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Commentary: The Federalization of Nonprofit Regulation and Its Discontents

James J. Fishman[1]

INTRODUCTION

We live in an age where charitable organizations are under increasing federal regulatory scrutiny. The Internal Revenue Service (the "Service"), at the instigation of the Senate Finance committee—the Service's primary congressional overseer—has commenced a corporate governance initiative by issuing announcements and guidelines, as well as providing educational advice as to how charities' internal affairs should be ordered. The Service also has revised the Form 990 Annual Information Return, a publicly available document, so that it contains mandatory corporate governance questions.[2] Nonprofit organizations traditionally have been creatures of state law and overseen by state agencies and regulators.[3] What is unique about the corporate governance initiative is the Service's admission that it lacks express statutory authority for this effort.

I. THE DEVELOPMENT OF THE FEDERAL INTEREST IN REGULATION OF CHARITIES

Until the twentieth century, the federal government had no interest in the regulation of charities. The introduction of the federal income tax changed that. Charities have been granted preferential federal tax status under the Internal Revenue Code since the Revenue Act of 1894.[4] The automatic nature of obtaining tax exemption and the deductibility of

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1 Professor of Law, Pace University School of Law. © 2011 James J. Fishman.

2 *See* IRS FORM 990 (2010), Part VI.

3 This issue is developed in James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 548 (2010).

4 Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. This statute was declared unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 637 (1895), because it was a direct tax not apportioned according to a state's population. The Sixteenth Amendment cured this objection by allowing individuals' incomes to be taxed without regard to each state's population. There was a personal tax in the Revenue Act of 1861, ch. 45, § 49, 12 Stat. 292, 309, but it was never implemented. The Revenue Act of 1862, ch. 119, § 90, 12 Stat. 432, 473 imposed an income tax to finance the Civil War. The Corporation Excise Tax Act of 1909 contained an exemption for charities in language that parrots most of the modern §501(c)(3). *See* Corporation Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 113.

contributions initially encouraged this lack of federal oversight.[5] Federal tax law relating to nonprofits has not evolved consistently, but has resulted from politics, policies, and responses to abuses of tax-exempt status brought to Congress's attention.

Marion Fremont-Smith has identified three stages in the federal development of charity regulation.[6] In the first, which lasted roughly until the 1940s, broad definitional parameters were established as to the boundaries of charity status. This enabled donors to deduct charitable contributions to certain nonprofits from their own tax liability. This stage generally relied upon self-policing to assure accountability.[7] A primary catalyst of federal scrutiny was the private foundation, which raised suspicions as far back as 1914.[8]

Private foundations were equal opportunity offenders. To those on the right, they promoted controversial activities such as civil rights and voter registration in favor of discriminated and disenfranchised minorities. The left believed foundations protected the affluent, shielded large pools of wealth from taxation, and possessed a shadowy behind-the-scenes influence. Periodic abuses were publicized in the press and taken up by

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> The essence of the advantage of [the coordinate privileges of tax exemption and deductibility] is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and the choices of private givers. The donors determine the direction of their own funds, and the distribution of "tax savings" as well. The income of each individual organization is a product of donations it receives and the investment wisdom of its managers. Since all of these operations are out of the hands of government under the exemption and deduction statutes, the beneficiary organizations receive their governmental aid without having to petition for it.

Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, *in* 4 RESEARCH PAPERS SPONSORED BY THE COMM'N ON PRIVATE PHILANTHROPY AND PUB. NEEDS 2025, 2039 (1977), *available at* http://www/eric.ed.gov/PDFS/ED143606.pdf (papers compiled by Department of the Treasury).

6 MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 300 (2004).

7 *Id.*

8 In 1914 the United States Commission on Industrial Relations, known as the Walsh Commission, learned that the Rockefeller Foundation was to study industrial relations and—fearing a whitewash—in turn studied Rockefeller. Two years later, it published a report which claimed that the concentration of wealth in large foundations was used by industrial magnates to control leading universities. The majority of the Commission recommended federal chartering of all "nonprofit organizations with more than one function and funds of more than $1 million," as well as federally imposed limitations on size, accumulation of unexpended income, and duration. It also called for strict supervisory procedures. Nothing came of these proposals. FREMONT-SMITH, *supra* note 6, at 68 (citing COMM'N ON INDUS. RELATIONS, INDUS. RELATIONS: FINAL REPORT AND TESTIMONY, S. Doc. No. 64-415, at 85 (1st Sess. 1916)).

