt entities on a voluntary basis.<sup>100</sup> It has historically collected these materials only in paper format, information from which can be distilled and screened only by an arduous manual process. Authorization for the IRS to require electronic filing and to institute systems to manage the data contained in these files could radically change the ability of the Service to analyze the information it receives. State regulators similarly lack the ability to electronically capture and screen information from disclosure documents.<sup>101</sup> Instructing the IRS to share information with states and to work with them to streamline the reporting process may spur improvements in these systems as well, particularly if funding for these purposes is made available to the IRS and the states.

96. *See id.* (requiring exempt organizations to "disclose material changes in activities, operations or structure" and to "accurately report the charity's expenses, including any joint cost allocations, in its financial statements and Form 990").

97. *See id.* at 8-9 (adding a third, highest tier to the current two-tiered penalty structure for failure to file complete and accurate Forms 990, and increasing the dollar amounts of various existing penalties for filing failures and delays). As noted *supra* note 69, the Nonprofit Panel has recommended that the IRS increase enforcement of existing penalties for filing failures, rather than the enactment of additional penalties.

98. *See* White Paper, *supra* note 1, at 9. The Nonprofit Panel has come out strongly in support of mandatory electronic filing, so long as appropriate provisions are made to allow filing of necessary attachments and to ease filing for organizations of all sizes and resource levels. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 21.

99. *See* White Paper, *supra* note 1, at 9 (demanding the IRS obtain electronic capture capability by January 1, 2007).

100. *See* Internal Revenue Service, *E-File for Charities and Non-Profits* (describing the newly available electronic filing process for Forms 990 and selected other tax-exempt filings), at <http://www.irs.gov/efile/article/0,,id=108211,00.html> (last visited Feb. 25, 2005); *see also* ZINA POLETZ ET AL., URBAN INST., CHARITIES READY AND WILLING TO E-FILE (June 2002) (reporting the findings of a survey on tax-exempt organizations' capacity to adopt electronic filing), available at <http://www.urban.org/UploadedPDF/410524.pdf>.

101. *See, e.g.*, William Josephson, Remarks at the Funders Alliance of Upstate New York 3 (Sept. 30, 2003) (draft of remarks dated Sept. 18, 2003 on file with author) (describing the automation of the 47,000 registrations and annual report files held by the New York Charities Bureau to be one of his goals as its Assistant Attorney General-in-Charge); *see also* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 21 (recommending that federal and state e-filing efforts be coordinated).

Finally, two recent state proposals for nonprofit legislative reform suggest further potential expansion of disclosure requirements. Recent bills in the Connecticut General Assembly would take disclosure to the extreme. These bills would require organizations that solicit charitable contributions to file with the state's consumer protection department not only annual financial reports, but also detailed quarterly reports.<sup>102</sup> Moreover, the House bill would require these reports to include a description of each check that a soliciting organization issued in the preceding quarter.<sup>103</sup> This excess of zeal may be due to legislators' overwhelming concerns regarding charitable solicitation fraud and the use of professional fundraisers;<sup>104</sup> the quarterly reporting requirements are but one small part of a larger bill updating the state's solicitation regime. Still, the Connecticut bills' use of disclosure mechanisms at this level of detail is remarkable.

A bill recently before the Minnesota House of Representatives likewise would add a disclosure requirement to address a hot-button nonprofit issue: excessive compensation. Current Minnesota law requires a nonprofit organization that solicits charitable contributions to file a financial statement with state authorities, listing information on its five highest paid directors, officers, and employees receiving compensation in excess of \$50,000.<sup>105</sup> The new bill targets compensation increases. If the compensation of any one of the individuals listed on such a statement has increased by more than five percent since the last statement filed, the bill would require the organization to disclose its reasons for increasing that compensation.<sup>106</sup> Although it is common for nonprofit regulators to focus on compensation and other self-dealing concerns, this reliance on increased disclosure as a way to target excessive compensation is noteworthy.

\* \* \*

The reform efforts described in this Part pursue nonprofit accountability through a variety of disclosure tactics. Officer certification mandates charge fiduciaries with responsibility for improving nonprofit disclosure

102. See H.B. 5313 § 1(f), 2004 Gen. Assem., Feb. Sess. (Conn. 2004); S.B. 396 § 2(f), 2004 Gen. Assem., Feb. Sess. (Conn. 2004).

103. See Conn. H.B. 5313 § 1(f).

104. See Brakman Reiser, *supra* note 54, at 235–40 (discussing AG's emphasis of donor protection in their nonprofit enforcement agendas); see also Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 947 & n.37 (2004) (noting a 1994 survey's finding that state attorneys general perceive charitable solicitation fraud as their "biggest problem" in the nonprofit enforcement context); Stephanie Strom, *New Equation for Charities: More Money, Less Oversight*, N.Y. TIMES, Nov. 17, 2003, at F1 ("Most states look at charity oversight as an extension of their role as consumer watchdogs and focus on [charitable] solicitation.").

105. See MINN. STAT. ANN. § 309.53(3) (West 2004).

106. See H.F. 1769 § 1(3)(i), 83d Leg., Reg. Sess. (Minn. 2004).

documents and the means by which the information disclosed is produced. Auditing oversight mandates likewise engage fiduciaries in the process of safeguarding the integrity of the nonprofit disclosure process. The additional requirements for disclosure auditing seek to harness the expertise of accounting professionals to improve the data and presentation in nonprofit disclosures. Various state and federal proposals would further increase nonprofit disclosure output. And, electronic filing and other efforts to improve the accessibility of nonprofit disclosures attempt to make it easier for regulators and the public to use the disclosures that nonprofits produce and disseminate. Having established the contours of these reforms, the next Part turns to evaluating the likely efficacy of their disclosure techniques in actually improving nonprofit accountability.

### III. DISCLOSURE-BASED REFORMS AND NONPROFIT ACCOUNTABILITY

Requiring disclosure can lead to improvements in an organization's accountability by two distinct, though interactive, paths. First, disclosure can improve accountability by spurring behavioral changes within the disclosing organization. In the nonprofit context, this path from disclosure to accountability assumes that when nonprofit organizations and actors know their errors and abuses will be disclosed, they will do more to avoid them. Second, disclosure also can improve accountability by facilitating enforcement—by providing information to parties able to monitor, prevent, or correct mistakes and misbehavior within a disclosing organization. For nonprofits to move along this path from disclosure to accountability, disclosure reforms must improve the ability of the existing government and private enforcers to target and prosecute abuses. Finally, of course, these two paths can be interrelated. If nonprofit actors believe it is unlikely that required disclosures will be used to facilitate enforcement efforts, this knowledge will undermine their motivation to improve their behavior in response to a disclosure mandate. This Part evaluates the ability of the various disclosure-based reform proposals described above to move nonprofits toward greater accountability, along either of these paths.<sup>107</sup>

107. It is important to note that, even if successful, the disclosure tactics found in recent state and federal legislative proposals for nonprofit reform only really offer to improve nonprofits' *financial* accountability. See Brakman Reiser, *supra* note 54, at 234–68. This financial dimension of nonprofit accountability—concerned with safeguarding nonprofit assets and the interests of their donors—is certainly important. To be truly accountable, though, nonprofits also must be faithful to their missions and must operate in accordance with the internal rules of governance they have adopted. See *id.* at 209–19. Disclosure reforms aimed at financial accountability, even if they succeed, can only be a partial solution to resolving the nonprofit sector's accountability gap.

The disclosure focus of Sarbanes-Oxley, and its reliance on officer certification and increased auditing to improve the accountability of the entities it regulates, can easily be understood as appropriate to its historical and legal context. The Act primarily regulates issuers of publicly-traded securities. American securities regulation has been deeply committed to a disclosure model since the inception of federal securities regulation in the 1930s.<sup>108</sup> Moreover, Sarbanes-Oxley was a response aimed to correct what

108. See, e.g., BROWN, *supra* note 73, § 2.01, at 2-4 to 2-6 (explaining that the Securities Act of 1933 “embraced the disclosure philosophy,” and that the Securities Exchange Act of 1934 made the importance of disclosure “unmistakably clear”).

Of course, even in the corporate securities context, the viability of disclosure as a regulatory mechanism has long been the subject of considerable debate. At the time of the federal securities laws’ enactment, even their boosters recognized that disclosure might not suffice to protect investors, especially unsophisticated ones. See, e.g., George J. Feldman, *The New Federal Securities Act*, 14 B.U. L. REV. 1, 3 (1934) (supporting the new Securities Act, while still noting that “the holder of the security is not completely protected even if the Act be effective and the security comes into his hands without any fraud or misrepresentation”); Chester Rohrlach, *The New Deal in Corporation Law*, 35 COLUM. L. REV. 1167, 1172 (1935) (stating that although one can assume even small investors eventually will learn of relevant facts through disclosure, “there still lurks the danger of vital information being concealed from the untrained and inexperienced by a judicious telling of the literal truth”). Despite these concerns, however, the regulatory tool of disclosure maintained widespread approval for decades. See e.g., Robert L. Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 623–31, 646 (1964) (asserting that, at least in normal times, disclosure-based regulation of initial securities offerings has effectively safeguarded investors and that extending and standardizing disclosure obligations would provide even greater protection). Some commentators even suggested new types of information that issuers might usefully be asked to disclose to regulators. See, e.g., Knauss, *supra*, at 646–48 (noting the potential use of securities disclosure regulations to promote corporate social responsibility); Thomas J. Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 FORD. L. REV. 565, 587–88 (1972) (advocating new categories of disclosure, such as environmental activities, hiring practices, and political contributions).

When Congress extended the range of required disclosures under the federal securities laws in the 1960s, however, rumblings of discontent with mandatory disclosure policy began to emerge. See George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 730 (1964) (concluding that his “studies suggest that the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public”); George J. Benston, *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471, 1480–82 (1979) (questioning the value and desirability of disclosure-based securities regulation and arguing against its extension to demand continuous corporate reporting). *But see* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 2 (1983) (arguing these and other critics of the mandatory corporate disclosure system have not properly accounted for concrete evidence validating the disclosure system). Debate over disclosure’s efficacy continued through the late 1990s, when critics and scholars began considering possible alternatives. *Compare, e.g.*, Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1 (proposing a regime in which issuers could opt to provide their own preferred level of disclosure), *and* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (proposing a market-based, competitive federalism approach, in which states would compete with the federal government for the power to regulate issuers’ securities and issuers would choose which regime applied to them by selecting a “securities domicile”), *with* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1337 (1999) (arguing that allowing U.S. issuers to select their own disclosure regimes in lieu of imposing mandatory disclosure would not lead to socially optimal rates of disclosure).

With the explosion of corporate scandals at the turn of the current century, however, the disclosure debate recently has turned from the question of whether to retain a mandatory securities disclosure system to that of how best to use this regulatory tool. See, e.g., Edward Rock, *Securities*

were perceived as gross inaccuracies in reporting by Enron and others, inaccuracies that were not adequately prevented by the existing disclosure-based system.

