



The Hauser Center
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**The Search for Greater Accountability of
Nonprofit Organizations:
Recent Legal Developments and Proposals for Change**

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Abstract

Recent changes in federal and state laws governing non-profit charitable organizations are transforming the rules under which they operate and the methods by which they and their fiduciaries are held accountable to government and the public. These changes include relaxing the rules prohibiting donors from bringing legal suits to enforce the terms of their gift or agreeing to modify restrictions; liberalizing the doctrines of cy pres and deviation under which charitable purposes and methods for administering them may be revised due to changed circumstances; imposing new duties on directors of charitable corporations and redefining the scope of their duties of loyalty and care. The Pension Reform Act of 2006 changed some of the IRC provisions dealing with charities and others are being considered in the Congress. Recommendations to increase federal and state regulation are also being considered together with proposals for expanding the breadth of self-regulation. The paper describes these changes and their proponents. It concludes with observations on their efficacy and the likelihood of their being adopted.

INTRODUCTION

Charity law is in a state of flux: the basic rules, many with roots in earliest common law, are being reconsidered and revised by legislators, scholars and practitioners. Among these are rules prohibiting donors from bringing legal suits to enforce the terms of their gifts; laws limiting the ability of donors to agree with charitable donees to modify the terms of their gifts; the doctrines of cy pres and deviation under which charitable purposes and methods for administering them may be altered due to changed circumstances; the statutory provisions imposing on all directors of charitable corporations a duty to participate in the affairs of the corporation; and the rules setting forth the extent to which charitable fiduciaries can be held liable for breach of their duties of loyalty and care.

In the realm of enforcement of these rules, Congress has been asked to consider measures to enhance the existing regulatory scheme which relies on the Internal Revenue Code to define the duties and obligations of charitable fiduciaries and looks to the Internal Revenue Service as the agency to enforce these obligations. At the same time, some scholars are suggesting that all regulation be removed from the IRS or that some of its powers be transferred to an agency more suited to regulate tax exempt entities than an agency whose principal focus is tax collection.

This paper contains a survey of the most recently adopted changes and pending proposals for change in both state and federal law applicable to nonprofit charitable organizations, focusing on developments in substantive state laws expanding the rights of donors and the doctrines of cy pres and deviation. It also describes amendments to the Internal Revenue Code enacted in August 2006 and others proposed by the Staff of the Senate Finance Committee and by the Joint Committee on Taxation since 2004 that remain under consideration in the Congress, together with responses to them from the nonprofit community and interested scholars and practitioners.¹

¹ The term “charities” as used herein refers to organizations described in section 501(c)(3) of the Internal Revenue Code that are eligible to receive contributions that are deductible by their donors for federal tax purposes. In some instances it also includes organizations exempt from tax by virtue of being described in

Current law grants privileges to charitable nonprofit organizations; of these, tax exemption is foremost, but they also include unlimited life, the ability to accumulate income, and protection to fiduciaries from suits by unhappy or unruly donors, as well as by members of the general public. Substantive laws in the individual states define charitable purposes, govern the creation and dissolution of charities, and set forth the duties and powers of their fiduciaries; the provisions of the Internal Revenue Code mirror these state rules - some impose more stringent limitations while others are more lenient.

Enforcement of state laws is the unique province of the attorneys general who have traditionally had exclusive jurisdiction to bring wrong doing to the attention of state courts, with the courts empowered to apply a wide range of sanctions to assure compliance with the rules and remedy violations. In contrast, as noted, enforcement of the federal laws is in the hands of the Internal Revenue Service, which has the power to revoke exemption, and apply financial sanctions in the form of excise taxes, as well as unique standing to pursue actions in the federal courts, including the Tax Court and the Court of Appeals. Thus, one must consider two levels of governments – each with differing interests and goals – and one must also consider the advantages of uniformity, lest compliance becomes an impossible burden or disparate rules create such confusion that enforcement becomes near impossible.²

STATE LAW: SIGNIFICANT DEVELOPMENTS AND PROPOSALS

State laws governing the organization and operation of charitable nonprofit organizations are to be found in the statutes enabling creation of charitable corporations and trusts, including statutes and case law defining accepted charitable purposes for which they may

Code section 501(c)(4), many of which are considered charities under state laws. The remaining universe of nonprofit organizations described in section 501 are not subject to the constraints under either federal or state law described herein, nor are they the focus of current interest in reform.

² Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation*, Belknap Press of Harvard University Press, 2004, contains detailed descriptions of the history of charity, existing laws and enforcement regimes referred to herein together with proposals for reform.

be created; statutes and case law describing the powers, duties and liabilities of fiduciaries in regard to the administration of these entities; and statutes and cases governing the dissolution or merger of charitable organizations that in all instances direct the application of their assets to other charitable entities or when circumstances require permit modification of their purposes or methods of administration so that they may continue to provide contemporaneous benefit to the general public.

The major recent changes in state laws that have been enacted or are being considered involve statutes governing creation and administration of charities; rights of donors; the doctrines of cy pres and deviation that the courts apply when there are changed circumstances; and the duties and extent of liabilities of trustees and directors in cases of breach. There has been far less interest in increasing regulation of charities in the states, although proposals to enhance the power of the attorney general have been considered in a few states together with provisions that would impose limits on charities similar to those in the Sarbanes-Oxley Act applicable to publicly traded companies.

The Proponents of Change

The leading proponents of change in state charity laws, in addition to individual legislators and members of the executive branch, notably the attorneys general, are the American Law Institute, the National Conference of Commissioners on Uniform State Laws, and the American Bar Association acting through committees of its various Sections. Since 1990 each of these groups has been considering major reforms of certain aspects of the laws governing charities. A number of their proposals have been adopted in various states, while others are still being refined. In addition the attorneys general in California, New York, Massachusetts and Texas had introduced bills designed to improve regulation. As of January 1, 2007, only the California bill had been adopted.

The first of the recent changes in state laws governing the administration of charities was the adoption in 1992 of a new “Prudent Investor Rule” as part of the Restatement (Third)

of Trusts, section 227.³ It incorporated the principles of modern investment theory and made obsolete old concepts of trust investment that in many jurisdictions severely restricted the ability of fiduciaries to make wise investments. The Rule is intended to apply to charitable and private trusts as well as charitable corporations and is now in force in 36 states.⁴ Additional changes to the Restatement (Third) of Trusts, adopted in 2001 and 2003, enlarged the definitions of specific categories of charitable purposes in earlier versions and liberalized the doctrine of cy pres.

In 2000 the National Conference of Commissioners on Uniform State Laws adopted the Uniform Trust Code, subsequently amending it in 2001 and 2003. As of January 1, 2007 it had been adopted in 19 states. Section 413 contains a new formulation of the doctrine of cy pres that follows Restatement (Third)⁵ but, in a radical change from prior law, section 405 grants standing to donors to enforce the terms of their charitable gifts.⁶

In 2002 the Commissioners constituted a study committee to consider amendments to the Uniform Management of Institutional Funds Act, first promulgated in 1972 and as of January 1, 2007, in force in 48 states.⁷ This Act governs investment and management of endowment and other restricted fund and was not in conformity with the principles in the Modern Prudent Investor Act. Proposed revisions were considered by the Commissioners at their annual meetings in 2004 and 2005 and it was adopted in July 2006. Revisions to the original act dealing with donor intent and donors' powers and cy pres are described below.

The major recent impetus for change in nonprofit law is the inauguration by the American Law Institute in 2001 of a project to define Principles of Nonprofit Law that

³ RESTATEMENT (THIRD) OF THE LAW OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992).

⁴ See UNIF. PRUDENT INVESTOR ACT and corresponding state statutes, *available at*: <http://www.law.cornell.edu/uniform/vol7.html#pruin>.

⁵ UNIF. TRUST CODE, §413 cmt. (2006).

⁶ *Id.* at §405 cmt.(2006).

⁷ UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (1972).

will parallel its Principles of Corporate Governance for business corporations adopted in 1992. Following its established procedures, the ALI formed a Committee of Advisors and a Members Consultative Group and appointed Professor Evelyn Brody of Chicago-Kent School of Law as Reporter. Preliminary drafts were published in subsequent years, and the membership reviewed provisions relating to governance. In September, the ALI Council reviewed a revised draft that reflected the May discussions.⁸ These provisions are described below.

In February 2006, a Task Force to Revise the Model Nonprofit Corporation Act, constituted by the Committee on Nonprofit Corporations of the Section on Business Law of the American Bar Association, circulated an exposure draft of the “Proposed Model Nonprofit Corporation Act, Third Edition.” A Model Nonprofit Corporation Act was first published in 1952. It was subsequently amended in 1987 and is referred to as the Revised Model Nonprofit Corporation Act.⁹

In the summer of 2006, the Commissioners on Uniform State Laws were asked to consider revisions to the Uniform Act for the Supervision of Charitable Trusts, adopted in 1954.¹⁰ This Act, which mandated registration and annual reporting by charities to the attorney general and enhanced his regulatory powers, formed the basis for statutes now in effect, but with major substantive changes, in California, Illinois, Michigan, Oregon, and New York.¹¹ There has been little interest in its adoption by other states since the mid-1960s and proponents of revision argued that it should be revised to reflect changes required since its adoption or whether it should be repealed.

Proposals to Modify Laws Relating to Governance

⁸ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS (Council Draft No. 4, 2006).

⁹ REVISED MODEL NONPROFIT CORPORATION ACT (RMNCA) (1987).

¹⁰ UNIFORM ACT FOR THE SUPERVISION OF CHARITABLE TRUSTS (1954).

¹¹ See MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 311-17 (The Belknap Press of Harvard University Press 2004).

Mandating audits and Audit Committees: In the wake of enactment by Congress in 2002 of the Sarbanes-Oxley Act, which imposed new obligations on publicly traded business corporations, a number of states considered extending some of its provisions to charities, most notably those mandating financial audits, audit committees comprised of independent directors, and certification of financial reports by CEOs and CFOs.¹² Although there appeared to be general interest in the initiative, only California adopted the proposed changes. This California Act, adopted in 2004, added an audit requirement for charities with gross receipts of \$2 million or more and mandated that they create audit committees.¹³ The original bill, submitted by the attorney general had a \$1 million threshold, but after protest from some parts of the nonprofit sector, it was raised before final passage.¹⁴

In 2004, the New York attorney general submitted a number of bills to the legislature designed to clarify his enforcement powers and “help prevent financial frauds from occurring within not-for-profit corporations.”¹⁵ In their original form, audits and audit committees would have been mandatory for charities with annual revenue and support of \$1 million or more.¹⁶ This provision was subsequently modified to encourage, but not require, boards to designate audit committees, while specifying its duties if one were to be established, mandating that the members be independent and prohibiting self dealing.¹⁷ However, only one of the bills submitted by the attorney general was passed in 2006: it clarified procedures for dissolution of charities.¹⁸ A bill introduced in Texas in 2005 was similar to the New York proposal, requiring audits for corporations with gross

¹² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

¹³ Nonprofit Integrity Act of 2004, CAL. GOV'T CODE § 12586 (2004).

¹⁴ See *Cal. Assemb. on Judiciary, Cal. Bill Analysis*, S.B. 1262 Assemb. (West June 22, 2004); *S. Judiciary Comm., Cal. Bill Analysis*, S.B. 1262 Assemb. (West April 20, 2004).

¹⁵ N.Y. Attorney General's Legislative Program Bill, #68-05, *available at*: http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf.

¹⁶ N.Y. S. Bill 4836-A (g)(1) (Apr., 23, 2003).

¹⁷ N.Y. Attorney General's Legislative Program Bill, #68-05, *available at*: http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf.