Congress.[9]

The second stage marked the creation of a border between exempt and nonexempt organizations. During the 1940s, Congress became concerned that individuals were using tax-exempt organizations to shelter or avoid taxable income[10] and reacted to these perceived abuses with the Revenue Act of 1950. This legislation added sections to the Internal Revenue Code that taxed the unrelated business income of most tax-exempt organizations[11] and denied exemption to feeder corporations by providing that an organization primarily engaged in a trade or business for profit did not qualify for exemption merely because its profits were destined for charitable ends.[12] Another provision prohibited certain charities from accumulating unreasonable income in such a manner that would jeopardize the carrying out of the charity's exempt purposes.[13] Also, some charities would lose their exemptions if they entered into certain kinds of self-dealing transactions or granted excessive compensation.[14] The last two limitations applied only to charitable organizations, which would later be defined as private foundations.[15] Public charities were exempted from these restrictions because they were viewed as less susceptible to abuses.[16]

This period introduced procedures for applying for recognition of tax-exempt status and filing an annual information return. Prior to 1950, the Service's initial focus on charities was at the front end—i.e., assessing whether an existing organization that caught its attention met

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9 *See* FREMONT-SMITH, *supra* note 6, at 67-68; JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 712-715 (4th ed. 2010); Laurens Williams & Donald V. Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations*, *in* 4 RESEARCH PAPERS SPONSORED BY THE COMM'N ON PRIVATE PHILANTHROPY AND PUB. NEEDS, *supra* note 5, at 2099, 2101-02.

10 In 1948, the Senate Committee on Interstate and Foreign Commerce investigated the economic situation of the textile industry in New Hampshire and came across the operations of Royal Little, president of Textron, Inc., who used private foundations to finance Textron business ventures. The investigation and Little's transactions are discussed in Comment, *The Modern Philanthropic Foundation: A Critique and a Proposal*, 59 YALE L.J. 477, 492-97 (1950).

11 I.R.C. §§ 512-14 (2006) (codified by Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 947-50).

12 I.R.C. § 502 (2006) (codified by Revenue Act of 1950, ch. 994, § 301(b), 64 Stat. 906, 953).

13 FREMONT-SMITH, *supra* note 6, at 60.

14 I.R.C. § 503 (2011) (codified by Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 947-50). The House Ways and Means Committee had wanted to prohibit self-dealing completely, but the Senate Finance Committee and the combined Conference Committee weakened the provision to require arms-length standards. Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52, 53-54 (2000).

15 FREMONT-SMITH, *supra* note 6, at 60-61.

16 *Id* at 61.

the requirements for tax-exempt status.[17] It was not until 1954 that a purportedly exempt organization had to obtain a determination from the Service that it was entitled to that status, though with the exception of churches, almost all organizations that relied on contributions did obtain such a ruling from the Service.[18]

In 1942, the Treasury Department required all tax-exempt organizations to file an annual information return, a two-page form that covered the 1941 tax year and consisted of three questions, an income statement, and a balance sheet.[19] Some organizations protested, so the next year the Treasury Department sought statutory authority from Congress to seek financial information from charities.[20] Congress required certain exempt organizations, principally foundations, to file returns that would disclose their financial affairs.[21] No one could have imagined from such a modest beginning that Form 990 would exponentially expand in page-length and importance to become the principal disclosure tool for government oversight of exempt organizations.[22]

In the third phase came an expansion in the Service's regulatory function. Again private foundations were the catalysts for Congressional action. The result was the adoption in 1969 of a complicated enforcement regime by which private foundations and their managers were regulated more strictly than public charities.[23] Sections 4940 to 4945 were added to the Internal Revenue Code and imposed a sliding scale of excise taxes (depending upon the offending foundation's willingness to correct its wrong) for abuses in which Congress felt private foundations were most likely to engage. The excise tax in the first instance of a violation replaced the draconian penalty of revocation of exempt status, the only previous

17 *Cf.* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).

18 FREMONT-SMITH, *supra* note 6, at 61. In 1954, Department of the Treasury made filing an exemption mandatory, for which the organization received a determination letter that recognized its exemption. Treas. Reg. § 1.501(c)(3)-1(b)(6) (2009).

19 Treasury's authority to impose this requirement was contested and compliance was poor. FREMONT-SMITH, *supra* note 6, at 65.

20 *Id.* at 59, 65.