Nonprofit regulation, by contrast, has not traditionally relied predominantly on a disclosure model. Enforcement occurs through investigation and litigation by state AGs, IRS auditing and prosecution, and negotiation of settlement agreements by both state and federal authorities. Nonprofit organizations have long been required to make various disclosures to these authorities,<sup>109</sup> and investigations and prosecutions may sometimes be triggered by revelations gained through review of nonprofit disclosure documents. But, nonprofit regulators also rely heavily on tips from insiders and the public, as well as the findings of investigative journalists.<sup>110</sup> Before a shift to disclosure as a significant, if not dominant, regulatory technique in the nonprofit sector can legitimately be advocated, the potential for disclosure methods to achieve nonprofit accountability gains should be demonstrated.

#### A. *Improving Behavior*

The recent state and federal proposals for disclosure-based nonprofit reform surely intend to work, at least in part, by improving behavior within nonprofit organizations. This subpart assesses the extent to which these disclosure enhancements are likely to improve the behavior of nonprofit actors and organizations. It highlights the sometimes duplicative nature of these proposals, their reliance on nonprofit actors' inclination to comply with the law, and the costs of their implementation. These costs are particularly important in the unique nonprofit environment, where losses often will be borne by vulnerable beneficiaries and by society at large.

*Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002) (supporting the current system of mandatory disclosure as mechanism by which issuers can make "credible commitments" to ongoing and indefinite disclosure, which is vital in order to raise capital); Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (arguing that mandatory disclosure may be improved by researching how investors and experts use disclosed information, and cautioning that due to "information overload" more disclosure is not always better); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004) (arguing that public companies should be required to disclose more management information, in order to make mandatory disclosure requirements more effective).

109. See FREMONT-SMITH, *supra* note 65, at 311–17 (describing the advent of state registration and reporting requirements for nonprofits under adoptions of the Uniform Act for Supervision of Trustees for Charitable Purposes and similar state legislation beginning in the 1950s).

110. See Brody, *supra* note 104, at 953 & n.60.



## 1. Officer Certifications

In order to analyze the ability of officer certification requirements to improve nonprofit behavior, it is helpful to separate the accuracy and reliability certifications that recent reforms proposals include. Again, accuracy certifications require nonprofit officers to take personal responsibility for the truth of the contents of nonprofit disclosures, however that information might be produced and whoever might ultimately see it. These reforms rely on the integrity and conscientiousness of nonprofit officers to ensure the quality of disclosed information. Reliability certifications focus less on promises and more on process. They work by stimulating improvement of the process by which disclosed information is produced and maintained. These techniques differ in their ability to encourage improvements in the behavior of nonprofit organizations and actors.

### *a. Accuracy Certification Requirements*

On the surface, it seems hard to quarrel with the imposition of accuracy certification requirements. Surely high-level nonprofit officers should believe in the verity of their entities' internal and external financial reports and their IRS filings. However, to evaluate the usefulness of the accuracy certification in improving nonprofit behavior, one must ask a harder question than whether nonprofit officers should believe their reports. Instead, one must question whether officers required to make accuracy certifications will be more likely than otherwise to cure defects in their disclosure processes and to resolve any underlying problems in their organizations' operations their disclosures might reveal. And, one should assess whether the benefits of those cures and resolutions will be worth their costs. Unfortunately, the answers to these questions are murky.

In the first place, accuracy certification proposals may do little to improve nonprofit behavior because they often will replicate existing statutory and regulatory requirements. Mandatory annual filings with state AGs already frequently require signatures by nonprofit officers and/or trustees, attesting to their belief in the correctness and comprehensiveness of the information submitted.<sup>111</sup> Indeed, the very states that have considered accuracy certification reforms, New York and Massachusetts, currently have

111. See, e.g., Attorney General Lisa Madigan, State of Illinois, Form AG990-IL, Illinois Charitable Organization Annual Report (requiring signatures of the president or trustee and treasurer or trustee certifying that they have examined the information in the report "and the facts therein stated are true and complete").

these requirements.<sup>112</sup> Likewise, the Form 990 cannot be filed without an officer's signature, which attests to the verity of the information provided.<sup>113</sup> It is difficult to imagine nonprofit officers will change their behavior in response to a proliferation of duplicative accuracy certification requirements.

Moreover, the extent to which any accuracy certification requirement can improve the behavior of nonprofit organizations and actors is premised on the assumption that certifying officers will be unwilling to sign falsely or carelessly. However, mandated accuracy certifications will not deter willfully abusive nonprofit actors.<sup>114</sup> Imagine an officer who is siphoning off assets from a tax-exempt, nonprofit entity or who is taking truly excessive compensation. This officer already is transgressing federal tax law, state fiduciary law, and perhaps even criminal law prohibitions. One must doubt she will be more likely to disclose or cease this activity out of fear that she will run afoul of a certification requirement if she reports inaccurately. It seems especially unlikely that our faithless officer will improve her behavior if the likelihood of detection of her abuse and enforcement of her fiduciary duty is (or is perceived to be) quite low.<sup>115</sup> Enforcement of fiduciary duty by state and federal regulators is indeed quite limited, as is the ability of the public to discipline the behavior of nonprofit actors and organizations.<sup>116</sup>

112. See Massachusetts Office of the Attorney General, Division of Public Charities, Form PC (annual reporting form requiring the president or other authorized officer or trustee to sign, declaring under penalty of perjury "that the information furnished in this report . . . is true and correct to the best of my knowledge"), available at <http://www.ago.state.ma.us/filelibrary/main-pc.pdf> (last visited Feb. 25, 2005); State of New York, Department of Law, Charities Bureau—Registration Section, Form CHAR010 (providing an example of the certification required by officer(s) submitting filings to the New York attorney general, which certification attests that the officer(s) examined the information submitted and "to the best of my (our) knowledge and belief the contents thereof are true, correct and complete"), available at <http://www.oag.state.ny.us/charities/forms/char010.pdf> (last visited Feb. 25, 2005).

113. See Department of Treasury, Internal Revenue Service, Form 990, Return of Organization Exempt from Income Tax (requiring signature of officer, under penalties of perjury, denoting that the officer has examined the form and that all of the information reported in it is "true, correct, and complete"), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> (last visited Feb. 25, 2005).

114. Cf. MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 456 (1965) ("Individuals whose acts are unequivocally *mala fides* can file incomplete or even false reports. The imposition of a duty to account is not designed to uncover these acts. They require investigation, audits, and alert enforcement.").

115. See Edward K. Cheng, *Fiat Versus Structure: Music Piracy, Speeding & the Regulation of Behavior* 26–27 (2004) (unpublished manuscript on file with author) (collecting studies demonstrating that the deterrent effect of prohibitions, even those with severe penalties, "falls rapidly (and nonlinearly) with lower probabilities of enforcement," and identifying possible sociological and cognitive explanations for this finding).

116. For a discussion of the acute resource and structural impediments to nonprofit enforcement, see *infra* Part III(B).

Furthermore, it is not necessary to portray our hypothetical officer as thieving or disloyal in order to predict that accuracy certifications will not spur significant improvements in behavior. In the absence of clear and effective penalties for noncompliance, a nonprofit officer envisioned as a Holmesian “bad man”—who follows only law that predictably will be enforced against him—likewise would not change his behavior in response to accuracy certifications requirements.<sup>117</sup> Thus, in the low enforcement environment of the nonprofit sector, accuracy certification requirements are not likely to spur improved behavior either by those officers intent on or complicit in abuse or by those officers who refuse to follow unenforced or underenforced legal mandates.

Still, one would think that non-duplicative accuracy certification requirements at least would improve the behavior of those officers who nevertheless feel obligated to comply with the law as enacted. We can call these officers “compliant officers,” and the argument would proceed as follows. Conscientious compliant officers concerned about making false certifications would improve their monitoring of organizational operations and employee and fiduciary conduct. New accuracy certification requirements also would focus otherwise lackadaisical compliant officers on the data contained in their reports and would motivate those officers to scrutinize their filings more closely. Taking these steps would enable compliant officers to find and correct mistakes or abuses within their own organizations. And, these improvements in behavior would thereby improve nonprofit accountability.

The problem with this argument, however, is that even compliant officers will limit the expenditures they make to support their accuracy certifications. All other things being equal, compliant officers would obtain all possible assurances to support their certifications of accuracy and correct any mistakes or abuses unearthed in the process of obtaining those assurances prior to signing reports or filings. But, all other things are not equal. The hours and resources that might be spent to provide officers with the assurances to support an accuracy certification must come from somewhere, presumably from the time and funds nonprofits can expend in pursuit of their missions. If he is also rational, a compliant officer will evaluate the costs and benefits of devoting time and funds to establishing the accuracy of his organization’s reports. In light of the paucity of penalties for

117. See Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) (arguing that to know the content of the law, one need only think of the law as would a “bad man,” who views the content of the law only as that which the courts predictably will punish). I thank Professor Harvey Dale for this insight.

failures in accuracy certifications provided by the proposals and the general lack of effective enforcement in the nonprofit area,<sup>118</sup> even a compliant officer is likely to see a significant portion of his organization's resources as better spent on its programs than on pursuing assurances to support an accuracy certification. Thus, even in the subgroup of compliant officers, improvements in behavior spurred by accuracy certification requirements will be limited.

Furthermore, even limited efforts to comply with accuracy certification requirements will exact costs on nonprofits and their beneficiaries. Nonprofit organizations often provide vital services that the market and government will not or cannot provide.<sup>119</sup> If the burdens of compliance with regulation push nonprofits to scale back their programs or force them out of existence, beneficiaries, communities, and society will bear a real loss. In addition to reducing resources available for mission achievement, all officer certification requirements may diminish the human resources made available to nonprofit organizations by hindering officer recruitment. Qualified candidates who would otherwise choose to work for nonprofits may opt not to do so if such positions become mired in legal compliance, or in order to avoid any lingering potential for personal responsibility for inaccurate disclosure.<sup>120</sup> Neither nonprofit managers nor law reformers should lightly brush aside these costs of new disclosure mandates.

The state reform proposals including accuracy certification requirements demonstrate an awareness of the new burdens these requirements will impose on nonprofits by keying application of these requirements to revenue or asset size. The trigger points vary,<sup>121</sup> and surely these facts will

118. See *infra* Part III(B).

119. See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 843–45 (1980) (explaining the existence of nonprofit organizations as a means to solving contract failures, where consumers lack the information and expertise to compare, bargain, and evaluate complex services); Dennis R. Young, *Government Failure Theory*, in *THE NATURE OF THE NONPROFIT SECTOR* 190, 190–91 (J. Steven Ott ed., 2001) (explaining that nonprofits also step in where government production is ineffective, due to the constraints of majority decision making, the universal access imperative, and the problems of government bureaucracy).

120. See Szymanski, *supra* note 11, at 1316–17 (addressing concerns regarding officer and director recruitment raised by application of Sarbanes-Oxley-type reforms to nonprofits); see also Pamela Yip & Terry Maxon, *CEOs Spending Less Time at the Top*, DALLAS MORNING NEWS, July 19, 2004, at 1D (identifying Sarbanes-Oxley's for-profit certification requirements as part of a backlash against CEOs that may result in shorter CEO tenures, but noting that for-profit CEO salaries remain high). *But see also* Bruce Meyerson, *A Shortage of "Qualified" Directors? Maybe Companies Aren't Looking Hard Enough*, PITTSBURGH POST-GAZETTE, Aug. 1, 2004, at D2 (challenging claims that the pool of interested and qualified directors will shrink due to legal and regulatory changes adopted in response to corporate scandals, and encouraging companies to look beyond "the corporate establishment").