¹⁸ N.Y. NOT-FOR-PROFIT CORP. § 10 (amended 2006).

revenues of \$750,000 and reviews if they were between \$500,000 and \$750,000.¹⁹ In January 2007 a bill was introduced in the Hawaii legislature that was similar in some respects to the California act, requiring audits and audit committees for nonprofit corporations with annual receipts of \$1 million or more, and including extensive provisions relating to whistleblowers.²⁰

As of January 1, 2007, Massachusetts, New Hampshire and California were the only states that required audits for charities. In Massachusetts and New Hampshire the only exemption is for religious organizations.²¹ California exempts religious organizations, cemetery corporations, educational institutions and health care agencies.²² Charities that solicit funds from the general public have been regulated for more than 30 years. Today, 39 states actively regulate fund-raising, although the statutes contain myriad exemptions for certain categories of charities, notably religious organizations, educational institutions and health care agencies.²³ Nineteen of these contain an audit requirement.²⁴

In almost all of the jurisdictions that require corporations to have audit committees, an indirect concomitant is that there be independent directors to serve thereon. California, Maine, New Hampshire, North Dakota and Vermont require that a majority of the directors of charitable corporations be “independent.”²⁵ However, in all of these except New Hampshire, independence is defined in terms of compensation, while in New

¹⁹ S.B. 1215, 79(R) Leg. (Tex. 2005).

²⁰ S.B. 73, 24th Leg. (Haw. 2007). *available at:* http://capitol.hawaii.gov/sessioncurrent/bills/SB73_.htm.

²¹ MASS. GEN. LAWS ch. 12, § 8F (2006); N.H. REV. STAT. ANN., §§ 7:19 and 7:28 (2006).

²² CAL. GOV'T CODE § 12586 (2004).

²³ See Fremont-Smith, *supra* note 2, at 55 and 476-95.

²⁴ See *Cal. Assemb. on Judiciary, Cal. Bill Analysis*, S.B. 1262 Assemb. (West June 22, 2004); *S. Judiciary Comm., Cal. Bill Analysis*, S.B. 1262 Assemb. (West April 20, 2004). See also Marion Fremont-Smith, *Requirements of Financial Statements* (Nov. 17, 2004) (unpublished chart on file with the author).

²⁵ CAL. CORP. CODE § 5227 (2006); ME. REV. STAT. ANN. Tit. 13-B, § 713A (2006); N.H. REV. STAT. ANN., § 7:19-a (2006); N.D. CENT. CODE § 10-33-27 (2006); VT. STAT. ANN. Tit. 11B § 8.13 (2006).

Hampshire the limitation, which does not apply to private foundations, defines independent in terms of family affiliation.²⁶

Mandating Board Size and Committee Structure: The thrust of the Sarbanes-Oxley Act and state laws with similar provisions was to increase accountability of directors. In direct contrast, the proposed revisions to the Model Nonprofit Corporation Act would eliminate provisions in the existing Model Act designed to protect assets upon the dissolution of charities, permit broader delegation of directors' duties and greatly narrow the extent to which fiduciaries could be held liable for violations of the duties of care and loyalty, permitting nonprofit corporations in effect to grant to their directors what would amount to virtually complete immunity from suit.

The current version of the model act was drawn from the California Nonprofit Corporation Act which divided nonprofits into three categories: public benefit (charities), mutual benefit, and religious corporations (under substantive law also charities) with provisions relating to organization, termination and duties of fiduciaries suited to their differences.²⁷ The impetus for the proposed revision was to make it follow more closely revisions to the ABA Model Business Corporation Act that was adopted in 2002.²⁸ The separate categories of nonprofit corporations are deleted in the proposed revision, as are provisions relating to the enforcement powers of the attorney general.

One of the major current issues in regard to governance of nonprofit organizations is the degree to which directors can be assigned less than full responsibility for the affairs of the corporation. The proposed new Model Nonprofit Corporation Act provides that some, but less than all, of the powers, authority or functions of the board may be vested in a "designated body," thereby relieving certain directors from their duties and liabilities with respect to those powers, authority or functions.²⁹ Some commentators have

²⁶ *Id.*

²⁷ See Fremont-Smith, *supra* note 2, at 52.

²⁸ See generally, MODEL NONPROFIT CORP. ACT, 3d Ed., Source Notes (Exposure Draft 2006).

²⁹ MODEL NONPROFIT CORP. ACT, 3d Ed. §8.12(c) (Exposure Draft 2006).

suggested amending enabling statutes to permit different classes of board members – those with full responsibility for oversight, and others with specific functions such as fund-raising, or with no specific duties or responsibilities other than lending their name and prestige to the organization.³⁰

The ALI Principles of Nonprofit Law Discussion Draft criticized the concept of “designated bodies,” considering as better policy the current law view that all board members should have the same responsibility for governance.³¹ It suggested that it was possible to find alternative ways to recruit supporters to provide financial and other aid but who did not want to make the commitment required for full board governance.³² The Discussion Draft also addressed the question of the size of a board, recommending that three unrelated individuals would be a necessary minimum in order to protect the public interest.³³ Under current law fourteen states permit one director, and the others specify three or more.³⁴ None set a maximum, although fifteen is considered by some commentators as optimal for for-profit corporations.³⁵ As noted below, a limit of fifteen was proposed by the Senate Finance Committee Staff as a best practice, compliance with which would be required as a condition of certification for tax exemption.³⁶ The charity governance bill submitted by the New York attorney general in 2006 did not contain a limit on size; rather it recommended that charities “with very large boards of directors (i.e. more than 25 members) should establish an executive committee.”³⁷

³⁰ Michael Klausner & Jonathan Small, *Failing to Govern? The Disconnect Between Theory and Reality in Nonprofit Boards, and How to Fix It*, 3 STANFORD SOCIAL INNOVATION REV. (Spring 2005).

³¹ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 320 cmt. (b)(2) (Discussion Draft 2006).

³² *Id.*

³³ *Id.* cmt. (g)(3).

³⁴ Marion Fremont-Smith, State Nonprofit Corporation Act Requirement (chart on file with author).

³⁵ *Tax-Exempt Reform Proposals*, Senate Finance Comm., 108th Cong. 12 (Roundtable Discussion July 22, 2004).

³⁶ *Tax-Exempt Reform Proposals*, Senate Finance Comm., 108th Cong. 12 (Staff Discussion Draft 2004), available at: <http://www.senate.gov/~finance/hearings/testimony/2004test/062204stfdis.pdf>.

³⁷ Memorandum from Elliot Spitzer, Summarizing N.Y. Attorney General’s Legislative Program Bill, #68-05, available at: http://www.oag.state.ny.us/charities/char_pdf/ag68-05memo.pdf.

Liability shields for directors and officers: On the issue of liability of board members for breaches of the duties of loyalty and care, the ALI Draft Principles propound a more restrictive rule than that contained in the proposed ABA Model Act, in section 370 prohibiting the application of a monetary shield when there is violation not only of the duty of loyalty but also of the duty of care if bad faith was also involved.³⁸ In contrast, the proposed ABA Model Act follows the provisions of the Model Business Corporation Act, 2.02-b(4) excepting from the protection of a shield only a financial benefit to which a director is not entitled, an intentional infliction of harm on the corporation, making improper distributions, or an intentional violation of criminal law.³⁹

Expanding The Legal Definition of Charitable Purposes

Charitable purposes are to be found in the earliest cases in the common law and were first codified in the 1601 Statute of Charitable Uses.⁴⁰ In fact, the current definition of charitable purposes remains strikingly similar to the examples in that formulation. In the United States, the definitions are to be found in early court decisions.⁴¹ They have always been phrased in general terms, permitting expansion to reflect the changing needs of society.⁴² Restatement of Trusts, Second, adopted in 1959, summarized the then current law by listing five specific categories – relief of poverty; advancement of knowledge or education; advancement of religion; promotion of health, and governmental or municipal purposes - together with a fifth -“other purposes that are beneficial to the community.”⁴³ It then stated: “A purpose is charitable if its accomplishment is of such social interest to

³⁸ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 370 (Discussion Draft 2006).

³⁹ REVISED MODEL NONPROFIT CORPORATION ACT § 8.30 (d) (shield) and § 2.02(b)(5) (exception) (1987).

⁴⁰ Statute of Charitable Uses, 1601, c. 4, 43 Eliz.

⁴¹ See FREMONT-SMITH, *supra* note 2, at 118-21.

⁴² See *id.*

⁴³ RESTATEMENT (SECOND) OF TRUSTS § 368 (1959).

the community as to justify permitting property to be devoted to the purpose in perpetuity.”⁴⁴

Section 28 of the 2001 revisions to the Restatement of Trusts added to this sentence the phrase “and to justify the various other special privileges that are typically allowed to charitable trusts.”⁴⁵ This was in reference to relaxation of the rules against perpetual existence and accumulations of income, as well as leniency in matters of interpretation. Each of the Restatements also emphasized that there is no fixed standard to determine what purposes are of such social interest to the community as to justify treating them as charitable: the interests of the community vary with time and place.⁴⁶

Legal recognition of the changing interest of the community and lenience in matters of interpretation of the definition of charity were demonstrated in the latter half of the 20th Century in cases challenging charities that restricted the class of beneficiaries on the basis of national origin, race, religion, gender, sexual preference, age, group, political affiliation or other characteristics or background.⁴⁷ As the law has evolved, the courts have held that restrictions that involve state action or invidious discrimination will be held invalid.⁴⁸ In general they have rarely found that state action is involved in the operation of charities, but have found invidious discrimination in the case of racial and some gender limitations, while upholding religious restrictions.⁴⁹

The Uniform Trust Code and the ALI Principles of Nonprofit Law contain phraseology that is essentially identical to that in Restatement of Trusts, Third, while Treasury Regulations defining charitable purposes refer to the English Statute of Elizabeth and

⁴⁴ *Id.* cmt. (b).

⁴⁵ RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. (a) (2003).

⁴⁶ RESTATEMENT (SECOND) OF TRUSTS § 368 cmt. (b)(1959) and RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. (a) (2003).

⁴⁷ *See* FREMONT-SMITH, *supra* note 2, at 122.

⁴⁸ *See id.* at 117 – 25.

⁴⁹ *See id.*

formulations of the definition under state law.⁵⁰ In general, the tendency continues to be one of expansion and liberalization, as signified in both the Restatement of Trusts, Third, and the ALI Principles. None of the other current proposals for modifying state charity law involve further amendment of the definition of charitable purposes.

On November 6, 2006, The Charities Act 2006 (c.50) was adopted in the United Kingdom. The changes followed five years of consideration of changes in charity law.⁵¹ It contained the first general statutory definition of charitable purpose, although it relied on the statute of charitable uses of 1601 and case law precedents. Under the act, a purpose is considered charitable if it meets two criteria: it must fall under one or more descriptions or "heads" of charity set forth in the act and if it is "for the public benefit."⁵² The descriptions follow precedents, but permit expansion in the future by permitting new charitable purposes to be recognized. The Public Benefit requirement is new. Under preexisting law, there was a presumption that the relief of poverty and the advancement of education or religion were for the public benefit, while other purposes were not charitable without a showing of this fact.⁵³ Under the new statute, the presumption was abolished and the Charity Commission was directed to publish guidance as to the scope of the requirement. This change mirrors suggestions for amendment of the definition of charity in the Internal Revenue Code suggested by some Congressmen who favor adoption of a similar requirement in the case of health care agencies and educational organizations.

Expanding Donors' Rights to Modify the Terms of their Gifts

Under common law, donors have no rights to change the terms of their gifts or release restrictions they may have placed on them, unless they have explicitly provided otherwise at the time of the gift. Section 7(a) of the Uniform Management of Institutional Funds

⁵⁰ See PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 210 (Preliminary Draft No. 3, 2005); RESTATEMENT (THIRD) OF TRUSTS § 28 (2003); 26 C.F.R. § 1.501(c)(3)-1 (2006).

⁵¹ Charities Act, 2006, c.50 (Eng.)

⁵² See *id.* at §2.

⁵³ See *id.* at Explanatory Note 25.