21 Revenue Act of 1943, Pub. L. No. 78-235, § 117, 58 Stat. 21, 37 (1944). Excluded from this filing requirement were churches and other religious organizations, certain educational institutions, and certain publicly supported organizations. One purpose of the 1943 legislation was to provide Congress with sufficient information to determine if further legislative restrictions were needed. Williams & Moorehead, *supra* note 9, at 2101.

22 The form has continually been revised to contain more information. All private foundations and most other § 501(c)(3) charities' annual reports are online with GuideStar. *See generally* GUIDESTAR, http://www2.guidestar.org/Home.aspx (last visited Mar. 31, 2011). FREMONT-SMITH, *supra* note 6, at 65–67, tracks the changes in the form.

23 This is a dauntingly complex area of the law. The description here does not do it justice. For elementary overviews, see FREMONT-SMITH, *supra* note 6, at 264–85; FISHMAN & SCHWARZ, *supra* note 9, at 672–99. For more technical analysis, see BRUCE R. HOPKINS & JODY BLAZEK, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE (3d ed. 2008 & Supp. 2010).

remedy. In 1987, the excise tax approach to regulatory violations migrated to the public charity sector to curb lobbying abuses and political activity.[24]

A fourth phase of federal oversight has now emerged where federal fiduciary norms of behavior have been applied to all § 501(c)(3) charities, effectively replacing the primacy of state law. This stage began in 1996 with the enactment of the so-called intermediate sanctions legislation that imposed an excise tax on "excess benefit transaction[s]" by "disqualified person[s],"—insiders who received excessive compensation.[25] This use of the excise tax approach to penalize excess benefit transactions in public charities differed from its use to punish violations of the lobbying and political restrictions. Previously, Congress had not addressed the setting of compensation, an area primarily governed by state nonprofit law. The intrusion of federal regulations into areas historically reserved for state governance and oversight expanded significantly with the Service's corporate governance initiative. The four papers commented upon herein examine aspects of this development.

II. The Federalization of the Duty of Loyalty

Professor Johnny Rex Buckles's paper, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries*,[26] offers a creative and rich analysis of its subject matter. He develops an interesting categorization of conflict of interest standards in the federal tax regime: supra-trustee, trustee, and nonprofit-corporate-director.[27] The three standards address very different problems. The affected organizations, in a sense, inhabit alternative universes within this enormous grouping called the nonprofit sector.

A conundrum with the federalization of the duty of loyalty is that it blends different issues and problems and upsets the federal/state balance. The federal government and the states have different fish to fry. States historically are more attuned to organizations' mission attainment. This is the reason for the relaxation of nonprofit corporate requirements for conflicts of interest. The federal concern is with the proper use of foregone tax revenues.[28]

State fiduciary standards are appropriate throughout much of the nonprofit sector, but state enforcement mechanisms and resources are

24 I.R.C. §§ 4912, 4955 (2006).

25 I.R.C. § 4958 (West Supp. 2010).

26 Johnny Rex Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries*, 99 Ky. L.J. 645 (2011).

27 *Id.* at 677.

28 Duty of loyalty violations can extend beyond the prohibition against private inurement, which is a violation dealing with insiders. *See* Buckles, *supra* note 26, at 16; *see also* United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1176-77 (7th Cir. 1999) For example, a non-insider, a low-level employee, may be guilty of disloyalty but not inurement.

inadequate. The strength of the federal interest in duty of loyalty issues rests on certain types of organizations where abuses have tended to occur. For most of the sector, the problems and concerns addressed by Congress with the corporate governance initiative may not be an issue, or if they are, no one really knows the extent of the abuses.

Professor Buckles argues that the governmental interest in requiring substantial fairness in conflict of interest transactions is strong, and that its interest in requiring procedural fairness is defensible.[29] State law, however, provides adequate requirements of fairness for nonprofit corporations and trusts for most types of organizations. I disagree that administrative efficiency is quite so important as Professor Buckles suggests, because the federalization of standards and their enforcement creates inefficiencies and costs for nonprofit organizations. I also question the value of uniformity of loyalty standards. The driving concept of the ALI's *Principles of the Law of Nonprofit Organizations*—that an organization's legal structure should not determine the applicable fiduciary standards—initially appealed to me. However, it may be that in some situations different organizational forms should have separate standards.

