REGULATING CHARITIES IN THE TWENTY-FIRST CENTURY: AN INSTITUTIONAL CHOICE ANALYSIS

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> "[T]he IRS has a clear, unambiguous role to play in governance. Some have argued that we do not need to be involved, because we can count on the states to do their job and the sector to stay on the path of self-regulation. While both state regulation and sector self-regulation are important . . . we cannot delegate to others our obligation to enforce the conditions of federal tax exemption."
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> - Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, June 23, 2009[1]

INTRODUCTION

Commissioner Ingram is only the latest official to state that the federal government should become more involved in the governance of tax-exempt organizations, particularly charities. Members of Congress, congressional staff, and other Internal Revenue Service officials have also called for an expanded federal role in this area.[2] At the same time, various commentators

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1. Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, Remarks at the Georgetown University Law Center Conference: Issues in Nonprofit Governance (June 23, 2009), *available at* http://www.irs.gov/pub/irs-tege/ingram__gtown__governance_062309.pdf; *see also* Diane Freda, *Governance Focus at IRS Continues as New Commissioner Stresses Diversity*, DAILY TAX REP., June 24, 2009, at G-6 (noting that these remarks were part of Commissioner Ingram's first major speech since assuming her current position).

2. *See, e.g.*, STAFF OF SENATE FIN. COMM., 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT 13–14 (2004) [hereinafter SENATE FIN. COMM. STAFF DRAFT], *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf (proposal to grant the IRS authority to remove the officers and board members of charity organizations); Bonnie S. Brier et al., *The Appropriate Role of the Internal Revenue Service with Respect to Tax-Exempt Organization Good Governance Issues*, *in* ADVISORY COMM. ON TAX EXEMPT AND GOV'T ENTITIES, REP. OF RECOMMENDATIONS 107–12 (2008), *available at* http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf (summarizing statements by IRS officials with respect to governance at tax-exempt organizations);

have expressed concerns about this federalization of governance oversight, especially if that oversight is to be provided by the IRS.[3]

This heightened interest in governance has grown out of problems at both for-profit and nonprofit organizations, ranging from Enron to the Smithsonian Institution.[4] Yet such concerns are not new. For more than fifty years scholars have expressed concerns that while there is a general consensus regarding the legal duties of nonprofit, and particularly charity, officers, directors, and trustees, enforcement of those duties has been spotty and haphazard at best.[5] Today, however, both the growth of the nonprofit sector and increasing frustration with perceived governance failures at nonprofits is leading to calls for either or both greater IRS involvement in governance and new state laws. The IRS has already begun to respond to such

Senator Chuck Grassley, Remarks at Buchanan Ingersoll & Rooney on Charities and Governance (Mar. 10, 2009), *available at* http://finance.senate.gov/press/Gpress/2009/prg031009a.pdf) (stating he will urge the IRS to improve reporting requirements for charities); *see generally* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 14 (2005) [hereinafter PANEL FINAL REP.], *available at* http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf ("Taken together, the examinations underway by Congress, the IRS, and the sector itself constitute the most comprehensive review of governance, regulations, and operations of the charitable community in three decades."); Dana Brakman Reiser & Evelyn Brody, *Introduction* to Chicago-Kent Symposium: *Who Guards the Guardians?: Monitoring and Enforcement of Charity Governance*, 80 CHI.-KENT L. REV. 543, 543 (2005) (summarizing recent government interest in reforming nonprofit governance).

3. *See, e.g.*, James J. Fishman, *Stealth Preemption: The I.R.S.'s Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. (forthcoming 2010) (manuscript at 46–48, *available at* http://papers.ssrn.com/abstract=1494932) (arguing that requiring increased governance and reporting for non-profit organizations will distract these organizations from their charitable missions); JOEL L. FLEISHMAN, THE FOUNDATION: A GREAT AMERICAN SECRET 257–58 (2007) (expressing skepticism that the IRS, in its current form, could provide such oversight, but supporting the concept of a private regulatory body like the National Association of Securities Dealers); Brier, *supra* note 2, at 46 (urging the IRS to proceed with caution when seeking to promote good governance at tax-exempt organizations); *see also* Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 FORDHAM L. REV. 521, 565–66 (2007) (while supporting more enforcement of existing legal standards, arguing against new legal mandates at either the state or federal level).

4. *See, e.g.*, PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 3–4 (Comm. Print 2002); SMITHSONIAN INSTITUTION GOVERNANCE COMMITTEE, REPORT OF THE GOVERNANCE COMMITTEE TO THE BOARD OF REGENTS 1–2 (2007), *available at* http://www.si.edu/about/regents/documents/Governance_Committee_Report.pdf. *See generally* JAMES J. FISHMAN, THE FAITHLESS FIDUCIARY AND THE QUEST FOR CHARITABLE ACCOUNTABILITY 3–5 n.1 (2007) (providing a list of recent, high profile charity scandals); Joel L. Fleishman, *Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform*, *in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172, 178 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999) (listing additional charity scandals).

5. *See, e.g.*, AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS 361 (Little, Brown and Company 1989) (1939) (the enforcement of charitable trusts is sporadic); ELEANOR K. TAYLOR, PUBLIC ACCOUNTABILITY OF FOUNDATIONS AND CHARITABLE TRUSTS 125 (1953) (expressing similar concerns with respect to both charitable trusts and charitable corporations); George Gleason Bogert, *Proposed Legislation Regarding State Supervision of Charities*, 52 MICH. L. REV. 633, 634–36 (1954) (expressing the difficulties involved in bringing actions against charitable trusts).

calls, as evidenced not only by the quote above from Commissioner Ingram, but also by its publication of a suggested governance practices list,[6] its addition of numerous governance questions to the recently revised IRS Form 990 that must be filed by most tax-exempt organizations with significant revenues or assets,[7] and its inclusion of governance issues in its 2009 annual training for exempt organization exam agents and managers.[8] Congress also already effectively federalized one aspect of these duties by granting the IRS explicit authority to impose financial penalties on charity insiders who receive improper financial benefits.[9] At the state level, various states and organizations that recommend state legislation, such as American Bar Association, the American Law Institute, and the Conference of Commissioners on Uniform State Laws, have expressed an interest in strengthening governance requirements for charities or for nonprofit organizations more generally.[10]

The choice of how to ensure improved governance at nonprofit organizations is not, however, as clear cut as Commissioner Ingram's comments might suggest. While two available options are either to maintain the status quo or to expand the role of the IRS, many other possibilities are available and have been proposed over the years. These possibilities range from new state-level agencies or commissions[11] to private, national bodies

6. INTERNAL REVENUE SERVICE, GOVERNANCE AND RELATED TOPICS – 501(C)(3) ORGANIZATIONS (2008), *available at* http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

7. *See* I.R.S. Form 990, Part VII (2008). *See also* Keith J. Kehrer & James M. Matthews, *Having Good Policies is Good Policy*, TAXATION OF EXEMPTS, Mar.-Apr. 2009, at 19; Lisa A. Runquist & Michael E. Malamut, *The IRS's New Regulation of Nonprofit Governance: The Annual Form 990 is Now Much More than a Tax Return*, BUS. L. TODAY, July-Aug. 2009, at 29, *available at* http://www.abanet.org/buslaw/blt/2009-07-08/runquist.shtml. For 2008, most tax-exempt organizations with gross receipts of $1 million or more or assets of $2.5 million or more must file Form 990, while organizations with receipts and assets below these thresholds may file the shorter Form 990-EZ which does not ask governance questions. *See* I.R.S. Instructions for Form 990, at 2–4 (2008). The Form 990-EZ filing thresholds declined over the next two years, eventually reaching $200,000 in gross receipts and $500,000 in assets for 2010. *Id.* at 3.

8. *See, e.g.*, Internal Revenue Service, IRS Training Materials – Governance (2009), *available at* http://www.irs.gov/charities/article/0,,id=208454,00.html (last visited Feb. 18, 2010); Internal Revenue Service, Governance and Tax-Exempt Organizations: 2009 CPE Training, *available at* http://www.irs.gov/pub/irs-tege/governance_training_presentation.pdf.

9. *See* I.R.C. § 4958 (2006); *see also* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 483–84 (1996); Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 FORDHAM L. REV. 609, 633–34 (2007).

10. For a summary of these activities, see Fremont-Smith, *supra* note 9, at 613–16. For example, California has enacted a law imposing new governance requirements. *See* Nonprofit Integrity Act of 2004, S.B. 1262, 2004 Cal. Legis. Serv. Ch. 919 (West) (amended 2010).

11. *See, e.g.*, MARION R. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT: STATE AND FEDERAL LAW AND SUPERVISION 441 (1965); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 272–74 (2003); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 467–77 (1960).

with limited legal authority,[12] to a new federal oversight agency,[13] to granting private parties greater ability to challenge the actions of charity managers in court.[14]

The goal of this article is to take advantage of this previous work while subjecting the various proposals to a more rigorous analysis. More specifically, this article uses institutional choice theory to consider systematically the advantages and disadvantages of various vehicles for regulating charity governance. Institutional choice theory recognizes that when considering what institution should be tasked with accomplishing a particular policy goal it is not sufficient to consider the advantages and disadvantages of only one institutional option. Instead, a comparative institutional analysis is required that considers the trade-offs among the range of institutions that could be given the task.[15] The current push for a greater IRS role makes thorough consideration of all possible options particularly urgent.

This article will focus on governance at charities. Charities represent the largest part of the nonprofit and tax-exempt organization sectors by almost any measure, and recent governance concerns relating to nonprofits have primarily involved charities.[16] A focus on charities is also appropriate because the vast majority of other nonprofit and/or tax-exempt organizations are mutual benefit entities, such as unions, trade associations, and country clubs, where the financial supporters and members have a stronger

12. *See, e.g.*, Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J. L. & PUB. POL'Y 1, 70 (2009); Elizabeth K. Keating & Peter Frumkin, *Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation*, 63 PUB. ADMIN. REV. 3, 12-13 (2003); Marcus S. Owens, *Charity Oversight: An Alternative Approach* 3 (Harvard University Hauser Center for Nonprofit Organizations, Working Paper No. 33.4, 2006), *available at* http://www.hks.harvard.edu/hauser/PDF_XLS/workingpapers/workingpaper_33.4.pdf.

13. *See supra* note 12.

14. *See, e.g.*, Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries*, 23 J. CORP. L. 655, 698–99 (1998) (exploring the possibility of expanded standing for individuals to challenge the actions of charity managers, but not providing a definitive recommendation); James J. Fishman, *The Development of Nonprofit Corporation Law and An Agenda for Reform*, 34 EMORY L. J. 617, 671–74 (1985) (suggesting an expanded role for relator suits to increase supervision of nonprofit corporations); Karst, *supra* note 11, at 446–49 (suggesting that permitting founders and substantial contributors to bring suit might be beneficial, if certain procedural limitations, such as a requirement to post security unless the attorney general can be persuaded to take up the suit, are in place); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 253 (1999) (suggesting the creation of private, for-profit monitoring companies to which nonprofits would grant the right to sue to enforce fiduciary duties and other obligations); Nicole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831, 852–53 (2007) (proposing a limited expansion of standing for donors).

15. *See generally* NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY 3–13 (1994).

16. *See* FISHMAN, *supra* note 4, at 3–5 n.1 (listing sources summarizing recent nonprofit governance scandals); Fleishman, *supra* note 4 (same).

incentive to monitor governance practices than most donors to charities (and most recipients of benefits from charities).[17]

For purposes of this article, "charities" are defined in a legal and tax sense; that is, as organizations that are both exempt from federal income tax and eligible to receive tax deductible contributions under federal law.[18] Additionally, the term "governance" is used in the legal sense of compliance with the three fiduciary duties of charity directors, trustees and officers: loyalty; care; and obedience.[19]

Part I of this article provides brief overviews of the charitable sector in all its diversity, of the current legal standards and enforcement mechanisms for charity governance, including the widely acknowledged flaws with those mechanisms, and of the various proposals for addressing those flaws. Part II will develop an institutional choice framework based on the framework developed by one of the authors for use in a narrower context.[20] Part III will then apply that framework to the range of options available for regulating charity governance, starting with state government options but also considering federal government options and two major self-regulatory approaches. For both the state and federal level discussions, consideration will be given to bodies with expansive powers and to bodies with less authority.

Part III ends by concluding that based on available information, the strongest candidate for more effective regulation of charity governance is a

17. *See* Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 890 (2003) (noting that membership nonprofit organizations have a greater ability to self-monitor); Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 243, 244 (Walter W. Powell & Richard S. Steinberg eds., 2d ed. 2006) (choosing to focus a discussion of nonprofit legal issues on charities "[b]ecause nonprofits lacking voting members present the greatest challenges to the law . . . .").

18. *See* I.R.C. §§ 170(c)(2), 501(c)(3), 2055(a)(2), 2106(a)(2)(A)(ii), 2522(a)(2) (West. Supp. 2008).

19. *See infra* notes 66–67 and accompanying text (listing these duties and noting the debate over whether the duty of obedience is a separate duty). A broader definition of governance could include related issues such as fidelity to donor intent and ensuring overall effectiveness, but the focus on this paper will be on these legal duties as compliance with these duties are generally viewed as correlated with accountability more generally. *See generally* Evelyn Brody, *Accountability and the Public Trust*, in THE STATE OF NONPROFIT AMERICA 471, 475–76 (Lester Salamon ed., 2002) (explaining that accountability has four meanings: financial probity; good governance; adherence to donor direction and mission; and effectiveness and public trust); Kevin P. Kearns, *The Strategic Management of Accountability in Nonprofit Organizations: An Analytical Framework*, 54 PUB. ADMIN. REV. 185, 187–89 (1994) (developing a four-part framework for defining accountability); Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205, 209–10 (2004) (identifying three strains of nonprofit accountability: financial, purposive, and organizational).

20. *See* Lloyd H. Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. 625, 650–56 (2007) (relating to the choice of which federal agency should regulate activities by so-called 527 organizations).

state-level entity that is connected to but maintains a degree of independence from the attorney general's office in each state. Such a body (a) takes advantage of existing state level authority and (in those states where it exists) expertise, (b) would be consistent with federalism and the historic role of state authorities with respect to charities, (c) would permit a greater level of experimentation to determine what governance rules and enforcement techniques are most effective, (d) reflects the fact that the vast majority of charities operate primarily in a single state, (e) would be accountable for the behavior of charities in that state, and (f) would have modest new compliance burdens and relatively less uncertainty because it is not a dramatic departure from the existing regulatory regime. As Part III details, these apparent strengths indicate this option is the strongest among the ones considered, although this choice is not without weaknesses. Those weaknesses include potential funding and coordination issues, as well as consistency across jurisdictions, particular for those charities that operate in more than one state, and questions regarding whether most or even many states could be persuaded to adopt this model. Part IV addresses the legal, political, and practical barriers to adoption of this preferred solution, and explores overcoming these issues through a federal funding incentive supported by the existing private foundation investment excise tax.

I. CHARITY GOVERNANCE TODAY

To situate our analysis, this Part I provides a brief overview of today's charitable sector and the challenges facing legislators and regulators trying to enact and enforce governance standards. With these challenges in mind, Part I concludes with a summary of the major proposals for improving charity governance through government regulation.

A. The Charitable Sector

The charitable sector is comprised of a wide variety of charitable, educational, religious, scientific and other organizations described in section 501(c)(3) of the Internal Revenue Code.[21] Over the past thirty years, the number charities registered with the IRS has grown exponentially, in-

21. Exempt organizations are those directed to charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. I.R.C. § 501(c)(3) (2006). The Treasury Department defines the term charitable, as used in this list, to include relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency. 26 C.F.R. § 1.501(c)(3)-1(d)(2) (2009).

creasing from approximately 276,000 501(c)(3) entities in 1977[22] to 1.186 million such entities today.[23] In addition to these 1.186 million registered charities, the charitable sector also includes thousands of churches and small charities that are not required to register with the IRS in order to qualify as organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code.[24] When added together, the total number of charities in the U.S. likely exceeds 1.3 million entities.[25]

As the number of charities in the U.S. has increased, so too has the charitable sector's economic strength. Over the past thirty years, the charitable sector has been growing significantly faster than both the government and the business sectors as a component of the economy,[26] and now has annual revenues of approximately $1.4 trillion.[27] Together with other non-profit organizations, the charitable sector employs approximately 9.7 percent of the total U.S. workforce and accounts for approximately five percent of the national gross domestic product.[28] The charitable sector's impact on the national economy is even more pronounced when the contributions of volunteers are added to these totals.[29]

22. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 6 (2004).

23. INTERNAL REVENUE SERVICE, DATA BOOK 56 (2008), *available at* http://www.irs.gov/pub/irs-soi/08databk.pdf; *see also* Amy Blackwood et al., The Nonprofit Sector in Brief 2 (2008), *available at* http://nccsdataweb.urban.org/kbfiles/797/Almanac2008publicCharities.pdf (between 1995 and 2005, "[t]he number of public charities registered with the IRS grew 53 percent, more than twice the rate of all non-profit organizations . . . .").

24. INTERNAL REVENUE SERVICE, *supra* note 23, at 56 n.1.

25. *See* Blackwood, *supra* note 23, at 1 (estimating that approximately one-half of the 350,000 religious congregations in the United States are not registered with the IRS).

26. KENNARD T. WING ET AL., THE NONPROFIT ALMANAC 10 (2008) (noting that the charitable sector's share of total wage payments made to American workers has been growing in comparison to the government and business sectors since World War II); FREMONT-SMITH, *supra* note 22, at 7 (reporting that between 1977 and 1997, the revenue growth of the charitable sector increased by 144 percent, while the national economy grew by about eighty-one percent); Blackwood, *supra* note 23, at 2 (noting that U.S. gross domestic product increased by approximately thirty-five percent between 1995 and 2005 after adjusting for inflation, while the total revenues and assets of non-profits that filed annual returns with the IRS rose by approximately fifty-four percent).

27. MOLLY F. SHERLOCK & JANE G. GRAVELLE, AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR 9 (2009), *available at* http://www.pppnet.org/pdf/R40919.pdf. In 2009, public charities also reported total assets of $2.6 trillion. *Id.* at 11.

28. *See* WING ET AL., *supra* note 26, at 20 (relying on financial data developed by the Bureau of Economic Analysis, U.S. Census Bureau, and the IRS to calculate the economic impact of non-profit institutions serving households, rather than businesses); *see also* SHERLOCK & GRAVELLE, *supra* note 27, at 4 (concluding that nearly ten percent of the total U.S. workforce works for non-profits, with more than seven percent working for charities).

29. It is difficult to estimate the amount of such volunteering, but recent studies have estimated that volunteers in 2006 contributed nearly thirteen billion hours of time, *see* WING ET AL., *supra* note 26, at 97, while another study estimated that volunteers in 2004 contributed the equivalent of 4.7 million full-time positions. *See* LESTER M. SALAMON & S. WOJCIECH SOKOLOWSKI, EMPLOYMENT IN AMERICA'S CHARITIES: A PROFILE 3 (2006), *available at*

To sustain this impressive growth, the charitable sector has developed a diverse funding base, which consists primarily of fees from the sale of goods and services, private donations, and government grants.[30] Of these three primary sources of revenue, fees from the sale of good and services are the most important, accounting for approximately seventy percent of reported revenues.[31] Private donations, which include contributions from individuals, foundations, and corporations, account for approximately twelve percent of total revenues,[32] and government grants account for less than ten percent of total revenues.[33] Revenue from other sources, such as investment income, dues payments, rental receipts, and income from special events makes up the rest of the charitable sector's annual income.[34]

As charitable revenues have grown, they have become highly concentrated among a select group of charities. At present, nearly seventy-five percent of the charitable sector's annual income flows to only two types of entities—health care and educational organizations[35]—while the remaining twenty-five percent is divided among a myriad of other charities. However, as of 2005, most of these remaining charities were quite small, with approximately seventy-three percent of all charities having annual expenditures of less than $500,000.[36] While numerous, these small charities collectively accounted for only 2.6 percent of the sector's total expenditures in 2005.[37] In contrast, charities with annual expenditures in excess of $10 million represented less than four percent of all registered charities, but accounted for more than eighty-two percent of the sector's total expenditures.[38]

These trends within the charitable sector suggest that regulation of charity governance is a complex problem that deserves careful attention. As the number of charities continues to increase, existing federal and state

http://www.ccss.jhu.edu/pdfs/NED_Bulletins/National/NED_Bulletin26_EmplyinAmericasCharities_2006.pdf.

30. *See* FREMONT-SMITH, *supra* note 22, at 8.

31. *See* WING ET AL., *supra* note 26, at 143–44. For non-profits other than health care organizations and institutions of higher learning, fees from the sale of goods and services account for a smaller portion of revenues, while private donations and government grants are relied upon more heavily. *Id.*

32. *Id.*

33. *Id.* at 144.

34. *Id.*

35. *Id.* at 4.

36. Blackwood, *supra* note 23, at 3.

37. *Id.* This figure would likely be higher if the expenses of organizations that are not required to register or report their annual expenses were included in the calculation.

38. *Id.* at 3. *See also* Paul Arnsberger, *Charities, Business Leagues, and Other Tax-Exempt Organizations, 2006*, *in* INTERNAL REVENUE SERVICE STATISTICS OF INCOME BULLETIN 251 (2009), *available at* http://www.irs.gov/pub/irs-soi/09fallbulchar.pdf (reporting similar data for the 2006 tax year).

regulatory resources will continue to be stretched and additional resources—or new approaches to regulation—will be needed to keep pace with the growth of the sector.[39] At the same time, donors have become less important to the overall economic health of the charitable sector, and it is unreasonable to expect, if it was ever reasonable to do so, that they will be able to effectively police the charitable sector by diverting their donations away from mismanaged charities. In fact, the decreasing importance of donors to the financial health of the charitable sector suggests that an effective third-party regulator is needed to enforce charity governance standards, especially for those charities that derive their financial support primarily or exclusively from revenue-generating activities such as fee-for-service arrangements. Such charities—which include non-profit hospitals—are presumably less sensitive to potential donor views because consumers who purchase goods or services from charities are presumably less concerned about governance matters.[40] Thus, all of these factors support growing scrutiny of charity governance.