Act (adopted in all jurisdictions except Alaska, Arizona, Pennsylvania, and South Dakota), permits donors to release restrictions they have placed on institutional funds, but affords them no right to agree to modifications or standing to sue to enforce restrictions.⁵⁴ During the process of revising UMIFA, the advisory committee to the Commissioners reflected differing positions. An early version included a provision permitting donors to approve of modifications of their gifts, similar to the provision in the Uniform Trust Code permitting donors to assent to terminations.⁵⁵ The draft submitted to the Commissioners in 2005 did not include this provision. However, the retitled Uniform Prudent Management of Institutional Funds Act (UPMIFA), as adopted by the Commissioners on Uniform State Laws in July 2006, permits an institution, with the donor's written consent, to release or modify restrictions on the management, investment, or purposes of an institutional fund so long as it does not allow the fund to be used for a purpose other than that of the charity.⁵⁶

The draft ALI Principles of Nonprofit Law, in section 430(b)(1), explain that a restriction can be released or modified according to a procedure included in the original gift instrument; pursuant to the UMIFA provisions if they are available under state law; or in a court proceeding (with the participation of the donor only if he has reserved this right in the gift instrument).⁵⁷ The draft ALI Comment notes, however, that donor input may be useful, suggesting that the charity may want to consult the donor, if living, or the court may permit the donor to be called as a witness or admit evidence as to his intent at the time of the gift.⁵⁸

As to the degree to which donor intent must be considered, in Restatement of Trusts, Third, the Reporter justifies what is termed a "more liberal application" than in the

⁵⁴ UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT, 7(a) (1972).

⁵⁵ Revisions to the Uniform Management of Institutional Funds Act, §6, *available at*: http://www.abanet.org/rppt/meetings_cle/spring2004/pt/UMIFA/gary.pdf.

⁵⁶ UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT §6, *available at*: http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm.

⁵⁷ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 430(b)(1) (Preliminary Draft No. 3, 2005).

⁵⁸ *Id.* §450 cmt. (c).

Second Restatement, both because settlors' "preferences are almost inevitably a matter of speculation in any event and because it is reasonable to suppose that among [relatively] similar purposes charitably inclined settlors would tend to prefer those most beneficial to their communities."⁵⁹ Nonetheless, he suggests that the courts consult the donor if available, but if not, they should consider his relationships, social or religious affiliations, personal background, charitable-giving history, "and the like."⁶⁰

Section 8 of Restatement of Trusts, Third, contains a rule governing the disposition of property on failure of an express trust.⁶¹ In those circumstances, generally the trustees will hold the property in resulting trust for the transferor or his successors. As to charitable gifts, Comment g of Section 8 states that "unless the settlor manifested an intention to substitute one or more other charitable purposes or a valid noncharitable purpose, or unless the doctrine of cy pres is applicable, a resulting trust normally arises."⁶² However, noting that it is rare for a settlor to forbid application of cy pres and provide no other purpose or disposition, the Comment acknowledges that the cy pres doctrine will ordinarily apply.⁶³

While, as explained further below, the UTC does grant standing to donors to bring cy pres actions, it limits their rights to retain reversionary interests in charitable trusts. Thus, section 413(b) states that the court may not apply cy pres if in the terms of the trust there is a provision that would result in distribution of the trust property to a noncharitable beneficiary, but only if the donor is living at the date the reversion is to take effect or fewer than 21 years have elapsed since the date the trust was created.⁶⁴ The Comment gives as the rationale for this position that when there is a gift over on failure of an original charitable gift to noncharitable beneficiaries, the overriding concern of the court

⁵⁹ RESTATEMENT (THIRD) OF TRUSTS § 67 cmt. (d) (2003).

⁶⁰ *Id.*

⁶¹ *Id.* at § 8.

⁶² *Id.* at § 8, cmt. (g).

⁶³ *See id.*

⁶⁴ UNIF. TRUST CODE, §413 (b) (amended 2005).

should be to preserve the original charitable trust, because doing so preserves the primary charitable intent of the testator and better serves the interests of society.⁶⁵ Thus the only circumstance in which a noncharitable gift in default should be upheld would be if it was completely impracticable to apply it to a modified charitable use that could be demonstrated by overwhelming evidence to be contrary to the donor's intent. The UTC provision appears to be a compromise in that it permits reversions during the donor's life or, if shorter, twenty-one years.

The draft ALI Principles of Nonprofit Law also recognize that failure of a charitable gift may under certain circumstances result in return of the property to the donor or his successors.⁶⁶ In addition, under section 425, they provide that if a charity has in good faith accepted a gift lawfully made and subsequently it becomes aware of circumstances that make retention of the gift imprudent or undesirable, the charity may return the gift.⁶⁷

There are a few, well-publicized, recent cases in which donors have attempted to enforce the terms of their gifts by relying on a contract theory of trusts or specific terms in their gifts, with reverter or its equivalent being the remedy sought on the grounds of breach of contract or unjust enrichment.⁶⁸ A Comment to section 750(a) in the draft Principles contrasts a reverter to individuals and a “gift over” to another charity specified in the gift instrument, suggesting that in the latter case, contract theory may be applicable and transfer of the property an appropriate “remedy.”⁶⁹ Judicial acceptance of this approach will, of course, drastically expand the degree of donor control, as well as change the law of standing described below.

Enabling Donors to Enforce the Terms of their Gifts

⁶⁵ *Id.* at §413 cmt. (amended 2005).

⁶⁶ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 425 (Preliminary Draft No. 3, 2005).

⁶⁷ *Id.* at § 425(b).

⁶⁸ *See* *Smithers v. St. Luke's-Roosevelt Hospital Center*, 723 N.Y.S.2d 426 (N.Y. Sup. Ct. 2001); *L.B. Research and Education Foundation v. UCLA Foundation*, 130 Cal.App.4th 171 (Cal. Ct. App. 2005).

⁶⁹ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 750(a) (Preliminary Draft No. 3, 2005).

Many legal scholars have criticized restriction on donor standing, and since 2003 there has been an increasing number of instances reported in the press in which donors attempted to enforce the terms of restricted gifts made to corporate charities.⁷⁰ Section 405 of the Uniform Trust Code provides a statutory basis for actions with respect to charitable trusts, although in some instances they have been permitted under a contract theory without aid of a statute.⁷¹ Under the Uniform Trust Code, donors are empowered to sue to enforce the terms of their charitable gifts.⁷² This UTC provision is described in the Comments as a corollary to section 413, Cy Pres.⁷³ It grants to the settlor of a charitable trust the right, among others, to maintain a proceeding to enforce the trust.⁷⁴ The Comment notes that this provision is contrary to section 391 of the 1959 Restatement of Trusts, Second.⁷⁵ Chester describes this provision as "a concession to a contractarian view of trust law promulgated by one of the UTC drafters, Professor John Langbein of Yale Law School."⁷⁶

Under this approach, a trust is treated as the functional equivalent of a third-party beneficiary contract, with the grantor considered the promisee and the trustee the promisor. The terms of the trust are then specifically enforceable by the grantor. In the case of restricted gifts to corporate charities, this analysis applies if there is an express

⁷⁰ See FREMONT-SMITH, *supra* note 2, at 341-42.

⁷¹ UNIF. TRUST CODE, §405 (amended 2005).

⁷² *Id.* at §405 (c).

⁷³ *Id.* at §405, cmt.

⁷⁴ *Id.* at §413, cmt.

⁷⁵ *Id.* at §405, cmt.

⁷⁶ See Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important Is it and How Extensive Should It Be?*, 37 REAL PROP. PROB. & TR. J. 611 (2003). See generally, Evelyn Brody, "From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing," prepared for the NYU School of Law National Center on Philanthropy and the Law Conference "Grasping the Nettle: Respecting Donor Intent and Avoiding the Dead Hand" and forthcoming 2007 in GA. L. REV. (nonprofit symposium issue organized by David A. Brennan).

contract distinct from the gift. In the 2001 New York case of *Smithers v. St. Luke's-Roosevelt Hospital Center*, the court did appear to give credence to this view.⁷⁷ A similar approach was taken in the case of *L.B. Research and Education Foundation v. UCLA Foundation*, decided in June 2005.⁷⁸ There were a number of instances reported in 2005 and 2006 in which donors were attempting to enforce the terms of gifts that included agreement by the charitable donee to acknowledge the gift by naming a fund or facility for the donors.⁷⁹ A 2005 study by Eason of charitable gifts with naming conditions contains an excellent analysis of the difficulties that can arise in these situations.⁸⁰

A proposed amendment to UMIFA granting standing to donors was initially rejected by the UMIFA drafting committee in 2003.⁸¹ Although support for its inclusion was voiced at the 2005 meeting of the Commissioners, the final version, UPMIFA, adopted in 2006, does not include the UTC rule.⁸²

In 2005 Delaware enacted a statute granting a settlor of a charitable trust the right to maintain an action to enforce the trust and to designate persons born or unborn to succeed to his rights.⁸³ This statute goes further than the UTC by permitting the donor to name successors.

The primary argument in favor of modifying the common law limits on donors' rights is that in the majority of the states, the attorney general is not fulfilling his duty to protect charitable assets; and that this failure is unlikely to change, given the shortage of funds

⁷⁷ See 723 N.Y.S.2d 426 (N.Y. Sup. Ct. 2001).

⁷⁸ See 130 Cal.App.4th 171 (Cal. Ct. App. 2005).

⁷⁹ See generally, John K. Eason, *Private Motive and Perpetual Conditions in Charitable Naming Gifts: When Good Names Go Bad*, 38 U.C. Davis L. Rev. 375 (2005).

⁸⁰ See *id.*

⁸¹ Revisions to the Uniform Management of Institutional Funds Act, Donor Standing, *available at*: http://www.abanet.org/rppt/meetings_cle/spring2004/pt/UMIFA/gary.pdf.

⁸² UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT §6, *available at*: http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm.

⁸³ 75 Del. Laws, c. 97, § 3 (2005), amending DEL. CODE ANN. tit. 12, §3303.

available in most states for the office of the attorney general. The donor is considered the most appropriate person to fill the gap. As noted it is likely that the UTC will be widely adopted within the near future, and thus one can expect to see the common law doctrine of limited standing eroded at least in regard to charitable trusts.

Liberalizing the Doctrines of Cy Pres and Deviation

Cy pres is the name of a doctrine that has been a part of the common law of charities since the Middle Ages under which, if the terms of a charitable gift are no longer capable of being carried out as originally designated, the courts may modify the gift to assure its continued utility to society. Until the start of the 20th Century, the courts construed the cy pres doctrine narrowly by requiring demonstration that the donor had a general charitable intent before applying the doctrine and, in its application, that new purposes have a close proximity to the original ones.⁸⁴ Liberalization started to appear at the start of the 20th Century as some judges looked at the broad purposes of a gift and expressed more concern for the needs of society than the narrow wishes of donors.⁸⁵ The Restatement of Trusts, Second, adopted in 1959, recognized this expansion of the traditional standards by providing in section 399 that it was permissible for the court to order application of the property “to some charitable purpose which falls within the general charitable intention of the settlor.”⁸⁶

Further liberalization of the cy pres doctrine was signaled with the adoption in 2003 of section 67 of Restatement of Trusts, Third, in which “wastefulness” was added to the conditions under which the doctrine could be applied: namely the purpose has become unlawful, impracticable, or impossible to achieve.⁸⁷ The guide for determining an alternative purpose was that it “reasonably approximates the designated purpose.”⁸⁸ The

⁸⁴ See FREMONT-SMITH, *supra* note 2, at 174–82.

⁸⁵ See *id.*

⁸⁶ RESTATEMENT (SECOND) OF TRUSTS § 399 (1959).

⁸⁷ RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).