121. Compare, e.g., Mass. Draft Leg., *supra* note 1, § 2(4) (imposing its most stringent accuracy certification requirement on nonprofit corporations that receive or accrue in any fiscal year gross revenue and support of at least \$750,000), with, e.g., N.Y. Senate Bill, *supra* note 1, § 1(e) (imposing its

not always indicate an individual organization's ability to absorb the costs of compliance. But, the states' attentiveness to finding some method by which to balance the burdens and benefits of accuracy certification reforms is promising. The federal proposal does not presently calibrate its accuracy certification proposal in this way, but its use of financial triggers in other contexts suggests that this might be modified on further articulation.

*b. Reliability Certification Requirements*

In addition to accuracy certifications, the New York Proposals, Massachusetts Draft Legislation, and federal White Paper all would require officers of nonprofit organizations to certify the reliability of the processes that produce and safeguard the information they disclose.<sup>122</sup> Unlike the accuracy certification proposals, these proposals are entirely novel and would impose new disclosure burdens on nonprofit actors. They also can have a somewhat different impact on nonprofit behavior. To appreciate this distinction, it is important to understand somewhat more about the content of these requirements.

Reliability certification requirements force nonprofit officers and their organizations to confront the issue of internal controls. The New York Proposals took the relevant provision almost directly from Sarbanes-Oxley, requiring officers of large-asset nonprofits to verify the existence and effectiveness of their "internal financial controls."<sup>123</sup> The Massachusetts proposal would require signing officers of large organizations to certify the establishment and maintenance of two types of internal controls, "disclosure controls" and "internal control over financial reporting."<sup>124</sup> The lengthy definitions of these terms include requirements for the process by which controls should be developed and used, as well as their substance.<sup>125</sup> In its reliability certification proposal, the White Paper would mandate that

most stringent accuracy certification requirement on nonprofit corporations with at least \$3 million in assets or that receive or accrue gross revenue and support of at least \$1 million in any fiscal year).

122. See Mass. Draft Leg., *supra* note 1, § 2(4); N.Y. Senate Bill, *supra* note 1, § 1(e)(2)-(4); White Paper, *supra* note 1, at 8.

123. N.Y. Senate Bill, *supra* note 1, § 1(e)(2)-(4). Compare *id.*, with Sarbanes-Oxley Act § 302(a)(4)(A)-(B) (requiring certifications as to the existence and accuracy of "internal controls" in substantially similar form to the New York Proposal's certification requirements as to "internal financial controls"), and *id.* § 302(a)(4)(C)-(D) (mandating that officers evaluate their companies' internal controls and present conclusions as to their efficacy, again in a form substantively identical to verifications required in the New York Proposals).

As noted above, the most recent legislative proposal from the New York AG removes the reliability certification requirement, while retaining a focus on internal controls. This new approach is addressed, *infra*, at text accompanying notes 128-30.

124. Mass. Draft Leg., *supra* note 1, §§ 1, 2(4).

125. See *id.* § 1.

CEOs of exempt organizations “sign a declaration under penalties of perjury that the chief executive officer has put in place processes and procedures to ensure that the organization’s Federal information return and tax return (including Form 990T) complies with the Internal Revenue Code.”<sup>126</sup> Rather than merely asking for assurances of accuracy, these reforms draft the signing officer into the process of designing methods to produce information and protect its integrity—internal controls.<sup>127</sup>

Although the New York AG’s most recent legislative proposals have abandoned reliability certification, they retain an emphasis on internal controls. The Revised New York Proposals instruct foreign and domestic not-for-profit corporations to: “maintain internal financial controls designed to reasonably ensure that material financial information relating to the corporation is made known to the corporation’s board of directors by others within the corporation.”<sup>128</sup> Rather than triggering this requirement at any particular level of assets or revenues, the Revised New York Proposals would require nonprofits of all sizes to adopt internal controls, but only those controls that would be reasonable. The provision goes on to impose obligations on officers to disclose to the audit committee or board of directors any deficiencies in these internal controls, any frauds by employees with a significant role in maintaining them, and any material information indicating a problem with the financial and operational information disclosed in the organization’s reports.<sup>129</sup> The substance of this internal controls mandate is quite similar to that of the New York Proposals’ original reliability certification requirement.<sup>130</sup> However, officers operating under the Revised New York Proposals would not be subject to the additional requirement to certify their actions. Thus, the Revised New York Propos-

126. White Paper, *supra* note 1, at 8. The Senate Finance Committee staff cites another piece of for-profit legislation, rather than Sarbanes-Oxley, as an analogue to its certification proposals. According to the draft, the JOBS bill would require taxable corporation CEOs to make a similar attestation on their corporate tax returns. *Id.*

127. The New York Proposals also would involve the audit committee in maintaining internal controls. See N.Y. Senate Bill, *supra* note 1, §§ 1(e)(4), 4(g)(4) (requiring audit committees to receive reports of failures in internal controls from officers signing required certifications and from accounting professionals engaged in audit functions). New York and Massachusetts both would rely on whistleblowers’ reports to audit committees to flush out internal control gaps. See *id.* § 4(g)(4) (charging the audit committee to create a process for receiving complaints regarding accounting, accounting controls, auditing, and other financial matters); Mass. Draft Leg., *supra* note 1, § 3(4)–(5) (requiring audit committees to establish procedures to receive, retain, and treat these complaints, and instructing them to forward such complaints to the attorney general at least annually).

128. See N.Y. AG Program Bill 68-05, *supra* note 17, § 6(a). The bill, like its predecessors, exempts membership organizations that do not solicit charitable contributions, as well as religious organizations, from its internal controls requirements. See *id.* §§ 6(c), 7.

129. See *id.* § 6(b).

130. Compare *id.* § 6, with N.Y. Senate Bill, *supra* note 1, §§ 1(e)(2)–(4).

als' affirmative mandate seeks to accomplish by direct instruction what reliability certification would achieve as a more indirect effect.

The direct approach is certainly more efficient regulation and would slightly reduce the paperwork burden on nonprofits attempting to comply. More importantly, however, the focus of both reliability certification and internal controls mandates on the disclosure process, rather than merely on disclosure outputs, increases the likelihood that these measures can improve the behavior of nonprofit actors and organizations. Still, the ultimate effectiveness of either technique remains linked to the questions whether and to what extent nonprofit organizations will adopt and maintain internal controls in response to their directives.

The first challenge for nonprofit organizations and officers subject to reliability certification and other internal controls mandates will be to design and maintain internal controls. In the for-profit arena, internal control has become a term of art with a more or less established meaning.<sup>131</sup> It will take time for government actors and the nonprofit sector to develop consensus around the baseline level of processes and procedures appropriate to provide reasonable assurances of the accuracy and completeness of nonprofit financial reports or IRS filings.<sup>132</sup> Some of this work is beginning to be undertaken. For example, the Massachusetts reform proposal provides a definition of internal controls.<sup>133</sup> According to the draft:

“internal control over financial reporting” . . . includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the public charity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the public charity are being made only in accordance with authorizations of the management, directors and/or trustees of the public charity; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisi-

131. See MICHAEL RAMOS, HOW TO COMPLY WITH SARBANES-OXLEY SECTION 404, at 29–61 (2004) (providing a thorough review of the internal control concept and its application in for-profit corporations).

132. See Letter from Carolyn Patterson, Chairperson, Alliance for Nonprofit Governance, to AG Eliot Spitzer Reporting on the Proceedings of the Alliance for Nonprofit Governance Conference: Changing Nonprofit Accountability 2 (Dec. 1, 2003) (describing the strong need for clarification of what internal controls will mean for nonprofit organizations), available at <http://www.angonline.org/spitzer.doc>; Ken Rankin, *Nonprofits Balk at Auditing Proposal*, ACCT. TODAY, Aug. 23, 2004, at 1 (reporting similar concerns).

133. See Mass. Draft Leg. § 1, *supra* note 1; see also Am. Law Inst., Principles of the Law of Nonprofit Organizations (Council Draft No. 2, Nov. 18, 2004) (addressing internal controls in the nonprofit context).

tion, use or disposition of the public charity's assets that could have a material effect on the financial statements.<sup>134</sup>

Although neither the New York Proposals nor the Revised New York Proposals provide a legislative definition of internal controls, AG Spitzer's office did recently released a publication on "Internal Controls and Financial Accountability for Not-for-Profit Boards." This pamphlet also concentrates on record-keeping and handling of a nonprofit's funds and other property.<sup>135</sup>

Assuming that appropriate and workable systems of internal controls can be identified, it still remains to be seen whether, or to what extent, mandating them will improve nonprofit behavior. Again, one cannot assume reliability certifications or internal control mandates will prompt improved behavior from officers already engaged in intentional misconduct. Further, if meaningful and unpleasant consequences will not predictably result from the failure to implement internal controls, it is likewise doubtful that requiring them will motivate behavioral improvements in officers who seek to follow only legal rules that are effectively enforced.

For compliant officers, however, reliability certification and internal control requirements not only issue a mandate to improve behavior, they provide a blueprint for how to accomplish such improvements. They do so by demanding the creation of individualized internal controls within organizations. Definitions like those in the Massachusetts draft and the New York AG's pamphlet instruct nonprofits to create processes to ensure record-keeping and to aid in detecting misappropriations or mistakes. In order to implement reliable internal controls and certify honestly to their existence, officers will need to establish the specifics of these processes for their particular organizations. An officer needs to decide how to record transactions, how long to keep those records, how often to update them,

134. Mass. Draft Leg. § 1, *supra* note 1. The Massachusetts draft also identifies the appropriate provenance of an internal controls system. It is to be:

a process designed by, or under the supervision of, the public charity's principal executive and principal financial officers, or persons performing similar functions, and effected by the public charity's board of directors and/or trustees, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

*Id.*

135. See N.Y. ATTORNEY GEN. ELIOT SPITZER, INTERNAL CONTROLS AND FINANCIAL ACCOUNTABILITY FOR NOT-FOR-PROFIT BOARDS (2004), available at [www.oag.state.ny.us/charities/charities.html](http://www.oag.state.ny.us/charities/charities.html). Although the New York AG's focus clearly is on tracking funds, this guide describes internal controls more broadly than the Massachusetts legislation, as "systems . . . not only related to accounting and reporting but also relate[d] to the organization's communication processes, internally and externally." *Id.* at 2. The six facets of internal controls it provides range from procedures for "handling funds received and expended" and conducting annual audits to "evaluating staff and programs" and "implementing personnel and conflicts of interest policies." *Id.*



and how to monitor them. This decision-making is a valuable governance exercise that boards and nonofficer employees hopefully would engage in along with any responsible signing officers. Such an internal evaluation would school important nonprofit actors in the operations of their nonprofits and should help them to improve their ability to manage and monitor their organizations.