An additional factor that adds to the complexity of regulating charity governance is the geographic diversity of charities. Charities can be formed under the laws of any of the fifty states, and can qualify to do business in multiple jurisdictions. Although charities are scattered throughout the country, a significant majority of them are located in a limited number of states. At present, approximately fifty-seven percent of all registered charities, which hold approximately sixty-two percent of all reported charitable assets, are incorporated or formed under the laws of the following sixteen states: California, Illinois, Massachusetts, Michigan, Minnesota, New Hampshire, New Mexico, New York, Ohio, Oregon, Rhode Island, South Carolina, Florida, New Jersey, Pennsylvania and Texas.[41] Accordingly, these sixteen states exercise control over a majority of the charities and charitable assets in the United States.[42]

States exercise control over charities through procedural mechanisms, such as annual registration and reporting requirements, and by imposing

39. *See infra* note 45 and accompanying text.

40. The institutional importance of health care is reflected in the amount of attention they receive from the IRS. *See, e.g.*, INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS HOSPITAL REPORT 1 (2009), *available at* http://www.irs.gov/pub/irs-tege/frepthospproj.pdf (191-page IRS report on multi-year study of non-profit hospitals).

41. *See* DAVID BIEMESDERFER & ANDRAS KOSARAS, THE VALUE OF RELATIONSHIPS BETWEEN STATE CHARITY REGULATORS & PHILANTHROPY 15 (2006), *available at* http://www.nasconet.org/hottopics/CoFs%20Value%20of%20Relationships.pdf (reporting that approximately sixty-four percent of all private foundations, which hold approximately sixty-eight percent of all private foundation assets, are also registered in these sixteen states).

42. *Id.*

civil and criminal penalties on charities that violate state law.[43] In a study of malfeasance by charitable fiduciaries, Marion Fremont-Smith and Andras Kosaras found that between 1995 and 2002, fiduciaries at only 152 organizations—out of a possible 1.4 million—were accused of civil or criminal wrongdoing.[44] Of the 152 accusations of wrongdoing, ninety-eight involved criminal activity, fifty-four involved breaches of the duty of loyalty and prudence, and another six involved both civil and criminal activity. As the authors of this study acknowledge, however, it is impossible to know whether this low level of publicly reported malfeasance represents the entire story or is only the tip of the iceberg because of underreporting and other factors.[45] So, while the existing evidence may not justify dramatic action,[46] it also does not lay to rest concerns that charity governance problems may be more widespread than is currently known.[47]

Even if the incidence of wrongdoing is relatively rare, a few such instances can still affect the reputation of the entire charitable sector. As Joel Fleishman has pointed out, "[a] potentially huge problem for the sector can be created by the tiny fraction of not-for-profit sector organizations which have been found to be willfully dishonest or which engage in illegal practices, and by the unethical individuals acting within otherwise reputable organizations."[48] When reporting on these incidents of wrongdoing, the

43. Breaches of fiduciary duty often involve lapses of governance, conflicts of interest and self-dealing, misappropriation of funds, or payments of excessive compensation. *See, e.g.*, *supra* note 4 (listing sources describing recent charity scandals); James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 FORDHAM L. REV. 567, 572–73 (2007) (additional discussion of alleged fiscal wrongdoing by charities).

44. *See* Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002*, 42 EXEMPT ORG. TAX REV. 25, 33 (2003) (studying newspaper reports of breaches of duty published between 1995 and 2002 by Lexis/Nexis).

45. *Id.* at 25–26, 33 (noting that serious under-reporting and the non-public nature of many government investigations prevented the drawing of any conclusions regarding the extent of such breaches in the sector as a whole based on this data); *see also* Brody, *supra* note 17, at 243 ("[I]t is impossible to determine how big a problem [misfeasance and malfeasance by nonprofit fiduciaries] is, and how well government is doing to address it."); PETER SWORDS & HARRIET BOGRAD, ACCOUNTABILITY IN THE NONPROFIT SECTOR: WHAT PROBLEMS ARE ADDRESSED BY STATE REGULATORS? 2 (1996), http://www.idealist.org/media/pdf/FAQ/Bograd-Swords-96.pdf (based on a year-long survey, concluding that no one, including no regulator, knows the breadth of abuses at charities).

46. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 15 (arguing that "draconian" solutions to the problem of fiduciary wrongdoing at charities are not necessary).

47. *See* JOHN TROPMAN & THOMAS J. HARVEY, NONPROFIT GOVERNANCE: THE WHY, WHAT, AND HOW OF NONPROFIT BOARDSHIP 31 (2009) ("Boards of directors are deeply flawed. They seriously underperform and malperform virtually everywhere."); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 632 (1998) (noting that there is significant anecdotal evidence that nonprofit governance is less efficient than for-profit governance).

48. Fleishman, *supra* note 4, at 178; *see also* Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393, 394 (1994) ("This depreciation of the goodwill associated with the term *non-profit* reduces the potential success of all nonprofit organizations, including those that are run by people of integrity for

press frequently neglects its "duty to put the 'bad' news it reports into the context of the 'good' news that forms the backdrop."[49] The result, of course, is that the public is often presented with a distorted picture of the charitable sector, which "undermines the public's confidence in the possibility of effective action."[50]

Effective regulation of charities is important, not only because of the prominent place of charities in our national economy, but also because of the public nature of the charitable sector. Charities, as a matter of law, are required to serve public purposes,[51] and as a matter of practice depend for their survival on public support, whether in the form of donations, volunteer service, or preferential tax and other legal treatment.[52] When those entrusted with fiduciary responsibility use charities to advance their own private purposes, the public trust is broken. As Marion Fremont-Smith has correctly observed, effective regulation of charity governance can protect the public trust by assuring the public that "there is a mechanism by which government can compel compliance with an accepted set of standards that we as a society are agreed should be observed by the entities that are the subject of regulation."[53] We turn now to review the set of standards that should be observed by charities, and consider how such standards are enforced under our current regulatory system.

B. Current Regulation of Charity Governance

Governments regulate charities in a variety of ways and through a variety of government agencies.[54] The Internal Revenue Service screens purported charities to determine if they comply with the requirements for the federal tax benefits they enjoy and then monitors them to ensure continued

good purposes and to good consequences."); Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571, 573–74 (1998) (stating that abuses by a small number of groups and people in the charitable system can cause deep harm to others in the system who are performing their roles with integrity).

49. Fleishman, *supra* note 4, at 178.

50. *Id.*

51. *See* 26 C.F.R. § 1.501(c)(3)-1(d)(1)(ii) (an organization does not qualify for 501(c)(3) status unless it serves a public, rather than a private, interest).

52. The public donated $307.65 billion to charity in 2008. INDEPENDENT SECTOR, FACTS AND FIGURES ABOUT CHARITABLE ORGANIZATIONS 4 (October 2009), http://www.independentsector.org/programs/research/Charitable_Fact_Sheet.pdf. For information about public support of charities through volunteer service, see WING ET AL., *supra* note 26, at 96–102.

53. Fleishman, *supra* note 4, at 177 (quoting a draft article by Fremont-Smith).

54. *See generally* FREMONT-SMITH, *supra* note 22, at 364–65, 368–70; Brody, *supra* note 17, at 250–52.

compliance.[55] The Federal Trade Commission and various state officials, usually but not always within the Attorney General's office, monitor solicitations for charitable contributions and prosecute fraudulent appeals for donations.[56] Secretaries of state review corporate filings, while state and local tax authorities process requests for various tax exemptions and review continued qualification for those exemptions.[57] For the most part controversies arise only with respect to specific disputes—for example, does this charity-owned building qualify for property tax exemption, does that fundraising mailing meet the solicitation requirements—and not larger issues such as whether the government should be involved in a particular kind of regulation at all or if a particular agency is the one best suited to do that regulating. Even when there is criticism of a government agency for being lax or ineffective in its enforcement activities, the usual proposed solution is more staffing and funding for that agency, with the implicit assumption that the agency is perfectly capable of doing its job if it only had access to sufficient resources to do so.[58] The one major exception, however, is governance—that is, ensuring that charity leaders comply with their duties to the organizations they lead.[59]

The legal standards for charity leaders—directors, trustees, and officers—have a long and rich history that has its roots in 16th century England and before, as various scholars have detailed.[60] Our concern, however, is with what those standards are today, which institutions are currently responsible for interpreting and enforcing those standards, and what problems exist with the current system. While such duties for directors or trus-

55. *See generally* INTERNAL REVENUE SERVICE, PUB. NO. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION 2–8 (2008), *available at* http://www.irs.gov/pub/irs-pdf/p557.pdf.

56. *See, e.g.*, Press Release, Fed. Trade Comm'n, FTC Announces "Operation False Charity" Law Enforcement Sweep (May 20, 2009) (announcing law enforcement actions by the FTC and officials from 49 states and the District of Columbia against both fundraising companies and nonprofits engaged in allegedly deceptive fundraising practices), *available at* http://www.ftc.gov/opa/2009/05/charityfraud.shtm.

57. *See generally* FREMONT-SMITH, *supra* note 22, at 364–65.

58. *See generally* FREMONT-SMITH, *supra* note 22, at 471 (besides reducing the liability protection generally enjoyed currently by charity fiduciaries, "the greatest need is to provide regulatory agencies in the states and the IRS adequate funds to effectively carry out their enforcement duties."); PANEL FINAL REP., *supra* note 2, at 24 (to improve government regulation, primarily recommending greater resources for both the IRS and states, as well as greater information sharing ability); Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559, 606 (2005) (concluding that requiring more disclosure of nonprofit activities is not by itself sufficient to ensure greater nonprofit accountability, but instead must be accompanied both by significant increased resources for state AGs and the IRS, possibly avenues for enforcement of nonprofit responsibilities by other parties, and increased training for nonprofit fiduciaries).

59. *See infra* Part I.C (summarizing the numerous proposals to change how the government regulates charity governance).

60. *See generally* FISHMAN, *supra* note 4, at 84.

tees of charities organized as nonprofit corporations and for trustees of charities organized as trusts have similar roots and share many commonalities, current state law tends to hold trustees of charitable trusts to stricter compliance with these duties than directors or trustees of corporations, particular regarding the need to be obedient to the organization's originally stated purposes.[61] This difference is moderated to a significant degree, however, by the fact that many if not most recent trust documents remove this stricter level of accountability if the applicable state law permits.[62] Regardless of the strictness with which the duties are, at least in theory, applied, the substance of the duties is similar to those of both charitable nonprofit corporations and charitable trusts.[63] Finally, while at one time there may have once been a difference in such duties for directors or trustees of a charitable nonprofit corporation on one hand and officers of such a corporation on the other hand, the duties for these individuals have generally converged.[64] This convergence mirrors a similar trend of for-profit corporations.[65]

With respect to current standards, there is general agreement that charity leaders owe their organizations two duties under state laws: care and loyalty.[66] There also appears to be an emerging consensus that a third duty, that of obedience, also applies, although there is some debate regarding whether this duty is a truly a separate one or merely an aspect of the other two duties.[67] These duties are similar to those applied to leaders of for-

61. *See generally* FISHMAN, *supra* note 4, at 10 (legal accountability can be based, to some degree, upon the form of the nonprofit organization); Karst, *supra* note 11, at 435–36 (describing the divergence in duties based on organizational form as of 1960 but calling for a uniform standard).

62. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 188, 199; Evelyn Brody, *Charity Governance: What's Trust Law Got to Do with It?*, 80 CHI.-KENT L. REV. 641, 644–45 (2005).

63. *See* AM. LAW INST., PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS (Tentative Draft No. 1) xxxiii (2007) [hereinafter ALI NONPROFIT PRINCIPLES 2007] ("[T]he corporate and trust standards of conduct do not seem to differ in substance."); FREMONT-SMITH, *supra* note 22, at 201 ("Thus the standard to be applied by a court when asked to determine whether there has been a breach of the duty of care by a director [of a corporation] is not essentially different from that used to determine a similar breach by a trustee [of a trust]."); Brody, *supra* note 62, at 652 (suggesting that the standards for trusts and corporations have "essential similarities").

64. *See* MODEL NONPROFIT CORP. ACT § 8.42 cmt. at 8-83 (2009) ("[A]n officer must meet standards of conduct generally similar to those expected of directors.").

65. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that under Delaware corporate law, officers owe the same fiduciary duties of care and loyalty to their corporations as do directors).

66. *See, e.g.*, UNIF. TRUST CODE §§ 802, 804 (amended 2005); AM. BAR ASS'N, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 19 (George W. Overton & Jeannie Carmedelle Frey, eds., 2d ed. 2002) [hereinafter ABA GUIDEBOOK]; ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 300.

67. *See, e.g.*, ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 300 cmt. g(3) (noting this duty but taking the position it is part of the duties of loyalty and care); FREMONT-SMITH, *supra* note 22, at 225–26 (noting this duty but expressing skepticism that it is really a separate duty); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience Into Fidelity*, 76 FORDHAM L. REV. 893, 897–98 (2007) (describing the uncertain status of this duty).

profit organizations, although the application of these duties naturally can be very different in the nonprofit, and particularly the charity, context.[68]

The duty of care requires that charity leaders act in good faith and use the degree of diligence, care and skill that prudent people would use in similar positions and under similar circumstances if they had similar skills as the leader.[69] It essentially requires reasonable attention to the charity's affairs through attending board meetings, reviewing material provided, making inquiries of charity employees, and so on.[70] However, the leaders may reasonably rely on representations from charity employees, outside advisors, and others.[71] Finally, liability for violation of this duty usually only applies if the leader has engaged in gross negligence (as opposed to mere negligence) with respect to this duty under the so-called "business judgment" rule that also usually applies in the for-profit context.[72]

The duty of loyalty requires charity leaders to act in the best interest of their organization.[73] The most obvious violation of this duty is if a charity leader improperly directs some of the charity's resources to himself or herself, such as through the payment of excessive compensation or a business deal that favors the leader to the charity's detriment.[74] Other, less obvious violations include personally taking advantage of an opportunity that would have benefitted the charity, such as the ability to purchase particular property at a favorable price, or directing grants from one charity to another

68. *See, e.g.*, MODEL NONPROFIT CORP. ACT, Introductory Comment to Subchapter C (2009) ("The provisions of this act with respect to the duties and liabilities of directors of nonprofit corporations closely follow the provisions of the Model Business Corporation Act on the same subjects."); FREMONT-SMITH, *supra* note 22, at 200 (noting that the courts have generally not distinguished between for-profit and nonprofit corporations when addressing alleged breaches of the duty of care or loyalty); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 632 (1998) ("Nonprofit directors and officers generally operate under the same legal standards under state law in terms of managerial obligations and the duties of loyalty and care as their for-profit peers.").

69. *See, e.g.*, MODEL NONPROFIT CORP. ACT § 8.30(b) (2009) (director duty of care); *id.* § 8.42(a)(2) (officer duty of care); REVISED MODEL NONPROFIT CORP. ACT § 8.30(a)(2) (director duty of care) (1987); *id.* § 8.42(a)(2) (officer duty of care); ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 315 (board member duty of care).

70. *See generally* MODEL NONPROFIT CORP. ACT § 8.30(b) cmt. (2009).

71. *See, e.g.*, MODEL NONPROFIT CORP. ACT §§ 8.30(f), 8.42(c) (2009); REVISED MODEL NONPROFIT CORP. ACT §§ 8.30(b), 8.42(b) (1987); ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 325(b).

72. *See* MODEL NONPROFIT CORP. ACT §§ 8.31(a) cmt., 8.42 cmt. (2009); ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 315 cmt. b.

73. MODEL NONPROFIT CORP. ACT §§ 8.30(a), 8.42(a)(3) (2009); REVISED MODEL NONPROFIT CORP. ACT §§ 8.30(a)(3), 8.42(a)(3) (1987); ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, at § 310.

74. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 225 (the duty of loyalty requires transactions with directors or officers to be substantively fair to the charity).

solely because the director or officer involved also is a director or officer of the other charity.[75]

The duty of obedience, whether treated as a separate duty or as part of the duties of care and loyalty, requires charity leaders to ensure the charity both obeys applicable laws and complies with the provisions of its governing documents, including its stated mission.[76] A stronger interpretation of this duty, that at least one trial court in New York adopted, is as a duty to comply with the originally stated purpose of the charity absent financial difficulties or other considerations that require a change in mission as a last resort.[77] The weaker view of this duty is what is more commonly accepted, however, and parallels the for-profit corporate director duty of good faith.[78]

Despite the recent inroads of Congress and the Internal Revenue Service into this area, these duties primarily flow from state law and the primary responsibility for enforcing these fiduciary duties generally remains with the attorneys general of the various states.[79] While the mechanisms vary somewhat, typically the attorney general of each state has the authority to investigate whether the leaders of any charity legally organized within their state are meeting their legal duties and, if the attorney general believes they are not, to go to court to seek corrective action up to and including removal and sanctioning of those leaders.[80] The scope of this authority with respect to charities operating in a given attorney general's state but not legally formed there are less clear, although attorneys general have

75. *See, e.g.*, ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 310 cmt. d (describing nonfinancial "duality of interests"); ABA GUIDEBOOK, *supra* note 66, at 34 (describing the "corporate opportunity" aspect of the duty of loyalty).

76. *See, e.g.*, ALI NONPROFIT PRINCIPLES 2007, *supra* note 63, § 300 cmt. g(3).

77. *In re* Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999) (the board of a nonprofit must first attempt to preserve its original mission before deciding to reprioritize this mission). A variation on this stronger version of the duty is the "charitable trust doctrine," adopted by a few courts, that requires a charitable nonprofit corporation to limit the use of unrestricted gifts to the purpose of the corporation at the time of the receipt of those gifts, even if the corporation later changes its purposes. *See* Robert A. Katz, *Let Charitable Directors Direct: Why Trust Law Should Curb Board Discretion Over a Charitable Corporation's Mission and Unrestricted Assets*, 80 CHI.-KENT L. REV. 689, 702 (2005).

78. *See, e.g.*, *In re* the Walt Disney Co. Derivative Litigaion, 906 A.2d 27, 67 (Del. 2006) ("The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."). *But see* Sugin, *supra* note 67, at 911 (arguing that interpreting the duty of good faith in the charity context as imposing a requirement to act in a charity's best interests may be going beyond the understanding of that duty in the for-profit corporation context).

79. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 305–09; BIEMESDERFER & KOSARAS, *supra* note 41, at 13; Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 938–39, 943 (2004).

80. *See* FREMONT-SMITH, *supra* note 22, at 309; BIEMESDERFER & KOSARAS, *supra* note 41, at 13.

on occasion asserted jurisdiction over such charities as well, sometimes leading to conflicts between attorneys general of different states.[81]

While attorneys general have the ability to bring suits to enforce fiduciary duties, private individuals generally do not.[82] The only exceptions are directors and trustees of the nonprofit entity involved, sometimes members for nonprofit corporations with "members" who have state-law governing authority, and, on rare occasion, members of the public with special interests in the charity.[83] Even donors and their heirs often lack standing to enforce agreements regarding the use of their donated funds.[84] Such suits therefore appear to be relatively rare, leaving enforcement of fiduciary duties almost always in the hands of the attorneys general.[85]

The widespread criticism of the current system is that while attorneys general have this authority in theory they rarely exercise it in fact, and when they do exercise it, they do so in flawed ways. More specifically, commentators generally agree that attorneys general, constrained by both their limited budgets and their wide-ranging responsibilities, tend to devote relatively few resources to monitoring charities.[86] Furthermore, when they do pay attention to charity activities they can be tempted to choose the objects of their attention based on political, not enforcement effectiveness, concerns.[87] So while there is uncertainty regarding the extent to which charity leaders violate their fiduciary duties, and in fact such violations

81. *See* FREMONT-SMITH, *supra* note 22, at 321–24; Brody, *supra* note 79, at 968, 980–81.

82. *See* MODEL NONPROFIT CORP. ACT § 13.02 (2009) (limiting standing to bring a derivative civil suit to directors and certain members); REVISED MODEL NONPROFIT CORP. ACT § 6.30 (same) (1987); FREMONT-SMITH, *supra* note 22, at 328–29 (members of the general public typically do not have standing to sue a charity for breach of duty); Fishman, *supra* note 11, at 258–59 (listing factors courts may use to determine whether to relax this limitation).

83. *See* FREMONT-SMITH, *supra* note 22, at 159 (noting that nonprofit corporations with members in the corporate sense are relatively rare); Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 61 (1993) (listing the factors state courts generally consider to determine if such a special interest exists); Fishman, *supra* note 11, at 257–59 (discussing members' standing to sue).

84. *See, e.g.*, Manne, *supra* note 14, at 246–47 (giving an example of donors being found not to have standing). *But see* RESTATEMENT (THIRD) OF TRUSTS § 94(2) (Tentative Draft No. 5, 2009) (permits the settlor of a charitable trust to maintain a proceeding to enforce the trust).

85. *See* Brody, *supra* note 9, at 484 ("Trustees, however, rarely sue each other, and few nonprofits (other than mutual nonprofits) have voting members. As a practical matter, only state attorneys general are likely to bring charities into court.").