⁸⁸ *Id.*

Comment noted that the term “wasteful” was intended to mean more than inefficient but less than destructive or ultra vires and that a purpose would be wasteful only if circumstances suggested that the donor would not have imposed the contested restriction had he know of the unanticipated circumstances.⁸⁹

This formulation of the cy pres doctrine was incorporated in section 413 of the Uniform Trust Code (UTC), adopted by the Commissioners on Uniform State Laws in 2003.

Paragraph (a) of section 413 of the UTC provides that if a charitable purpose “becomes unlawful, impracticable, impossible to achieve or wasteful:

(1) the trust does not fail, in whole or in part;

(2) the trust property does not revert to the settlor or the settlor’s successors in interest; and

(3) the court may apply cy pres to modify or terminate the trust by directing that the trust property be applied or distributed, in whole or in part, in a manner consistent with the settlor’s charitable purposes.”⁹⁰

The Comments make it clear that this section was intended to codify the court’s inherent authority to apply cy pres to modify an administrative or dispositive term, thereby removing a distinction that was made in the common law and that in almost every state between the doctrine of cy pres and a more liberal doctrine called “deviation” that applied when a proposed modification was not to the purposes of the gift as is the case with cy pres, but to the methods prescribed by the donor for its administration.⁹¹ It noted that the new formulation was similar to the rule in Tentative Draft No. 3 of Restatement of Trusts, Third, section 67 (the final version not yet having been adopted by the ALI), by presuming a general charitable intent.⁹² Finally, the Comment makes clear that the doctrine applies not only to trusts, but also to other types of charitable dispositions,

⁸⁹ *Id.* at § 67 cmt. (c).

⁹⁰ UNIF. TRUST CODE, §413(a) (amended 2005).

⁹¹ UNIF. TRUST CODE, §413 cmt. (amended 2005).

⁹² *See id.*

including those to charitable corporations.⁹³ Although it does not control dispositions made in nontrust form, the Comment recognizes that courts often refer to the principles governing charitable trusts, which would include the UTC.⁹⁴

A corollary to section 413 of the UTC is to be found in paragraph (b) of section 405 of the UTC. Paragraph (a) of this section contains a definition of charitable purposes that restates what is described in the Comment as "well-established categories of charitable purposes" found in Restatement of Trusts, Second, and the then-Tentative Draft Restatement, Third.⁹⁵ Subsection (b) then provides that "If the terms of a charitable trust do not indicate a particular charitable purpose or beneficiary, the court may select one or more charitable purposes or beneficiaries. The selection must be consistent with the settlor's intention to the extent it can be ascertained."⁹⁶ The Comment contains a paraphrase of section 413(a): "A trust failing to state a general charitable purpose does not fail upon failure of the particular means specified in the terms of the trust. The court must instead apply the trust property in a manner consistent with the settlor's charitable purposes to the extent they can be ascertained."⁹⁷ This final phrase does not appear in section 413(b), raising the question of how far a court must in fact attempt to "ascertain" the original purposes.

The ALI Principles of the Law of Nonprofit Organizations, Preliminary Draft Number 3, published in May 2005, contains in section 440 a formulation that adopts "the liberalized standards of Restatement of Trusts, Third, while providing more guidance on factors that determine the rigor or liberality of available relief."⁹⁸ Unlike the UTC, the distinction between *cy pres* and deviation is retained, with greater flexibility accorded in determining when deviation may be applied and the degree of proximity to the donor's original intent.

⁹³ *See id.*

⁹⁴ *See id.*

⁹⁵ UNIF. TRUST CODE, §405 cmt. (amended 2005).

⁹⁶ UNIF. TRUST CODE, §405(b) (amended 2005).

⁹⁷ *Id.* at §405 cmt.

⁹⁸ PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 440 cmt. (a) (Preliminary Draft No. 3, 2005).

Recourse to donor intent is retained as a guide in determining alternate use. If the gift instrument provides for a gift over to an alternate beneficiary, deviation may be applied, but cy pres will not “ordinarily” be available if transferring the gift to the taker in default will carry out the donor’s charitable purpose.⁹⁹

UPMIFA, adopted by the Commissioners in July 2006, added three important provisions making the doctrines of cy pres and deviation applicable to institutional funds, defined as any fund held by an institution exclusively for its charitable purposes.¹⁰⁰ In addition to granting power to donors to release or modify restrictions described above, section 6(b) contains a restatement of the doctrine of deviation:

If a restriction contained in a gift instrument on the management or investment of an institutional fund becomes impracticable or wasteful or impairs the management or investment of the fund, or if because of circumstances not anticipated by the donor a modification will further the purposes of the fund, the court, upon application of the institution, may modify the restriction.¹⁰¹

This section requires advance notice to the attorney general and then states: “To the extent practicable, any modification must be made in accordance with the donor’s probable intention.”¹⁰²

Section 6(c) provides that if a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund: namely, if it becomes “unlawful, impracticable, impossible to achieve, or wasteful,” the court, after notice to the attorney general, may modify the purpose or restriction in a manner consistent with the charitable purpose expressed in the gift instrument.¹⁰³

⁹⁹ *Id.* at § 440(d).

¹⁰⁰ UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT §2(5), *available at*: http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm.

¹⁰¹ *See id.* at §6(b).

¹⁰² *Id.*

¹⁰³ *Id.* at §6(c).

Unique to the act is a provision permitting modification of small restricted funds without resort to the courts. If a restricted fund has a value less than a stated amount (\$25,000 is suggested in the act), and if more than a fixed number of years (20 is suggested) has passed since the fund was established, and if the conditions under which *cy pres* can be applied exist, the charity, after notice to the attorney general, may release or modify the restriction in whole or in part.¹⁰⁴ There are similar provisions in the laws of some states permitting termination of smaller trusts, again reflecting the trend toward liberalization of the conditions under which donor imposed restrictions can be modified.¹⁰⁵

In direct contrast to these developments, the Massachusetts Supreme Judicial Court in October 2006 refused to grant the request of the trustee of a private foundation to modify the terms of the trust to permit the trust to meet the requirements of Internal Revenue Code section 4942 and Massachusetts law incorporating those requirements.¹⁰⁶ The trust was established in 1959 to distribute the net income for scholarships. The court's rationale was that to do so would require distributions from principal and this would conflict with the donor's expressed intent that the scholarships continue "in perpetuity". It held that "Allowing the requested reformation might avoid tax liability under Sec 4942, but would almost certainly result in inappropriate diminution of the trust's principal."¹⁰⁷ In reaching this conclusion, the court erroneously equated income yield with total return and ignored the principles underlying modern prudent investment theory that have been incorporated in Massachusetts statutes, specifically the Modern Prudent Investor Act and UMIFA.

The court further noted that reformation of trusts had been allowed in cases in which there was either a "scrivener's error" or a clear intent on the part of the settlor to minimize, or avoid, adverse tax consequences, and held that it could not conclude that the

¹⁰⁴ See *id.* at §6(d).

¹⁰⁵ See *FREMONT-SMITH*, *supra* note 2, at 179.

¹⁰⁶ *U.S. Trust Co v. Attorney General*, 854 N.E. 2d 1231 (Mass. 2006).

¹⁰⁷ *Id.* at 1235.

settlor intended this outcome. No mention was made of the doctrine of deviation which, in this instance would, under Massachusetts precedents have afforded the appropriate rationale for permitting the reformation.¹⁰⁸

The changes in charity law adopted in England in 2006 included provisions liberalizing the cy pres doctrine similar to those being adopted or under consideration in the United States. Section 18 of The British Charities Act of 2006 amended the traditional cy pres rule found in section 13 of the 1993 Charities Act that required new purposes to be as close as practicable to the original purposes.¹⁰⁹ Under new section 14B, the courts or the Charity Commission are required to consider three matters when applying the doctrine: 1. the desirability of choosing new purposes that are close to the original purposes; 2. the spirit of the gift by which the property came to the charity; 3. the need to ensure that the charity has purposes which are suitable and effective in the light of current social and economic purposes.¹¹⁰ Thus, proximity to original purpose is no longer to be considered paramount, rather, equal weight is to be given to all three requirements.

The act also contained provisions dealing with instances in which property is transferred from one charity to another where the original purposes are still useful, but the court or the Commission believes that the it can be used more effectively in conjunction with other property.¹¹¹ In those instances, the act permits the court or the Commission to require the trustees of the transferee to use the property for purposes as similar as practicable to the original purposes for which the property was held.¹¹²

Cy pres applied to charitable corporations: An important, largely undecided issue in regard to the doctrines of cy pres and deviation is whether and if so to what extent they are applicable to assets held by charitable corporations. Both the Second and Third

¹⁰⁸ See *infra* pp. 43-44.

¹⁰⁹ Charities Act, 1993, c.10, §(Eng.)

¹¹⁰ Charities Act, 2006, c. 50, § 18 (Eng.)

¹¹¹ See *id.* at §18(4).

¹¹² See *id.*

Restatements of Trusts make it clear that the doctrines apply to all funds devoted to charitable purposes, including gifts to and property held by charitable corporations that are subject to specific restrictions, but not for the general purposes of the corporate charity.¹¹³ Some courts and commentators take a contrary position, holding that these doctrines do not apply to assets of a charitable corporation that have been received for services rendered or to income from the investment of those receipts, it being within the power of the board to determine their disposition.¹¹⁴ Others go further, arguing that the doctrines should apply only to gifts specifically designated to be used for named purposes or to be permanently held as endowment.¹¹⁵

Section 240 of Preliminary Draft No. 3 of the Principles of Nonprofit Law contains a liberal position in this regard, providing that the governing board of a charity other than a charitable trust may change its purpose to another charitable purpose without the need to determine that the current purpose has failed.¹¹⁶ The determination of a new purpose is to be considered a matter of business judgment, not subject to judicial review except for abuse of discretion.¹¹⁷ In contrast, restricted gifts are subject to the rule applicable to charitable trusts, requiring that the nonprofit corporation institute judicial proceedings to change the purposes of those gifts, unless their terms provide otherwise.¹¹⁸ This proposed rule follows from a decision by the drafter that there is a difference in the legal regime of trusts and corporations; that founders of charities are free to choose the regime they wish; and that charitable trustees will be limited in their ability to change purposes, while a corporate board has broad freedom to change its purposes and to apply existing funds to the new purposes, with some limitations described below.¹¹⁹

¹¹³ RESTATEMENT (SECOND) OF TRUSTS § 399 (1959); RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).

¹¹⁴ *See* PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 240 cmt. (a) (Preliminary Draft No. 3, 2005).

¹¹⁵ *See id.*

¹¹⁶ *See id.* at § 240(c)(1).

¹¹⁷ *See id.* at § 240(c)(2).

¹¹⁸ *See id.* at § 240(a).

¹¹⁹ *See id.* at § 240 cmt. (a).

The Principles also posit a duty to keep the purposes of the charity current and useful, thereby rejecting a duty of obedience to the extent that it prevents a board from altering purposes prospectively.¹²⁰ Most important, there is no requirement that the new purposes reasonably approximate or reasonably relate to the prior purposes. This proposed rule is contrary to the law in a number of states and the Reporter acknowledged that such a liberal policy may have untoward consequences that may require some degree of state oversight or greater judicial control, as for example when the purposes of a charitable hospital are changed after its conversion to support the arts, or, as posited in a Massachusetts case, from operating a home for abandoned animals to support of “research vivisectionists.”¹²¹

Section 245 of the draft Principles provides that a charity other than a charitable trust, after it has changed its purposes, may use its assets, other than restricted gifts imposing contrary requirements, for any pre- or post-amendment charitable purpose.¹²² The effect of this is that restricted gifts must be applied for their original purpose unless the gift instrument provides for modification, UMIFA is available, or there is judicial reformation under cy pres or deviation. However, the other corporate assets, namely unrestricted gifts and non-donated assets may be directed by the board to any purposes, old or new. This includes income received from the sale of goods and services as well as income earned from investment of earnings and of unrestricted gifts.¹²³ The assumption here is that unless a donor specifically imposes restrictions, he has implicitly consented to future amendments to the purposes for which his gifts may be used.