Regrettably, however, the costs of complying with reliability certification requirements and internal control mandates will cause even compliant officers to limit the resources they devote to establishing individualized internal controls. The organizational exploration imagined above requires substantial expenditures of time and human and financial resources, and maintaining and updating internal controls generates continuing costs.<sup>136</sup> These costs could well drive nonprofit officers to respond to these new requirements by adopting generic policies, rather than creating individualized controls sensitive to their specific needs. Nonprofits could adopt such boilerplate policies in order to devote more resources to other pressing needs. Or, they might do so as an exercise in calculated risk management in light of the low level of enforcement. Whatever their motivation, widespread adoption of generic internal controls will decrease the improvements in nonprofit behavior, and thereby accountability, to be achieved through reliability certification and internal control requirements.

The financial and other burdens these reforms will impose on nonprofits should not be ignored. Rather, they should be considered in relation to the likely accountability gains such mandates will create, particularly in comparison to educational or aspirational approaches. In estimating the relative gains from mandating reliability certification or internal controls more generally, one again encounters the problem of potentially overregulating compliant organizations with a requirement their noncompliant counterparts will flout. Even without these mandates, many nonprofits already engage in self-evaluative processes and establish needed con-

136. During the transitional period in which consensus on the basic frameworks for nonprofit internal controls will be developed, reliability certification or internal controls requirements also will exact some special costs. Uncertainty may cause conscientious officers to expend significant resources obtaining advice on process creation and implementation. These resources may be difficult to garner without an accompanying decrease in those dedicated to pursuit of organizational missions. In addition, the federal proposal's contemplation of personal liability for mistaken reliability certifications may create additional burdens for the nonprofit sector, as qualified individuals may be further discouraged from serving as officers in an atmosphere where the route to compliance remains uncertain. These costs are temporary and may be worth bearing, especially if the requirements are variable or limited to organizations of significant financial magnitude or sophistication. Still, the costs are real, and they should be recognized in any careful analysis of these reforms.

trols.<sup>137</sup> More organizations likely would do so if educated about the importance of internal controls and if offered the needed training—at least to the extent possible without unreasonably detracting from their ability to accomplish their missions.

Thus, reliability certification and internal control mandates would improve nonprofit accountability over educational or voluntary programs only to the extent they more effectively motivate nonprofit leaders to establish and engage in an ongoing process by which abuses and errors may be discovered and corrected. Whether these accountability gains will be deemed by organizations or should be deemed by legislatures as sufficient to justify the burdens created by such mandates is an empirical question that will be difficult to answer with precision. Still, legislators should consider these issues and cautiously enact reliability certification or internal controls mandates only if they are persuaded the potential for these gains is worth this risk. Again, the use of financial triggers in at least the state reliability certification proposals suggests some encouraging sensitivity to this question of balance.<sup>138</sup>

## 2. Auditing Reforms

An analysis of the auditing reforms described in Part II(B) can follow roughly the same trajectory as that of officer certification requirements, as they too proceed along dual tracks. Like accuracy certifications, one set of auditing reforms primarily would enhance disclosure outputs by demanding that nonprofits generate new audited disclosure documents or, alternatively, obtain audits of disclosures that they already produce.<sup>139</sup> Like reliability certifications and other internal control mandates, the other set of proposed auditing reforms addresses process. These reforms instruct organizations to

137. See Grant Thornton, LLP, National Board Governance Survey for Not-For-Profit Organizations 8 (2004) (reporting that 81% of organizations it surveyed had evaluated their internal control structure); Warren Strugatch, *Nonprofit Agencies' Books Face More Scrutiny*, N.Y. TIMES, Sept. 12, 2004, § 14LI, at 6 (noting charities' concerns about potential regulation akin to Sarbanes-Oxley and that many already have begun conducting thorough annual audits in response); see also, e.g., News Release, Office of the President, Drexel University, Drexel Adopts the Sarbanes-Oxley Act (Feb. 26, 2003) (describing Drexel University's decision to adopt a series of "best practices" modeled on the Sarbanes-Oxley Act), available at [http://www.drexel.edu/papadakis/news\\_releases/news\\_releases\\_feb26\\_03.asp](http://www.drexel.edu/papadakis/news_releases/news_releases_feb26_03.asp).

138. Cf. Susan Woodward, "Not-For-Profit" Motivation in a "For-Profit" Company Law Regime—National Baseline Data, 21 CO. & SEC. L.J. 102, 105–06 (2003) (arguing that disclosure requirements for Australian nonprofit organizations should vary depending on size and other factors); SUSAN WOODWARD & SHELLEY MARSHALL, A BETTER FRAMEWORK: REFORMING NOT-FOR-PROFIT REGULATION 4–6 (2004) (making a similar recommendation for "a sliding scale of disclosure requirements" in a report discussing a survey of Australian nonprofit organizations and recommending various legal reforms).

139. See, e.g., Cal. Act, *supra* note 1, § 7(e)(1); White Paper, *supra* note 1, at 9; ME. REV. STAT. ANN. tit. 9, § 5004(4)(D)(1) (West Supp. 2004) (as amended March 2004).

vest their boards or board committees with the responsibility to monitor audit functions.<sup>140</sup> Each type of auditing reform offers some potential to improve nonprofit behavior; but, again, these improvements will be attainable only if nonprofits are willing and able to bear the costs of their implementation.

*a. Increased Audit Requirements*

Reforms that expand audit outputs obviously respond to concerns about the accuracy of nonprofit disclosures. In this vein, California's proposal would increase audit outputs by requiring large-revenue nonprofit organizations to begin filing financial reports audited by an independent CPA.<sup>141</sup> The White Paper proposes independent auditing of all Forms 990 by rotating auditors, as well as auditing of financial statements in nonprofits with substantial gross receipts.<sup>142</sup> These reforms call on professionals to present nonprofits' financial information truthfully and comprehensively, and thereby set these gatekeepers to work improving nonprofit behavior.

Although it is hard to argue against independent, expert review of financial statements and tax forms per se, the ability of the proposed output-focused auditing reforms to improve nonprofit behavior still can be questioned. Like the accuracy certification requirements addressed earlier, proposed requirements for nonprofits to produce audited documents may be duplicative. Most importantly, various states already require many nonprofit organizations to produce audited financial reports. Massachusetts has required its larger nonreligious charities to submit audited financial reports to the AG for decades.<sup>143</sup> A number of other states require significant subsets of their nonprofit communities to produce and file audited financial reports, generally as part of state regulation of charitable solicitation or oversight of charitable assets.<sup>144</sup>

140. See N.Y. AG Program Bill 68-05, *supra* note 1, § 3(g)(2); N.Y. Senate Bill, *supra* note 1, § 4(g)(2); Mass. Draft Leg., *supra* note 1, § 3; Cal. Act, *supra* note 1, § 7(e)(2); White Paper, *supra* note 1, at 12.

141. See Cal. Act, *supra* note 1, § 7(e)(1).

142. See White Paper, *supra* note 1, at 9. As noted earlier, *supra* note 81, the Nonprofit Panel has also recommended a significant increase in required auditing of nonprofit financial statements.

143. See MASS. GEN. LAWS. ANN. ch. 12 § 8F (West 2004) (originally enacted in 1979 and triggering the audited financial statement requirement at receipts of \$100,000, \$250,000, and most recently \$500,000).

144. See *supra* note 76 and accompanying text. The fact that audited financial statements are already often required, particularly of larger nonprofits, should not necessarily be interpreted as evidence that auditing can forestall lapses in nonprofit accountability. One cross-industry study indicated that internal audits detected a smaller percentage of occupational frauds in not-for-profit organizations than did most other detection methods. See ASS'N OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 25 (2004), available at <http://www.cfenet.com/pdfs/2004RttN.pdf>. The study also showed that internal audits detected a

To the extent that the proposed reforms will impose new audit requirements, the degree of compliance with them still may vary across organizations. Certainly, if the scandal at Enron has taught us anything, it is that auditing of financial disclosures cannot bring to light those abuses with which the auditor is complicit or willfully ignorant. Nonetheless, compliant nonprofits subject to new audit requirements can be expected to obtain audits and file audited documents in response to them. Furthermore, audit requirements will be more difficult to fudge than officer certifications, unless audited documents are easily faked or even total failure to file them will go unnoticed and unpunished. Thus, one should expect new audit requirements to spur some increase in the incidence of nonprofit auditing.

Review by objective outside auditors should improve the accuracy and clarity of the information nonprofits produce and report. It also should unearth at least some inaccuracies and abuses that otherwise would go unnoticed. And, auditors, barring complicity in abuse or disregard of their professional obligations, should demand their correction. Thus, increasing the incidence of auditing could produce at least some improvements in nonprofit behavior.

To determine the value of increased audit requirements as nonprofit reform legislation, however, the cost of these requirements also is an important factor. Hiring auditors obviously demands funds;<sup>145</sup> rotating auditors on a periodic basis, as the White Paper proposes, would add to this cost of audit procurement. For increased audit requirements to be effective reforms, the gains in nonprofit behavior and accountability they promise must justify the additional costs they will impose on nonprofit organizations, for some of whom these new costs could be fatal. All of the state and most of the federal reform proposals acknowledge the reality of this trade-off, again by keying their increased auditing requirements to some indicators of financial magnitude.<sup>146</sup>

smaller percentage of frauds in not-for-profits than in other types of organizations, even when one controlled for not-for-profits' lower incidence of auditing. *Id.* According to this research, a much greater percentage of occupational frauds were detected through tips, both in not-for-profit and other types of organizations. *Id.*

145. The Nonprofit Panel considered these costs in crafting its recommendations on auditing. *See* NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 23–24 (explaining that the Panel decided to trigger an audit requirement at \$2 million in annual revenues because of data suggesting audits would cost such organizations less than 1% of their total budgets). For another commentator's estimates of audit costs, see Szymanski, *supra* note 11, at 1318.

146. Only the federal proposal demanding auditing of the Form 990 appears not to differentiate by size. *See* White Paper, *supra* note 1, at 9.

*b. Auditing Oversight Reforms*

Rather than relying on external gatekeepers, the auditing oversight reforms set out to improve nonprofit behavior by activating self-regulation. These proposals demand that nonprofits of a certain size improve their ability to self-monitor and provide them with a process for doing so. In the New York, Massachusetts, California, and federal reforms, a large nonprofit is instructed to charge an internal body with scrutinizing the work of auditors and to empower that body to compensate, hire, and fire auditors.<sup>147</sup> The state reforms assign this responsibility to an audit committee whose members must be financially independent,<sup>148</sup> while the White Paper designates the entire board as the appropriate audit oversight mechanism.<sup>149</sup> Regardless of the oversight group selected, these proposals focus the attention of an identifiable set of nonprofit fiduciaries on the importance of accurate and effective financial reporting and grant them the authority to demand it from the auditors they engage.

Auditing oversight reforms thus demand improvements of the disclosure process, and not merely an escalation of disclosure outputs. These reforms leverage the capacities already within nonprofit organizations by demanding that they self-monitor and self-enforce.<sup>150</sup> Without strengthen-

147. See N.Y. AG Program Bill 68-05, *supra* note 17, § 3(g); N.Y. Senate Bill, *supra* note 1, § 4(g); Mass. Draft Leg., *supra* note 1, § 3; Cal. Act, *supra* note 1, § 7(e)(2); White Paper, *supra* note 1, at 12.