The author speaks of the inconsistencies of most fiduciary standards except for the nonprofit corporate directors' standard for unaffiliated public charities.[30] Congress responds to perceived problems as they occur. Congress has not considered fiduciary problems in a coherent way. Its attitudes towards fiduciary duties seem similar to the expansion and contraction of organizations entitled to exemption under § 501. By contrast, when the Service acts, it does so consistently across all parts of the sector. Thus, there is a discrepancy between Congress's approach and that of the Service in corporate governance. Professor Buckles's paper justifies an examination by Congress of the inconsistencies he points out in applying the duty of loyalty to the regulation of nonprofits.

III. Choking Out Local Community Service Organizations

Professor Nicole Dandridge has done a real service in pointing out the size and impact of smaller charitable nonprofits, their importance in our communities, and the governance initiative's burdens upon them.[31] Despite their numerical superiority, smaller nonprofits tend to be slighted or given lip service when considering regulation of the sector and the burden of governance upon these organizations.

Statistical data on smaller nonprofits is very soft. Professor Dandridge

29 Buckles, *supra* note 26, at 685-87.

30 *Id.* at 3680-81.

31 Nicole S. Dandridge, *Choking Out Local Community Service Organizations: Impact and Implications of Recent Upsurge in Federal Regulation Imposed Upon Small Community Nonprofit and Charitable Entities*, 99 Ky. L.J. 695 (2011).

presents many interesting facts about this enormous, yet unknown part of the nonprofit universe. While it may be useful for the Service to obtain information on smaller organizations in the sector through the new Form 990-N, loss of exemption for failing to file seems a heavy price for small tax-exempt organizations that are operating yet flying under the Service's radar. Many may lack the capability of filing electronically, which is the only way the Service will accept the form. As Professor Dandridge points out, the result of noncompliance with the seemingly innocuous 990-N will be the loss of tax exemption by many operating organizations, a devastating event to the organization in terms of donor relationships and financial viability. Restoration of exempt status may not be so easy. Professor Dandridge also points out that the costs to re-file and the complexity of Form 1023 will create barriers to reentry.[32]

For organizations filing Form 1023, there are relatively recent demands for applicants to have certain corporate governance procedures and practices in place. These practices and procedures appear in Form 1023's questions and raise new expectations for organizations applying for recognition of tax-exempt status. There is no data to my knowledge about the extent of fraud in smaller organizations or whether conflicts of interest policies and board independence are truly helpful in increasing the probity of smaller nonprofits. Yet, the clear implication of Form 1023 is that organizations should spend substantial amounts of time thinking about corporate governance procedures. The increased burdens of filling out Form 1023 make it more likely organizations will have to spend scarce funds to hire a specialist to assist in completion of the form.[33]

Overregulation of smaller organizations, if not a disincentive to their full formation, may impact their ability to attract volunteers and their continuance. As Professor Dandridge points out, smaller nonprofits are unlikely to have counsel except in cases of emergency or when faced with perceived Service governance mandates.[34] Often smaller organizations believe elaborate governance procedures will make it easier to attract funding. The focus on procedure necessarily takes away resources and makes more difficult mission attainment and fundraising.[35] The full Form

32 Dandridge, *supra* note 31, at 721-22.

33 I have very mixed feelings about creating new nonprofits and almost always recommend to people who want to form a new organization to find a fiscal sponsor so the organization can use the sponsors' tax exemption. The sponsor can handle books and filing requirements until the organization reaches a certain size and indicates viability. I also recommend to organizers and their counsel, if they have one, GREGORY COLVIN, FISCAL SPONSORSHIP: 6 WAYS TO DO IT RIGHT (2006), an excellent resource for organizations contemplating a fiscal sponsorship arrangement.

34 Dandridge, *supra* note 31, at 701-02.

35 An example of this is that an IRS official mentioned in November 2009 that sixty-six percent of organizations that filed the then new Form 990 were eligible to file the Form 990-EZ. Simon Brown, *Most EOs That Filed the New Form 990 Could Have Filed the 990-EZ,*

990 must be filled out by a specialist, which smaller organizations can hardly afford. It also must be reviewed by the board of directors.[36]

I agree with Professor Dandridge's citation to the comment in the report of the Service's *Advisory Committee on Tax Exempt and Governmental Entities* that "[g]eography, size, type of activities the organization engages in, and the make-up of its leadership must be considered when deciding which governance practices will be most successful and appropriate for a nonprofit organization."[37] Although there has been lip service for this, it tends to get lost when translated to small organizations.