86. *See, e.g.*, FLEISHMAN, *supra* note 3, at 256 ("According to a recent count, there were fewer than one hundred full-time charity supervisory officials among the fifty state governments."); Blasko, *supra* note 83, at 48 ("Attorneys general's offices are traditionally understaffed, underfunded, (citation omitted) and have many pressing concerns aside from charities." (citation omitted)); Brody, *supra* note 79, at 951 ("State budgets allocate insufficient resources, and most attorneys general concentrate their charitable firepower on fraudulent and misleading fundraising." (citation omitted)).

87. *See* Blasko, *supra* note 83, at 48 (citing political concerns as creating a lack of interest in enforcing fiduciary duties); Brody, *supra* note 79, at 947–48 (arguing that political incentives can drive case selection).

may be relatively rare,[88] it is generally agreed that the importance of public trust to the charitable sector requires that there be more effective mechanisms for uncovering and remedying such violations.[89] Despite this agreement more than fifty years of calls to increase attorney general or other government attention to this issue have resulted in incremental and, for the most part, insufficient changes. This lack of progress has not, however, deterred commentators from putting forward numerous proposals for reforming the oversight of governance at charities. It is to those proposals that we now turn.

C. Proposals for Regulation of Charity Governance

While there is general agreement that the current regulatory system is in need of improvement, there is widespread disagreement about how the system should be reformed to make it more effective.[90] As noted above, various authors have put forward a diverse array of proposals for reform, ranging from simple statutory amendments to the creation of new state and federal regulatory agencies.[91] Summarized below are six of the most significant proposals that have been put forward to date. For the sake of convenience, the proposals have been classified into three broad categories covering state-level reforms, federal-level reforms, and self-regulatory reforms. In Part III, we evaluate each of these proposals using an institutional choice analysis and highlight their various strengths and weakness.

1. State-Level Reforms

As described in Section I.B, state attorneys general are vested with primary responsibility for regulating governance, but most state attorneys general offices lack the resources or the will to actively enforce state fiduciary standards.[92] As a result, some commentators have recommended the transfer of oversight responsibility from the attorneys general to new state-level bodies established for the sole purpose of regulating charities.[93] Two

88. *See supra* notes 45–46 and accompanying text.

89. *See supra* notes 48–50 and accompanying text.

90. *See, e.g.*, Owens, *supra* note 12, at 3 ("Recent media reports of abuses and resulting overbroad legislation suggest that it might be appropriate to consider alternative structures to the Internal Revenue Service-based system currently in place."); *Cf.* Brody, *supra* note 9, at 504 (acknowledging the shortcomings of the current regulatory system, but warning against over-regulation of the charitable sector).

91. *Compare, e.g.*, Gilkeson, *supra* note 14, at 851–54 (recommending administrative and statutory changes) *with, e.g.*, Fishman, *supra* note 43, at 594–98 (recommending the creation of state-level charitable commissions) *and* Fleishman, *supra* note 4, at 187–88 (recommending, as a last resort, the creation of a new federal agency to serve as a national regulator of the charitable sector).

92. *See supra* notes 86 and accompanying text.

93. *See supra* note 11.

of the most important and innovative of these state-level proposals for reform are described below.

a. New State Agency (Karst)

In 1960, Kenneth Karst, who was then an assistant professor of law at Ohio State University, recommended that oversight responsibility be transferred from the state attorney general to a new state agency that would "bear primary responsibility for supervising private charities and administering the various state controls over their operations."[94] The state agency would maintain a registry of all charities operating in the state, collect and evaluate periodic reports, investigate possible breaches of fiduciary duty, and call abuses of fiduciary responsibility requiring remedial action directly to the attention of the proper court.[95] In addition to taking over these traditional duties of the attorney general, the state agency would also oversee all aspects of charitable regulation within the state, including regulation of obsolete charities, the consolidation of charities of uneconomical size, and the administration of the state system of control over the solicitation of funds.[96]

Karst argued that the creation of a single state agency that focused solely on the charitable sector would be more effective at regulating charities than the attorney general, whose office may not include accountants and other experts specifically trained to audit charities.[97] Centralizing the regulation of charities in one agency would also achieve economies of scale, lower the registration and reporting burden on charities, and eliminate some of the coordination problems that result when multiple state agencies regulate charities.[98] In Karst's view, this new regulatory approach would allow for worthwhile state-level experimentation while ensuring that charities would be accountable to "the communities from which they spring, and which they seek to serve."[99]

b. State Charity Commissions (Fishman)

In contrast to Karst's proposal to create new state agencies that would be separated from the attorney general, long-time nonprofit organization scholar and Pace Law School Professor James Fishman has recommended

94. *See* Karst, *supra* note 11, at 476.
95. *Id.* at 477.
96. *Id.*
97. *Id.* at 478.
98. *Id.* at 477.
99. *Id.* at 482.

the creation of state charity commissions that would work with the state attorney general to improve oversight of the sector.[100] Fishman's proposed charity commission would consist of fifteen unpaid citizens, seven appointed by the state attorney general and eight appointed by the governor.[101] An assistant attorney general would serve as chief administrator of the commission.[102] In smaller states, a single commission would be responsible for overseeing the charitable sector, while in larger states a separate commission would be established in each judicial district.[103]

Under Fishman's proposal, each commission would have authority to investigate and process complaints from members of the public.[104] Initially, complaints would be investigated on a confidential basis by a panel of three randomly-selected commissioners.[105] If the complaint was validated, the assistant attorney general would serve a copy of the complaint on the charity.[106] If necessary, the assistant attorney general could subpoena witnesses and collect evidence that would be presented to the three-person panel at a hearing.[107] If the three-person panel could not resolve the issue through settlement, conciliation or remediation, or felt that it was an important issue that warranted more attention, the panel could turn the matter over to the full commission for confidential review.[108] If the full commission could not reach a decision on the matter, the attorney general would take responsibility for the matter.[109]

Fishman argued that one of the principal benefits of his proposed charity commissions would be their ability to serve as remedial bodies, rather than mere enforcement bodies, which could help to inculcate new sector-wide norms for fiduciaries.[110] By leveraging the enforcement capacity of the attorney general, the charity commissions would also help to preserve

100. Fishman, *supra* note 11, at 272. The concept of a charity commission originally developed in connection with the passage of The Statute of Charitable Uses, which established local commissions to investigate any breach of trust, falsity, non-employment, concealment or conversion of charitable funds. *Id.* at 275–76 (citing GARETH JONES, HISTORY OF THE LAW OF CHARITY 1553–1827, at 25 (1969)).

101. *Id.* at 273.

102. *Id.*

103. *Id.* at 272.

104. *Id.* at 273.

105. *Id.*

106. *Id.*

107. *Id.* at 273–74.

108. *Id.* at 274. Fishman argued that an unmerited public hearing could damage the reputation of a charity, and that all hearings should be confidential until at least until probable cause is found. *Id.*

109. *Id.*

110. *See* Fishman, *supra* note 43, at 595. Fishman noted that charity commissions operating during the first quarter of the seventeenth century were very active in issuing decrees and that these original commissions constitute one of the few successful systems of charity oversight yet created. *Id.* at 596–97.

state-level oversight of charities through the involvement of interested citizens,[111] which would have the indirect effect of freeing up the IRS to focus its attention on enforcing federal tax laws rather than state-level fiduciary standards.[112]

2. Federal-Level Reforms

At the federal level, the IRS is responsible for determining the tax-exempt status of charitable organizations and enforcing other applicable federal tax laws.[113] Despite the IRS's recent attempts to regulate charity governance, it is generally recognized that Congress, in granting tax exemption to charitable organizations, did not intend for the IRS to become a national regulator of the charitable sector.[114] While some commentators believe that the IRS is well-suited to take on that responsibility,[115] others have argued that federal oversight of the charitable sector would be more effective if it was carried out by a separate federal agency or commission that focused its attention exclusively on the charitable sector.[116] Two such federal-level proposals for reform are described below.

a. Federal Regulatory Agency (Fleishman)

In 1999, Duke Law Professor Joel Fleishman recommended the establishment of an independent federal agency with authority to regulate charities.[117] This new U.S. Charities Commission would be modeled after the Federal Trade Commission or the Securities and Exchange Commission

111. *Id.* at 598.

112. *Id.*

113. *See supra* note 55 and accompanying text.

114. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 459; *see also* Marcus S. Owens, *Charities and Governance: Is the IRS Subject to Challenge*, TAX ANALYSTS 2008-9664 (2008) (noting that the IRS's new effort to regulate charity governance goes "beyond the requirements of the code").

115. *See, e.g.*, SENATE FIN. COMM. STAFF DRAFT, *supra* note 2, at 13–14 (recommending the expansion of the IRS's role as principal federal regulator of the charitable sector); FREMONT-SMITH, *supra* note 22, at 465–66 (arguing in favor of retaining the regulatory powers of the IRS); *see also* David Ginsburg et al., *Federal Oversight of Private Philanthropy in* DEP'T OF THE TREASURY, RES. PAPERS SPONSORED BY THE COMM'N ON PRIV. PHILANTHROPY AND PUB. NEEDS 2575, 2578–79 (1977) (arguing in favor of retaining the IRS as the principal federal regulatory of the charitable sector).

116. *See* FREMONT-SMITH, *supra* note 22, at 82.

117. Fleishman, *supra* note 4, at 186. Fleishman actually proposed three "complementary, sequential strategies" for policing the charitable sector, which included the creation of a non-governmental accountability-enforcement organization, a public-private partnership to coordinate the investigation of alleged misconduct, and the creation of a new federal agency, which he characterized as a "strategy of last resort." *Id.* at 186–87. Fleishman later renounced his support for the creation of a new federal agency, claiming that such an agency was "at odds with the history, culture, and need for independence" of the non-profit sector. *See* FLEISHMAN, *supra* note 3, at 257. Fleishman now endorses Owen's proposal to create a new federally-chartered entity that would work in tandem with the IRS to regulate the charitable sector. *Id.* at 258.

and would focus on the procedural—not substantive—functioning of charitable organizations.[118] As a body with regulatory authority, the new agency would be empowered to investigate instances of alleged wrongdoing, subpoena witnesses, and institute civil or criminal proceedings on its own motion. It would also have authority to supervise interstate charitable solicitation, monitor the function of the charitable sector as a whole, gather data and create databases about the sector, commission studies on various aspects of the sector, provide periodic reports to Congress on the operation of the sector, issue regulations to guide the sector in conforming with applicable laws, and make recommendations for potential legislative changes.

Despite the new agency's extensive list of responsibilities, Fleishman believed that it should not be responsible for handling tax-related issues affecting the charities that it regulates. Instead, Fleishman argued that the IRS, given its vast experience administering federal tax law, should continue to process annual returns (*e.g.*, Form 990) and make decisions about exempt status under Section 501(c) of the Internal Revenue Code, deductibility of contributions, and the tax on unrelated business income.[119] Fleishman thus conceived of a bifurcated system of federal oversight, with the IRS responsible for enforcing applicable tax rules and a new U.S. Charities Commission responsible for enforcing fiduciary duties and other non-tax aspects of charitable governance. The benefit of this bifurcated system is that it would allow the IRS to focus its attention on enforcing federal tax laws, while enabling the U.S. Charities Commission to fill the regulatory gaps left by state attorneys general.

b. Federal Advisory Commission (Fremont-Smith & Yarmolinsky)

As an alternative to the creation of a new regulatory agency, a number of commentators have recommended the creation of a national advisory commission that would help improve state and federal regulation of the charitable sector primarily through research, education, and advocacy,

118. Fleishman preferred that the new agency be independent, but he recognized that that it would be small in size and might be more effective if it was part of the Securities and Exchange Commission. *See* Fleishman, *supra* note 4, at 190. *See also* Donald R. Spuehler, *The System for Regulation and Assistance of Charity in England and Wales, with Recommendations on the Establishment of a National Commission on Philanthropy in the United States*, *in* DEP'T OF THE TREASURY, RESEARCH PAPERS SPONSORED BY THE COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 3045, 3045 (1977) [hereinafter FILER RESEARCH PAPERS] (noting that many legal scholars from the U.S. who participated in a 1972 conference in Ditchley Park, England, supported the concept of a charity commission similar to the Charity Commission in the United Kingdom).

119. *See* Fleishman, *supra* note 4, at 189 (recognizing the value of the IRS's experience, but stating that in an ideal world the proposed U.S. Charity Commission would also handle exemption determinations).

rather than through enforcement efforts.[120] In a paper prepared for a 1970's blue-ribbon panel that generally supported such a commission, Marion Fremont-Smith, then a private practitioner in Boston and now a Senior Research Fellow with the Hauser Center for Nonprofit Organizations at Harvard University, and Adam Yarmolinsky, then a University of Massachusetts professor, provided perhaps the most detailed account of how such a commission might be organized and what functions it would serve.[121] As a structural matter, Fremont-Smith and Yarmolinsky envisioned that the commission would be an independent federal agency, organized outside the confines of any of the cabinet departments, with a chief executive officer selected by the commission itself. The commission would include representatives from federal, state and local government, from the executive and legislative branches, and from the general public. Once established, the commission would appoint an advisory council of up to one hundred members representing a broad cross-section of the charitable sector. The commission would also hire a small staff to handle its daily activities, while relying primarily on outside consultants to conduct major studies and prepare reports.

As a functional matter, the proposed advisory commission would serve as an information source and a clearinghouse for the charitable sector, collecting and disseminating useful information for charities and their advisors. In addition, the proposed advisory commission would have authority to issue non-binding fiduciary standards for the sector and serve as a

120. For example, in 1969, the Peterson Commission recommended the creation of a National Advisory Board on Philanthropy to evaluate the performance of charities and to make recommendations on how to improve the regulation of the charitable sector. *See* COMMISSION ON FOUNDATIONS AND PRIVATE PHILANTHROPY, FOUNDATIONS, PRIVATE GIVING, AND PUBLIC POLICY 181–88 (1970) [hereinafter PETERSON COMM'N REP.]. In 1977, the Filer Commission recommended the creation of a permanent quasi-governmental national commission on the non-profit sector). *See* COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 191–93 (1975) [hereinafter FILER COMM'N REP.]. In the research papers prepared for the Filer Commission, Donald Spuehler also suggested the creation of a temporary national commission to conduct research regarding the charitable sector, perform a survey of state attorneys general enforcement efforts, and explore means of improving the regulation of charities. *See* FILER RESEARCH PAPERS, *supra* note 118, at 3045. Alan Pifer, as well as Thomas Troyer and John Noland, also recommended the establishment of a new federal oversight body. *See id.* at 3080. Commentators have also put forth a number of other proposals for federal-level reform. *See, e.g.*, Keating & Frumkin, *supra* note 12, at 12–13 (recommending the establishment of an independent accounting board to audit financial reports from charities).

121. *See* Adam Yarmolinsky & Marion Fremont-Smith, *Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy*, *in* FILER RESEARCH PAPERS, *supra* note 118, at 2857. Their article was a valiant although ultimately unsuccessful attempt to develop a proposal that was satisfactory to all of the Filer Commission members. ELEANOR L. BRILLIANT, PRIVATE CHARITY AND PUBLIC INQUIRY: A HISTORY OF THE FILER AND PETERSON COMMISSIONS 130 (2000). Fremont-Smith now generally supports maintaining and strengthening the existing regulatory structure, including the current role of the IRS. *See* FREMONT-SMITH, *supra* note 22, at 465.

watchdog to review the work of state and federal regulators. While such a commission would lack the authority to promulgate and enforce binding rules, it would serve as an advocate for the sector and help to strengthen the sector's compliance with state and federal laws. Such a body would not have regulatory powers, however. Furthermore, in many ways the role of such a body has been assumed by Independent Sector, which, while not having express federal government blessing or backing, has taken on in large part research, education, and advocacy roles for the charitable sector as a whole.[122]

3. Self-Regulatory Reforms

In addition to government oversight of the charitable sector, some commentators have recommended the use of self-regulatory mechanisms to improve the governance of charitable organizations.[123] At present, there are numerous standards-setting bodies active in the non-profit sector,[124] but most have voluntary membership requirements, lack meaningful enforcement authority, and cover only a limited segment of the charitable sector.[125] Despite these present shortcomings, many commentators recognize that the sector itself has a strong incentive to promote good governance, and that self-regulatory approaches, if properly designed, might provide the most effective means of enforcing fiduciary standards.[126] Described below are two very different, but important, self-regulatory proposals that offer unique alternatives to federal and state regulation of the charitable sector.

a. Expanding Standing in State Courts (Manne)

In an article published in 1999, Geoffrey Manne, then a John M. Olin Fellow at the University of Virginia School of Law, argued that charities

122. The Filer Commission's recommendations lead to the creation of Independent Sector in 1980 once it became clear that the preferred quasi-governmental body would not be created. *See* BRILLIANT, *supra* note 121, at 144–45.

123. *See, e.g.*, Fleishman, *supra* note 4, at 186–87 (recommending the creation of a non-governmental oversight and enforcement agency).

124. For a description of the most prominent self-regulatory organizations already operating in the non-profit sector, see THE NAT'L CTR. ON PHILANTHROPY & THE LAW, STUDY ON MODELS OF SELF-REGULATION IN THE NONPROFIT SECTOR (2005) [hereinafter NCPL STUDY], *available at* http://www1.law.nyu.edu/ncpl/pdfs/Self%20Regulation%20Final%20Report-040307updates.pdf.

125. The Council on Foundations, for example, is an important membership organization that requires its members to subscribe to and follow a set of Principles and Practices for Grantmakers, but membership is voluntary, the Principles and Practices for Grantmakers are not legally enforceable, and the Council on Foundations rarely sanctions its members for failure to comply with such standards. *Id.* at 8.

126. *See, e.g.*, Fleishman, *supra* note 4, at 183 (explaining the importance of good governance to the reputational integrity of the sector and arguing that the sector needs to "redouble its efforts to police itself").

could be regulated more effectively by private actors who had standing to sue rather than by public officials who had regulatory enforcement powers.[127] Manne proposed the creation of private, for-profit companies that would monitor charities and, if necessary, bring relator suits against them, using the threat of litigation to encourage directors and officers to fulfill their fiduciary duties.[128] Under Manne's proposal, a charitable organization would contract with a for-profit company, and pay the company a fee to monitor the financial and charitable aspects of its operations.[129] Pursuant to the terms of the contract, the monitoring company would have the right to sue the charity if it violated its charter or if its directors or officers breached their fiduciary duties.[130] If the monitoring company failed to appropriately protect the interests of the organization, the directors could terminate its contract and replace it with another monitoring company.

In essence, these monitoring companies would act as private attorneys general with the power to uphold a charity's charter by monitoring for violations and enforcing the charity's charter in arbitration or in court. As private attorneys general, contract plaintiffs would serve as clearinghouses for complaints against the charities they regulate, and would effectively represent the interests of the charity's donors and beneficiaries in court.[131] Through the use of relator suits, Manne argued that monitoring companies could improve accountability within the charitable sector, and could do so without subjecting charities to frivolous suits from the public or imposing any significant costs on state or federal governments.[132]

127. Manne, *supra* note 14, at 253; Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2037–38 (2007) (in the context of a proposal to permit for-profit entities to be eligible to receive the tax benefits available to charities, arguing that private auditing and litigation may be as or more effective than government regulation to ensure charity accountability, including adherence by charity managers to their fiduciary duties). *See also supra* notes 82–85 and accompanying text for additional information about standing to sue.

128. *See* Manne, *supra* note 14, at 253.

129. *Id.*

130. Manne argued that a contract plaintiff would have standing to sue because, to the extent the charity violated its charter it would also be breaching its contract with the for-profit company. *Id*. Manne acknowledged that "some judges would consider the inclusion of a nonprofit's purpose clause in the contract as merely an attempt by the parties to waive into court and avoid standing limitations." *Id.* at 254. To solve this problem, Manne suggested that the charity remove the purposes clause from its charter and include its purpose clause on its contract with the for-profit company. *Id*. Manne did not explain how a charity that has no purpose clause in its organizing document would qualify for exemption under Section 501(c)(3) the Internal Revenue Code. *See* I.R.C. § 501(c)(3)-1(b)(1)(i).

131. *See generally* Manne, *supra* note 14, at 252–54.

132. The use of realtor suits has also been proposed in the for-profit context. *See* Mark Latham, *The Corporate Monitoring Firm*, CORPORATE GOVERNANCE, Jan. 1999, at 14, *available at* http://www.cema.edu.ar/cegopp/download/TheCorporateMonitoringFirm.pdf.

b. Self-Regulatory Organization (Owens)

In contrast to Manne's free-market approach, Marcus Owens, a former director of the IRS's Exempt Organization Division, proposed the creation of a new, quasi-public/private federal oversight entity that would work in conjunction with the IRS in a manner similar to the relationship between the Securities and Exchange Commission (SEC) and the former National Association of Securities Dealers (NASD) (now called the Financial Industry Regulatory Authority).[133] By virtue of its relationship with the IRS, the oversight entity would have the ability to sanction those who transgress its rules, but it would not be structured as part of the federal government. Instead, the new oversight entity would be chartered by Congress as a tax-exempt organization under Code Section 501(c)(1), and would be supported primarily by user fees and payments from private foundations, which would be given a credit against the excise tax on net investment income under Code Section 4940 for payments made to the oversight entity.[134] To ensure that its independence would not result in it being captured by the charitable sector, the governing body, or a majority of the governing body, would be appointed by the Commissioner of the Internal Revenue Service and the National Association of Attorneys General. Minority members or advisors would be appointed by the majority and minority leaders of the Senate or the Senate Finance Committee.[135]

As a body whose authority would not have to flow exclusively from the Code, the oversight entity could regulate the charitable sector without being constrained by the limits of federal tax law. In this way, the entity would serve as a sort of a national, private attorney general with the power to conduct examinations of charities and issue sanctions, including revocation of exempt status.[136] The oversight entity would also have authority to promulgate rules that govern both charities and their advisors, much as

133. *See* Owens, *supra* note 12, at 10–15. In a release dated July 26, 2007, the SEC announced that it had approved the transfer of NYSE, Inc.'s regulation and enforcement functions and employees to the NASD and had also approved a proposed rule change allowing NASD to amend its bylaws to implement certain governance changes. The SEC also announced that the proposed rule change would allow NASD to change its name to the "Financial Industry Regulatory Authority," a new self-regulatory organization under the Securities and Exchange Commission. *See* SEC Release No. 34-56145, *available at* http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

134. *See* Owens, *supra* note 12, at 11–12. As an alternative funding mechanism, Owens recommended the use of a licensing process for charities and private foundations over a certain size or according to a sliding scale to reduce the burden on smaller organizations. *Id.* at 12. He also recommended that user fees currently paid to the U.S. Treasury be channeled to the oversight entity. *Id.* at 13.