148. See N.Y. AG Program Bill 68-05, *supra* note 17, § 3(g); N.Y. Senate Bill, *supra* note 1, § 4(g); Mass. Draft Leg., *supra* note 1, § 3; Cal. Act, *supra* note 1, § 7(e)(2).

149. See White Paper, *supra* note 1, at 11–12. As discussed *supra* note 83, the Nonprofit Panel Interim Report parts ways with all of these reform efforts on this issue. The Nonprofit Panel recognized the importance of audit oversight, but urged organizations to decide for themselves how best to engage in this function, and opposed imposition of a government-mandated mechanism. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 31.

150. The White Paper also offers other proposals aimed more broadly at improving governance within tax-exempt organizations. Unfortunately, many of these proposals take the form of governance mandates and stark prophylactic rules. See, e.g., White Paper, *supra* note 1, at 4, 13 (imposing onerous penalties on even beneficial transactions between tax-exempt public charities and their directors and managers and imposing a strict fifteen-member limit on tax-exempt boards of directors). Parts of the New York and Massachusetts efforts also aim at more general governance concerns; however, they tend to set up default measures or processes to enable good governance that are more flexible than those the White Paper suggests. Compare *id.*, with N.Y. AG Program Bill 68-05, *supra* note 17, § 3(f) (requiring an executive committee in boards with more than twenty-five members, unless the bylaws prohibit such a committee); N.Y. Senate Bill, *supra* note 1, § 4(f) (similar); N.Y. AG Program Bill 65-05, *supra* note 17 (adding a fairness requirement to protect self-dealing transactions and setting procedures to protect a board's compensation decisions); N.Y. Senate Bill, *supra* note 1, § 5 (similar), and Mass. Draft Leg., *supra* note 1, § 4 (similarly revising state law on nonprofit self-dealing and compensation).

In one striking example of the White Paper's mandate approach, it provides an extensive list of "best practices" for boards of exempt organizations, all of which each organization would be required to "confirm" on its Form 990. White Paper, *supra* note 1, at 12–13. Many of these practices are indeed those to which exempt organizations should aspire, and an educational effort to apprise organizations of these and other methods for achieving greater accountability would be quite beneficial. The

ing the mechanisms for enforcement, no new legal requirement can hope to secure improvements in behavior from willfully disloyal or criminal fiduciaries, or those who respond only to the likelihood of public or private sanctions. It also remains unclear whether and to what extent nonprofit actors charged with auditing oversight will have the expertise to improve auditing performance and financial accountability.<sup>151</sup> However, the auditing oversight reforms at least direct some individuals within the nonprofit to work on this important task. For those compliant officers and organizations that follow this direction, the auditing oversight reforms educate them in one technique available to improve their behavior and provide a framework for their efforts to achieve greater accountability. In addition to thereby improving specific audit oversight behavior, active members of auditing oversight groups will develop more general skills of supervision. These fiduciaries can then employ these skills to improve their conduct in other areas of nonprofit governance entrusted to them.

Of course, the benefits that auditing oversight reforms promise will not come free of charge. New responsibilities for audit committee or board members may make it more difficult to recruit volunteers to these crucial roles. Individuals asked (or required) to conduct auditing oversight also may need additional training and legal or accounting support. These costs may encourage organizations that would otherwise prefer full compliance

Form 990 confirmation, however, appears instead to require all exempt organizations to attest to their adoption of these particular practices, an unwise attempt to mandate governance techniques across the sector. Rather than relying on "one-size-fits-all" mandates, good nonprofit governance requires each individual organization to evaluate itself and to determine those structures and practices that will ensure accountability within its unique circumstances.

One commentator has advocated an intriguing alternative approach to motivating best practices through Form 990 disclosures, proposing that the form be revised to ask nonprofits a series of yes-or-no board governance questions. See Deborah S. Hechinger, *A Simple Way to Help Nonprofit Boards*, CHRON. PHILANTHROPY, Aug. 5, 2004, at 45. She explained:

While the primary purpose of the form would be to allow government and the public to keep a closer eye on board activities, developing questions about board-governance practices could be a powerful way to educate executives and board members of charitable organizations about the importance of governance in general, and about basic practices that put boards in a position to act as independent overseers.

*Id.* The Nonprofit Panel recommended at least partial adoption of this suggestion, on a similar rationale. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 30 (proposing that organizations be required to disclose on Forms 990 whether they have a conflict of interest policy).

151. While none of the current nonprofit reform proposals demand that the audit committee include a financial expert, an early draft of the California proposal did contain such a requirement, as does the Sarbanes-Oxley Act itself. Compare Sarbanes-Oxley Act § 407(a) and Attorney General, State of California, Proposed Amendments to Government Code Section 12580 *et seq.* 3 (Jan. 8, 2004) (unpublished memorandum on file with author) (requiring a financial expert to serve on the audit committee), with Cal. Act, *supra* note 1, § 7(e)(2) (imposing an audit committee requirement without demanding that a financial expert be a member). The Nonprofit Panel recommends the inclusion of financially literate individuals on boards of directors as a good practice, but would not go so far as to mandate it. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 31.

with these reforms to skimp on their implementation. And, even if the reforms are fully implemented, these costs will reduce the nonprofit resources available to serve their missions and beneficiaries. Thus, again, the benefits of increased audit oversight should be weighed carefully against the costs it will impose, and these serious burdens should not lightly be imposed on strapped nonprofit organizations. The triggers currently contained in the state proposals attempt to limit the application of these reforms to organizations of sufficient financial magnitude or sophistication to bear them. These and other limitations of expensive auditing reforms should be set carefully, as errors could reduce the availability of vital nonprofit services.

### *B. Facilitating Enforcement*

This subpart considers the potential for disclosure reforms to enhance nonprofit accountability by facilitating enforcement. Thus far, this Article has used the concept of disclosure to refer to both disclosure to regulators and disclosure to the public. Many of the recent disclosure-based reforms identified here provide for both of these audiences.<sup>152</sup> In analyzing the ability of disclosure-based reforms to improve behavior,—in effect, by deterring misbehavior for fear of detection and its consequences—the two types of disclosure can be effectively analyzed together. When considering the ability of these reforms to facilitate enforcement, however, it is important to separate at least two distinct methods for enforcing the obligations of nonprofit actors and organizations. Enforcement may be pursued by government actors, including state AGs, other state regulators, and the federal IRS. Nongovernmental actors also may engage in enforcement. Occasionally, this might occur through private litigation of nonprofit fiduciary breaches or other wrongs. Nongovernmental enforcement of nonprofit activities more likely occurs, however, through actions short of litigation that nonetheless have the power to discipline the behavior of nonprofits and their fiduciaries. In order for disclosure-based reforms to enhance accountability by facilitating enforcement, they must boost the enforcement capacity of one or both of these groups.

152. Of course, at least one important set of disclosure-based reforms addressed here would not necessarily require enhancements of data provided to regulators or the public. The certification requirements in the original New York Proposals would have applied only to nonprofits' *internal* reports. It is considerably more difficult to argue that changes to internal reports will facilitate enforcement by any external monitors.

### 1. Facilitating Enforcement Through Disclosure to Regulators

At present, governmental enforcers of nonprofit obligations are seriously encumbered by their lack of resources. The scarcity of resources for nonprofit enforcement by states is legendary. In the legal literature, the identification of this lack of staffing and funding for state investigation and enforcement of wrongdoing in nonprofits goes back forty years or more.<sup>153</sup> Over the decades since these early critiques of states' nonprofit enforcement capacity, some advances have been made,<sup>154</sup> particularly in the states with the greatest amount of assets under nonprofit control.<sup>155</sup> Despite this incremental improvement, however, recent work confirms that the nonprofit enforcement budgets of state AGs remain limited or, in some cases, nonexistent.<sup>156</sup> While IRS enforcement does ameliorate to some degree this lack of enforcement at the state level,<sup>157</sup> even the Commissioner of Internal Revenue has recognized the inadequacy of his agency's resources devoted to the tax-exempt area.<sup>158</sup>

153. See Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 452–54 (1960); FREMONT-SMITH, *supra* note 114, at 446.

154. Marion Fremont-Smith and others have compiled detailed information tracking the staff size of state AG charities bureaus over time. See FREMONT-SMITH, *supra* note 65, at 351–61; FREMONT-SMITH, *supra* note 114, at 446; HARRIET BOGRAD, THE ROLE OF STATE ATTORNEYS GENERAL IN RELATION TO TROUBLED NONPROFITS 8–11 (Program on Nonprofit Orgs., Yale University, Working Paper No. 206, Aug. 1994); see also Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1184–85 & nn.465–72 (2001) (collecting and analyzing information from Bograd and a 1998 Chronicle of Philanthropy study by Thomas J. Billitteri).

155. See, e.g., FREMONT-SMITH, *supra* note 65, at 353–54 (describing the increase in AG staff in California, from 4 in 1965 to 10 attorneys and 10 auditors in 2003, and in New York, from 10 in 1974 to 13 in 1996 at a total of 18 attorneys and 6 accountants since the late 1990s); Josephson, *supra* note 101, at 2 (describing hiring 14 of New York Charities Bureau's 20 attorneys during his tenure, although not discussing whether these were additional attorneys or replacements); Brody, *supra* note 104, at 951 (noting that "a simple headcount is misleading" in light of Bograd's 1996 findings that the thirteen states with charities divisions within their AG offices were home to 55% of the country's charities and 62% of its charitable revenues). *But see* Crimm, *supra* note 154, at 1184 (asserting that the number of staff attorneys available for nonprofit enforcement had declined in some of the most historically active states).

156. See FREMONT-SMITH, *supra* note 65, at 352 (noting that although state AGs have managed to achieve some nonprofit regulatory and enforcement successes, "[a]ll of them operate with severely limited budgets, which has meant a shortage of legal and accounting support"); see also Evelyn Brody, *Accountability and Public Trust*, in THE STATE OF NONPROFIT AMERICA 471, 479 (Lester M. Salamon ed., 2002) ("Funding for charity enforcement has never been high, at either the state or federal level . . .").

157. See FREMONT-SMITH, *supra* note 65, at 377 (describing the federal government as "the primary source of regulation" of nonprofits since the 1950s); NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR 151 (2001) (reporting and critiquing the assertion that the IRS can or has effectively played this role).

158. See Mark W. Everson, Commissioner of Internal Revenue, Written Statement of Appearance Before the Committee on Finance of the United States Senate at the Hearing on Charitable Giving Problems and Best Practices, June 22, 2004, available at <http://finance.senate.gov/hearings/testimony/2004test/062204metest.pdf>. Everson noted:



Reforms that increase or improve disclosure to regulators will be hard pressed to facilitate enforcement in the context of such limited resources for governmental enforcement. Disclosure documents can be used for governmental enforcement only if regulators read them, investigate the inconsistencies or problems they reveal, and act to correct or stop errors or abuses. State regulators are ill-equipped to initiate enforcement efforts based on the more limited disclosures they already receive. Without increased funding for staffing and other resources, they cannot be expected to make serious accountability gains through investigation, prosecution, or settlement of problems revealed by improved disclosures. Disappointingly, none of the nonprofit reform proposals recently before state legislatures envisions this necessary allocation of resources to state regulators.