Statutes in twenty-three states govern the distribution of assets on dissolution of charitable corporations, requiring application of the property under the cy pres doctrine, but with no requirement of a showing of general charitable intent, although a right of

¹²⁰ *See id.*

¹²¹ *See id.* at § 240 cmt. (d), *citing* Attorney General v. Hahnemann Hospital, 494 N.E.2d 1011 (Mass. 1986).

¹²² PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS § 245 (Preliminary Draft No. 3, 2005).

¹²³ *Id.* at § 245 cmt. (a).

reversion expressly stated will be respected.¹²⁴ In New York the courts have articulated what is described as a quasi-cy pres doctrine that applies to the general assets upon dissolution of a charitable corporation under which the degree of proximity to original purposes is more relaxed than is the case with charitable trusts or restricted funds of charitable corporations.¹²⁵

As a practical matter, state laws governing dissolution of charitable corporations and termination of charitable trusts rest on a floor provided by a requirement for obtaining exemption from federal income taxes under Internal Revenue Code section 501(c)(3) that a charity's governing instrument contain a provision that on its dissolution or termination, its assets must be distributed to other organizations then exempt from federal income tax.¹²⁶ This test can be met if there is a similar requirement under state law that is enforced locally. In 1982, the Service issued a Revenue Procedure stating that only eight states had enacted legislation meeting the Code requirements, so that charities in the remaining ones and the District of Columbia were required to adopt an express dissolution provision.¹²⁷ This requirement has been of great importance in the vast number of states in which charity law is not actively enforced, and it set a precedent for federal/state cooperation that was extended in the 1969 private foundation provisions described below.

Expanding and Enhancing State Enforcement

There has been far less current interest in expanding or improving regulation of charities at the state level than in issues of governance. Only eight states require charitable corporations and trusts to register and file annual financial reports with the attorney general, one more than was the case in 1965.¹²⁸ Exempted from these requirements in all

¹²⁴ See FREMONT-SMITH, *supra* note 2, at 185.

¹²⁵ N.Y. NOT-FOR-PROFIT CORP. LAW §1005 (2006).

¹²⁶ Treas. Reg. §1.501(c)(3)-1(b)(4) (2006).

¹²⁷ See Rev. Proc. 82-2, 1982-1 C.B. 367.

¹²⁸ See FREMONT-SMITH, *supra* note 2, at 476-95.

of these states are religious organizations, while California and New York exempt educational organizations and California also exempts hospitals. In four other states, certain charitable trusts must register and report, but they are few in number compared to charitable corporations. Active enforcement programs are in place in almost all of these twelve states and in a handful of others, notably Pennsylvania. In 2006 the Commissioners on Uniform State Laws were requested to consider revisiting the Uniform Supervision of Trustees for Charitable Funds Act, or of repealing it for lack of interest. Although 39 states regulate solicitation of charitable funds from the general public, these statutes are framed in terms of consumer protection, not the administration of charitable assets.¹²⁹ The 2004 California statute requiring mandatory audits did contain provisions regulating professional fund raisers, while the New York legislation that was adopted clarified state laws regarding dissolutions and terminations of charities.¹³⁰ Provisions that would have extended the enforcement powers of the attorney general and the courts have not been passed.

The original bill submitted to the legislature by the Massachusetts attorney general in 2005 contained provisions that would have clarified his enforcement powers, but after objections from the nonprofit community, these provisions were deleted.¹³¹

Another approach to expanding the enforcement powers of the attorney general was taken by the Ohio attorney general in 2006. Rather than seeking legislation, he issued a set of proposed amendments to the regulations under the Ohio Charitable Trust Act that would, among other changes, have had the effect of limiting or eliminating payment of fiduciary compensation, mandated audit committees and adoption of conflict of interest policies and greatly increased the scope of annual financial reports.¹³² The changes were to be

¹²⁹ *See id.* at 317.

¹³⁰ Nonprofit Integrity Act of 2004, CAL. GOV'T CODE § 12586 (2004); N.Y. NOT-FOR-PROFIT CORP. § 10 (amended 2006).

¹³¹ Act to Promote the Financial Integrity of Public Charities, Mass. Att'y Gen., *available at*: <http://www.ago.state.ma.us/sp.cfm?pageid=2059>.

¹³² Proposed Changes to OHIO ADMIN. CODE 109:1-1, *available at*: http://www.ag.state.oh.us/business/pubs/char/rule/Full_Text_Changes.pdf.

accomplished by suggestions that conflict of interest policies, together with excessive compensation and expense reimbursement policies “should” be adopted, coupled with expanded annual reporting requirements designed to elicit compliance with the recommendations, with threat of an investigation for failure to comply.¹³³ The proposals generated widespread criticism from the sector, particularly from hospitals and health care agencies, which were targeted in the proposed regulations. The proposals were subsequently amended, shrinking from 46 pages to seven. The revision included measures to increase the investigatory powers of the attorney general and the establishment of a citizens advisory committee to assist him in the execution of his duties under the act.¹³⁴ The Massachusetts attorney general appointed such a committee in 1961 without legislative authorization, and succeeding attorneys general have followed the precedent.¹³⁵ In 2001 the Illinois legislature enacted a bill directing establishment of a permanent charitable advisory committee in the office of the attorney general. It is the only state in which such a committee has been created by the legislature.¹³⁶

Proposed legislation introduced in Texas in 2005 would have mandated audits for certain charities and required that the financial reports be made publicly available to the attorney general and to the general public on demand under the same terms and conditions that apply under the Internal Revenue Code to Form 990, the annual information return required of public charities.¹³⁷ Monetary penalties would be imposed for violation of the requirements. It did not pass during the 2005 legislative session.

¹³³ *See id.*

¹³⁴ Revised Proposed Changes to OHIO ADMIN. CODE 109:1-1, *available at*: http://www.oano.org/Docs/AG_Revised.pdf.

¹³⁵ See the study of several models of nonprofit-sector/attorney-general working relationships in DAVID BIEMESDERFER and ANDRAS KOSARAS, *The Value of Relationships Between State Charity Regulators and Philanthropy*, FORUM OF REGIONAL ASSOCIATIONS OF GRANTMAKERS AND COUNCIL ON FOUNDATIONS (2006), *available at*: http://www.givingforum.org/cgi-bin/doc_rep/public/file.pl/3664/regpubfull.pdf.

¹³⁶ Solicitation for Charity Act, 225 ILL. COMP. STAT. 460/23 (2001), *available at*: <http://www.ilga.gov/legislation/ilcs/documents/022504600K23.htm>.

¹³⁷ S. B. No. 1215, 79(R) (Tex. 2005), *available at*: <http://www.legis.state.tx.us/tlodocs/79R/billtext/pdf/SB01215I.pdf>.

The District of Columbia in 2006 also was considering measures to improve regulation of charities; the District is unique in that the District attorney general has traditionally taken the position that he has no power to regulate charities. The proposal, drafted at the request of the Mayor, would amend the District's nonprofit corporation, charitable solicitation and consumer protection acts, substituting the attorney general for the mayor as the official authorized to institute involuntary dissolutions, and granting him new remedies and investigatory powers.¹³⁸ This initiative is unique in the history of the District and of particular importance in view of the fact that almost all federally chartered charitable corporations are within the jurisdiction of the District.

A different approach to annual reports was taken in a bill introduced in the Hawaii legislature in 2007 that would amend the Nonprofit Corporation act by requiring nonprofit corporations with gross revenue of one million dollars or more, excluding revenue from certain government contracts, to file annually a complete audited financial report with the Department of Corporations.¹³⁹ Willful or persistent failure to file would constitute a breach of the directors' and officers' duty and subject them and the corporation to suit of the attorney general.¹⁴⁰ It was unclear whether the reports would be public record, but in all events the provision would have the effect of establishing a registry of financial information about nonprofit corporations in the state. Noteworthy is the fact that the provisions appear to apply to all nonprofit corporations, not just charities.

In contrast to the lack of interest in expanding the powers of state attorneys general to enforce the duties of charitable fiduciaries, during the period between 1996 and 2000, twenty-five states enacted thirty statutes to regulate the conversion of nonprofit charities, most notably hospitals and health insurance providers, to for-profit status.¹⁴¹ These

¹³⁸ See Nonprofit Organizations Oversight Improvement Act of 2006, D.C. B16-0759, *available at*: <http://www.dccouncil.washington.dc.us/images/00001/20060525131713.pdf>

¹³⁹ S.B. 73, 24th Leg. § 2(Haw. 2007). *available at*: http://capitol.hawaii.gov/sessioncurrent/bills/SB73_.htm.

¹⁴⁰ *Id.* at § 6(g).

¹⁴¹ See FREMONT-SMITH, *supra* note 2, at 432.

statutes were in response to a number of conversions in which assets were sold for less than fair market value to insiders, and the proceeds of sale passed into private hands rather than being held for continuing charitable purposes.¹⁴² Several proposed conversions involved charities operating in several states and entailed what became conflicts between state officials attempting to assert jurisdiction to prevent charitable assets from leaving the state.¹⁴³ The speed with which the states acted was undoubtedly due to the size of the assets involved and the importance of health care corporations to the communities involved. It is of interest that despite these developments, one of the Senate Finance Committee Staff proposals described below would transfer regulation of conversions from the states to the IRS, regardless of the fact that its powers to regulate these transactions are extremely limited.

FEDERAL LAW: SIGNIFICANT DEVELOPMENTS AND PROPOSALS

The Proponents of Change

Traditionally, the Treasury Department has taken the lead in framing major revisions of the Internal Revenue Code, working primarily with the House Ways and Means Committee. In some instances, the Finance Committee has assumed primary responsibility for framing amendments, usually on discrete matters that are of particular interest to its leaders. Such has been the case in recent years. Senator Grassley, the former chairman of the Finance Committee, has been joined by his counterpart Senator Baucus, in supporting a major research project undertaken by the Committee staff that resulted in a 2004 Staff Report that contained proposals to amend not only the substantive restrictions on charities, but also to vastly expand federal regulation of exempt organizations.¹⁴⁴

¹⁴² *See id.*

¹⁴³ *See id.* at 366-67.

¹⁴⁴ *See* STAFF OF S. COMM. ON FINANCE, 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT (2004), *available at* <http://www.senate.gov/~finance/hearings/testimony/2004test/062204stfdis.pdf>.

In the fall of 2006, Senator Grassley conducted hearings on hospitals, focusing on the amount of charity care they were providing and the compensation of their officers.¹⁴⁵ During this same period, the Minority Staff of the Finance Committee prepared a report entitled "Investigation of Jack Abramoff's Use of Tax-Exempt Organizations,"¹⁴⁶ which contained recommendations that are described below.

During this same period, the Ways and Means Committee also focused on hospitals and other health care organizations. The Chairman conducted a series of hearings in 2005 during which he questioned the rationale for tax exemption of these organizations - and others that rely principally on receipts for services.¹⁴⁷ The issues raised for the hospitals were the degree of charity care they were providing and whether and how they can be differentiated from for-profit corporations that provide the same services for a fee. This question is not new to Congress; in the past it has been raised in connection with the effectiveness of the tax on unrelated business income and the degree to which "commerciality" in operations should be considered incompatible with exemption.

A third source for proposals for amendments to the Internal Revenue Code has been the Joint Committee on Taxation, a standing committee of Congress, which serves as a permanent resource for the tax committees, advising on technical matters, preparing estimates of the revenue effect of proposed legislation as well as background information for the committees during hearings, and providing summaries of tax legislation that become the basis of the legislative history of specific bills. The Joint Committee, in January 2005, issued a major set of proposals to amend the IRC provisions governing tax

¹⁴⁵ See *Taking the Pulse of Charitable Care and Community Benefits at Nonprofit Hospitals: Hearing before the S. Comm. on Finance*, 109th Cong. (2006).