135. *See id.* at 12.

136. Owens suggested that, as with NASD enforcement actions, adverse findings by the entity could be appealed to the IRS or to the courts. *See id.* at 11.

Circular 230 governs practice before the IRS, but subject to approval by the IRS.[137]

Owens argued that the oversight entity's independence would allow it to overcome "the idiosyncratic limitations inherent in using systems and procedures developed to administer the tax-collecting provisions of the Internal Revenue Code."[138] For example, the new entity would be empowered to require certain charities to file quarterly financial reports and coordinate enforcement efforts with state attorneys general.[139] It would also be able to pay true market-rate compensation and recruit employees based on needs rather than federal budgeting cycles.[140] Likewise, the organization would be freed from the constraints of federal contracting requirements and would be able to implement state-of-the-art systems that would enhance its regulatory effectiveness.[141] These advancements, argued Owens, would help to "address the inefficiencies and anomalies that have been exposed by 35 years of experience with the current system."[142]

As the above discussion demonstrates, there is no lack of ideas for improving charity oversight through improved government or private oversight. What is lacking, however, is a systematic methodology for choosing among the many possible options. The next part develops such a methodology, drawing on the developing area of institutional choice theory.

II. AN INSTITUTIONAL CHOICE FRAMEWORK

The current charity governance situation is fertile ground for application of institutional choice theory. In general, institutional choice theory asserts that to determine appropriate public policy it is not enough to define the desired public policy goal. It is also important to decide who—that is which institution—will be tasked with pursuing that goal. To make that decision requires comparing the available institutions, all of which are "imperfect alternatives" in that they will each have their strengths and weaknesses with respect to the task at hand.[143] The challenging but necessary task of an institutional choice analysis is therefore to analyze those strengths and weaknesses to determine, if possible, which institution is best suited to pursue the stated goal.

137. *Id.* at 13.
138. *Id.* at 14.
139. *Id.*
140. *Id.* at 15.
141. *Id.*
142. *Id.*
143. *See generally* KOMESAR, *supra* note 15, at 5.

With respect to charitable governance, there is relative consensus regarding the goal of ensuring compliance by charity directors, trustees, and officers with their generally agreed upon fiduciary duties, not only among scholars but also among policy makers and even within the charitable community.[144] The absence of such a consensus would otherwise require us to consider both goal choice and institutional choice to determine the appropriate laws and public policy.[145] The institutional choice issue remains, however, because there is a great disparity of views regarding which institution or institutions should determine what specific actions are required to fulfill those duties and should enforce those duties—*i.e.*, which institution(s) is best suited to achieve the greatest level of compliance with these duties through rulemaking *and* enforcement.[146] While such an entity could serve in other roles as well, such as mobilization, agenda setting, and information gathering,[147] we focus on rulemaking and enforcement because those are the roles that are most commonly seen as not being fulfilled in the current system.[148] While commentators have in the past expressed concern about the fulfillment of these other roles, the maturation of private groups, as illustrated by Independent Sector and its organization of the Panel on the Nonprofit Sector, and the growing availability of information about charities both because of increased and more effective data collection by the IRS and the distribution of such data by the private nonprofit entity Guidestar USA, Inc. have reduced concerns about these functions.[149]

Given these rulemaking and enforcement roles, we can then develop relevant considerations for determining the best institution to accomplish each role. For these purposes, available institutions include governmental

144. *See supra* Part I.B.

145. *See* KOMESAR, *supra* note 15, at 5 (noting that both goal choice and institutional choice are required to determine the appropriate public policy in a given area); *see also* Thomas W. Merrill, *Institutional Choice and Political Faith*, 22 LAW & SOC. INQUIRY 959, 965 (1997) (reviewing NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994)).

146. *See infra* Part III.

147. *See generally* JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 2–3 (2d ed. 2003) ("Though a drastic oversimplification, public policy making can be considered to be a set of processes, including at least (1) the setting of the agenda, (2) the specification of alternatives . . . , (3) an authoritative choice among those specified alternatives . . ., and (4) the implementation of the decision."); Jeb Barnes, *In Defense of Asbestos Tort Litigation: Rethinking Legal Process Analysis in a World of Uncertainty, Second Bests, and Shared Policy-Making Responsibility*, 34 LAW & SOC. INQUIRY 5, 6 (2009) (listing these three roles along with rule making as constituting policy making).

148. *See supra* notes 82–85 and accompanying text.

149. *See generally* GuideStar Home Page, http://www2.guidestar.org/ (last visited Mar. 23, 2010) (providing free access to annual information returns filed by charities and other tax-exempt organizations with the IRS); About the Panel on the Nonprofit Sector, http://www.nonprofitpanel.org/about/Index.html (last visited Mar. 23, 2010) (describing the formation and work of the Panel on the Nonprofit Sector).

bodies at both the state and federal levels as well as self-regulation by the charitable community or by interested individuals through the courts, but do not include other, more informal structures because assigning either a rulemaking or enforcement role to such informal structure would be difficult as a legal matter.[150] The same institution may be responsible for both rulemaking and enforcement, in which case it has to be evaluated under both set of criteria. Or either function might be divided among multiple institutions requiring consideration of more than one entity under one or both set of criteria. These various permutations will be considered in the next part, once we have established the analytical framework.

There are five important caveats to this framework. First, implicit in the acceptance of this goal are certain institutional choice assumptions: that the existence of charities furthers one or more fundamental, generally accepted societal goals (*e.g.*, liberty of one or more types, equality along one or more dimensions, efficiency), and that charities will better further such goals if their leaders fulfill these duties.[151] These assumptions feed into the criteria chosen, as issues such as capture and accountability in rulemaking rest on an assumption that representational equality and participation is desirable, while cost-benefit issues such as efficiency and compliance burden rest on an assumption that efficiency is desirable. None of these assumptions is particularly controversial, and so it is beyond the scope of this article to explore them.[152]

Second, the relevant considerations for each role could be divided or characterized in ways other than the labels and categories chosen here. For example, certain labels we use, like "expertise" and ability to "coordinate," could instead be characterized as "substantive and structural competence"[153] or as aspects of "efficiency" respectively, while our terms "capture" and "accountability" could also be characterized as "principal/agent issues" or "democracy concerns."[154] The key question is therefore not what

150. This difficulty may explain why law professors tend to concentrate on a "narrow" definition of the term institution. *See* Benjamin H. Barton, *An Institutional Analysis of Lawyer Regulation: Who Should Control Lawyer Regulation-Courts, Legislatures, or the Market?*, 37 GA. L. REV. 1167, 1176 (2003) (noting that legal scholars normally limit the available institutions to formal governmental entities and the market).

151. *See, e.g.*, Ingram, *supra* note 1, at 3 ("[A] tax-exempt charity should actually provide charity; it should provide some meaningful and measurable benefit or service to the public.").

152. For a recent discussion of the various societal goals that charities may further, see generally Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505 (2010).

153. *See generally* Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM J. CORP. & FIN. L. 225, 262–64 (2005) (discussing these two aspects of competence).

154. *See, e.g.*, Barton, *supra* note 150, at 1177 (in the context of lawyer regulation, focusing on three goals when making an institutional choice: limiting the potential for rent-seeking; maximizing

exact labels or categories should be used but instead whether the criteria selected, however identified and categorized, cover the issues that should be considered when making an institutional choice. This part draws upon the existing institutional choice literature, as well as the regulation of nonprofit and charity governance scholarship, to develop a framework that meets this requirement.

Third and similarly, the relevant considerations do not easily lend themselves to either pinpoint determinations or easy comparative weighting, particularly when new, as opposed to existing, institutions are under consideration. For example, it is sometimes too difficult to measure "expertise" or "efficiency," much less to decide how the advantages of a certain level of expertise should weigh against a certain lack of efficiency. These difficulties, which are inherent in almost any institutional choice analysis, do not mean engaging in such an analysis is always or even often doomed to be futile, but they do mean that the results of such an analysis necessarily have a certain degree of uncertainty.

Fourth, we are avoiding perhaps the most difficult issue for institutional choice analysis: *who decides who decides?*[155] In one sense we are answering this question by the very writing of this article, in that we as authors are seeking to make this institutional choice. But unless the relevant policymakers are overwhelmed by our brilliant analysis—the almost never fulfilled dream of scholars everywhere—this institutional choice decision rests not with us but with those very policymakers, who may or may not be part of the institution best suited to make that choice. To engage that decision would, however, require an entirely different analysis that is beyond the scope of this article. In the last part of this paper, however, we will address the practical realities of attempting to implement our proposed institutional choice.

Finally, both because this part draws heavily on a previously developed institutional framework and in the interests of not unnecessarily lengthening the article, we have chosen to limit the footnoting in this part. For a more comprehensive set of references, interested readers should see

procedural efficiency; and democratization); Francesco Parisi, *Sources of Law and Institutional Design of Lawmaking*, 19 J. PUB. FIN. & PUB. CHOICE 95, 95–96 (2001) (identifying three institutional design criteria when choosing between institutional sources of law: minimization of agency problems; minimization of rulemaking costs; and the stability and transitivity of collective outcomes).

155. *See* Merrill, *supra* note 145, at 991–93 (identifying this issue in a book review of Professor Komesar's book, and suggesting that it may create an insoluble dilemma); Neil K. Komesar, Commentary, *The Perils of Pandora: Further Reflections on Institutional Choice*, 22 LAW & SOC. INQUIRY 999, 1007 (1997) (in response to Professor Merrill, noting this issue but concluding that depending on the issue at stake, a good institutional choice decision might come from any number of different institutions).

the article that is the main source of the framework that forms the basis for this part.[156]

A. Authority

A threshold issue for any proposed rulemaking or enforcement institution is whether that institution has the requisite legal authority to make rules in the relevant subject matter area. At first glance this criterion might appear to unnecessary for an institutional choice analysis focused on lawmaking, as any legal limitations on a given institution's authority could potentially be changed as needed. But this criterion is still relevant because it may be unrealistic to believe that such a change could be made. For example, if the Constitution bars Congress from exercising rulemaking authority in a certain area based on established Supreme Court precedents, a constitutional change to grant such authority would often not be remotely possible in the foreseeable future. In this situation, Congress' lack of current or plausible future legal authority would remove Congress from the list of viable institutional options. The issue of authority is particularly important in the context of charity governance because historically it has resided at the state level, so that the authority of the federal government over charity governance is not immediately obvious.

A related issue is that of federalism. Regardless of whether the federal government may be able to exercise authority over a given area under existing Supreme Court precedents, it would seem generally desirable when determining whether the federal government should exercise such authority to consider the general architecture of our constitutionally established, federated system of government.[157] All other things being equal, an assignment of authority that was consistent with federalism would therefore, under this reasoning, be desirable.

B. Rulemaking

Assuming that a proposed institutional choice for rulemaking has or has a reasonable chance of obtaining the requisite authority, then the question turns to whether that choice is the best of the choices available to perform that function. For the reasons detailed in this section, the relevant criteria for choosing among possible rulemaking institutions are *expertise*, *coordination*, *capture*, *accountability*, and *funding*.

156. *See generally* Mayer, *supra* note 20.

157. *See, e.g.*, Fishman, *supra* note 3, Part V.

1. Expertise

Expertise refers to the knowledge that a rulemaking institution has of the subject matter at issue, including whether such knowledge could be easily obtained to the extent it does not already exist (*i.e.*, the cost of acquiring necessary information). Such expertise might be evidenced by previous experience enacting rules in the relevant area, conducting relevant hearings or other investigations, or staffing by individuals with appropriate backgrounds. For example, a legislature with a committee that has made laws in a given area for many years presumably would have greater expertise with respect to that area than a legislature that lacked a committee or subcommittee with such experience. An institution with greater expertise is preferable, all other things being equal.[158]

2. Coordination

To the extent that a relevant subject matter area or regulated community is overseen by more than one institution, coordination refers to the ability of an institution to coordinate its rulemaking with rulemaking by such other institution(s). For example, when the Treasury Department issued a list of voluntary best practices for charities engaged in overseas charitable activities in the wake of 9/11, at least one commentator raised concerns that those recommendations might be inconsistent with existing state-level legal requirements.[159] Coordination also refers to the ability of an institution to coordinate its rulemaking with rules in related areas, *i.e.*, rules that reach the same activities or persons, that could influence the effectiveness of that rulemaking.[160] The possible level of coordination could be determined by the historical record of coordination by the same institution on other topics, or by general trends with respect to coordination among institutions of a similar type. For example, there is significant evidence that government agencies are relatively effective at coordinating

158. *See, e.g.*, David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 985–986 (2004) (noting that greater expertise normally allows and individual or organization to perform the same activity more rapidly, more accurately, or otherwise better).

159. COUNCIL ON FOUNDATIONS, COMMENTS ON U.S. DEPARTMENT OF THE TREASURY ANTI-TERRORIST FINANCING GUIDELINES: VOLUNTARY BEST PRACTICES FOR U.S.-BASED CHARITIES 10 (2003), *available at* http://www.cof.org/files/Documents/Legal/Treasury_Comments_06.03.pdf; *see also* COUNCIL ON FOUNDATIONS, COMMENTS ON REVISED U.S. DEPARTMENT OF THE TREASURY ANTI-TERRORIST FINANCING GUIDELINES: VOLUNTARY BEST PRACTICES FOR U.S.-BASED CHARITIES 8–9 (2006), *available at* http://www.usig.org/PDFs/Comments_to_Treasury.pdf (also raising this concern with respect to a revised version of the guidelines).

160. *See* Stuart Minor Benjamin & Arti K. Rai, *Fixing Innovation Policy: A Structural Perspective*, 77 GEO. WASH. L. REV. 1, 21–23 (2008) (providing examples of inter-agency conflicts relating to use of the Internet for voice communications and to regulation of radio spectrum use).

within themselves (intra-agency) but relatively ineffective at coordination with other agencies (inter-agency), even other agencies within the same level of government, absent compelling outside pressures to cooperate.[161] Similarly, attempts by Congress to create joint authority at the federal level over a given area have had mixed results at best.[162] Greater ability to coordinate is generally preferable, to avoid both the development of inconsistent rules and the existence of unintended regulatory loopholes.

3. Capture

Capture refers to the extent to which a given institution is likely to be co-operated by one or more outside groups so as to issue rules that favor the interests of those groups instead of the stated goal of the rulemaking when those interests and the goal come into conflict.[163] For these purposes capture is an aspect of interest group theory, which posits that a relatively small, discrete group with concentrated interests may be able to able to unduly influence an institution that in theory is supposed to serve the more diffuse interests of the public generally.[164] The extent of vulnerability to capture depends both on the characteristics of the institution and on the characteristics of the outside parties, as some parties may be more inclined to engage in capture than others. For example, congressional tax-writing committees may be more resistant to capture than other subject-matter specific committees such as agricultural committees because the former tend to attract the attention of many, diverse constituencies while the latter are usually the focus of far fewer, less diverse groups.[165] As capture results in subordination of the stated goal to the interests of certain parties, it is generally undesirable.

4. Accountability

Accountability, like capture, is another measure of the extent to which a rulemaking institution is responsive to its purported principal—that is, the

161. *See generally* CRAIG W. THOMAS, BUREAUCRATIC LANDSCAPES: INTERAGENCY COOPERATION AND PRESERVATION OF BIODIVERSITY 276–79 (2003) (explaining how a combination of potential litigation exposure and scientific consensus encouraged cooperation among government officials that probably would not otherwise have occurred).

162. *See* Mayer, *supra* note 20, at 654–55 n.135 (listing articles).

163. *See* Benjamin & Rai, *supra* note 160, at 35 (highlighting the capture concern, as well as noting that specialized institutions may develop "tunnel vision" that causes them to lose sight of the costs particular choices may impose on society as a whole).

164. *See generally* Merrill, *supra* note 145, at 960–61 n.2 (describing the recent history of academic thought regarding capture by interest groups).

165. Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1177 (1993).

public or the relevant subset of the public. While capture focuses on whether an institution is being unduly influenced by a relatively small outside group or groups, accountability focuses on whether an institution's internal actors are responsive to the majority or the public generally (which may serve as a counter-balance to capture[166]).

Indicators of accountability include the extent to which the institution's rulemaking activities are visible, the public meaningfully participates in the rulemaking process, the institution's internal actors have other incentives to pursue the stated goal of the rulemaking as opposed to goals such as ensuring their own job security or authority, and the internal decision making process takes into account the preferences of the public.[167] Relevant factors for the last indicator include whether the institution has either sole responsibility for regulating a particular area or has regulation of that area as its sole responsibility as opposed to having other responsibilities.[168] Accountability is generally desirable. It can, however, be a negative factor when control by the majority results in institutional choices that favor the majority even when the total benefit to the majority is less than the harm caused to the minority, an undesirable "tyranny of the majority" result.[169] In this respect, capture and accountability are both aspects of who participates in the decision-making by a particular institution—distinct, organized groups representing a minority and the majority, respectively.[170]

5. Funding

A final, necessary consideration, particularly given the current financial status of both the private sector and governments, is the extent to which the institution has sufficient funding to accomplish its rulemaking role. While in theory any rulemaking institution could be fully funded, there may be practical or political realities that make certain institutions

166. *See* KOMESAR, *supra* note 15, at 65–66 (developing what he refers to as a "two-force" model).

167. *See, e.g.*, Parisi, *supra* note 154, at 100–01 (noting that resolving principal/agent problems with respect to political representatives requires either alignment of the representatives' incentives with those of the represented citizens or else effective monitoring and accountability, and that even if there are no principal/agent problems, distortions can occur if the process for aggregating perfectly represented individual preferences (*i.e.*, the political bargaining process) is not sufficiently responsive to those preferences).

168. *See generally* Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 617–18, 633–35 (2005) (noting that shared responsibility for regulating charities may leave both agencies pointing to the other as the responsible party, with an alleged misdeed thereby escaping investigation).

169. *See generally* KOMESAR, *supra* note 15, at 65–66. While Professor Komesar discusses majoritarian bias only with respect to the political system, it also may be manifested in other institutions. *See* Merrill, *supra* note 145, at 983 (making this point in a review of Professor Komesar's book).

170. *See* KOMESAR, *supra* note 15, at 65–66 (arguing for the need to consider both minoritarian and majoritarian influence).

more likely to receive needed funding than others. For example, one institution might have a dedicated funding source that is relatively stable while another institution might have to compete with other entities for a share of a fixed or even shrinking revenue pie. Alternatively, an existing institution might already have a demonstrated revenue stream dedicated to the rulemaking function at issue. Sufficient and stable funding is preferable.

C. Enforcement

Whether the same or a different institution (or institutions) has responsibility for enforcement of the rules previously enacted, a different set of criteria apply to determine the relative advantages and advantages of various institutions with respect to such enforcement. Those criteria are *effectiveness*, *compliance burden*, *arbitrage*, and *funding*.

1. Effectiveness

Effectiveness refers to the institution's ability to ensure compliance with the relevant rules. It may be measured by the extent to which the institution reviews such compliance, the sanctions available to that institution, and, to the extent it exists, the track record of the institution or similar institutions with respect to enforcing rules in the relevant area or a similar area. The division of enforcement responsibilities between multiple institutions may also raise effectiveness issues. For example, with respect to charities various commentators have raised concerns about the ability of the IRS to coordinate its enforcement activities with state-level entities, primarily attorneys general, because of both limitations on information sharing and other barriers.[171] Greater effectiveness is generally desirable.

2. Compliance Burden

At the same time, the compliance burden on the regulated community is relevant. This burden arises in many forms, including the costs of learning the applicable rules, ensuring compliance with those rules, and responding to enforcement efforts. These costs are likely to increase if rulemaking and/or enforcement responsibility is divided among multiple institutions, which at a minimum requires a regulated party to become familiar with two or more institutions and two or more sets of rules and/or enforcement procedures. If coordination between the multiple institutions is lacking, the compliance burden also reflects the cost of attempting to rec-

171. *See, e.g.*, PANEL FINAL REP., *supra* note 2, at 25 (recommending increased sharing of information between the IRS and state charity oversight officials).

oncile what may be contradictory demands. Greater compliance burdens lead not only to greater costs to the regulated community but often less compliance with the applicable rules. A lower compliance burden is therefore preferable.

3. Arbitrage

If multiple sets of rules exist, the possibility arises that members of the regulated community may be able to choose among the rules in a manner that undermines the accomplishment of the underlying goal of the rules. For example, in the for-profit corporation context some scholars have asserted that large, publicly traded companies mostly choose to incorporate in Delaware because it favors management interests over those of shareholders.[172] All other things being equal, the existence of such regulatory arbitrage opportunities is not desirable since they weaken the regulatory structure and, in the worst case scenario, result in a "race to the bottom" between competing rulemaking and enforcement institutions.