In contrast, the federal proposal does include significant reforms addressing this fundamental resource problem. Like state regulators, the IRS presently has more information regarding compliant tax-exempt organizations than it is able to review systematically, as well as broad investigatory and enforcement powers over tax-exempt entities without adequate staff to exploit them. To remedy this, the White Paper would direct new funding to the IRS unit on exempt organizations.<sup>159</sup> In addition, the proposal would

Historically, IRS functions regulating tax-exempt entities have not been well funded due to the lack of revenue they generated. . . . With staffing in this area flat at best and with the number of charities increasing annually, our audit coverage has fallen to historically low levels, compromising our ability to maintain an effective enforcement presence in the exempt organizations community.

*Id.*

The need for investment in IRS enforcement may be even more acute in the exempt organizations area than in other areas of tax enforcement. In general, the return on investment from auditing and other IRS enforcement activities is quite significant, in terms of the quantum of tax liability recommended, assessed and collected directly traceable to IRS enforcement or by fostering norms of greater tax compliance. See U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-98-128, REPORT TO THE HONORABLE ROB PORTMAN, COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES 14-15 & tbl. 3 (June 23, 1998) (reporting an 11:1 average ratio of tax payments collected from audits to the direct staff costs of such audits, although conceding there may be some measurement problems with this data); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1510-13 (2003) (noting the GAO study results and arguing that investment in tax enforcement can generate returns beyond the taxes collected in audits, by fostering norms of tax compliance). Thus, an initial investment in tax enforcement may well be quickly recouped. In the exempt organizations area, increased enforcement may result in some additional payment of taxes, at least initially, but ultimately may not provide a significant financial return on investment to the IRS. For example, additional enforcement may unearth abuses that merit imposition of excise taxes or stripping of exemption from taxable entities masquerading as exempts. In the long run, however, if increased enforcement leads to a higher level of compliance with exemption criteria, this enforcement may not provide significant financial returns to the IRS. I thank Richard Schmalbeck for this insight.

159. See White Paper, *supra* note 1, at 15-16 (proposing authorization for \$5 million to facilitate public access to Forms 990, as well as additional funds to establish a whistleblower hotline, to ease information sharing with other state and federal regulators with overlapping oversight responsibilities in the nonprofit sector, and to fund the proposed process of periodic review of the continuing eligibility of exempt organizations). The Nonprofit Panel has indicated its strong support for increasing the resources

allocate funds to improve enforcement by states and self-regulation within the nonprofit community.<sup>160</sup> The federal proposals also come at a time when the President and the IRS are seeking to increase funding for the Service's enforcement in the tax-exempt area.<sup>161</sup>

One might criticize as inadequate the \$200 million envisioned by the White Paper to improve nonprofit enforcement, but the more basic problem with this funding proposal is that it may never come to fruition. The plans for increasing enforcement resources and the sweeping scope of the proposed uses of them are tempting, but it remains highly uncertain that the IRS, states, and others will ultimately receive these funds, and from what sources they will be obtained. The White Paper proposes to fund its initiatives by two alternative routes: earmarked tax revenues or filing fees.<sup>162</sup>

Under its first funding scenario, the White Paper would reinstate an authorization for up to \$200 million of revenue collected from the 2% investment income tax on private foundations to be appropriated for IRS enforcement in the exempt organizations area.<sup>163</sup> This tax was imposed in 1969, along with an authorization for the funds to be earmarked for exempt organizations enforcement.<sup>164</sup> However, authorization alone cannot channel revenues from the general treasury to specific programs; this requires appropriation.<sup>165</sup> In 1998, when almost thirty years had passed without appropriation of these authorized funds for exempt organizations enforcement, Congress repealed even the authorization provision.<sup>166</sup> The Senate Finance Committee proposes only to reinstate the authorization; it does not have the power to provide for appropriation. Considering its provision of alternative means to fund many of its proposals through filing

available to the IRS for nonprofit enforcement. See NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 47.

160. White Paper, *supra* note 1, at 15 (offering grants and matching funds to states for use in nonprofit enforcement).

161. See Everson, *supra* note 158, at 2 (noting the President's request for a 4.8% increase in the IRS budget in 2005 and that he expects to increase spending on examination of government and tax-exempt entities by 17% in that year).

162. See White Paper, *supra* note 1, at 15. The vagaries of the congressional and IRS budget processes are beyond the scope of this Article; therefore, it will discuss in detail only the potential funding solutions currently proposed in the White Paper. It should be kept in mind, however, that the IRS' receipt of the President's proposed budget increase and the Service's ultimate use of these funds certainly are not a foregone conclusion.

163. *Id.*

164. See Catherine E. Livingston, *Analysis of the Repeal of the Section 4940 Excise Tax*, at [http://www.abagmd.org/info-url3989/info-url\\_show.htm?doc\\_id=204851](http://www.abagmd.org/info-url3989/info-url_show.htm?doc_id=204851) (last visited Feb. 25, 2005).

165. See BILL HENIFF, JR., CONG. RES. SERV., OVERVIEW OF THE AUTHORIZATION-APPROPRIATION PROCESS (2003), available at <http://www.senate.gov/reference/resources/pdf/R-S20371.pdf>.

166. See Livingston, *supra* note 164.

fees, it seems the Committee anticipates a repetition of this unsatisfying appropriation history.

Failing appropriation of tax revenues to fund its reform proposals, the White Paper recommends a series of fees to be imposed on tax-exempt filers.<sup>167</sup> Serious doubts can be raised too as to whether this funding solution will come to pass or would be advisable. At times, the filing fees contemplated by the reform proposal are helpfully described as based on a “sliding scale.”<sup>168</sup> Still, legislators will be beseeched to consider carefully the financial burden any additional fees may place on resource-strapped nonprofits. These concerns are not specious. Even small fees, when added to the substantial costs of preparing the documents to be filed, may overwhelm some nonprofits’ administrative budgets, compelling them to reallocate funds from worthy programs or even forcing them to close their doors. In the face of these concerns, legislators might understandably opt to enact their proposed reforms without the filing fee funding solution to which they are currently linked.

Unfortunately, without an improvement of funding and thereby of manpower, the federal proposal’s certification and auditing reforms will do little to improve the capacity of the IRS to enforce nonprofit accountability. In this reasonably likely scenario, the resource obstacle to successful disclosure-based regulation will persist on the federal level as well.

## 2. Facilitating Enforcement Through Public Disclosure

In addition to requiring greater disclosure to regulators, many of the current disclosure-based proposals for nonprofit reform demand that disclosures be made available to the public.<sup>169</sup> Perhaps individuals or groups with access to this new and improved public information could use it to pressure nonprofits to be more accountable. Unfortunately, nongovernmental actors have insufficient resources, incentives, and authority to adequately enforce nonprofit accountability. These persistent deficits are in large part due to structural characteristics inherent to nonprofit organizations and the nonprofit sector, and will limit the ability of disclosure-based reforms to facilitate public enforcement.

167. *See, e.g.*, White Paper, *supra* note 1, at 15 (providing for fees to be assessed on Form 990 filers and for these fees to be used to fund various initiatives, in lieu of an appropriation).

168. *See, e.g., id.* at 1 (describing a sliding scale filing fee for its proposed periodic reporting system for tax-exempt organizations).

169. *See, e.g.*, Cal. Act, *supra* note 1, § 7(e)(1) (requiring charities to make available to the public audited financial statements required by the Act); White Paper, *supra* note 1, at 10 (requiring public disclosure of financial statements by exempt organizations); *see also* Joint Committee Report, *supra* note 41, at 308–12 (proposing a requirement that exempt organizations should publicly disclose their Forms 990-T, which forms report exempt organizations’ unrelated business income).

These differences in context expose the inadequacy of analogies to the for-profit sector to justify disclosure-based nonprofit reform. In the for-profit context, particularly when dealing with the publicly-traded companies regulated by Sarbanes-Oxley, lawmakers need not rely solely on government regulators to unearth and contest errors and abuses revealed in disclosure documents. Several groups of private actors have incentives to dissect these disclosures and authority to challenge any questionable activity they bring to light. Stockholders with assets bound up in shares of a company have a personal financial motivation to review the company's disclosures, and are empowered to take action when warranted through the derivative suit mechanism. Collective action problems undoubtedly hinder monitoring and enforcement by widely dispersed equity shareholders.<sup>170</sup> But, these problems are mitigated by the existence of research analysts and plaintiffs' attorneys with the expertise and incentives to obtain and distribute information about companies' strengths and weaknesses, and to challenge mistakes and misbehavior in court.<sup>171</sup>

The nonprofit sector lacks comparable private groups motivated and authorized to act on disclosed information.<sup>172</sup> Charitable trusts and nonprofit corporations with self-perpetuating boards lack any analogue to for-profit shareholders. Moreover, even in those nonprofit corporations that opt to empower members to elect directors and vote on major corporate decisions, these members lack the personal financial incentives that equity shareholders have to track and challenge the behavior of nonprofit managers and fiduciaries.<sup>173</sup> Members also may lack enforcement mechanisms, as standing to challenge nonprofit actions often is severely limited.<sup>174</sup> There are currently no actors with access and powers analogous to those of research analysts and plaintiffs' lawyers in the nonprofit context; the collective action problem for members remains intractable.

170. This insight can be traced back as far as Berle and Means. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (making the seminal point that, in corporations with many widely dispersed individual shareholders, these shareholders cannot practically control management).

171. See Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 340–42 (1998) (describing how class action plaintiffs' attorneys compensated with contingency fees can overcome shareholders' collective action problems); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302 (2004) (noting the function of research analysts in overcoming shareholder collective action problems).

172. See Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 859–64 (2003).

173. See *id.* at 859–62.

174. See Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 54–59 (1993) (describing the differential availability of member standing in various states).

Rather than looking to members, one might consider donors as the appropriate nongovernmental group to engage in nonprofit enforcement. Limited standing rules generally will prevent donors from engaging in enforcement of nonprofit obligations in court.<sup>175</sup> But, lawsuits are clearly not the only powerful sanction for misconduct within nonprofit organizations. For those nonprofits that rely on individual donations, grant funding, or both, donors' ability to withhold future contributions could influence nonprofit fiduciaries regardless of the possibility of a future lawsuit. If so, one must ask whether recent disclosure reform ideas are likely to enhance nonprofit accountability by facilitating enforcement by donors. If nonprofits disclose sufficient and comprehensible information to the public, will donors use it comparatively, and donate more time and money to more accountable nonprofits? Unfortunately, this important question has not yet been satisfactorily answered.

Among individual donors, evidence has not yet suggested that donor choice will be a robust enforcement tool.<sup>176</sup> As a group, individual donors making relatively small contributions have serious collective action problems. Many such donors will quite reasonably not be willing to expend the time and energy required to investigate potential recipients of their charity in advance. The threat of withholding future contributions also may not be powerful enough for individual small donors successfully to demand that a nonprofit improve its accountability. Some AGs and umbrella organizations of nonprofits have begun to pool information regarding nonprofit performance and financial accountability, in order to enable enforcement through individual donor choice.<sup>177</sup> The federal proposal appears to support

175. See Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 657 (1998) (noting that traditionally only the attorney general and perhaps cofiduciaries will have standing and access to standing for all others is extremely limited). But see Unif. Trust Code § 405(c), 7C U.L.A. 184 (Supp. 2004) (expanding standing to settlors of charitable trust in a recent revision); *Smithers v. St. Luke's-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426 (N.Y. App. Div. 2001) (granting standing to enforce the terms of a gift to the widow of the donor, in what for now remains an exceptional case).