¹⁴⁶ See MINORITY STAFF OF S. COMM. ON FINANCE, 109TH CONG., INVESTIGATION OF JACK ABRAMOFF'S USE OF TAX-EXEMPT ORGANIZATIONS (Comm. Print 109-68).

¹⁴⁷ See *The Tax Exempt Hospital: Hearing Before the Comm. on Ways and Means*, 109th Cong. (2005); *Review of Credit Union Tax Exemption : Hearing Before the Comm. on Ways and Means*, 109th Cong. (2005).

exempt charities, in some instances endorsing the 2004 proposals from the Finance Committee Staff, while in others suggesting more stringent limits.¹⁴⁸ In addition to committee recommendations, from time to time individual legislators will introduce reform proposals. Historically, it was not uncommon for congressmen to conduct hearings and otherwise promote their initiatives individually, the most prominent being Congressman Patman who is credited as the originator of the restrictions on private foundations enacted as part of the Tax Reform Act of 1969.¹⁴⁹ The power of individual Congressman is no longer comparable to that in the 60s and 70s.

The Tax Section of the American Bar Association has always been a major proponent of changes in the tax code, and its Committee on Exempt Organizations has had primary responsibility for providing analysis and commentary on amendments affecting organizations under its jurisdiction. Within the nonprofit sector, there are myriad organizations that lobby on behalf of their members and the sector at large. Notable are Independent Sector and the Council on Foundations, while there are several hundred organizations formed to support various segments of the nonprofit universe. In 2005, in response to requests from Senators Grassley and Baucus to respond to the proposals from the Finance Committee staff,¹⁵⁰ Independent Sector constituted a Panel on the Nonprofit Sector. The Panel issued a preliminary report in March 2005,¹⁵¹ a Final Report the following June,¹⁵² and a Supplemental Report in June 2006.¹⁵³ Shortly

¹⁴⁸ See STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (JCS-02-05), available at <http://www.house.gov/jct/s-2-05.pdf> [hereinafter STAFF OF J. COMM.].

¹⁴⁹ See FREMONT-SMITH, *supra* note 2 at 72-76.

¹⁵⁰ See Letter from Sen. Charles E. Grassley, Chairman, Sen. Fin. Comm., and Sen. Max Baucus, Ranking Member, Sen. Fin. Comm., to Diana Aviv, President and C.E.O., Independent Sector (Sept. 22, 2004), available at <http://www.nonprofitpanel.org/about/SFCltr.pdf>.

¹⁵¹ See PANEL ON THE NONPROFIT SECTOR, INTERIM REPORT PRESENTED TO THE SENATE FINANCE COMMITTEE (2005), available at <http://www.nonprofitpanel.org/interim/PanelReport.pdf>.

¹⁵² See PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT

thereafter, the Panel constituted a special committee to consider self-regulation,¹⁵⁴ with a report anticipated in early 2007. The Panel made major efforts to include the entire nonprofit community in its deliberations, through a web site,¹⁵⁵ a number of regional open meetings, and open conference calls. The specific recommendations from these groups are summarized below.

Regulating Self-Dealing by Fiduciaries of Public Charities: the Excess Benefit Provisions of Internal Revenue Code Section 4958

The first major change in the substantive provisions in the Internal Revenue Code dealing with tax exempt charities since 1969 was passage in 1996 of prohibitions on certain self-dealing transactions between publicly supported charities and persons who were in positions to exert substantial influence over the organization.¹⁵⁶ They are described as “Intermediate Sanctions” by virtue of the fact that the penalty for breach of the prohibitions is not loss of tax exemption,¹⁵⁷ as is the case with the prohibitions against private benefit and private inurement that have always applied to all tax exempt charities.¹⁵⁸ Instead, the provisions call for imposition of excise taxes on any “disqualified persons” who receive the excess benefit and those managers of the charity

SECTOR (2005), available at http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf [hereinafter PANEL, FINAL REPORT].

¹⁵³ See PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A SUPPLEMENT TO THE FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR (2006), available at http://www.nonprofitpanel.org/supplement/Panel_Supplement_Final.pdf [hereinafter PANEL, SUPPLEMENT].

¹⁵⁴ See Panel on the Nonprofit Sector, New Committee to Advise the Panel to the Nonprofit Sector on Self-Regulation, <http://www.nonprofitpanel.org/press/advisorygroup/view?searchterm=self-regulation> (Mar. 28, 2006).

¹⁵⁵ See <http://www.nonprofitpanel.org> (last visited October 24, 2006).

¹⁵⁶ See Pub. L. No. 104-168, §1311, 110 Stat. 1452, 1475-79 (codified as I.R.C. §4958 (1996)).

¹⁵⁷ See I.R.C. §4958 (West 2006).

¹⁵⁸ See Treas. Reg. §§1.501(c)(3)-1(c)(2), 1.501(c)(3)-1(d)(1)(ii) (2006).

who willfully approved of the arrangement knowing that it was prohibited.¹⁵⁹ Disqualified persons are defined as those in a position to exercise substantial influence over the charity,¹⁶⁰ whether or not they have official positions as directors, officers or trustees.¹⁶¹ Although the Code provisions follow in form the absolute prohibitions on self-dealing applicable since 1969 to private foundations transactions, self-dealing transactions between publicly supported charities and their disqualified persons are permitted so long as the disqualified persons do not receive more than fair market value and the excise tax is applied only to the amount of the excess benefit.¹⁶²

This legislation had long been supported by the Internal Revenue Service as well as Independent Sector and most commentators, who recognized that revocation of exemption is an inappropriate tool for enforcing fiduciary duties.¹⁶³ In some instances revocation is too severe a sanction; in others, it is not a sufficient deterrent, because it may harm the charity while permitting the persons responsible for the transgressions to continue to control its destiny. The 2004 proposals from the Staff of the Senate Finance Committee, described in the following section, recommended repealing these provisions and substituting for them the more drastic prohibitions against any self-dealing that apply to private foundations. In contrast, the Joint Committee on Taxation recommended tightening the existing excess benefit rules, while adding a tax on the charity itself, contrary to the recommendations of virtually all scholars who have considered the efficacy of the tax exemption provisions.

Reform Proposals from the Staff of the Senate Finance Committee 2004; the Pension Protection Act of 2006; and Responses from the Sector

¹⁵⁹ See I.R.C. §4958 (West 2006).

¹⁶⁰ I.R.C. §4958(f)(1) (West 2006); Treas. Reg. §53.4958-3 (2002).

¹⁶¹ See I.R.C. §4941 (West 2006).

¹⁶² See I.R.C. §4958(c)(1)(A) (West 2006); Treas. Reg. §53.4958-1 (2002); Treas. Reg. §53.4958-4 (2002).

¹⁶³ See FREMONT-SMITH, *supra* note 2 at 99-100, 379 (2004).

As noted above, the most recent impetus for change in federal nonprofit law and regulation has centered on a set of legislative proposals circulated by the Staff of the Senate Finance Committee in spring 2004.¹⁶⁴ In addition to tightening numerous substantive provisions governing the administration of tax exempt charities, these proposals were designed to expand the enforcement powers of the IRS and the federal courts by providing them with new enforcement tools that are currently available only in state courts,¹⁶⁵ as well as grant standing to members of the general public to sue charities and their fiduciaries for breach of the federal rules.¹⁶⁶

The report issued by the Joint Committee on Taxation in January 2005¹⁶⁷ contained proposed amendments to the Internal Revenue Code that in almost all instances are more restrictive than those recommended by the Finance Committee Staff.¹⁶⁸ The hearings held by the Ways and Means Committee in 2005 considered revisions to the basic requirements for exemption of hospitals and, possibly, other charities that rely for financial support primarily on fees for services, questioning whether they deserved the benefits of tax exemption in light of their similarity to for-profit entities conducting essentially identical activities.¹⁶⁹

In September 2006 the Senate Finance Committee took up the question of exemptions for hospitals, echoing some of the concerns of the Ways and Means Committee, but focusing primarily on the efficacy of Code provisions requiring hospitals to provide charity care

¹⁶⁴ See STAFF OF S. COMM. ON FINANCE, 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT (2004), available at <http://www.senate.gov/~finance/hearings/testimony/2004test/062204stfdis.pdf>.

¹⁶⁵ See *id.* at 16-17.

¹⁶⁶ See *id.* at 17-18.

¹⁶⁷ See STAFF OF J. COMM. ON TAXATION, *supra* note 140.

¹⁶⁸ See *id.* at 220-337.

¹⁶⁹ See, e.g., *The Tax Exempt Hospital: Hearing Before the Comm. on Ways and Means*, 109th Cong. (2005); *Review of Credit Union Tax Exemption : Hearing Before the Comm. on Ways and Means*, 109th Cong. (2005).

and community benefit as a condition for exemption.¹⁷⁰ The Chairman also indicated concern with high levels of executive compensation and benefits being provided by nonprofit hospitals, and indicated that his staff would be drafting corrective legislation.¹⁷¹

The Pension Protection Act of 2006: In August 2006 Congress enacted the Pension Protection Act of 2006, which contained provisions affecting charities and their donors.¹⁷² Almost all of the provisions follow the spirit if not the letter of a number of the proposals made by the Staffs of the Senate Finance Committee and the Joint Committee on Taxation. Among the provisions designed to “responsibly regulate exempt organizations,”¹⁷³ organizations previously exempt from filing annual returns because their gross receipts did not exceed \$25,000 will henceforth be required to file an annual notice containing current contact and some basic financial information.¹⁷⁴ The Act increased the rates of fines and penalties applicable to public charities and private foundations;¹⁷⁵ required public disclosure of the information contained in Form 990-T, the return filed by organizations that receive taxable unrelated business income;¹⁷⁶ adopted new substantiation rules for gifts of tangible personal property;¹⁷⁷ and included new requirements for exemption for credit counseling organizations,¹⁷⁸ a category of tax exempt entities that had been of particular concern to the Finance Committee

¹⁷⁰ See *Taking the Pulse of Charitable Care and Community Benefits at Nonprofit Hospitals: Hearing before the S. Comm. on Finance*, 109th Cong. (2006).

¹⁷¹ See *id.*

¹⁷² See Pension Protection Act of 2006, Pub. L. No. 109-280, §§1201-1245, 120 Stat. 780.

¹⁷³ REP. BILL THOMAS, COMM. ON WAYS AND MEANS, THE PENSION PROTECTION ACT OF 2006: DETAILED SUMMARY OF CHARITABLE PROVISIONS 2 (July 28, 2006), *available at* <http://waysandmeans.house.gov/media/pdf/taxdocs/072806charitable.pdf#search=%22responsibly%20regulate%20exempt%20organizations%22>.

¹⁷⁴ See *id.* at §1223, 120 Stat. 1090-91 (to be codified as amended at I.R.C. §6033 (West 2006)).

¹⁷⁵ See *id.* at §1212, 120 Stat. 1074-75 (to be codified as amended at I.R.C. §§4941-45, 4958 (West 2006)).

¹⁷⁶ See *id.* at §1225, 120 Stat. 1093-94 (to be codified as amended at I.R.C. §6104 (West 2006)).

¹⁷⁷ See *id.* at §§1218-1219, 120 Stat. 1080-86.

¹⁷⁸ See *id.* at §1220, 120 Stat. 1086-89 (to be codified as amended at I.R.C. §§501, 513 (West 2006)).

leadership¹⁷⁹ as well as the Government Relations and the House Ways and Means Committees.