4. Funding

The availability of funding for enforcement is also an important consideration, as it was with respect to the rulemaking function. As with rulemaking, a sufficient and stable level of funding is desirable. Such a level may be demonstrated by historic funding either for the institution at issue's enforcement functions or by the ability to create funding mechanisms that have been successful in similar contexts.

D. Transition Costs

A final consideration for an institutional choice analysis, especially where the analysis must consider not only new roles for existing institution but possibly entirely new institutions, is the transition costs associated with any institutional choice that departs from the status quo.[173] While a one-

172. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits of State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1438, 1444 (1992); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 697–98 (1974). Not all scholars agree that this incorporation choice has negative outcomes. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–16 (1993); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1064 (2000) (asserting that Delaware is the incorporation place of choice because of reliance on judge-made corporate law that results in "flexibility, responsiveness, insulation from undue political influence, and transparency.").

173. *See* Benjamin & Rai, *supra* note 160, at 32 (noting that when making institutional choices, the costs of change from the existing structure should be considered).

time occurrence, such costs may make the difference between otherwise closely matched institutional choices. Relevant factors with respect to transition costs include the costs associated with instituting new roles and/or creating new institutions, with educating the regulated community about any new roles or institutions, and the costs associated with the uncertainty created by any transition. Such costs may be particularly high if the new roles or institutions go against long-established divisions of federal versus state authority.[174] While the "distance" a particular choice is from the status quo is one relevant consideration, it may in some instances be easier (i.e., less costly) to create a new entity than to try to change an existing one. On the other hand, creating a new entity may result in unexpected transition costs. For example, the recent decision by Congress to create a new "Public Company Accounting Oversight Board" to oversee the auditors of public companies as opposed to granting the existing Securities Exchange Commission this authority has had a variety of costs, not the least of which has proven to be the litigation and uncertainty costs arising from the need to defend this new entity's authority in court.[175]

III. APPLYING THE FRAMEWORK

Having developed an institutional choice framework, we can now apply that framework to the range of possible options for overseeing charity governance. This Part first considers possible state government institutions, then possible federal government institutions, and finally two different self-regulatory options. In the course of each of these discussions reference will be made to the proposals discussed previously,[176] but we will not limit the discussions to only those proposals.

We end with our conclusion that the institutional choice that appears to have the greatest strengths and the fewest weaknesses is a state government institution that, as Fishman has proposed, builds on the existing authority, expertise (in those states where it exists), historic role of state authorities with respect to charities, and other strengths of state legislatures and Attorneys General offices.[177] At the same time and drawing on Karst's

174. *See* Thomas W. Merrill, *Ordering State-Federal Relations Through Federal Preemption Doctrine: Preemption and Institutional Choice*, 102 NW. U. L. REV. 727, 748–49 (2008) (in the context of preemption doctrine, identifying this concern as recognizing the importance of stability in the federal/state division of authority).

175. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 537 F.3d 667 (D.C. Cir. 2008), *cert. granted*, 129 S. Ct. 2378 (2009) (No. 08-861) (lawsuit challenging the constitutionality of this new entity).

176. *See supra* Part I.C.

177. *See* Fishman, *supra* note 43, at 594–98.

proposal, such an institution should have relatively broad rulemaking and enforcement powers, as well as sufficient independence to ensure both a single-minded focus on charity governance (thus enhancing accountability) and a significant degree of freedom from the political considerations that understandably tend to govern—and may skew—AG decisions.[178]

For reasons that will become clear, such an institution should not be particularly vulnerable to capture or intentional arbitrage, should be relatively effective in its enforcement, and will not generate as large compliance burdens or transition costs as most of the other institutional choices. That said, it will suffer from four weaknesses: lack of sufficient funding for both rulemaking and enforcement; coordination problems, particularly with similar institutions in other states and federal authorities such as the IRS; the lack of political will to establish such an entity in at least some states; and the related problem of unintentional arbitrage, as charities incorporated or otherwise created in different states could face regulatory regimes with varying effectiveness if many states do not create the proposed new institution. We will address how these weaknesses might be addressed in Part IV.

A. State Government Options

Even with the recent congressional and IRS ventures into charity governance, oversight of charity governance still primarily rests at the state level and usually with the Attorney General.[179] Responding to the identified problems with this current arrangement, state-level reform proposals have ranged from requiring more disclosure of information by charities to creating advisory bodies with certain limited authority to creating new, independent entities dedicated to overseeing charities.[180] All of these options have the advantage of drawing on existing legal authority and expertise, but they vary significantly in their capacity for coordination, accountability, and effective enforcement, as well as with respect to their funding requirements, compliance burdens, and transition costs.

With respect to the threshold issue of authority, any state government institution could either draw upon the existing oversight authority that normally resides with the state legislature and the Attorney General or could be granted such authority by the state legislature. In fact, most state

178. *See* Karst, *supra* note 11, at 478.

179. *See supra* note 79 and accompanying text.

180. *See, e.g.*, TAYLOR, *supra* note 5, at 136–38 (recommending requiring the registration and annual reporting of most charitable endowments to state attorneys general); Ben-Ner & Van Hoomissen, *supra* note 48, at 409 (proposing the creation of state "offices for nonprofit organizations" to support their proposed stakeholder system, with responsibilities including enforcing compliance with nonprofit governance laws).

legislatures have over the years confirmed by statute the Attorney General's common law authority over charities.[181] With this authority comes access to a broad range of potential sanctions. Over time, however, Congress has increased the federal government's sanction options. For example, Congress has authorized financial penalties known as intermediate sanctions on charity insiders who receive improper economic benefits.[182] Moreover, state legislatures themselves clearly have the authority to impose specific governance requirements on charities formed under the laws of their states, although it is less clear whether they have similar authority with respect to charities operating within their states but formed elsewhere.[183] Leaving such authority with the states would also be consistent with federalism and the historic regulation of charity governance. That said, state legislatures have shown a reluctance to change the status quo with respect to either the substance of such requirements or the entity charged with enforcing them, a point we will return to in Part IV.[184]

As compared to Congress, state legislatures and their staffs likely have more expertise with respect to governance issues, both for nonprofit and for-profit entities, because laws governing such issues are primarily, although not exclusively, the province of state legislatures as opposed to Congress.[185] With respect to nonprofit governance provisions, state legislative committees regularly consider proposals containing such provisions, such as the Model Nonprofit Corporation Act and its later editions and the

181. *See* FREMONT-SMITH, *supra* note 22, at 306 (noting that thirty-seven states grant such authority to the attorney general by statute, although with limitations in a few instances).

182. *See supra* note 9 and accompanying text.

183. *See* FREMONT-SMITH, *supra* note 22, at 323–24 (noting the ongoing uncertainty regarding whether the controlling laws governing the "internal affairs" of a nonprofit corporation are always those of the state under which's laws the nonprofit corporation was formed). *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. e (1971) (describing why matters involving "a corporation's organic structure or internal administration" are generally governed by the laws of the state of incorporation).

184. *See* FREMONT-SMITH, *supra* note 22, at 363 (noting that state legislatures generally lack interest in charity governance and so usually only act when facing "forceful presentations from several sources"); *id.* at 375 (noting that in over forty years only three states adopted legislation enhancing state enforcement powers while at the same time other states repealed or curtailed such efforts).

185. *See, e.g.*, Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1072–75 (2008) (explaining how state law primarily governs the internal affairs of corporations, with federal (securities) law usually only playing a role when a corporation seeks to enter the public capital markets); Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 40–41 (2004) (discussing the historical although now challenged split of responsibilities between the state corporate law and federal securities law); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596–97 (2003) (there is an "informal line" between state corporate law and federal securities law, although that line is sometimes breached, particularly with respect to publicly traded companies).

Uniform Unincorporated Nonprofit Association Act.[186] It should also not be presumed that the lack of much recent state legislative action with respect to expanding or clarifying governance standards reflects a lack of such expertise; as commentators have noted, it is far from certain what specific governance practices or changed standards would actually improve actual governance.[187] Similarly, at least those Attorneys General offices that have created a dedicated charity bureau have also presumably developed at least some expertise with such issues, expertise that likely has been further developed through the National Association of State Charity Officials and the Charities Law Project that is part of Columbia Law School's National State Attorneys General Program.[188] Retaining governance authority at the state level would therefore maintain access to this existing expertise both within the legislature and, for those states that have developed it and assuming any new entity is able to retain existing personnel, within the executive branch.

The lack of definitive information about what specific governance practices actually improve the governance of charities also suggests that taking advantage of existing state-level expertise is desirable for two reasons. First, a state-level option would be able to take advantage of all of the expertise that already exists at the state level, while a national or federal option could only take advantage of that expertise to the extent such an entity could gather the individuals and institutions with that expertise under its umbrella. Second, by having multiple regulators looking at a variety of specific governance practices and regulatory approaches, there is significant room for flexibility and experimentation to determine what does in

186. *See* FREMONT-SMITH, *supra* note 22, at 116 n.1 (noting that the latter Act has been adopted in eleven states); *id.* at 514–16 (listing state nonprofit incorporation acts, including the fact that thirty states have adopted either the Model Nonprofit Corporation Act (1952) or the Revised Model Nonprofit Corporation Act (1987), either as promulgated or in a modified form).

187. *See, e.g.*, Jeffrey A. Alexander et al., *Governance and Community Benefit: Are Nonprofit Hospitals Good Candidates for Sarbanes-Oxley Type Reforms*, 33 J. HEALTH POL., POL'Y & L. 199, 218–20 (2008) (based on a limited set of empirical data, concluding that there is little correlation between certain common governance reforms and the provision of certain representative community benefits by charity hospitals); Kathleen M. Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance*, 75 TENN. L. REV. 83, 136 (2007) (concluding that the much promoted concept of director independence as promoting better nonprofit governance is not supported by existing empirical evidence, although there charity boards should have at least a few independent directors who serve in a publicly identified "monitoring" role); Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 FORDHAM L. REV. 795, 831–32 (2007) (concluding that director independence, even if carefully defined, only makes a limited contribution to overall accountability in charity governance).

188. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 15, 17 & n.13 (noting that in almost all of the sixteen states reviewed, which are the home states for a majority of charities both by number and assets held, the attorney general has created a separate charities section or unit, with the sole exception being Florida where the charities unit is housed in the Department of Agriculture and Consumer Services instead).

fact work best given the current lack of data on this point and the diversity of the charitable sector.[189] The states that are already active in this area have in fact already demonstrated a willingness to explore innovative regulatory approaches.[190]

Both state legislatures and state executive branch bodies are also likely to be more accountable to the vast majority of charities that are primarily if not exclusively located in a single state than would any national body. At the same time, members of the public with an interest in such charities, whether as supporters, potential or actual beneficiaries, employees, or in some other way, would also likely be more able to hold state-level bodies accountable with respect to charity governance oversight.[191]

That said, a state-level body might be too accountable to the will of the majority as has been the repeated criticism of elected Attorneys General with respect to charity governance enforcement.[192] At the same time, the breadth of Attorney General responsibilities detracts from more general accountability for charity governance, effectiveness of enforcement, and funding for both enforcement and rulemaking because the AG can always plead convincingly that other important tasks trump charity governance oversight.[193] Addressing these weaknesses lies at the heart of Karst's proposal for a new state agency, separate from the AG, that he argues would also enjoy economies of scale and impose lower compliance burdens on charities and eliminate state-level coordination problems.[194] Karst down-

189. *See supra* note 187 and accompanying text.

190. *See* Biemesderfer & Kosoras, *supra* note 41, at 23–41 (describing in detail the different regulatory approaches used by Illinois, Michigan, New Hampshire, and Ohio).

191. *See, e.g.*, Karst, *supra* note 5, at 481–82. It is true that even relatively local charities may solicit contributions from residents of other states, but regulation of charitable fundraising is a separate issue. *See* FREMONT-SMITH, *supra* note 22, at 370–74, 424–25 (describing the status of such regulation); *id.* at 443 ("[Regulation of charitable fundraising] is far better staffed and managed in most states than the efforts to police fiduciary duties.").

192. *See generally* FREMONT-SMITH, *supra* note 22, at 464 (raising this concern with respect to Fishman's proposal); Karst, *supra* note 5, at 478–79; Manne, *supra* note 14, at 267 (raising this concern with new state or federal entities generally).

193. *See* Harvey P. Dale, *Diversity, Accountability, and Compliance in the Nonprofit Sector*, Norman A. Sugarman Memorial Lecture, Mandel Center for Nonprofit Organizations, Case Western Reserve University, Cleveland, Ohio (Mar. 20, 1991) 4, *available at* http://archive.nyu.edu/bitstream/2451/23385/2/HPD.TEO.CaseWest.91.pdf ("government regulators (and most particularly state Attorneys General . . .) tend to allocate their scarce regulatory resources to other more-politically-potent portions of their domains." (alteration added)); Marion R. Fremont-Smith, *Attorney General Oversight of Charities* 29 (Harvard University Hauser Center for Nonprofit Organizations, Working Paper No. 41, 2007), *available at* http://www.hks.harvard.edu/hauser/PDF_XLS/workingpapers/workingpaper_41.pdf ("[C]harity regulation competes with other duties of the attorney general, often having the lowest priority.").

194. Karst, *supra* note 5, at 477–78; *see also* Blasko, *supra* note 83, at 50–51 (describing steps various states have taken to supplement—but not supplant—the attorney general's responsibilities in this area by granting standing to bring enforcement actions in court to newly created commissions or

plays, however, the strengths that come with maintaining a significant AG connection, including existing authority and expertise.[195] He also wrote before the establishment of active charities bureaus within AG's offices in many of the largest states.[196] Given the existence of those bureaus, transition costs could be kept relatively low if the new state-level institution could be based on those existing staffs, which presumably would be easier if a connection with the AG's office remained.

Such a connection might also provide resistance to capture by charities or some powerful subset of charities (such as hospitals or universities) to advance their own interests and frustrate the pursuit of the broader public interest, although the risk of such captures appears to be relatively small for a variety of reasons. First, the charitable sector, unlike many other sectors, is relatively open to effective government regulation and enforcement, with prominent members of the charitable sector often supporting stronger governance standards and/or more effective government enforcement of existing standards.[197] The reasons for this support are probably both enlightened self-interest—a better regulated sector means more public trust which means more (or at least stable) public support[198]—and the sincere desire of such leaders to do what is best for society as a whole and not only for their particular organization. These same motivations probably also lead many if not most charitable leaders to resist any temptation to capture regulatory entities in order to use such entities against their "competition," including new organizations attempting to enter their particular field or geographic area of activity.

These competing concerns indicate that the best state level solution probably lies somewhere between Fishman's charity commission with lim-

other, existing officials, such as local district, county, or circuit attorneys and the chief state revenue officer).

195. *See* Karst, *supra* note 5, at 478–79 (rejecting the attorney general because of both the lack of appropriate staff and an attorney general's sensitivity to politics).

196. *See, e.g.*, *id.* at 443 (noting that in California it is the usual practice for state tax officials to wait for federal investigation); *id.* at 453 (noting that even those few states that had such an office were headed up by an assistant attorney general who was only a part-time public employee); *id.* at 478 (noting that attorneys general offices, with one exception, are not staffed to audit charity financial reports). Now attorneys general's offices have significantly larger staffs, most of whom are full-time and which include non-attorneys such as accountants. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 17 (while noting that since the 1970s attorney staffing of charity units have not increased significantly, but that a number of states now employ non-attorney employees, including auditors, financial investigators, and other staff to review reports and aid in investigations).

197. *See, e.g.*, INDEPENDENT SECTOR, POLICY PROPOSALS TO STRENGTHEN THE NONPROFIT COMMUNITY'S ABILITY TO SERVICE OUR SOCIETY 6 (2009), *available at* http://www.independentsector.org/programs/gr/2009_Nonprofit_Platform.pdf (calling for increased funding for federal and state oversight of charities); PANEL FINAL REP., *supra* note 2, at 24 (calling on Congress to increase funding for federal and state regulation of charities) (2005).

198. *See supra* notes 48–50 and accompanying text.

ited authority and Karst's independent agency. More specifically, to take advantage of the existing AG authority and expertise the new institution could have an assistant attorney general as its chief administrator, as Fishman proposes, but it would enjoy greater separation from the elected attorney general to both increase overall accountability and enforcement effectiveness. Moreover, the role of this entity would include explicit rule-making authority and pro-active enforcement and not only, as Fishman envisions, reactive enforcement.[199] While we do not attempt to resolve all of the details involved in the structure of such an institution, we discuss some of those details further in Part IV.

The creation of such a semi-independent state body would not, however, resolve three concerns. First, coordination would still be an issue, particularly with charity oversight bodies in other states and the IRS at the federal level.[200] Absent some type of incentive to facilitate such communications, such "coordination" might be limited to inter-state disputes over whether one or another state had jurisdiction over a particular charity and its assets.[201] Second, there is no particular reason to believe such a body would be any more effective in competing for limited state funding than existing, AG charity offices.[202] Third and finally, if some states adopted this model but others did not, there is the risk of regulatory arbitrage as charities in different states faced different levels of rulemaking and enforcement (even all states impose generally the same fiduciary duties on charity leaders).[203]

So the bottom line is that while a state level entity with modest AG connections has significant strengths, it also has some weaknesses. The question is then how do the other possible institutional choices compare. The next section looks at possible federal government options.

B. Federal Government Options

Federal government oversight of charity governance is a much-discussed but until recently not-much-acted-on proposal. Commentators

199. *See* Fishman, *supra* note 11, at 272–75.

200. PANEL FINAL REP., *supra* note 2, at 25.

201. *See* FREMONT-SMITH, *supra* note 22, at 321–22 (providing an example of such a dispute).

202. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 464 (raising this concern about Fishman's proposal); BIEMESDERFER & KOSARAS, *supra* note 41, at 17–18 (while acknowledging it can be difficult to determine the exact amount of funding for such offices, noting that only a few states earmark funds for this function and usually only modest amounts); Manne, *supra* note 14, at 267 (raising the funding concern with respect to new state or federal entities generally).

203. *See generally* FREMONT-SMITH, *supra* note 22, at 464 (criticizing Fishman's proposal because it would result in lack of uniformity).

have suggested everything from simply enhancing disclosure through the Form 990 requirement (which the IRS has now implemented) to expanded governance authority for the IRS to a new federal agency to focus on governance issues (Congress has not implemented either of these latter two proposals to date).[204] A federal government approach avoids the potential regulatory arbitrage problems raised by state-level institutions, is unlikely to be subject to capture, and may also resolve the troubling funding problem if the already existing private foundation excise tax can be at least partially dedicated to such an effort.[205] At the same time, however, such an approach raises expertise and accountability concerns, coordination issues with respect to state authorities (assuming there is not complete federal preemption), and, especially in the case of a new federal agency, significant additional compliance burdens and transition costs. There is also a serious authority concern that must be addressed.

Turning the threshold authority issue first, the breadth of Congress's authority with respect to charities outside of the tax context is unclear, especially given the local nature of many charities.[206] Congress therefore would face a choice of making compliance with fiduciary duties an additional requirement for charitable tax-exempt status—which it clearly has the authority to do[207]—or face the uncertain prospect of whether another federal agency (whether newly created or not) could excise such authority absent the tax connection. Creating a new agency also brings its own risks, such as Congress' ability to delegate certain powers to the agency.[208] But the first choice would essentially reduce the choice to enhancing IRS au-

204. *See, e.g.*, Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 FORDHAM L. REV. 765, 792 (2007) (urging "consideration of legislation establishing some federal minimum standards of nonprofit governance for the IRS to enforce . . . ."); Fleishman, *supra* note 4, at 187–88 (proposing a new federal agency, but only as a third alternative if both his private and joint private/government proposals cannot be made to work); Swords, *supra* note 48, at 571 (arguing for greater use of the IRS Form 990 to promote charity accountability).

205. *See generally* FREMONT-SMITH, *supra* note 22, at 461 ("Although one might have considered delegating regulation to the states at some time during the 1950s, the growth of the nonprofit sector . . . combined with the failure of the states to provide effective enforcement, have rendered this question moot.").

206. Congress's power over local activities has limits. *See, e.g.*, Gonzales v. Raich, 545 U.S. 1, 16–17 (2005) (Congress's Commerce Clause power extends only to regulating the channels, instrumentalities, persons, or things in interstate commerce).

207. *See* Regan. v. Taxation with Representation, 461 U.S. 540, 550 (1983) (noting the "broad power" of Congress to place conditions on I.R.C. § 501(c)(3) status, even conditions that infringe on protected First Amendment rights).

208. *See, e.g.*, Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 537 F.3d 667 (D.C. Cir. 2008), *cert. granted*, 129 S. Ct. 2378 (2009) (No. 08-861).

thority over governance, which for reasons that will be detailed raises its own concerns.[209]

Before turning to the other framework criteria, it is important to note that there is one option that is clearly not on the table because of authority issues. Under current Supreme Court precedent, it is beyond Congress' power to force states to either create a regulatory regime or to enforce a federally created regime.[210] Congress cannot, therefore, legislate that the states must adopt and enforce a particular state-level governance regime or enforce a federally defined standard of fiduciary duties. Congress must either authorize the federal government to do this work or, alternatively, create a strong enough incentive for states to voluntarily assume this role.[211] We will return to the latter possibility in Part IV.

At first glance granting the IRS explicit authority over charity governance is attractive for several reasons.[212] Congress and the IRS could provide a single national governance standard thereby eliminating much of the need for coordination and the risk of regulatory arbitrage, and the IRS appears to be highly resistant to both capture by minority groups and to political influence from the majority.[213] That said, however, Congress and the IRS are sorely lacking in other areas. Neither Congress nor the IRS have developed much expertise in governance matters, particularly with respect to nonprofit organizations.[214] Even in the for-profit context, Congress and

209. Transferring all federal authority over charities, including with respect to tax-related matters, to a new federal agency would add significantly to the complexity of tax collection. *See* FREMONT-SMITH, *supra* note 22, at 465.