I thought a very interesting part of the paper was the discussion of the concepts of responsive regulation and new governance, both of which present useful frameworks within which to examine and debate these regulatory issues. The Service was responsive to outside comments in the redrafting of Form 990, but there was relatively little evidence of interaction with and concern for smaller nonprofits. The Independent Sector's *Principles for Good Governance and Ethical Practice*,[38] as useful as they are to larger organizations, may be more burdensome than relevant to smaller nonprofits. Hopefully, the coming review of Form 1023 will result in increased participation by small organizations.

Professor Dandridge's suggestion of a restoration of exemption procedure short of reapplication for organizations that have missed the 990-N deadline and thereby lost their exemption is an excellent recommendation. The Service could have a procedure similar to that in effect for churches when they engage in political activity. If the church says it will discontinue the activity, the exemption is renewed.[39] Of course, churches don't have to file a Form 1023, but a similar procedure could attach to an operating nonprofit

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Says IRS Official, 64 EXEMPT ORG. TAX REV. 570 (2009). There are several reasons for this: approximately thirty states accept Form 990 as a substitute for the state annual filing form, but they may not accept Form 990-EZ; organizations may file the full Form 990 to impress upon donors that they are mature and have the recommended level of transparency; filing Form 990 requires paid specialist assistance from accounting firms or consultants who have their own interest in pushing the filing of the full Form 990.

36 IRS FORM 990, Part VI (2010). The organization is asked to respond 'yes' only if a copy of the organization's final Form 990, including required schedules, as ultimately filed with the Service, was provided to each voting member of the governing body of the organization, whether in paper or electronic form, prior to its filing with the Service. The organization must also describe in Schedule O the process, if any, by which any of the organization's officers, directors, trustees, board committee members, or management reviewed the prepared Form 990, whether before or after it was filed with the Service, including specifics regarding who conducted the review, when they conducted it, and the extent of any such review. If no review was conducted, the organization must so state.

37 Dandridge, *supra* note 31, at 713.

38 PANEL ON THE NONPROFIT SECTOR, INDEPENDENT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE: A GUIDE FOR CHARITIES AND FOUNDATIONS (2007), *available at* http://www.nonprofitpanel.org/report/principles/principles_guide.pdf.

39 *See* Branch Ministries v. Rossotti, 211 F.3d 137, 143 (D.C. Cir. 2000).

after it files the Form 990-N. I am less certain that the notification to the states will result in much greater contact than exists at the federal level.[40] Professor Dandridge's paper offers a useful framework for dealing with the difficult issues that affect smaller nonprofits.

IV. Federal Regulation of Nonprofit Board Independence: Focus on Third-Party Stakeholders as a "Middle Path"

Professor Benjamin Leff views the problem of federal regulation through a law and economics prism, a creative and interesting focus.[41] He believes the government under certain circumstances has a legitimate interest in charity board independence and develops what seems to be a probable cause standard of private benefit, whereby third-party stakeholders can assist in evaluating whether exemption should be conditioned on the existence of some sort of independent board.[42] Both the Service and Professor Leff place great faith in board independence. Does board independence have an impact on good governance or organizational probity? Professor Dana Brakman Reiser has questioned the value of independence in the nonprofit context.[43] Few state jurisdictions require independent members of a nonprofit Board. The argument that the Service does not require governance procedures is to favor form over substance.[44] If as Chief Justice John Marshall wrote, "The power to tax involves the power to destroy,"[45] the power to grant or withhold recognition of tax exemption is the power to bully and impose the Service's desired governance structures. Questions on the Service's forms must be answered, and the Form 990 questions on corporate governance procedures and conflict of interest policies are reviewable by donors—a very strong incentive to comply with the Service's wishes.

What justification is there that independent board members will be effective as third-party stakeholders? The law gives few rights to third-party stakeholders. Members and directors can bring suit, although this rarely happens, but donors cannot. The Service's approach is wishful thinking. Even with an independent board, independence does not mean

40 Dandridge, *supra* note 31, at 727.

41 Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Third-Party Stakeholders as a "Middle Path"* 99 Ky. L.J. 731 (2011).

42 *Id.* at 780.

43 Dana Brakman Reiser, *The Increasing Resemblance of Nonprofit and Business Organizations Law: Director Independence in the Independent Sector*, 76 Fordham. L. Rev. 795, 797-798 (2007). Professor Brakman Reiser also concludes that director independence makes a relatively limited contribution in addressing real accountability issues facing nonprofit organizations. *Id.* at 831-32.

44 Leff, *supra* note 41, at 733 & n.8, 734 n.10, 737-38 & nn. 23-26, 739 & nn. 29, 32, 740 (discussing and citing relevant IRS statements and publications).