The most far-reaching changes in the 2006 Act will affect two types of charities whose operations had been of particular concern to the Finance Committee during its 2004 and 2005 hearings: donor advised funds and “supporting organizations” described in section 509(a)(3) of the Internal Revenue Code¹⁸⁰ – organizations that qualify as public charities rather than private foundations by virtue of their connection to and support of other public charities.¹⁸¹ In addition to directing the Treasury to conduct a one-year study of these entities to determine if additional restrictions are necessary,¹⁸² the Act extended the excess benefit transactions prohibitions to certain transactions between them and their donors and other related parties and added new requirements designed to increase the degree of accountability of certain supporting organizations to the public charities they support.¹⁸³ These provisions are described more fully below. Finally, the Act contained a provision long advocated by the Joint Committee on Taxation and state charity officials that permits the IRS to exchange information with state regulators about charities violating the Code provisions.¹⁸⁴

The need for greater understanding and cooperation between state attorneys general and the Internal Revenue Service was highlighted in a unanimous decision of the

¹⁷⁹ See *Review of Credit Union Tax Exemption : Hearing Before the Comm. on Ways and Means*, 109th Cong. (2005).

¹⁸⁰ See, e.g., *Charities and Charitable Giving: Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. 33-35 (2005) (statement of Dr. Jane Gravelle, Senior Specialist in Economic Policy, Congressional Research Service)

¹⁸¹ See Pension Protection Act of 2006, Pub. L. No. 109-280, §1241, 120 Stat. 1103 (to be codified as amended at I.R.C. §509(a)(3) (West 2006)).

¹⁸² See *id.* at §1226, 120 Stat. 1094.

¹⁸³ See *id.* at §§1231-1235, 1241-1245, 120 Stat. 1094-1108.

¹⁸⁴ See *id.* at §1224, 120 Stat. 1091-93 (to be codified as amended at I.R.C. §§6103, 6104, 7431 (West 2006)).

Massachusetts Supreme Judicial Court decided in October 2006.¹⁸⁵ The case was brought by the trustee of a perpetual trust established in 1959 to apply the net income to provide scholarships in amounts not to exceed \$400 each to graduates of the high school in the city in which the donor resided. In its petition, the trustee requested the court to modify the terms of the trust in three respects. The court granted its requests to include students from other high schools established in the city and to increase the amount of the individual scholarships. It refused, however, a request to permit the trustee to increase the aggregate annual distributions to equal the amount required to be distributed by private foundations under Internal Revenue Code section 4942, currently equal to the greater of the net income of the trust or five percent of the value of the foundation's investment assets.¹⁸⁶ The trustee had alleged that the change was necessary if the trust was to avoid the tax on private foundations imposed under section 4942 (as well as under Massachusetts General Laws section 68A).

At the time the petition was filed, this tax was equal to fifteen per cent of the difference between the required distribution and the amount actually distributed at the end of each tax year in which it remains undistributed. The Pension Reform Act of 2006 increased the tax to 30% effective for tax years beginning after the date of enactment which was August 2006. The court held that such a change, although it would "avoid a relatively small tax," would result in annual distributions of a large portion of the principal, thereby departing from the donor's intent that the trust be perpetual.¹⁸⁷ This conclusion ignored, as did the briefs submitted by attorneys for the trustee, the fact that section 4942 provides for two levels of tax: an initial tax equal at the date the decision was rendered to 30% of any undistributed amounts remaining at the end of each tax year; and an additional tax equal to 100% of the amount remaining undistributed at the end of such year and each succeeding one. Thus the court's conclusion that without reformation it would be possible to use some of the income for scholarships and the rest for tax without touching

¹⁸⁵ U.S. Trust Co v. Attorney General, 854 N.E. 2d 1231 (Mass. 2006).

¹⁸⁶ I.R.C. § 4942 (2007); *see also* MASS. GEN. LAWS ch 68A, § 2 (2007) which applies as a matter of state law the provisions of IRC section 4942 to Massachusetts private foundations.

¹⁸⁷ U.S. Trust Co., 854 N.E. 2d at 1236.

the principal misstates the effect of its decision. It reflects a basic misunderstanding of the Internal Revenue Code provisions; the Massachusetts statute that applies the federal rules to all private foundations in the state; and the state statutes and cases adopting the Uniform Prudent Investor Rule, the Uniform Principal and Income Act, and liberal interpretations of the doctrines of cy pres and deviation. Greater exchanges of information between state and federal regulators may not obviate errors of this nature, but one hopes that at the least the regulators might gain a better understanding of the respective laws it is their duty to enforce.

PENDING PROPOSALS FROM THE SENATE FINANCE COMMITTEE STAFF: As noted above, the 2006 legislation incorporated only a portion of the more than thirty-five recommendations from the Finance Committee Staff. A few of these recommendations were included in a bill passed by the Finance Committee on June 28, 2006.¹⁸⁸ These included mandating electronic filing;¹⁸⁹ increasing funding to the IRS to combat abusive tax avoidance;¹⁹⁰ clarification of the definition of a church tax inquiry;¹⁹¹ increased penalties for certain charities engaging in lobbying and election activity;¹⁹² increasing disclosure of certain transactions;¹⁹³ and extending declaratory judgment procedures now available to charities to other exempt organizations.¹⁹⁴

Not included in the new and pending legislation as of October 2006 were recommendations that eligibility for exemption be reevaluated every five years;¹⁹⁵ improvements to Forms 990 and 990-PF;¹⁹⁶ mandatory audits¹⁹⁷ and IRS compilation of

¹⁸⁸ STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO S. 1321 AND S. 832 (2006).

¹⁸⁹ *See id.* at 23-24.

¹⁹⁰ *See id.* at 21.

¹⁹¹ *See id.* at 22.

¹⁹² *See id.* at 55-60.

¹⁹³ *See id.* at 62-64.

¹⁹⁴ *See id.* at 123.

¹⁹⁵ *See* STAFF OF S. COMM. ON FINANCE, *supra* note 35 at 1.

¹⁹⁶ *See id.* at 7-9.

uniform reporting standards;¹⁹⁸ establishment of a certification system to assure compliance with a set of “best practices” monitored by the IRS and reporting by charities of their compliance with performance standards;¹⁹⁹ prohibitions against payment of compensation to trustees and directors and limits on reimbursement for travel expenses;²⁰⁰ a requirement of a minimum of three and a maximum of 15 directors of all charities, and that a majority of the directors be independent;²⁰¹ and adoption of a federal prudent investor rule.²⁰²

Among the remaining proposals of the Finance Committee Staff designed to enhance regulation were provisions to provide funds to the states for enforcement; permit the IRS to remove fiduciaries and employees if they were found to have violated the self-dealing rules; and grant to the Federal Tax Court equity powers to enforce the Code provisions, similar to the powers held by state courts.²⁰³ Those powers would include the ability to remove directors and trustees, require restitution, impose surcharges, issue injunctions, and order dissolutions.²⁰⁴ The Staff also proposed that co-fiduciaries and private citizens be empowered to bring suit in federal court to enforce the Code restrictions.²⁰⁵ Finally the Staff recommended that solicitation of charitable donations and conversion of charities to for-profit status be regulated by the Internal Revenue Service,²⁰⁶ rather than remain the province of the states as they presently are.

RECOMMENDATIONS FROM THE PANEL ON THE NONPROFIT SECTOR: In its response to the Finance Committee proposals, the Panel on the Nonprofit Sector

¹⁹⁷ *See id.* at 9.

¹⁹⁸ *See id.*

¹⁹⁹ *See id.* at 11-14.

²⁰⁰ *See id.* at 5-6.

²⁰¹ *See id.* at 13.

²⁰² *See id.* at 15.

²⁰³ *See id.* at 13-16.

²⁰⁴ *See id.* at 16.

²⁰⁵ *See id.* at 17-18.

²⁰⁶ *See id.* at 6-7.

supported tightening Code provisions affecting donor advised funds and supporting organizations;²⁰⁷ increasing the exchange of information between the IRS and state regulators;²⁰⁸ and requiring annual status reports from small organizations exempt from filing annual information returns.²⁰⁹ All of these recommendations were part of the 2006 Pension Protection Act. The Panel also recommended mandating audits for organizations with annual revenues of \$1 million or more and requiring public disclosure of their contents.²¹⁰

Among proposals to amend governance and administration that the Panel did not endorse were those that would require disclosure of performance data;²¹¹ prohibit payment of compensation to fiduciaries;²¹² limit foreign grant making;²¹³ and enact a federal prudent investor rule.²¹⁴ The Panel also objected to certain of the proposals designed to improve regulation, specifically those that would require periodic review of exempt status,²¹⁵ regulate conversions,²¹⁶ provide the federal courts with equity powers,²¹⁷ regulate charitable solicitations,²¹⁸ and mandate public disclosure of Form 990-T reports of unrelated business income.²¹⁹ Of these, only the final one requiring public disclosure of Form 990-T was enacted in the Pension Protection Act of 2006.

²⁰⁷ See PANEL, FINAL REPORT, *supra* note 144 at 39-48.

²⁰⁸ See *id.* at 24.

²⁰⁹ See *id.* at 26.

²¹⁰ See *id.* at 35.

²¹¹ See *id.* at 37.

²¹² See PANEL, SUPPLEMENT, *supra* note 145 at 13-15.

²¹³ See *id.* at 5-6.

²¹⁴ See *id.* at 16-17.

²¹⁵ See PANEL, FINAL, *supra* note 144 at 33-34.

²¹⁶ See *supp.* At 18-20.

²¹⁷ See *id.* at 28-29.

²¹⁸ See *id.* at 10-12.

²¹⁹ See *id.* at 26-27.

There is a final important recommendation, not clearly articulated in the Finance Committee Staff proposals, but developed in the Panel Report, that is designed to achieve better coordination of federal and state regulatory efforts. Section 508(e) of the Code conditions tax exemption for a private foundation on inclusion in its governing document of a provision requiring compliance with the limitations on private foundation operations contained in Chapter 42 and prohibits their managers from entering into any self-dealing transactions prohibited in that chapter.²²⁰ Instead of inclusion of the requisite language in articles of organization or trust documents, regulations promulgated in 1972 provide that the governing instrument requirement can be met if a valid state law imposes these obligations on all private foundations within its jurisdiction.²²¹ By 1975 forty-eight states and the District of Columbia had passed such laws.²²² These laws have provided state regulatory officials with grounds for prosecuting failures to comply with federally imposed rules, an unprecedented example of coordination of the two regulatory schemes.²²³

Under the Panel's proposal, a similar provision would apply to all publicly supported charities (the remaining universe of organizations exempt under section 501(c)(3)), requiring compliance with the Excess Benefit provisions in Code section 4958.²²⁴ Maine adopted such a provision in its 2002 act²²⁵ and a similar requirement is part of the bill submitted by the Massachusetts attorney general in 2004 to improve state regulation.²²⁶ However, it is unlikely that other states will follow suit without impetus from Congress, as was the case in the 70s. Furthermore, there are no reported instances in which a state has taken legal action against a private foundation solely on the grounds of failure to comply with these state provisions. This does not mean that the prohibitions have not

²²⁰ I.R.C. §508(e) (West 2006).

²²¹ Treas. Reg. §1.508-3(d) (as amended in 1980).

²²² FREMONT-SMITH, *supra* note 2 at 267.

²²³ *See id.*

²²⁴ *See* PANEL, FINAL, *supra* note 144 at 24-25.

²²⁵ *See* ME. REV. STAT. ANN. tit.13-B §718 (2003).

²²⁶ *See* H.B. 4347, 184th Gen. Court (Mass. 2005).

served as a deterrent, nor that threat of state litigation has not resulted in corrections. At best, it provides one more weapon for regulators and contributes to uniformity among the states.