210. Printz v. United States, 521 U.S. 898, 932 (1997) (citing New York v. United States, 505 U.S. 144, 188 (1992)) ("[T]he Federal Government may not compel the States to enact or administer a federal regulatory program.").

211. One way that the Congress can incentivize states is through the Constitution's Spending Clause. *See* South Dakota v. Dole, 483 U.S. 203, 207–08 (1987) (holding that Congress may, constitutionally and subject to certain limitations, use its spending power to influence state laws and state government actions by placing reasonable conditions relating to one or more federal interests on the receipt of federal funds).

212. The IRS has explicitly acknowledged it does not have such authority generally, although it apparently still reserves the right to offer more lenient penalties in the event of tax law violations if a purported charity agrees to governance changes. *See* INTERNAL REVENUE SERVICE, EO DETERMINATIONS CPE-GOVERNANCE 2 (2009) (noting that the IRS may consider whether a charity that is not in compliance with federal tax laws has taken steps to "assure the fairness of the arrangement" to the organization, but also noting that the IRS does not make decisions for charities).

213. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 466 (arguing for an IRS-based solution in large part on these grounds); FILER COMM'N REP., *supra* note 120, at 167 (over thirty years ago, recommending that the IRS continue in its role as the principal agency responsible for the oversight of tax-exempt organizations because there is no viable alternative and because the IRS has generally be independent and impartial).

214. *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, AND ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A SUPPLEMENT TO THE FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 29 (2006), *available at* http://www.nonprofitpanel.org/Report/supplement/Panel_Supplement_Final.pdf; Fishman, *supra* note

the Sarbanes-Oxley Act have been the target for much criticism, in part stemming from the apparent lack of expertise of Congress and the SEC in this area.[215] While Loyola-Los Angeles Law School Professor Ellen Aprill has demonstrated why some of these criticisms turn on factors that are less relevant (or not relevant at all) to nonprofit organizations, including that leaders in the charitable community have embraced some (but far from all) of the governance reforms that were in the Sarbanes-Oxley Act, these points do not demonstrate that Congress and the IRS have the necessary expertise to determine what specific governance rules will in fact improve compliance with fiduciary duties by charity leaders.[216]

Furthermore, the compliance burden of having to look to federal as well as state law for fiduciary duty standards would be significant, as would the transition costs involved in establishing such a national standard.[217] One option, proposed by Aprill, would be to establish federal governance standards that would constitute a floor but which the states could exceed.[218] Such a solution assumes, however, that Congress and/or the IRS have sufficient expertise to develop such a floor—which does not appear to be the case—and it does not address the transition costs generated by a new, federal standard or the additional compliance burden of having potentially to respond to either or both federal and state regulators with respect to an alleged fiduciary duty violation. Perhaps anticipating these concerns, Aprill also proposes that the IRS could defer to state enforcement of the

3, at 43. While Fremont-Smith argues that IRS personnel have over the years developed significant expertise with respect to tax-exempt organizations, *see* FREMONT-SMITH, *supra* note 22, at 465–66, it is far from clear that they have developed such expertise specifically with respect to fiduciary duties. *See* Brier, *supra* note 2, at 29–41 (finding a lack of guidance as to how Congress and the IRS consider nonprofit governance).

215. HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 88 (2006) (concluding that Congress failed to foresee the full effects of the corporate reforms embodied in the Sarbanes-Oxley Act); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 291 (2005) (based on the available empirical evidence, concluding that Congress both significantly underestimated the cost of the Sarbanes-Oxley Act reforms and overestimated their likely benefits); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1544 (2005) (concluding that both members of Congress and their staffs did a particularly poor job in designing the corporate governance mandates contained in the Sarbanes-Oxley Act). *But see* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1845 (2007) (defending Congress's choices when enacting the Sarbanes-Oxley Act, although acknowledging that Congress may not have carefully considered the available empirical literature regarding those choices).

216. *See* Aprill, *supra* note 204, at 770–80; *see also* Brier, *supra* note 2, at 15–17 (citing the lack of evidence demonstrating that certain specific governance practices improve overall compliance with fiduciary duties for nonprofit organizations).

217. *See, e.g.*, Yarmolinsky & Fremont-Smith, *supra* note 121, at 2863 (citing as one advantage of an advisory body's lack of regulatory authority, other than to compel the filing of reports, is that it would not threaten the pluralism and diversity of the philanthropic sector).

218. Aprill, *supra* note 204, at 793–94.

federal standard and only step in if such enforcement was lacking, which is the "cooperative federalism" model used in the environmental law area.[219] The problem with this solution, however, is it assumes a relatively vigorous level of state enforcement, at least in many states, which does not appear to match state activities to date.[220]

Of course, Congress could simply empower the IRS to enforce *state-created* fiduciary duty standards by requiring compliance with such standards as a condition of tax-exempt status. Such a role would be somewhat more consistent with the historical division of authority between the states and the federal government, although far from completely so, and would take advantage of the states' rulemaking expertise in this area.[221] This solution, however, would raise significant coordination concerns. Would the IRS have to go to state court to determine if a fiduciary duty violation had occurred? What happens if the IRS on its own determines such a violation has occurred but a later state court or AG decision says it had not? Such an approach would also still presumably leave some rulemaking to be done by the IRS, which again lacks expertise in this area, at least as compared to those state AG offices that have become increasingly active with respect to charity governance issues.

Finally, any IRS-based option brings with it the decades of complaints about the IRS rulemaking and enforcement with respect to the existing federal tax rules for charities, although it has been arguably more successful with respect to education and disclosure initiatives.[222] These complaints include a lack of funding for both functions and a similar lack of accountability because the IRS Exempt Organizations division is but a small part of the much larger IRS which, like the AGs, can convincingly plead the need to pay attention to other, arguably higher priorities (especially in the era of $1.4 trillion annual federal government deficits).[223] In part because

219. *Id.* at 792–93.

220. *See supra* notes 82-85 and accompanying text.

221. *See, e.g.*, Spuehler, *supra* note 118, at 3084–85 (citing such concerns in support of any national body not usurping existing state-level efforts to regulate charities and also striving to encourage similar efforts in other states).

222. *See, e.g.*, Owens, *supra* note 12, at 4–6.

223. *See, e.g.*, FLEISHMAN, *supra* note 3, at 256 (concluding that given its many other responsibilities, simply increasing funding to the IRS' Exempt Organizations Division will not be sufficient to address shortcomings in nonprofit oversight); Fleishman, *supra* note 4, at 188 (rejecting the idea to strengthen the IRS as an alternative to a new federal agency as he is not confident that the IRS Exempt Organizations Division will ever be anything other than "a Cinderella in the kitchen" when competing for resources within the IRS); Marcus S. Owens, *Federal Oversight: The Role of the Internal Revenue Service* 3–4 (2007), (describing concerns with IRS enforcement and regulatory activity with respect to tax-exempt organizations) *available at*. http://www1.law.nyu.edu/ncpl/pdfs/2007/Conf2007_Owens.pdf.

of these failings, the IRS also is generally viewed as being a relatively ineffective enforcer of the existing federal tax laws governing charities.[224] So the bottom line is that an IRS-based institutional choice is a mixed bag at best.

Setting aside the serious authority issues, what about the option of a new federal body? To engage in enforcement and rulemaking, that body's role would need to go beyond that of a federal advisory commission along the lines of the proposal by Fremont-Smith and Yarmolinsky, which arguably is no longer needed under any conditions given the success of Independent Sector and other private bodies, and could be a full-blown new federal agency with broad powers as proposed (but now abandoned) by Fleishman.[225] The lesser the body's rulemaking and enforcement powers, the lesser authority concerns it raises but at the same time the less potential it has to improve enforcement of fiduciary duties (or at least do a better job than the IRS would be likely to do).

Starting at just beyond the federal advisory commission end of the spectrum with a body with a limited enforcement (perhaps responding to governance complaints or referring them to other government bodies), such a body would have to gather both charity fiduciary duty expertise—including what little it could obtain by poaching existing IRS personnel with such knowledge, but presumably most such expertise would have to be gathered from state-level entities, currents practitioners, and academics, a difficult task to accomplish much less accomplish well.[226] It would also have to coordinate its efforts with both the IRS and with state bodies, especially if had no binding rulemaking or enforcement authority of its own. Such a body, unlike the IRS, would presumably be more vulnerable to capture, although that seems a relatively small risk given that a significant portion of the charitable community favors strong regulation.[227] Finally, if its enforcement powers were relatively limited it would not significantly resolve the existing enforcement effectiveness problems, although it could try to be a bully pulpit for drawing public and regulatory agency attention

224. *See supra* notes 204, 212 and accompanying text.

225. *See, e.g.*, PETERSON COMM'N REP., *supra* note 120, at 181–83 (proposing the creation of a "Advisory Board on Philanthropic Policy"); Ginsburg, *supra* note 115, at 2640–42 (summarizing a proposal for a new federal agency that would assume the IRS' current exemption and deduction eligibility determination functions as well as having broad rulemaking, enforcement, and data collection functions, including with respect to fiduciary duties); Yarmolinsky & Fremont-Smith, *supra* note 121, at 2858 (proposing to create an independent public agency to study private philanthropy).

226. *See* U.S. GOV'T ACCOUNTABILITY OFF., HUMAN CAPITAL: TRANSFORMING FEDERAL RECRUITING AND HIRING EFFORTS 1 (2008) (federal human capital management has been an identified high-risk area since 2001).

227. *See supra* note 197.

to particularly prominent governance failures or for advocating regulatory changes to improve governance.[228] At the same time, however, it would impose only a mild compliance burden increase, if any. Moreover, it would not change the regulatory arbitrage situation, and would probably require only minimal funding and transition costs. Nonetheless, it is unclear how much such an entity would improve the charity fiduciary duty situation.

The other end of the new federal entity spectrum is not much more promising. Again, gathering expertise and coordination loom as major concerns, while capture is a potential but unlikely concern, and at least the sole focus on charities paired with actual rulemaking or at least enforcement authority would create a significant level of accountability for what actually occurs in the charitable sector and improve, hopefully, enforcement effectiveness.[229] With these greater powers come, however, the increased compliance burden of being subject to a new agency with its own rules, procedures, and eventual culture, the funding costs of supporting such an entity with oversight over more than a million charities (although, again, dedication of at least a portion the foundation excise tax revenues might solve this problem), and substantial transition costs. An additional concern with a new federal entity is coordination with the IRS, as to remove the IRS from involvement with charities would create substantial transition costs even if it were politically possible.[230] Nothing in between the two extremes appears to be a clear improvement, as expertise and coordination remain perennial issues while accountability and enforcement effectiveness are in a trade off with compliance burden and transaction cost issues.

As with an IRS-based approach, the creation of new federal entities appears to be mixed bag using the criteria we previously identified. Compared to the state government options discussed above, the federal government options appear to trade off expertise, coordination (absent federal preemption), and more local accountability, as well as significantly higher compliance burdens and transition costs in the case of a new, dedicated federal agency, in exchange for the possibility of avoiding the probably small risk of capture, more effective enforcement, reduction or elimination of unintentional arbitrage (there being no evidence of intentional arbitrage by charities), and possibly increased funding. Given the relatively small

228. *See, e.g.*, FILER COMM'N REP., *supra* note 120, at 191–92 (recommending the creation of such a permanent national commission to gather and analyze information about nonprofit organizations and to serve as a public forum for discussion of issues affecting the nonprofit sector).

229. *See* Fleishman, *supra* note 4, at 185–86 (citing the lack of a single entity that is "in charge" of overseeing the nonprofit sector as leading to a lack of accountability for such oversight).

230. *See* FREMONT-SMITH, *supra* note 22, at 465 (expressing skepticism that Congress would seriously consider removing regulation of charities or other tax-exempt organizations from the IRS).

risks of capture and intentional arbitrage, and the strong federalism and expertise headwinds against pre-empting state fiduciary duty standards (and so resolving in large part the problem of coordination with the states), this trade-off does not appear to be worth it. There are, however, additional options that rely more on self-regulation than on government institutions.

C. Self-Regulation

As the above discussion indicates, any government institution option raises both funding and more general political will problems. Especially in an era of shrinking state government budgets and exploding federal government debt, options that instead look to self-regulation by charities or their supporters are therefore attractive.[231] This section considers two such options. The first is increasing the ability of interested, private persons to pursue alleged breaches of fiduciary duties in state court. The second is the creation of a national, self-regulatory body.

1. Expanded Standing in State Courts

As detailed above, most private persons with an interest in how charity leaders govern lack standing to challenge any alleged breaches of fiduciary duties in state courts.[232] The only exceptions are usually fellow directors or trustees and, for charities that have members in the corporate law sense, sometimes those members.[233] Such suits are relatively rare, especially given that most charities do not have such members, leaving only directors or trustees (or the Attorney General) to bring such suits.[234] One possible way to increase enforcement of fiduciary duties would therefore be to expand the universe of private parties who could bring such suits, as Geoffrey Manne and others have suggested.[235] Since many private parties, including supporters and beneficiaries of charities, have a sufficient interest in how the charities with which they are associated are governed, and since state courts are generally not bound by the federal constitutional limitations

231. *See* Brier, *supra* note 2, at 21–27 (describing various self-regulatory efforts); Fleishman, *supra* note 4, at 183-85 (describing the most prominent sector-wide self and other private regulation efforts as of the 1990s but noting it is no substitute for good governance within organizations). *See generally* NCPL STUDY, *supra* note 124.

232. *See supra* note 84 and accompanying text (describing this lack of standing).

233. *See supra* note 85 and accompanying text (describing these exceptions).

234. *See supra* note 88 and accompanying text (noting the rarity of such suits).

235. *See, e.g.*, Atkinson, *supra* note 14, at 698; Fishman, *supra* note 14, at 671; Manne, *supra* note 14, at 253; *see also* REST. (THIRD) OF TRUSTS § 94 (Tentative Draft No. 5, 2009) (permits the settler of a charitable trust to maintain a proceeding to enforce the trust); UNIF. TRUST CODE § 405 cmt. (granting standing to settlors to enforce the terms of charitable trusts) (amended 2005).

on standing, state legislatures should have the authority to approve such an expansion.[236]

A moment's thought, however, reveals numerous downsides with a broad expansion of standing for such cases. It is true that the state legislatures would have the authority to grant such standing, that state courts at least have some expertise in this area although only as one of the numerous legal issues they are called upon to address, and that these courts are generally well immunized from capture (to the extent that is a risk).[237] The same courts, however, even with elected judges, would have very limited accountability with respect to resolving such challenges as such cases would presumably make up only a small part of their dockets.

The greatest weaknesses, however, relate to the fact that the suit bringers may have a wide range of motivations, with only some motivated by the desire to see actual or perceived fiduciary duty breaches corrected.[238] For example, a staunch opponent of a Planned Parenthood local chapter or a crisis pregnancy center (take your pick) could bring suit after suit alleging such breaches in order to drain the treasury of the target with legal bills. Donors and especially heirs of donors may have less than pure motives, including wanting to retrieve the original donation for their own benefit.[239] Even members of the public acting in good faith could overwhelm a well-known charity with their many attempts to correct or improve a charity's governance when they have only limited information about its operations.[240] Less dramatically, certain types of charities that engage in more high profile activities or have either supporters or beneficiaries who are more willing to consider such claims might attract the lion share of such suits while other charities that rely on relatively small donors

236. *See* 59 AM. JUR. 2D PARTIES § 36 (2009) ("[S]tate courts are not bound by [federal] constitutional strictures on standing; as with state courts standing is a self-imposed rule of restraint.").

237. Even with respect to elected judges, since charities are prohibited from intervening in political campaigns. I.R.C. §§ 170(c)(2)(D), 501(c)(3) (2006).

238. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 448–49. Atkinson has also identified theoretical flaws with most type of standing expansion regardless of what particular model of individual involvement with a charity is chosen. *See generally* Atkinson, *supra* note 14.

239. *See, e.g.*, FISHMAN, *supra* note 4, at 66 (describing how the medieval right of visitation by a charity's founder and his heirs could lead either to no oversight because the ones with this right lost interest or to hostile interest when the founder or his heirs sought to recapture their family's former assets, whether directly or by using the charity for their own benefit).

240. *See, e.g.*, FREMONT-SMITH, *supra* note 11, at 200 (tracing the common law denial of standing for members of the general public to "the purely practical consideration that it would be impossible to manage charitable funds, or even to find individuals to take on the task, if the fiduciaries were to be constantly subject to harassing litigation"); Karst, *supra* note 5, at 444 ("The reason for the frequently seen statement that the attorney general alone can enforce a charitable trust is of course that the charity needs to be protected from constant harassment by meddlesome individuals who have no interest in the charity except as members of the public.") (citation omitted).

and serve less engaged beneficiaries might escape any such scrutiny even though there is no reason to believe they are less prone to fiduciary duty lapses. This likely result suggests that only a modest increase in enforcement effectiveness will be gained in exchange for significantly increased compliance burdens especially for controversial charities. The state courts are also not exactly flush with funding to handle the increased caseload generated by such suits, raising that potential concern as well.[241]

To address many of these concerns, Geoffrey Manne's proposal would limit the increase in standing to for-profit monitoring companies that a charity contracts with to monitor its fiduciary duty compliance.[242] Those companies would then be able, at least in theory, to use the courts to ensure such compliance in the event the charity did not respond to less confrontational attempts to correct governance concerns.[243]

Nonetheless, there are problems with Manne's proposal, including the untested nature of such for-profit monitoring companies, the need to create such entities from whole cloth, the financial incentives such companies would have to downplay potential problems in the interest of keeping as many charity clients as possible, and the lack of public accountability of such companies. Manne appears to dismiss these concerns by assuming that market forces would require these "contract plaintiffs" to fulfill their enforcement duties so as to ensure long-term financial success.[244] It seems just as or more likely, however, that such contract plaintiffs would try to maximize current profits by going easy on their charity clients, especially if by doing so they could increase their revenues either by attracting more clients or providing other fee-based services.[245] So while such companies would probably reduce, but not eliminate,[246] the compliance burden issue—by eliminating the risk of harassment lawsuits—it is far from certain that they would actually improve the effectiveness of fiduciary duty en-

241. *See* NATIONAL CENTER FOR STATE COURTS, FUTURE TRENDS IN STATE COURTS 2009 2 (2009) (twenty-five of the thirty-four state and territory court administrative offices that responded to a survey reported a reduced budget appropriation for the next fiscal year).

242. *See* Manne, *supra* note 14, at 229–30.

243. *See id.* at 253–54 (describing ways to address possible state court objections to a contractual grant of standing).

244. *See id.* at 254–55, 261–62.

245. *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 13–14 (2002) (noting pressures on purportedly independent auditors, including financial pressures, that worked against doing diligent work); *id.* at 30 (noting that even limiting the sale of non-audit services may not be sufficient to ensure diligent auditors given "the strong-profit-oriented culture that now seems to pervade accounting firms").

246. *See* Manne, *supra* note 14, at 257 (acknowledging that in addition to the fees paid to the monitoring firms, his proposal would likely also increase the amount of litigation against nonprofits, at least initially); *id.* at 263 (acknowledging these and other compliance burdens, such as a likely increased cost of finding willing board members, as imposed by his proposal).

forcement. As Robert Atkinson has examined in some detail, identifying another appropriate group to serve in this role by having standing—whether donors, beneficiaries, or others—is also problematic.[247]

2. National Self-Regulatory Body

An alternative approach put forward by Marcus Owens would be the creation of a single, nonprofit monitoring entity that operates on a national scale, modeled loosely on the National Association of Securities Dealers (now named the Financial Industry Regulatory Authority).[248] This entity would wield both rulemaking and enforcement authority under the auspices of Congress, the IRS, the federal courts, and state attorneys general, but would be a private entity and so not part of the federal government or state governments.[249] More specifically, Congress would charter the new entity and thus define its role in general terms, the IRS, the National Association of Attorneys General, and Congress would have a role in choosing its governing body members, the IRS would have an approval process for rules promulgated by the new entity, and adverse enforcement actions could be appealed either to the IRS or the federal courts.[250] The new entity would not, however, be funded by the federal or state governments, and would not be subject to civil service and government contracting rules because it would not be a government agency. Because the legal authority for this new entity would derive from existing authority of Congress and the IRS with respect to tax exemption, compliance with such an entity's rules and enforcement processes as a condition of tax exemption should be within their authority.[251]

As compared to the IRS or even a new federal government entity, this quasi-public entity would have several significant advantages, including greater accountability for charity governance because of both its sole focus on regulating charities and the greater transparency of its enforcement process than current federal tax rules provide to the IRS.[252] To the extent capture is a risk the various forms of government involvement, including IRS approval of rulemaking, would limit or eliminate that risk.[253] The new

247. Atkinson, *supra* note 14.

248. Owens, *supra* note 12, at 11.

249. *Id.* at 11–14.

250. *Id.*

251. *See id.* at 13–14 (the oversight of the organization would include tax-exempt organizations and their advisors).

252. *See id.* at 14–15.