176. See William F. Meehan III et al., *Investing in Society*, STANFORD SOC. INNOVATION REV., Spring 2004, at 35, 36 (describing studies and comments indicating that donors do not investigate the financial and governance practices of an organization before donating to it); Katie Cunningham & Marc Ricks, *Why Measure?: Nonprofits Use Metrics to Show that They Are Efficient. But What if Donors Don't Care?*, STANFORD SOC. INNOVATION REV., Summer 2004, at 44 (reporting a study of donor interest in performance measures, and finding it negligible); see also David Bornstein, *Let's Make Sure Worthy Groups Get Aid*, CHRON. PHILANTHROPY, Jan. 22, 2004, at 37 (opining that "most donors . . . pay little attention to the comparative performance of the organizations they support," based on limited information currently available, and advocating establishment of nonprofit research analysts to provide more).

177. See, e.g., OFFICE OF N.Y. ATTORNEY GEN. ELIOT SPITZER, PENNIES FOR CHARITY: WHERE YOUR MONEY GOES, TELEMARKETING BY PROFESSIONAL FUNDRAISERS (Dec. 2003) (reporting one AG's findings on comparative fundraising costs), available at <http://www.oag.state.ny.us/charities/pennies03/penintro.html>; Maryland Association of Nonprofit Organizations, *Standards for Excellence: An*

these efforts through its advocacy of accreditation.<sup>178</sup> For now though, even if more and better public disclosures are made available to individual donors through officer certification, increased audit requirements, or enhanced tax reporting, individual donors' incentive and coordination problems will continue to impede their ability to enforce nonprofit obligations.<sup>179</sup>

The disclosure-based reforms addressed here also will have only a narrow impact on larger, more sophisticated donors. Donors who make large contributions and are predictable repeat players, particularly grantmakers, are less subject to the problems of collective action that frustrate enforcement by small donors. But, enhancing public disclosures as envisioned by recent proposals for disclosure-based reform will do little to expand the already significant informational access grantmakers enjoy. Consider a foundation whose major purpose is to make relatively large grants. This foundation can and should devote resources to gathering information that will allow it to choose the best recipients from among various applicants. Further, the substantial funds the foundation's grants can offer, as well as the potential to obtain a stream of such funding from this foundation or others, provide a significant incentive for nonprofit grant applicants to provide the foundation with information it requests and to conform their activities to the foundation's preferences.<sup>180</sup> Simply put, if a nonprofit wants a grant from the foundation, it will provide it with a significant amount of information, whether or not that information must be

*Ethics and Accountability Code for the Nonprofit Sector* (explaining the nonprofit accountability standards and practices to which its members must commit), available at [http://www.marylandnonprofits.org/html/standards/04\\_02.asp](http://www.marylandnonprofits.org/html/standards/04_02.asp) (last visited Feb. 25, 2005); BBB Wise Giving Alliance, *About the BBB Wise Giving Alliance* (describing the Wise Giving Alliance charity rating program, sponsored by the Better Business Bureau), at [www.give.org/about/index.asp](http://www.give.org/about/index.asp) (last visited Feb. 25, 2005). See generally Silverman, *supra* note 27, at D1 (reporting on these and other ongoing nonprofit accreditation efforts).

178. See White Paper, *supra* note 1, at 14–15.

179. Even if one assumes a sufficient number of individual donors would seek out information about potential donee nonprofits, and that this donor-choice activity would powerfully discipline nonprofit actors, donor enforcement remains problematic. Measuring nonprofit effectiveness is notoriously difficult, and it is particularly difficult to measure, report, and compare nonfinancial performance. See, e.g., Rosabeth Moss Kanter & David V. Summers, *Doing Well While Doing Good: Dilemmas of Performance Measurement in Nonprofit Organizations and the Need for a Multiple-Constituency Approach*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 154 (Walter W. Powell ed., 1987). Moreover, donors may misinterpret the information they receive. Cf. Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 *VILL. L. REV.* 433, 502 (1996) (warning that expanded standing will not improve charity oversight unless and until the nonprofit sector educates the public about its real fiscal needs and cost constraints, of which the public seems unaware). If donors misinterpret the information they review, and their desires are anticipated and catered to by nonprofit organizations, it may skew nonprofit activity in undesirable ways.

180. Of course, this desire to offer programs that foundations or other grantmakers will fund may also skew nonprofit activities away from some socially desirable activities.

made available to the general public. Thus, although grantmakers can be effective donor enforcers, it is difficult to believe that officer certifications, audit reforms, and other requirements for increased disclosure will make them substantially more effective in this role.

Finally, it is worth noting that even if disclosure-based reforms might facilitate enforcement by donors, these efforts are certain to be incomplete. Many nonprofits do not support their programs primarily through fundraising or grant-seeking activities; they rely instead on fees paid for services and other income sources. It is very difficult to imagine that consumers will obtain and use the enhanced public disclosures demanded by the proposals addressed here to elect where to receive medical care, obtain an education, or attend a performance.

There is a basic problem of fit when adapting disclosure-based reforms stemming from Sarbanes-Oxley to the nonprofit context. Disclosure-based reforms have been seen as a useful technique to improve financial accountability in for-profit entities, especially large, publicly-traded companies with the capacity to bear these costs. These reforms work in part by improving the quality of information disclosed to regulators, shareholders, plaintiffs' attorneys, and the public. The same types of reforms, however, are unlikely to translate into similar gains in the nonprofit sector, due to differences in the capacity of nonprofit regulators and private groups to use information disclosed to them to enforce accountability. Unless disclosure reforms target and overcome these impediments, they will be unable to move nonprofits toward greater accountability by facilitating enforcement.

\* \* \*

Disclosure-based reforms are often advocated with a nod to Justice Brandeis' pithy observation that "sunlight is . . . the best of disinfectants."<sup>181</sup> However, the preceding analysis reveals the serious limitations of disclosure to improve nonprofit behavior or facilitate nonprofit enforcement. Those disclosure reforms that merely replicate existing requirements show little promise to improve the behavior of nonprofit organizations and actors. Even when they impose new disclosure requirements, these reforms can improve behavior only to the extent that nonprofit fiduciaries will be willing and able to expend organizational resources on compliance with them. The officer certification and additional audit requirements also will do little to facilitate enforcement. Without addressing serious staff and funding shortages faced by regulators, increasing the incidence or depth of

181. LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY* 62 (Richard M. Abrams ed., Harper & Row 1967) (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

disclosure will not significantly facilitate enforcement. Nor can they empower other stakeholders lacking sufficient incentives and authority to enforce effectively. Finally, this lack of enforcement will further limit the ability of disclosure reforms to deter carelessness or misconduct by non-profit actors.

#### IV. IMPROVING DISCLOSURE-BASED NONPROFIT REFORM

For the reasons articulated in Part III, disclosure-based reforms like mandatory officer certification and increased auditing requirements are unlikely alone to transform the accountability of the nonprofit sector. At the same time, legislators' clear desire to improve nonprofit accountability should not be squandered. Given the already extensive body of legal and regulatory requirements imposed on nonprofits, and the distressing shortage of enforcement capacity of regulators and others to investigate and prosecute violations of these requirements, this legislative momentum ideally would be directed toward invigorating enforcement. First and foremost, this would entail significantly improving the resources available for enforcement of nonprofit responsibilities by state AGs and the IRS. As a complement to government enforcement, legislators might consider reforms to counter impediments to enforcement by members, donors, and beneficiaries. They also should invest in training nonprofit fiduciaries to engage in self-regulation on the organizational level.

If legislators and regulators cannot or will not pursue an alternative enforcement-based agenda, they might at least be convinced to adopt only those disclosure-based reforms suited to facilitating nonprofit enforcement and improving the behavior of nonprofit organizations and actors. Reformers committed to a disclosure approach should look for tactics that will improve regulators' ability to analyze the information they already receive. They also should concentrate on disclosure requirements that will spur the creation and improvement of internal processes in those nonprofits to which they apply.<sup>182</sup> However, this regulated group should be deliberately limited, in recognition of the thin line between demanding the creation of structures to foster accountability and compelling nonprofits to pursue regulatory compliance at the expense of their missions. This Part addresses these alternatives and adjustments to the disclosure-based agendas represented by recent legislative proposals for nonprofit reform.

182. As discussed below, the evolution of the proposals for nonprofit reform in New York represent a substantial and positive advance in this direction. *See infra* text accompanying notes 188–90.



### A. Targeting the Impediments to Enforcement

As the regulatory systems for enforcing obligations within the non-profit sector are currently funded and staffed, it is simply not possible to use disclosure as the primary means for enforcement. Neither state AGs nor the IRS have the capacity to analyze and manage the information presently disclosed to them, let alone more frequent or more voluminous submissions. Therefore, rather than emphasizing disclosure enhancements, legislatures seeking nonprofit accountability gains should authorize and appropriate significantly increased funds earmarked for regulators to enforce current nonprofit law. Hopefully, the White Paper's funding proposals represent more than mere wishful thinking. If these and additional funding provisions could be obtained in Congress and imitated in further revisions of state reforms,<sup>183</sup> significant improvements in enforcement and accountability would be within reach.

If political realities suggest that enlarging the governmental enforcement pie is unlikely,<sup>184</sup> legislatures still can use their reform efforts to improve the efficiency of the resources already deployed in this area. One promising route is to harness technology, as in the White Paper's endorsement of electronic filing. Electronic filing would allow nonprofits to submit more useful and accurate filings and provide regulators a better means to use disclosed information to target their limited enforcement resources. The White Paper's proposal for increased information sharing between federal and state regulators likewise offers streamlining improvements, by saving time for existing staff to engage in more individualized investigations. Even if vastly increased funding of nonprofit enforcement is unlikely, disclosure-based reforms that aim to more efficiently deploy limited government enforcement resources will be some consolation.

When customizing disclosure reforms to the nonprofit sector, legislators should limit their reliance on public disclosure to improve accountability by facilitating enforcement. Again, the problem is the lack of constituencies sufficiently motivated and educated to scrutinize nonprofit disclosures and empowered to act on discrepancies or abuses they uncover.

183. Of course, even if funding for external enforcement could be substantially increased, it will never be possible for state attorneys general and internal revenue agents to police the activities of every nonprofit intimately, nor would it be desirable to do so. The attorney general is not intended, after all, to be "a 'super' member of the board." Brody, *supra* note 104, at 976.

184. One Senate Finance Committee staffer's comment that calls to focus on enforcement of existing rules rather than the creation of new ones should be left on "the cutting room floor" does not augur well for a renewed focus on enforcement. *See* Stokeld, *supra* note 37. *Cf.* Cheng, *supra* note 115, at 71–76 (identifying a range of forces that motivate legislators to enact new criminal prohibitions, rather than focusing on improving enforcement).