Situs of Federal Regulation: A New Agency and Other Proposals

The role of the Internal Revenue Service as regulator of tax exempt entities has long been subject to question by commentators, government officials and practitioners. Proposals to create a new agency to regulate charities, some modeled on the English Charity Commissioners, some on the Securities and Exchange Commission or the quasi-governmental bodies which operate in conjunction with it have been considered.²²⁷ In the mid 1970s the Filer Commission Report contained proposals for alternative regulatory schemes, but they received little attention in succeeding years.²²⁸ Some commentators argue that improvements in IRS administration of the tax exemption provisions warrant continuing its role, although they uniformly argue that funding for its operations has been inadequate.²²⁹ Most recently, Marcus Owens, former director of the Exempt Organization Division of the IRS, has suggested moving enforcement to a new agency modeled on the National Association of Securities Dealers.²³⁰ This would be a quasi-public agency, financed in part by credits against the excise tax on private foundations or a licensing fee, operating in conjunction with the Internal Revenue Service as the NASD does, with the new body granting exemptions and receiving and reviewing annual reports.²³¹ Other proposals, old and new, have focused on increasing cooperation between federal and state regulators, in particular by permitting the Service to refrain from imposing sanctions if

²²⁷ See FREMONT-SMITH, *supra* note 2 at 462-63.

²²⁸ See *id.* at 461-66.

²²⁹ See, e.g., Panel on the Nonprofit Sector Work Group, #14: Funding for Federal and State Enforcement at <http://www.nonprofitpanel.org/workgroupprecs/Initial14.pdf> (Jan. 26, 2005); FREMONT-SMITH, *supra* note 2 at 471.

²³⁰ See Marcus S. Owens, Charity Oversight: An Alternative Approach (Dec. 11, 2004) (unpublished manuscript, on file with author).

²³¹ See *id.* at 9-14.

the state attorney general has taken corrective action.²³² There is precedent for this in section 507, under which the Service may abate the confiscatory tax that is imposed on private foundations under certain extreme circumstances if corrective action has been taken under state law to assure that the assets of the foundation have been preserved for charitable purposes under order of a state court.²³³

Extending the application of an abatement power to violations of the Code would provide the Service and the federal courts with the broader range of equity powers held by the state courts, affording remedies directly designed to preserve charitable funds. It must be recognized however, that there is a general lack of interest in the states in suggestions of this nature, undoubtedly due to budget constraints. To overcome the states' failure to act, it has been suggested that Congress could provide subsidies to those states that adopt the federal requirements for administration of charities and establish enforcement programs that conform to federal rules. There is precedent for such subsidies in the administration of social security and unemployment benefit provisions, but little impetus in Congress to increase funding for enforcement of nonprofits, whether by the IRS or the states.

FINANCE COMMITTEE MINORITY STAFF REPORT ON ABRAMOFF'S USE OF TAX-EXEMPT ORGANIZATIONS

In September 2005 the Minority Staff of the Senate Finance Committee issued a report summarizing findings from an investigation conducted during 2005 of the use by a lobbyist, Jack Abramoff, of charities to further his and his clients' personal ends.²³⁴ The report contained detailed summaries of the relationship of five tax exempt charities to Mr. Abramoff²³⁵ and a set of recommendations for amendments to the Internal Revenue Code suggested for consideration by the Majority Staff and the Members of the Finance

²³² See FREMONT-SMITH, *supra* note 2 at 460.

²³³ See I.R.C. §507(g) (West 2006).

²³⁴ See Comm. Print 109-68, *supra* note 138.

²³⁵ See *id.* at 9-51.

Committee.²³⁶ Among the proposals was one to expand the definition of lobbying to include payment of travel, meals, and similar expenses of a government official by a section 501(3)(3) organization if a registered lobbyist is a disqualified person or a substantial contributor to the charity.²³⁷ A second would further expand the definition of lobbying activity to cover lobbying of the Executive branch, including lobbying with respect to administrative agencies and federal appointments.²³⁸ With changes in the composition of the majority and minority committees in Congress as a result of the November 2006 elections, it was uncertain as of the end of the year what the likelihood of Congressional attention to these proposals would be in 2007 and thereafter.

CONCLUSION

The length of this summary demonstrates an unprecedented degree of current interest in charity law. Congress has periodically focused on charities since the early years of the 20th century and, following extensive Congressional investigations in 1950 and 1969, substantially expanded the scope of the Code provisions and the sanctions for violations. Public disclosure of financial and other data was increasingly relied on to supplement direct enforcement. Interest in the states has been far less intense. As noted, aside from the adoption of registration and reporting requirements and establishment of charity bureaus in ten states in the 1960s and 1970s (New Hampshire having enacted the first such statute in the 1940s), no similar programs have been instituted, and regulation in the vast majority of jurisdictions has fallen by default to the Internal Revenue Service.

Many of the new initiatives to change state law described herein have been influenced by the scandals that led to passage of the Sarbanes-Oxley Act. It is open to question whether these new laws will in fact improve the administration of nonprofit organizations, although it is too soon to tell. Reliance on mandatory audits appears to be universally accepted as a necessary minimum requirement. However, there is no evidence that there

²³⁶ *See id.* at 52-55.

²³⁷ *See id.* at 54.

²³⁸ *See id.*

is less wrongdoing by charities in Massachusetts than in other states, despite the fact that for thirty years audits have been required in Massachusetts for all charities with gross receipts of \$500,000 or more, other than religious organizations.²³⁹

What is notable about the enacted and proposed changes in substantive state laws is that they have greatly restricted the influence of donors and their heirs in cases involving a change of purposes necessitated by changed circumstances. Much has been written about the adverse effect of the “Dead Hand” and in the past that doctrine has certainly restricted efforts to reform obsolete charitable purposes. Today that is no longer the case. However, as the influence of donors has greatly diminished in cases involving a change of purposes, the opposite has occurred in regard to enforcement. Here the trend in statutes and cases has been to greatly expand the rights of donors to bring suit to enforce the terms of their gifts in state courts under the Uniform Trust Code and as proposed by the Finance Committee staff for the federal courts. Proponents of expanding standing do express concern as to whether it will limit the willingness of individuals to serve as directors and trustees – the same rationale that is put forth by proponents of limiting liability of fiduciaries and providing them with immunity shields. The rationale for the change is usually that it is necessary because the states will not act and some enforcement mechanism is necessary to correct abuses.

At the federal level, the adoption of intermediate sanctions for violation of the excess benefit transaction provisions was a major turning point in federal regulation. Congress recognized, as it had failed to in 1969, that wrongdoing was not confined to private foundations and that the public could not be relied on to police public charities by withholding contributions to those whose administrative costs were excessive or who had dubious records.

The more recent proposals from the Finance Committee Staff would fundamentally change the nature of federal regulation, vastly extending the power of the Service to

²³⁹ See MASS. GEN. LAWS ch. 12, §8F (2006).

control the manner in which charities are administered. This is best exemplified in the proposals to condition tax exemption on compliance with a set of “best practices” through a certification system, adopt a federal prudent investment rule, grant the IRS power to remove fiduciaries, and give the federal courts equity powers to effect corrections. It is unlikely that such far reaching changes will become law in the immediate future. But they have been a valuable impetus to sector-wide consideration of the optimum methods for policing charities and as such a most valuable contribution. The process by which they are being considered is unprecedented and can only result in wiser consideration of the manner in which we can achieve greater accountability for the nonprofit sector.

In considering the principles that should underlie any efforts to improve governance and accountability in the nonprofit sector, one must take into account the disparate nature of our current regulatory schemes. Federal and state laws may coincide, but rarely have they been devised in concert and rarely have enforcement efforts of the two governmental entities been coordinated in any meaningful way. The provisions in the 2006 Pension Protection Act permitting more meaningful exchange of information between federal and state regulators may lead to a change. It cannot obliterate the fact that the purposes of the two enforcement regimes are at base diverse – the purpose of state rules and state regulation is to preserve charitable funds for the continuing benefit of society as its needs evolve, while the purpose of the federal rules is to preserve the integrity of the tax system.

In the 1950s and 1960s, the tax focus was foremost in the eyes of federal regulators. However, this view changed gradually in the 1960s, particularly after passage of the 1969 Tax Reform Act, which added intermediate sanctions to the Code for violation of the private foundation rules. The change continued with subsequent restructuring of the IRS in response to the growth of the nonprofit sector, particularly in the number and size of pension plans under their jurisdiction following enactment of ERISA in 1974. This growth forced the Treasury Department and the Service to recognize that enforcement of laws governing tax exempt entities required vastly different tools and personnel than that

needed for enforcement of laws designed to assure collection of taxes from individuals and business entities. The result has been vast improvement in federal regulation, but a failure to address the dichotomy. The rationale for proposals to create a new federal agency to regulate charities is that the IRS can never be the appropriate vehicle for enforcing laws that do not involve tax collection.

Regardless of the situs of federal regulation, there remains the basic question of what if any regulatory role should be retained by the states. One of the justifications for retaining state power is the proximity of state attorneys general and state courts to the entities subject to regulation. This is viewed as permitting more appropriate applications of the law, particularly in cases involving cy pres and deviation. Another advantage is the breadth of sanctions available in state courts in the exercise of their equity powers, sanctions that are, at all times, aimed at preserving charitable assets rather than imposing taxes that diminish charitable assets. Proposals to confer equity powers on the Tax Court signify that this may no longer be considered a valid argument for preserving a state role. The Finance Committee Staff proposals for federal regulation of conversions and solicitation confront us with the same questions.

As a society, we have encouraged the creation and growth of nonprofit charitable organizations on the grounds that they provide unique benefits to the general public different in nature and purpose from those provided by government or the private sector. In encouraging the growth of the nonprofit sector, we have afforded great leeway to individuals to determine the purposes to which their gifts will be applied and the manner in which these purposes will be accomplished. We have said to charitable fiduciaries that if you act in furtherance of any one or more of a broad range of purposes sanctioned in the law by virtue of their being considered as beneficial to society; if you do not benefit personally at the expense of the charity; and if you are not reckless in the administration of its assets, we will not attempt to second guess the methods you choose to accomplish those purposes nor apply sanctions, even if you do so in ways that may be considered by government or the private sector as inefficient or inappropriate.

Current reform efforts described herein are directed at base in assuring the integrity of the sector. That is what we mean when we call for greater accountability. As the recitation of the numerous initiatives demonstrates, the tension is always between granting more freedom to fiduciaries to determine how best to frame and then carry out the mission of the organization they are entrusted to manage (e.g. immunity from liability), and limiting that freedom by prescribing the forms in which they can be organized and the manner in which they will operate (e.g. limiting the size of boards and mandating governance structures).

It is generally accepted that the strength of the nonprofit sector is attributable in large part to the freedom afforded to charities and their creators. But critics also point to this lack of regulation as the cause of excesses that they believe can best be curtailed by limiting the freedom of choice or demanding compliance with standards of efficiency or propriety. Others argue that there is insufficient connection between the benefits given to charities and the value they give back to the public. They would require a more immediate demonstration of public benefit from funds for which tax deductions and exemptions are granted – whether through expanding the pay out requirement now imposed on foundations to endowment funds held by publicly supported charities, or by limiting the life of charities. Still others would require charities to demonstrate compliance with specific standards that will permit measurement of the extent of their contribution to society.

If one believes that rigorous monitoring of charitable performance is needed, then one must consider who can best do the monitoring. Some commentators argue that only government can carry out this function. Others believe it can be accomplished by requiring charities to justify their status through expanded public disclosure requirements. Expansion of self-regulation is also under study. If government is doing the monitoring, it can be afforded sanctions to compel compliance. If it is the public, withholding contributions and fees will be effective sanctions for charities that rely on contributions from the public or from receipts for services they provide for funding. It will not be so for foundations and public charities with endowments that make them virtually self-sufficient

or for those that rely solely on receipts for services. For these self-regulation, with all its limitations, may be the only answer. Underlying all analyses must be consideration of the degree to which measure of this sort will change the basic nature of the sector; whether restricting its freedom will curtail its ability to be innovative, to respond promptly to unforeseen needs and to operate without some of the bureaucratic constraints that are a concomitant of governmental activity. This is undoubtedly the greatest challenge that must be faced by those who want to preserve the sector.