253. The extent of government involvement needed to prevent capture is unclear, however, as the experience of securities regulation shows. *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE:

entity would also create a single set of national standards eliminating arbitrage risk except to the extent states adopt more stringent standards, and Owens has also proposed a funding mechanism that effectively redirects a portion of the private foundation investment excise tax to this new entity through the use of a tax credit against that tax for foundations that financially support this new entity.[254]

This proposal overlooks several significant concerns, however. First, it assumes that the necessary expertise can be easily gathered into this new entity simply by virtue of its ability to pay market-rate compensation.[255] It is not clear, however, that this would necessarily be the case, or that this entity would in fact be as free to set compensation at perceived market levels as it is hoped.[256] And while presumably the IRS would not approve rules that conflicted with the federal tax rules for charities, the proposal does not address how the rules promulgated by this new entity would be reconciled or coordinated with state laws governing the same activities. The proposal also flies in the face of the historic authority of state officials, which could create conflicts and coordination problems with at least those state officials that have shown an interest in charity governance. There also could be significant coordination issues with the IRS, particularly if the new entity assumed the IRS' current task of processing exemption applications, as Owens has proposed.[257] Furthermore, the increased compliance burden and transition costs of creating a new such entity, establishing its relationships with numerous government actors not to mention the charitable sector itself, and educating the charitable community about this brand new regulator (on top of the IRS and the attorneys general) would be substantial, perhaps even more than the burden and costs associated with creating a new federal government agency.[258] Finally, the self-regulatory organization model has routinely been criticized with respect to disclosure and governance standards for public companies, leading to responsibilities

PROMISES KEPT, PROMISES BROKEN 106–07 (2008) (summarizing recent criticisms of the Securities and Exchange Commission's oversight performance).

254. *See* Owens, *supra* note 12, at 11–12.

255. *See id.* at 15; *see also* Fleishman, *supra* note 4, at 186–87 (asserting that skilled IRS and state attorney general personnel would be easy to attract to a new nonprofit oversight entity).

256. *See* Ian Wilhelm & Grant Williams, *Salary Under Scrutiny*, CHRONICLE OF PHILANTHROPY, Feb. 26, 2009, at 28 (summarizing divergent views about appropriate levels of compensation at private nonprofit organizations).

257. Owens, *supra* note 12, at 13. *See also* Ginsburg, *supra* note 115, at 2643 (rejecting a proposal to transfer tax-administration functions from the IRS to a new federal agency, in part, because the "exemption provisions are interrelated with other Internal Revenue Code provisions" and should therefore be administered by the IRS).

258. *See* FREMONT-SMITH, *supra* note 22, at 465 ("Bifurcating regulation at the federal level would add a third regime of regulation that would add immeasurably to complexity and delay.").

for these areas incrementally being moved from such organizations to government agencies.[259] Concerns in these areas may arise from the fact that these areas may be ones where publicly desired outcomes depart most sharply from the interests of company managers and financial sector actors.[260]

A variation on Owens' proposal would be to empower existing self-regulatory bodies, such as the Joint Commission (healthcare organizations). Such empowerment could be accomplished by requiring charities to meet the governance standards of one of these entities that had been approved to serve in this role by Congress or the IRS.[261] A recent study highlights the significant role that such entities, even when their rules only cover groups that voluntarily choose to become subject to them, have played in promulgating good governance practices and encouraging fiduciary duty compliance.[262] This variation would also avoid the need to create, at least for most parts of the charitable community, an entirely new national entity that would be untested, unfamiliar to charities, and which would have to start from scratch in obtaining the necessary expertise.

The key issue, however, would be the selection of the existing or new self-regulatory bodies to serve in this role. Presumably this selection would lie either with Congress or the IRS, which raises its own expertise concerns. How can we be confident that either body has the ability to choose the best self-regulatory body or bodies for particular types of charities? Even the IRS' modest task of choosing what organizations should be able to certify appraisers for purposes of charitable contribution deduction valuations—an area where the IRS does have many years of experience—has resulted in the IRS choosing so far not to identify any specific organizations or even to provide clear criteria regarding what organizations qualify.[263] It is also far from clear that such bodies, once selected by the IRS and so in a monopoly or oligopoly position, would continue to put the interests of the public in having fiduciary duties fulfilled above the interests

259. *See* Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 324–25 (2007).

260. *See id.* at 323 (noting that self-regulatory organizations tend to be least effective when they "are asked to take on regulatory obligations that are at best tangential, and at worst inimical, to their managers' or members' interests").

261. *See generally* FLEISHMAN, *supra* note 3, at 259–62 (for private foundations, arguing for increased self-regulation, including through the existing Council on Foundations and a newly created "Foundation Transparency Rating Board"); Brier, *supra* note 2, at 21–27 (describing many of the existing self-regulatory organizations).

262. *See generally* NCPL STUDY, *supra* note 124.

263. *See Speakers at IRS Hearing Praise Proposed Substantiation Regs, Suggest Improvements*, 122 TAX NOTES TODAY 14-5 (2009) (describing comments recommending specific criteria for recognized professional appraisal organizations and apparent IRS reluctance to adopt such criteria).

in maintaining their status with the public by careful selection of enforcement targets and priorities that may not result in particularly effective enforcement or even could be counter-productive (*e.g.*, selecting particularly high-profile or disfavored charities, for example). Alternatively, such entities could be captured by a portion of their particular charitable sub-sector, again leading to ineffective enforcement.[264] And this variation does nothing to relieve the coordination and, at least for those charities that were not voluntarily members of such a monitoring group previously, compliance burden concerns that existed with the single, national entity. This coordination problem is highlighted by the fact that it appears the ability to assert legally enforceable sanctions is key to the success of such entities.[265]

3. Conclusion

Both types of self-regulatory proposals raise significant concerns regarding the expertise and effectiveness of the self-regulators, as well as their ability to coordinate their activities with government regulators and the transition costs and increased compliance burdens associated with such proposals. For expanded standing, a broad expansion opens the doors to frivolous and harassing suits while not necessarily encouraging significant numbers of suits aimed at actual fiduciary duty violations. A narrow expansion, such as that proposed by Manne, requires the creation of new, untested entities that may lack the proper incentives to ensure effective enforcement of those duties. A new national, nonprofit body raises similar concerns, which are relieved only in part by substituting existing self-regulatory bodies. And for all of these proposals, charities would have to become familiar with a new set of rules, enforcement procedures, and processes even if they believe they do not have any fiduciary duty problems. The difficulty of predicting with any certainty how well such proposals would perform in practice is further complicated by the fact that given they would be new approaches there is little to no hard data on which to base such predications. Thus while these proposals may not raise authority issues and may resolve funding concerns, it is far from clear that that will result in sufficiently improved enforcement and reduced arbitrage (to the extent this a concern) to justify these negative aspects.

264. *See, e.g.*, Gilbert M. Gaul, *Accreditors Blamed for Overlooking Problems; Conflict of Interest Cited Between Health Facilities, Group That Assesses Conditions*, WASH. POST, July 25, 2005, at A1 (raising this criticism with respect to the Joint Commission on the Accreditation of Healthcare Organizations (now called the Joint Commission)).

265. NCPL STUDY, *supra* note 124, at 62.

IV. IMPLEMENTING THE INSTITUTIONAL CHOICE

We turn now to consider in more detail a state-level approach to governance, drawing from the proposals of both Karst and Fishman, as well as other commentators whose insights shed light on this issue. While a state-level approach appears to be the best institutional choice for regulating charitable governance, subject to any additional data regarding the relevant considerations, it is not without shortcomings. This Part IV addresses some of the weaknesses of the state-level approach and suggests ways that federal and state governments can work together to mitigate them. At the end of Part IV, we also offer some general comments about our institutional choice analysis and future research initiatives that would help to advance the current discussion of this topic.

A. Advantages of a State-Level Approach

The results of the institutional choice analysis described in Part III are likely a surprise to many commentators. On the whole, state-level regulation of charities has not been viewed as a particularly successful endeavor to date.[266] Only a few states have established general registration and reporting requirements for charities,[267] and virtually no states have committed sufficient resources to effectively enforce state charitable laws.[268] As a result of these shortcomings, many commentators have concluded that a comprehensive regulatory system cannot be effectively administered at the state level.[269]

Despite the shortcomings of the current regulatory system, however, when compared with the other available choices—all of which have their own significant shortcomings—there are many factors indicating that a state government institution modeled after the proposals of Karst and Fishman would be the most effective institution for regulating the charitable sector. This is true, in part, because a state-level approach would build on the existing expertise and authority of state legislators and regulators, who have a history of making and enforcing state laws pertaining to gov-

266. *See supra* notes 86–89 and accompanying text.

267. BIEMESDERFER & KOSARAS, *supra* note 41, at 17 (noting that only 11 states have enacted general registration and reporting statutes for private foundations).

268. *Id.* at 4 (reporting that over the "past several decades there has not been a significant increase in the number of attorneys assigned to charity oversight" and, in most states, "there are no funds earmarked to support the attorney general's enforcement of charitable organizations").

269. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 461 ("[T]he growth of the nonprofit sector [since the 1950's] and its complexity since that time and the concomitant overriding federal interest in its operations, combined with the failure of the states to provide effective enforcement, have rendered [the issue of state-level regulation] moot.").

ernance.[270] Maintaining responsibility for charity regulation at the state level also makes this institutional choice more consistent with traditional notions of federalism,[271] permits greater experimentation with respect to governance rules and enforcement procedures, is more likely to result in lower transition costs than a federal-level solution, and also creates less uncertainty as compared to creating a completely new federal entity. In addition, a state-level approach has the added benefit of ensuring that charity oversight is conducted by local regulators, who are more likely to be accountable to the public than distant federal regulators, and more likely to pay attention to reports of abuse at small charities operating in their local communities.[272] To the extent that the new institution is given authority to oversee charitable solicitation and other aspects of charity regulation, the new institution will also help to improve coordination among state agencies and lower compliance costs for charities.[273]

The proposals put forward by Karst and Fishman both capitalize on these advantages of a state-level solution, although they do so in different respects. Fishman's proposal is premised on the notion that states will not significantly increase their funding for charity oversight[274] and generally lack the political will to effectively regulate charities.[275] Building on these assumptions, Fishman's proposal calls for the creation of new charity commissions comprised of volunteer commissioners who would have only limited authority to investigate complaints about charities and their managers. Conversely, Karst's proposal is premised on the notion that states will provide funding for the creation of a new agency if it shown to be effective.[276] Consistent with this assumption, Karst's proposal calls for the creation of a new agency comprised of paid staff members who would have

270. *See supra* notes 189–190 and accompanying text.

271. *See* Cass R. Sunstein, *Social Norms and Social Roles*, 69 COLUM. L. REV. 903, 952 (1996) ("[I]t is probably best to have a presumption in favor of the lowest possible level of government [because it] is closest to the people, and in that sense most responsive . . . and most likely to be trusted . . . .").

272. This is an especially important point given the fact that a vast majority of charities are small charities with fewer than $500,000 of annual revenue. *See supra* note 36 and accompanying text.

273. One option we did not consider is whether oversight of charities could be divided between state-level entities and the federal government based on, for example, the size of charities (however measured) or the geographic scope of their activities (*e.g.*, whether primarily or solely in one state or in multiple states). We did not explore this option because even to state it illustrates the difficult issue of how to make such a division, nor does this option resolve many of the concerns raised by federal government supervision as compared to state-level supervision.

274. *See* Fishman, *supra* note 11, at 272 ("It is doubtful that there will a substantial increase in funding for enforcement at either the federal or state levels.").

275. *Id.* at 268.

276. *See generally* Karst, *supra* note 5, at 482–83.

authority to engage in a much broader range of regulatory functions, including rulemaking, auditing and educational outreach activities.[277]

As a result of these differences, the proposals put forward by Karst and Fishman each has its own particular weaknesses. For example, Karst's proposal, which would result in the transfer of regulatory authority from the attorney general's office to a new state agency, downplays the importance of the attorney general's expertise and authority in this area, and overlooks the added costs of establishing a new state-level agency (not to mention possible Attorney General resistance to this loss of authority). In contrast, Fishman's proposal, which would involve the appointment of volunteer commissioners by the attorney general and governor, ignores the fact that the attorney general, governor and the volunteer commissioners they appoint may be subject to political capture,[278] and fails to provide the commission with authority to engage explicitly in rulemaking, audits, or educational outreach initiatives (presumably because of the limited time of the volunteer commissioners).[279]

Although neither Karst's proposal nor Fishman's proposal is without flaws, based on our institutional choice analysis, their respective shortcomings can likely be mitigated by incorporating into a new state institution the best aspects of both proposals. In this regard, two aspects of Fishman's proposal should be considered when establishing a new state-level institution. First, the new institution should maintain its connection with the state attorney general's office by having an assistant attorney general serve as the institution's chief administrator.[280] As the chief administrator, the assistant attorney general would oversee the activities of the institution, manage its staff, and establish its educational, rulemaking and enforcement priorities. The assistant attorney general would also have the authority to determine if the institution should respond to an alleged incident of misconduct, including through the courts.[281]

277. *Id.* at 476–77.

278. *See, e.g.*, Brody, *supra* note 79, at 939.

279. Under Fishman's proposal, the attorney general presumably would handle rulemaking and outreach activities rather than the commission.

280. Having a permanent institution that is managed by an unelected assistant attorney general will reduce the risk that regulation of charities at the state level will be driven by the personality of an elected attorney general. *See, e.g.*, BIEMESDERFER & KOSARAS, *supra* note 41, at 35–36 (discussing recent efforts in New Hampshire to establish a charitable advisory group that will provide a regular mechanism for the charitable sector to communicate with the attorney general that will not be dependent on the personalities of the attorney general or the officers of New Hampshire's most prominent charities).

281. *See* Fishman, *supra* note 43, at 595 (suggesting that the assistant attorney general should have authority to determine whether the charity commission or the attorney general should have jurisdiction over a matter of alleged malfeasance by a charity or one of its managers).

Maintaining the institution's connection to the attorney general's office will help to overcome the shortcomings of Karst's proposal by allowing the institution to build on the attorney general's existing expertise and authority[282] and by avoiding the substantial transaction costs of establishing a new state agency with no history or experience.[283] Maintaining the institution's connection with the state attorney general's office will also improve the institution's political viability by ensuring that the institution is a natural extension of, rather than a departure from, the existing state regulatory system, and not a threat to the attorney general's existing authority.[284]

One potential drawback of maintaining the institution's connection to the attorney general's office is the risk of political capture, which may arise if the attorney general uses the office for political purposes.[285] It should be noted, however, that an elected attorney general already oversees the regulation of charities in most states, which means that the new institution's connection with the attorney general's office will not exacerbate the risk of political capture already present under the current state regulatory system. In fact, the new institution will be somewhat insulated from the risk of political capture in comparison to the current system by having an unelected assistant attorney general serve as its chief administrator and by relying primarily on a permanent staff of charity experts to handle day-to-day regulatory activities.

A second key aspect of Fishman's proposal is the appointment of a commission to investigate complaints against charities and their officials, hold hearings, and issue rulings on governance matters.[286] As Fishman explains, these commissions would "serve an educational or remedial func-

282. Some states have authorized departments or individuals other than the attorney general to regulate charities. *See* FREMONT-SMITH, *supra* note 22, at 364. In such states, the institution would presumably maintain a formal connection with such departments or individuals.

283. The transition costs would be minimal in states that have already established separate units or charity bureaus to handle and coordinate charity oversight. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 17.

284. Since Karst proposed the creation of new state agencies in 1960, "only three states have adopted legislation enhancing state enforcement powers, while two statutes passed in the 1960s that increased state enforcement programs were repealed and other programs were vastly curtailed." FREMONT-SMITH, *supra* note 22, at 375.

285. *See, e.g.*, Karst, *supra* note 5, at 478 (claiming that the new institution should not be regulated by the attorney general in part because the attorney general is too deeply involved in politics to be impartial).

286. These commissions would have authority to "exonerate the charity or individual, resolve the problem by working with the charity, recommend it to a service organization that might provide assistance, or turn the matter over to the attorney general for routine prosecution." Fishman, *supra* note 43, at 595.

tion more easily than a governmental enforcement agency alone"[287] and would help to "inculcate new sector-wide norms of behavior"[288] by working with charities to address governance failures. Despite these benefits, Fishman's proposal to establish a commission consisting of volunteer commissioners appointed by the attorney general and governor raises some significant problems.[289] In particular, there is a risk that the attorney general and governor may use the commission as a way of making patronage appointments to reward their political allies, who may themselves be subject to political capture or use the commission for self aggrandizement. To avoid these potential problems, the institution should adopt Karst's proposal to use paid staff with expert knowledge of state charity law to handle the regulatory activities of the commission, which would be structured as a division of the new institution. By using paid staff rather than appointed commissioners, the institution would enjoy a degree of independence from the political influences that might otherwise be at play.[290]

Consistent with Karst's proposal, the new institution should also have broader regulatory authority than Fishman's state charity commission. In particular, the institution should have the power to engage in rulemaking, auditing, and educational activities, in addition to traditional enforcement activities.[291] As part of these regulatory powers, the new institution could have authority to establish a registry of all charities operating in the state, and could collect and evaluate periodic reports from such charities, subject to applicable exceptions.[292] It could also have authority to publish guidance for charities, issue rulings with respect to obsolete charities or charities of uneconomic size, pursue court proceedings against charities and their officials who break the law, administer a state-wide system of control over charitable solicitation, conduct studies of the charitable sector, and cooper-

287. *Id.* at 594.

288. *Id.* at 595. Fishman envisioned that the commissions hearings and investigations would be done on a confidential basis due to the fact that "[p]ublic investigations are a disaster for a charity's reputation." *Id.*

289. Fishman envisioned that the state commissions would consist of unpaid volunteers *See* Fishman, *supra* note 11, at 273. The commissions would have authority to investigate and hold hearings in response to complaints from the public, but the commissions presumably would not have authority to engage in formal rulemaking or educational outreach endeavors. *Id.*

290. Many federal agencies use permanent staff, rather than volunteer (or paid) commissioners, to carry out most of their regulatory functions. *See, e.g.*, Internal Revenue Manual, Part 1, Chapter 1, Section 7 (describing the structure of the IRS Office of Appeals); Internal Revenue Service, *What Can Appeals Do for You?*, http://www.irs.gov/individuals/article/0,,id=160726,00.html (describing the Office of Appeals as "independent of any other IRS office and serves as an informal administrative forum for any taxpayer who disagrees with an IRS determination.").

291. *See* Karst, *supra* note 5, at 477.

292. *Id.*

ate with state and federal tax officials to address incidents of abuse.[293] These broad powers would allow the new institution to centralize state regulation of charitable governance in one institution, which would be entirely focused exclusively on charity governance.

In summary, then, the best institution to regulate charities would combine Fishman's proposal to create a state government institution managed by an assistant attorney general, with Karst's proposal to provide the institution with a dedicated staff of charity experts and broad authority to engage in enforcement, rulemaking, auditing and educational activities.[294] While this hybrid approach appears to be superior to either Karst's proposal or Fishman's proposal standing alone, our institutional choice analysis reveals that it too is subject to certain potential problems, which are addressed below.

B. Overcoming the Obstacles

As described in Part III, any state-level approach, including the one proposed above, will suffer from several weaknesses: (i) the lack of sufficient funding for both rulemaking and enforcement purposes; (ii) coordination problems with other state agencies and with federal agencies such as the IRS; (iii) the lack of political will to establish such an entity in at least some states; and (iv) the related problem of unintentional arbitrage, as charities incorporated or otherwise created in different states could face significantly different regulatory regimes, particularly if many states do not create the proposed new institution. Overcoming these obstacles will be the key to creating a state institution that can effectively regulate charity governance. We turn now to consider each of these weaknesses and recommend potential ways that such weaknesses can be eliminated or mitigated.

1. Funding

A lack of funding at the state level has been one of the most significant and persistent obstacles to effective state regulation of charities.[295] A recent study of the charitable sector concluded that in "most states, there are no funds earmarked to support the attorney general's enforcement of

293. *Id.*

294. This assumes that states would have access to additional funding to establish and staff this new institution. For a discussion of funding issues, *see infra* Part IV.B.1 and accompanying text.

295. Federal funding for charity oversight has also been inadequate in light of the growing number of charitable organizations. *See, e.g.*, Owens, *supra* note 12, at 6 ("IRS staffing and other resources dedicated to tax-exempt organizations oversight have fallen or remained stagnant, and there is no evidence that historic levels have been adequate to ensure that significant abuses can be addressed in a timely manner.").

charitable organizations."[296] Another study reached a similar conclusion, finding that funding for charity oversight "varies substantially among states, but all lack sufficient resources to provide adequate oversight of the charitable sector."[297] As a result of these funding shortfalls, the number of attorneys assigned to charity regulation at the state level has remained relatively constant over the past several decades, despite the substantial increase in the number of charities under supervision.[298]

In an effort to remedy this problem, some prominent members of the charitable community have begun to press Congress for more funding state and federal regulation of charities, a proposal that Marion Fremont-Smith also suggested almost forty years ago.[299] For example, in a 2005 report to Congress and the nonprofit sector, the Panel on the Nonprofit Sector recommended that Congress earmark funds derived from a variety of sources, including excise taxes and penalties imposed on charitable organizations, for federal and state regulation of charities.[300] Owens also made a similar argument in a 2006 article on government regulation of charities, where he pointed to the fact that the revenues collected annually from the excise tax on private foundations under Section 4940 of the Internal Revenue Code were originally intended to be earmarked for charitable oversight.[301] The excise tax on private foundation investments is certainly a strong candidate for this funding, not only because it was originally intended for such use but because from 2004 through 2006 it generated annual revenue of over $450 million.[302] Earmarking even a portion of these funds for state regulation of charities would easily provide states with the resources needed to effectively regulate the charitable sector without significantly impacting the federal government.[303] Whether the funds came from this or another fed-

296. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 17.

297. *See* PANEL FINAL REP., *supra* note 2, at 24.