Grantmakers already have the capacity to demand and analyze information and pursue change by those nonprofit actors and organizations seeking their support. But, even significantly enhanced disclosure will not facilitate enforcement by relatively inattentive and weak individual donors or by consumers of the goods and services nonprofits provide. Enhancing public disclosures may add to the “sunlight” factor in deterring misbehavior. It may also be socially valuable in increasing the information available to the public about nonprofit organizations for reasons other than facilitating enforcement.<sup>185</sup> Yet, legislators should not overestimate the ability of disclosure-based reform to secure nonprofit accountability by aiding nongovernmental enforcement.

### *B. Stimulating Improved Nonprofit Behavior*

Realistically, enforcement alone cannot fully safeguard nonprofit accountability. Funding for government enforcement is unlikely to increase dramatically, and donors and consumers are inconsistent enforcers at best. Instead, serious gains in accountability require those within nonprofits to initiate changes in their personal or organizational conduct. These actors have proximity and access to the information that regulators and donors lack or are unable to manage and compare effectively. Through their roles in the governance and operations of their organizations, directors, officers, and staff also have the power to demand and implement ongoing and responsive change. The desire of these nonprofit actors to see their organizations thrive should be leveraged to the cause of improving accountability within individual nonprofits.

In an environment of limited external enforcement and internal resources, simple commands that nonprofits improve their behavior are unlikely to secure real change. Nonprofit fiduciaries and employees need to be trained to fulfill their monitoring and enforcement roles more effectively. Therefore, again, providing funds for education and capacity-building would be highly desirable. In this vein, the White Paper’s proposal of \$25 million aimed to “ensure an education presence”<sup>186</sup> in the nonprofit

185. Commentators had hoped the IRS’ e-filing initiative would pave the way for the establishment of a publicly-available database of nonprofit information, to be used by scholars and policymakers. Unfortunately, the IRS recently announced plans for capturing and maintaining information electronically provided by exempt filers that would make such a database infeasible. See Harvy Lipman, *Tax Agency Declines to Create Separate Charity Database*, CHRON. PHILANTHROPY, Feb. 17, 2005, at 27.

186. White Paper, *supra* note 1, at 15. The Nonprofit Panel also has advocated an important role for education and training. See, e.g., NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 31–33 (recommending technical assistance and “a sector-wide effort to educate charitable organizations” about auditing and oversight roles of board members and education about whistleblower protections).

sector is heartening. The drafters' commitment to education, however, appears closely linked to their interest in accreditation and its potential use in determining eligibility for tax benefits or federal grants.<sup>187</sup> It is unclear whether the educational initiative, and the funding for it, would survive if unhinged from the Committee's accreditation imperative. Some states do provide materials and training for nonprofit fiduciaries and employees, but none of the recent state legislative proposals includes a commitment to maintain or increase funding for educational efforts. If, as it appears, legislators favor enacting new disclosure directives over directly investing in the training of nonprofit fiduciaries and employees, they would be well-advised to emphasize reforms that can educate and empower these potential internal monitors.

In particular, disclosure-based reforms that focus on process can spur those within nonprofit organizations to develop their monitoring skills, and provide a framework within which these actors can exert their influence. For example, reliability certification requirements demand that officers scrutinize their operations, particularly as to financial matters, and establish and maintain ongoing efforts to examine and safeguard them. If officers are unsure how to accomplish this, the reliability certification requirement will prod them to secure the necessary assistance to put adequate measures in place. Once internal controls have been established, fiduciaries and staff can continue to use these processes to assist their monitoring and enforcement efforts over time. These internal controls will include procedures by which information about financial and other lapses will reach managers,

187. See White Paper, *supra* note 1, at 15. The White Paper describes the intended recipients of the proposed funding as "nonprofit exempt organizations that educate other tax exempt organizations on best practices and inform the public of charities that are engaged in best practices" and notes that "priority would be given to organizations that assist small charities in meeting proper standards and accreditation." *Id.* (emphasis added). The White Paper's accreditation proposals include authorization for the IRS to base charitable status or eligibility to receive charitable donations on accreditation, *id.* at 14, and requiring government agencies to "give favorable consideration" to accredited organizations in awarding grants or contracts, *id.* Several associations of nonprofit organizations offer accrediting programs, in addition to or in concert with offering education on effective governance practices. See *supra* note 177.

Accreditation is an intriguing concept, and it may become useful as an adjunct to regulation over time. Before considering whether delegation tax and government contract determinations would be prudent, however, additional research is necessary to understand how accrediting organizations conduct their programs and to evaluate the effectiveness of the techniques they employ. Cf. NONPROFIT PANEL INTERIM REPORT, *supra* note 41, at 55 (noting that the Panel deferred making recommendations on accreditation so that it could review findings from a forthcoming study of nonprofit self-regulatory, certification, and accreditation systems). This research is beyond the scope of the current Article. However, it is worth noting that even if this data could be amassed and analyzed, delegation to accrediting agencies should not be considered until provisions are made to monitor the accreditors and the precision and reliability of their programs. Also, for a comparative analysis of nonprofit accreditation efforts, see Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT L. REV. 803 (2005).

officers, and directors. If failures do come to light, officers can use the reliability certification requirement to bolster their demands that they be addressed and corrected.

An internal controls mandate, like that in the Revised New York Proposals,<sup>188</sup> would pursue process enhancements even more directly. The removal of the disclosure output element—officer certification—from the proposal appropriately places the regulatory emphasis on improving internal processes and thereby behavior. Auditing oversight reforms also engage internal monitors straightforwardly, by specifically expanding the responsibility of fiduciaries to examine and discipline auditors. Still, the drawback to disclosure-based reforms that demand the creation of processes is the expense of their implementation.<sup>189</sup> Therefore, these reforms should be applied selectively, targeting only those entities that can bear their costs without intolerable losses in programs and services.<sup>190</sup>

Disclosure reforms that merely increase outputs, on the other hand, often will impose high costs of compliance without energizing internal monitors or providing them opportunities to learn the skills of self-regulation. Some refinements to forms and questions may provide marginally better information to regulators and focus compliant officers and organizations on new data to improve their performance. But, for example, dramatically increasing the frequency and comprehensiveness of required IRS filings by exempt organizations is unlikely to prompt criminals or intentionally non-compliant officers or organizations to prevent or correct abuses. It is unlikely even to motivate them to make more complete and accurate disclosures to the IRS. And if it did, with the Service's current review technology and staff size, its agents might well never happen upon these damning disclosures. At the same time, the multiplication of filing burdens

188. N.Y. AG Program Bill 68-05, *supra* note 17, § 6

189. As discussed above, *supra* note 150, disclosure-based reforms that rely on process but are crafted as mandates for specific governance techniques are also subject to an autonomy critique. However, nonprofits can be instructed to create and maintain effective processes without being compelled to adopt a string of particular techniques. *See, e.g.*, N.Y. AG Program Bill 68-05, *supra* note 17, § 6 (imposing a general, but generally applicable, internal controls mandate).

190. Although the financial triggers contained in several of the proposed reliability certification requirements attempt to account for this balance, it should be recognized that asset and revenue size alone will not always be a good proxy for this cost-benefit determination. Sadly, constructing more precise triggers is likely beyond the capacity of any legislature.

The Revised New York Proposals attempt to avoid this quandary. The internal controls mandate issued there applies broadly across organizations, but demands that each organization adopt only those controls that are "reasonable." *See* N.Y. AG Program Bill 68-05, *supra* note 17, § 6(a). This tact will not, however, necessarily solve the problem of implementation cost. The mandate does impose some minimum requirements, *see id.* § 6(b), and the reasonableness standard is set to require controls reasonable to ensure material information reaches the board, not to require only reasonableness in light of an organization's other priorities, *see id.* § 6(a).

would impose unsustainable administrative burdens on those nonprofits who do attempt to comply. These reforms, therefore, should be used sparingly, if at all.

Other disclosure-based reforms described above fall somewhere in the middle. Non-duplicative accuracy certifications should motivate compliant officers to engage in some annual probing of their operations and staff. If additional penalties are likely, officers' incentives to investigate increase. Moreover, other nonprofit fiduciaries and employees may be more hesitant to falsify information or misuse their positions if they are aware that an officer will be scrutinizing the information contained in the organization's disclosures. By inserting an outside professional reviewer into a nonprofit's internal affairs, increased auditing requirements can have a similar effect. These kinds of reforms will still impose serious, sometimes insurmountable, costs on nonprofits. These costs may result in some improvements in nonprofit behavior. Yet, they cannot offer the same level of benefits as process-based reforms, in terms of educating internal monitors and institutionalizing enforcement mechanisms within individual organizations. Legislators should thus view these reforms cautiously because of their potential to create unjustifiable burdens on nonprofits regulated by them.

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Nonprofit reform and accountability should not be pursued primarily through disclosure. Wherever possible, funding should be increased for the regulatory staff and fiduciary education necessary to facilitate nonprofit enforcement and improve nonprofit behavior. To the extent these remedies are financially and/or politically unavailable, disclosure-based reforms should be carefully chosen and selectively applied. They can create serious costs for this vulnerable and vital sector. But, to the extent these costs can be tolerated, disclosure-based reforms that will facilitate enforcement of nonprofit obligations, motivate nonprofit fiduciaries to more actively self-monitor, or both, can generate important and lasting accountability benefits.

#### CONCLUSION

Recent efforts by state and federal regulators and legislators to reform nonprofit accountability might simply be early reactions to a general sense that "there ought to be a law" to prevent nonprofit scandals.<sup>191</sup> These pro-

191. Legislators' recent efforts at nonprofit reform left another nonprofit commentator with this same impression of their frustrations, and likewise prompted him to recommend an enforcement alternative. See Michael S. Kutzin, *Don't Change the Law—Enforce the Old Ones*, CHRON. PHILANTHROPY, Sept. 30, 2004, at 57.

posals, however, also share a common focus on disclosure as the route to achieve desired improvements in nonprofit accountability, notably by mandating officer certification and increased use and oversight of disclosure auditing. This emphasis on disclosure may reflect legislators' desire to replicate in the nonprofit context the perceived success of the Sarbanes-Oxley Act in the for-profit context.

However, as legislatures continue to pursue nonprofit reform efforts, they should be mindful of the limitations of a disclosure model of regulation in the nonprofit sector. For disclosure to induce greater accountability, it must either stimulate those within disclosing organizations to improve their behavior or facilitate outside enforcement of their obligations. The balance of costs and benefits relevant in the nonprofit sector will cause even compliant nonprofit actors and organizations to limit their investments in implementing disclosure reforms. Moreover, the lack of funding for government enforcement and the lack of empowered enforcement alternatives in this sector diminish the accountability value that improved disclosure can promise. To realistically improve nonprofit accountability, legislators must seriously reconsider the disclosure imperative.

More specifically, legislatures seeking to enhance nonprofit accountability should change their emphasis from enacting new legal requirements for disclosure to strengthening enforcement of existing laws and educating nonprofit fiduciaries and employees in how to comply with them. Regulators need resources and technology to police the nonprofit sector, and nonprofit fiduciaries and managers need education and training to enable them to self-enforce. Disclosure-based reforms should be adopted only if they will complement invigorated enforcement, motivate improvements in nonprofit behavior, or both. Moreover, the application of such reforms should be sparing and selective, so that they will not intolerably undercut nonprofits' pursuit of their missions. Only in these limited circumstances can a disclosure model of regulation truly serve the goal of enhancing nonprofit accountability.