298. BIEMESDERFER & KOSARAS, *supra* note 41, at 17.

299. FREMONT-SMITH, *supra* note 11, at 455–56.

300. *See* PANEL FINAL REP., *supra* note 2, at 24.

301. Owens, *supra* note 12, at 11–12 (recommending an amendment to section 4940 to permit a credit against the excise tax on net investment income for payments made to a federal entity chartered to regulate charity governance).

302. *See* Internal Revenue Service, *SOI Tax Stats: Domestic Private Foundation and Charitable Trust Statistics*, http://www.irs.gov/taxstats/charitablestats/article/0,,id=96996,00.html#2 (Under "Domestic Private Foundations" and "Number and Selected Financial Data," click on the links to the years 2004 through 2006, to view that respective year's financial records in a spreadsheet. Find the column entitled "Excise tax on net investment income" to view the year's total collected excise tax).

303. *See* Fishman, *supra* note 43 at 588–89 (stating his doubts about the possibility of increasing federal funding for state regulation of charities, but agreeing with the proposition that funding for IRS oversight "could come from earmarking excise taxes imposed on private foundations and public charities or from earmarking fees based on asset size that would be imposed on exempt organizations that file Form 990 information returns.").

eral source, these funds could then be allocated to the states by the IRS based on such factors as the number of charities formed in a particular state and the amount of charitable assets and revenues controlled by those charities.

Calls for federal funding of state-level charity regulation have also come from within government, indicating there may be some openness to making such funding a priority even in the current budget environment. In a Staff Discussion Draft published in 2004, the staff of the Senate Finance Committee recommended that Congress authorize the appropriation of up to $200 million of revenue from the tax on private foundations for state and federal funding for charity oversight.[304] Of the $200 million, the staff recommended that $25 million be directed to the states to fund oversight and enforcement efforts, with each state receiving at least $100,000 annually.[305] To encourage states to increase their own funding for state charity oversight, the staff also recommended that states receive federal matching funds for each new dollar of state spending for charity oversight.[306]

This potential solution to state funding shortfalls is attractive in principle because it allows the charitable sector to pay for its own regulation without requiring federal or state governments to come up with new funds for charity oversight. However, given the current fiscal pressures facing Congress, it may be politically challenging to convince Congress to divert assets from the general treasury to state institutions at this time. Nevertheless, federal funding for new state institutions may be the only viable method of providing the states with a consistent source of funding for charity oversight, and should remain a top legislative priority for those seeking an improvement in the current regulatory system.

2. Coordination

Even if federal funds are earmarked for state use, each new state institution will still have to coordinate its regulatory activities with other state and federal agencies charged with regulating charities. At the state level, the new institution will likely need to coordinate with a state executive agency such as the Secretary of State or State Corporation Commission, which handles the filing of corporate charters,[307] and the Department of

304. *See* SENATE FIN. COMM. STAFF DRAFT, *supra* note 2, at 15 (recommending various funding options for state and federal oversight of charities).

305. *Id.*

306. *Id.*

307. *See* FREMONT-SMITH, *supra* note 22, at 364 (noting that the principal purpose of present-day corporate chartering laws is not regulatory, and that states require charities to file annual reports containing no more than a list of current officers and their addresses).

Revenue or Taxation, which processes tax returns and certain state tax exemption applications.[308] The new institution may also need to coordinate with local property tax assessors and the state-level Departments of Education or Health, as well as agencies operating in other states.[309] At the federal level, the new institution will primarily need to coordinate its activities with the IRS, but it may occasionally work with other federal agencies such as the Department of Justice or Federal Trade Commission, which play a more limited role in regulating charities.[310]

The institution's exclusive focus on state charity regulation will likely improve coordination at the state level. Instead of relying on the attorney general to handle intra-state and inter-state (for charities with activities in more than one state) regulatory coordination while also managing an array of other responsibilities, the new agency will have a dedicated staff whose attention will be focused entirely on the charitable sector and who will be well positioned to refer issues to other appropriate state and federal agencies. Where the new institution is also given responsibility for overseeing charitable solicitation and non-profit corporate charter registration and reporting, as recommended by both Fremont-Smith and Karst more than forty years ago,[311] the agency will also be able to take advantage of certain economies of scale by having all of those regulatory functions provided by one institution.[312]

The more difficult challenge involved in establishing a new state-level institution will be the problem of coordinating each institution's regulatory activities with the IRS, especially if the IRS is responsible for allocating to the states any federal funding, whether from the revenue derived from the tax under section 4940 on the net investment income of private foundations, or from some other source. Until recently, coordination between state and federal charity regulators has not been particularly strong, in part because certain provisions of the Internal Revenue Code prevented the Treas-

308. Some states require local or municipal agencies to administer property tax exemptions. *See, e.g.*, MD. CODE ANN., INS. § 7-103(b)(1) (West 2009) ("A person claiming an exemption shall apply to the supervisor of the county where the real property is located on the form that the Department requires.").

309. *See* FREMONT-SMITH, *supra* note 22, at 365–66.

310. *Id.* at 400, 423–25.

311. *See* FREMONT-SMITH, *supra* note 11, at 441; Karst, *supra* note 5, at 477. Questions about the preferred method of enforcing charitable solicitation and corporate charter registration and reporting rules are not addressed and this article.

312. Not all state-level functions will be easily transferred to the new institution. For example, many states may prefer to have local and municipal agencies administer property tax exemptions rather than a centralized state agency. *See supra* note 308. However, the staff of the new institution will be able to refer issues to local and municipal agencies if they become aware of potential abuses.

ury Department from disclosing information to state officials.[313] However, amendments introduced by the Pension Protection Act of 2006 provide that the Secretary of the Treasury may disclose significantly more information to state regulators than in the past, including notices of proposed denial or revocation of tax-exemption of a 501(c)(3) organization, and certain tax return information of organizations that have applied for or obtained tax-exempt status.[314] As a result of these recent changes to the Internal Revenue Code, the potential coordination problems between the new institution and the IRS appear to be less significant than they were in the past.

The transfer of funds from the IRS to the states may also help to improve the flow of information between state and federal regulators by providing state and federal regulators with regular opportunities for communication. In exchange for federal funds, the IRS could require states to satisfy certain uniform *procedural* standards for regulating charities. For example, the IRS could require the state institution to file an annual, public report with information about the institution's use of the federal funds, its regulatory and educational initiatives, and any disciplinary actions taken against particular charities. The IRS could also require the state institution to create a state registry of charitable organizations, and require charities to file annual reports containing information about their governance activities. These federally-imposed standards would help to ensure a level of procedural uniformity among the states, while protecting the right of each state to enact and enforce its own governance rules without interference from the IRS.[315]

Many federal agencies have already adopted similar programs involving the disbursement of federal funds for state-administered programs. For example, under the Housing and Community Development Act of 1974, Congress authorized the U.S. Department of Housing and Urban Affairs ("HUD") to provide funding for state-administered Community Development Block Grants ("CDBG"), which help expand housing and work opportunities for low- and moderate-income individuals.[316] Under the CDBG program, "HUD distributes funds to each state based on a statutory formula which takes into account population, poverty, incidence of overcrowded

313. *See, e.g.*, FREMONT-SMITH, *supra* note 22, at 426 (describing the problems of federal-state coordination); Owens, *supra* note 12, at 8 (finding that certain provisions of the Internal Revenue Code precludes coordination between the IRS and state charity regulators).

314. *See* I.R.C. § 6014(c) (2009). For an explanation of the changes to the Internal Revenue Code introduced by the Pension Protection Act of 2006, see JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF H.R. 4 (Aug. 3, 2006), *available at* http://www.dol.gov/ebsa/pdf/x-38-06.pdf.

315. The IRS has acknowledged that it generally has limited authority to create substantive rules pertaining to charitable governance. *See generally supra* note 212.

316. *See* 42 U.S.C. § 5301(c).

housing, and age of housing."[317] States that receive funding from HUD then distribute the funds to local governments pursuant to their respective community development objectives.[318] As long as the states comply with certain minimal federal requirements, including the obligation to use the funds to provide fair housing for low- and moderate-income individuals, HUD generally allows the states to make their own disbursement decisions.[319] Another example of a federally-funded program administered at the state level is the Department of Energy ("DOE") Weatherization Program, which provides federal funding to states to help weatherize homes of low-income individuals.[320] Under the Weatherization Program, the DOE provides funding to the states based on established formula,[321] but allows the states to run their own weatherization programs.[322] In exchange for the funds from DOE, states must satisfy certain ongoing reporting requirements.[323] An even more established federal-state partnership involves the provision of unemployment compensation under the Federal-State Unemployment Insurance Program ("UI Program").[324] Under the UI Program, the federal government establishes certain minimum standards and requirements that the states accept (and can build upon) in exchange for a federal subsidy.[325]

Following the example of these and other federal programs,[326] the IRS could be authorized to develop a formula that would allow it allocate funds to the states for charity governance oversight.[327] In order to keep administrative costs to a minimum, the IRS could annually disburse such funds using a simple method of allocation based on the number of charities regis-

317. *See* U.S. Department of Housing and Urban Development, State Administered CDBG, http://www.hud.gov/offices/cpd/communitydevelopment/programs/stateadmin/.

318. *Id.*

319. *Id.*

320. *See, e.g.*, Department of Energy, Weatherization Assistance Program: The American Recovery and Reinvestment Act of 2009 http://apps1.eere.energy.gov/weatherization/pdfs/wx_recovery_fact_sheet.pdf.

321. *See id.*

322. *See* Department of Energy, About the Weatherization Assistance Program, http://apps1.eere.energy.gov/weatherization/about.cfm.

323. Department of Energy, 2009 Recovery Act: Frequently Asked Questions about Weatherization, http://apps1.eere.energy.gov/weatherization/recovery_act_faqs.cfm.

324. *See, e.g.*, 20 C.F.R. § 601.1(c) (2009).

325. *See id.*; FREMONT-SMITH, *supra* note 11, at 455–456 (drawing this parallel).

326. *See, e.g.*, Fremont-Smith, *supra* note 9, at 641–42 (describing social security, as well as unemployment benefits, as federally-funded programs that are administered by state agencies).

327. For example, the Federal Highway Administration disburses funds to states using federally mandated formulas and procedures. *See, e.g.*, U.S. DEP'T. OF TRANSP. FED. HIGHWAY ADMIN., FINANCING FEDERAL-AID HIGHWAYS 56 (2007), http://www.fhwa.dot.gov/reports/financingfederalaid/financing_highways.pdf.

tered in a particular state and the size of assets under supervision.[328] In special circumstances, the IRS could also disburse additional matching funds or one-time grants to incentivize states to implement effective oversight programs. By taking this approach to coordination, the IRS's disbursement of funds would improve procedural uniformity among the states without interfering with state substantive standards for charity governance.

3. Political Will

One of the most significant obstacles to the creation of new state-level institutions is a lack of political will. To date, very few state legislatures have enacted legislation requiring charities to register and file reports with the attorney general's office,[329] and it is questionable whether any state legislatures have provided the state attorney general's office with adequate funding or staffing to effectively regulate charities.[330] The result, of course, is that many states have had ineffective regulatory programs in place for many years, and have shown little interest in changing the status quo.[331]

Despite the perceived lack of political will at the state level, there are signs that many states, including some of the states with the largest concentration of charities, are beginning to take a more active role in regulating charities. At present, most of the sixteen states in which the majority of charities are clustered already have charitable sections within their respective attorneys general offices.[332] As described in Part I.A, theses states are home to approximately fifty-seven percent of all U.S. charities, which hold approximately sixty-two percent of all reported charitable assets. Thus, more than half of all charities are already located in states that have in place a foundation for the development of a new state institution.[333]

328. More complex methods could also be developed, but any level of additional complexity would increase the problem of coordination between the federal and state government. In developing the allocation formula, assets under supervision could be determined based on amounts reported on Forms 990 and 990-PF. However, Form 990 and Form 990-PF reporting is frequently inaccurate and would not account for the assets held by non-filing religious organizations.

329. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 4 (noting that only 11 states have enacted general registration and reporting statutes); FREMONT-SMITH, *supra* note 22, at 642 (noting that no new states have enacted general registration and reporting requirements since the 1970s).

330. *See* Fishman, *supra* note 11, at 262–63, 272 (describing funding problems and other obstacles to enforcement of state governance standards).

331. *See* Swords, *supra* note 48, at 577.

332. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 17.

333. For example, New York has 20 full-time attorneys in the charities section of the attorney general's office, while Pennsylvania has 12, California has 11, and Ohio has 10. *See id.* at 4. Several states also employ auditors or financial investigators to assist with reviewing reports filed by charities and with active audits or investigations of charities. *Id.*

A number of recent state-level initiatives also indicate that many state legislatures and state attorneys general are committed to, or at least have a significant interest in, finding effective ways to regulate charities.[334] For example, over the past three years, a significant number of states have enacted the Uniform Prudent Management of Institutional Funds Act, which established new standards to govern the investment and management of endowment funds.[335] In addition, a number of states have proposed or enacted laws requiring charities of a certain size to complete annual financial audits,[336] and a few other states have pursued new public-private partnerships to improve charity governance.[337]

These new public-private partnerships provide a particularly strong example of the way in which state legislators and regulators are taking a more active role in educating and policing charities and their managers. In Illinois, for example, the state legislature recently passed a law establishing a permanent advisory body of professionals and practitioners to advise the attorney general on issues affecting the charitable community.[338] Likewise, in Michigan, the attorney general recently established an advisory council consisting of volunteers from Michigan non-profit and philanthropic organizations.[339] Although these state advisory boards lack any enforcement or rulemaking authority, they are evidence of the facts that states—or at least some states—are actively pursuing new methods of regulating charities.

Building on these developments, the federal government can help states to further improve their regulation of governance through the offer of federal funding. Even though the federal government cannot force states to create a regulatory regime or enact specific laws,[340] it can use federal funds to provide states with an incentive to establish the proposed institution. Of course, states are always free to reject federal funds, as some have recently done in connection with the federal stimulus plan.[341] To further encourage states to accept federal funding, and to ensure long-term success of the state institution, the federal government could permanently earmark federal

334. *See* Fremont-Smith, *supra* note 9, at 642 (summarizing legal developments at the state and federal level and concluding that there is an unprecedented interest in charity law right now).

335. *See* UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (2009).

336. *See* Brakman Reiser, *supra* note 19, at 243 (noting these efforts tend to focus on financial accountability).

337. *See, e.g.*, BIEMESDERFER & KOSARAS, *supra* note 41, at 23–27.

338. *Id.* at 23 (also discussing public-private partnerships in New Hampshire and Ohio).

339. *Id.* at 28.

340. *See supra* note 210 and accompanying text.

341. *See, e.g.*, Shaila Dewan, 6 Governors May Reject Portions of Stimulus, N.Y. TIMES, Feb. 20, 2009, at A12, *available at* http://www.nytimes.com/2009/02/21/us/21govs.html.

funds for state use. Given that states are already responsible for enforcing fiduciary duties, and are struggling with significant budget shortfalls, it seems unlikely that states would refuse federal funding for this purpose. If successful, the use of federal funds to support state regulation of charities would help to resolve the problem of a lack of political will at the state level and would lead to widespread improvement in the ability of states to enforce fiduciary duties and implement effective remedial and educational programs.

4. Arbitrage

Even if it is possible to convince Congress to earmark funds for state use, and thereby incentivize states to create new institutions, there is still a risk that some states will be more active than others in terms of developing and enforcing state governance laws. The lack of uniformity among states, both in terms of their substantive laws and the vigor of enforcement, creates a risk that charities formed in states with weak standards and lax enforcement will not comply with basic governance norms or will not be called to account for violations of state law. In a worst-case scenario, this potential disparity among the states could lead to a "race to the bottom" where charities incorporate or re-incorporate in states with the weakest standards in order to avoid having to comply with more demanding state laws.

On this last point, it should be noted that there is no convincing evidence that charities generally decide where to form based on the specifics of a state's charity oversight regime. In fact, the little evidence that exists indicates to the contrary. In a recent study, Garry Jenkins found that unlike their for-profit counterparts, nonprofit corporations usually simply incorporate where they initially begin their activities even if they hope to eventually have multi-state, national, or even international activities.[342] Moreover, there appears to be little re-incorporation activity by established charities in an attempt to come under a less restrictive or otherwise more favorable

342. *See* Garry W. Jenkins, *Incorporation Choice, Uniformity and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1152 (2007) (finding that compared to their corporate counterparts, the incorporation decisions of nonprofit organizations are far more parochial). Of course, some new charities probably do choose to incorporate in states perceived as having more friendly—or inattentive—regulators. *See generally* Douglas M. Mancino, *Dealing with Multiple Masters: Planning Opportunities*, *available at* http://www1.law.nyu.edu/ncpl/pdfs/2006/Conf2006_Mancino_FINAL.pdf (discussing formation decisions for nonprofit organizations, including legal differences between different jurisdictions). The Jenkins study indicates, however, that charities engaging in such behavior are relatively uncommon as compared to their for-profit counterparts.

state regulatory regime.[343] This lack of strategic incorporation and re-incorporation decisions may stem from a number of motivations, including that charities simply have other priorities than trying to avoid state regulatory oversight, they perceive limited gain from such changes because substantive legal standards are generally the same across the states,[344] and/or they perceive significant potential costs from such changes including adverse attorney general attention[345] and the need to reapply for federal tax-exempt status.[346]

Larger charities that are registered to do business in multiple jurisdictions, and who are more capable of engaging in forum shopping, may be discouraged from doing so if a significant majority of states create new state institutions to oversee charities. With more state regulators reviewing annual filings, responding to complaints of governance failures, investigating newspaper reports of malfeasance, and sharing information with other regulators, larger charities that operate in multiple jurisdictions are more likely to get caught even if their home state is not being vigilant.

Given these facts, the real arbitrage risk is not of *intentional* arbitrage by charities but of *unintentional arbitrage* where some charities, by accident of birth, find themselves in lower enforcement jurisdictions.[347] Such a result is particularly likely if this state-level option is only adopted by some states, which has been the general pattern even when seemingly non-controversial ideas such as requiring charities to at least register with a state authority have been proposed.[348] To reduce the risk of unintentional

343. *See id.* at 1165–67 (noting that the process of reincorporation is fairly complex for nonprofit organizations and can result in significant costs, which many non-profits are unwilling or unable to bear).

344. *See supra* notes 60–61 and accompanying text.

345. *See* Jenkins, *supra* note 342, at 1166–67 (explaining the role of the attorney general in overseeing corporate transactions that result in charitable assets leaving the state). State attorneys general have actively resisted attempts by non-profit hospitals to remove assets from the state through sales of assets, corporate combinations, or other transactions. *See, e.g.*, Banner Health Sys. v. Lawrence E. Long, 663 N.W.2d 242, 243 (S.D. 2003); In re Manhattan Eye, Ear & Throat Hosp., 715 N.Y.S.2d 575, 576–77 (N.Y. Sup. Ct. 1999).

346. *See* Rev. Rul. 67-390, 1967-2 C.B. 179 (holding that a new legal entity is created when a tax-exempt organization incorporated in one state is re-incorporated in another state with no change in its corporate purposes, and that the new legal entity is separate from the predecessor organization for purposes of applying the notice requirements of Code Section 508, which generally require non-profit organizations are required to file an application with the IRS on Form 1023 in order to be recognized as being tax-exempt under Code Section 501(c)(3)); Jenkins, *supra* note [342], at 1166.

347. It is true that if regulatory oversight increases in at least some jurisdictions, the incentive to engage in intentional arbitrage would increase. There are, however, reasons why even then the vast majority of charities would not engage in such behavior. *See supra* notes 197–198 and accompanying text (describing the reasons why charities, unlike for-profit entities, are less likely to uniformly oppose or seek to avoid government regulation).

348. *See* BIEMESDERFER & KOSARAS, *supra* note 41, at 4 (noting that only eleven states have enacted general registration and reporting statutes).

arbitrage, it will be important to find ways to incentivize all states to improve their enforcement of fiduciary duties. Certainly, the possibility of federal funding could serve as a significant inducement for states to improve their enforcement efforts, but other pressures—including political pressure from neighboring states and the broader charitable community—might also help to create an effective, national regulatory system administered at the state level.

CONCLUSION

There has been no lack of thought regarding how to ensure better compliance with the duties the law imposes on charity leaders. Nor has there been a lack of concern with the need for such improvement, given the sharp growth of the charitable sector, its reduced dependence on donor support, the uncertainty regarding the extent to which charity leaders neglect or intentionally violate their duties, and the harm to the public's trust in charities that even a relatively few well published cases of such violations can cause. What this article adds to this discussion is a methodology for more rigorously evaluating the various options available for seeking that improvement, an application of that methodology to identify the best available option, and a suggestion for how to minimize the downsides of implementing that best but still imperfect option.

There may, of course, be disagreement regarding the specifics of the methodology, how the article applies it to the available options, and the federal financing proposal the article puts forward. Furthermore, new data regarding the factors considered in choosing the best option might lead to a change in the ultimate conclusion. Regardless of such disagreements and new data, however, the framework put forward here should help advance the ongoing debate over what institution should be given the authority to develop and enforce charity governance standards. It is particularly important to advance that debate in light of the apparently flawed push to grant the IRS authority in this area, a choice that is not supported by this article's analysis.

Finally, while this article's focus has been on the question of improving charity governance, the framework may have broader applications. There are numerous substantive areas, including financial regulation, for-profit corporate governance, legal ethics, and others, where one of the key questions is what institution—government versus private, local versus state versus federal, agency one versus agency two—should be charged with responsibility for promoting or reaching agreed upon policy goals. Hope-

fully the approach developed in this one important but limited area will also advance the discussions in these other areas of public concern.