45 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

the individual director will be a monitor or gatekeeper. Daniel Kurtz, a longtime practitioner in the nonprofit area, has written that "probing questions by charity board members have been viewed as 'simply bad manners.'"[46] There is no empirical data to support the view that independence matters.[47]

One has no problem when the Service goes after an organization if there is definite evidence of private purpose. Certain areas of the sector deserve more scrutiny than others, credit counseling bureaus for instance. It may be that an independent board is a proxy for such scrutiny, but to extend that requirement throughout the sector makes little sense. The Service's approach—presuming that a nonprofit organization whose founders sit on its board is likely to confer excess benefits to them or advance their private interests—is akin to arresting people because they look like troublemakers. It is uncertain that an independent board would cure that situation. The risk of private purpose if an organization is dominated by founders may be a reason to deny exemption to some nonprofits, but surely should not create a presumption against all. Nor can one overestimate the difficulty of finding board members, independent or otherwise. A 2007 study by the Urban Institute found that seventy percent of the organizations surveyed stated it was difficult to find new board members. Twenty percent said very difficult.[48]

The federal emphasis differs from state law, which does not prescribe specific corporate governance approaches. State law promotes flexibility in organizational structure, allowing organizations to develop the appropriate structures and policies most suitable in the board's vision.

The description of the Service's model conflict of interest argument demonstrates its departure from existing state law.[49] Under both New York law and the Model Act, the transaction described as impermissible could be approved. Under the typical state conflict of interest statute, there is a procedure for the organization or the board to review a conflict. The statutes mandate disclosure. If the procedures are not followed or there is

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46 Felicity Barringer, *Charity Boards Learn to be Skeptical*, N.Y. TIMES, Apr. 19, 1992, at 10.

47 Empirical studies of for-profit corporations have shown little correlation between board independence and increase in firm value. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002); Kathleen M. Boozang, *Does An Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83, 84 (2007); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for the Policymakers Too*, 22 GA. ST. U. L. REV. 251, 255-57 (2005); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528-31 (2005). There have been no empirical studies relating to the impact of good nonprofit governance on mission outcome.

48 FRANCIE OSTROWER, CTR. ON NONPROFITS AND PHILANTHROPY, URBAN INST., NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY 16 (2007).

49 Leff, *supra* note 41, at 738.

not a disinterested majority of the board to approve, the only consequence is that the burden of proof shifts to the board in proving the fairness of the transaction to the organization at the time it was entered into.[50] Impliedly, the Service views conflicts as a bad thing. State nonprofit law proceeds from a different perspective. Interested transactions are common and cannot be avoided even if there is full disclosure of them.

Professor Leff's analysis of private letter rulings is very informative and provides added texture to the debate. Interestingly, he finds that in many of the adverse determination letters the organization should have been clearly classified as a private foundation.[51] One can only wonder how many of the organizations whose applications for exemption were rejected would have been saved by better lawyering.

Professor Leff states: "organizations with no meaningful independent stakeholders are *low* on the state's priority list but *high* on the federal government's priority list *in both cases because of the lack of independent stakeholders*."[52] This is a useful distinction but one not made by federal or state regulators. This is a well-reasoned and provocative paper and any of my disagreements with the points it makes do not diminish that fact.

V. THE "FEDERALIZATION" PROBLEM AND NONPROFIT SELF-REGULATION: SOME INITIAL THOUGHTS

Professor Mark Sidel notes two perhaps contradictory trends in the regulation and self-regulation of the nonprofit sector. First, federalization of nonprofit regulation is increasing, and second, increased federal regulation is matched by the development and spread of nonprofit self-regulation.[53] He points out the importance of self-regulation. Without question, self-regulatory structures are important contributors to the integrity and health of various parts of the nonprofit sector and beyond. With weaknesses and lapses in government oversight, self-regulation is indispensable for setting standards, identifying inappropriate and illegal behavior, reaffirming norms of behavior, and improving the integrity and efficiency of the nonprofit sector. However, self-regulation has its limitations.

The National Center on Philanthropy and the Law (NCPL) has examined self-regulation throughout the nonprofit sector. NCPL's *Study on Models of Self-Regulation in the Nonprofit Sector* concluded that "[e]xpectations . . . should remain nuanced. . . . If the virtues of self-regulation are trumpeted with too much enthusiasm, disappointment is inevitable

50 *See*, N.Y. NOT-FOR-PROFIT CORP. LAW § 715(b) (McKinney 2005); MODEL NONPROFIT CORP. ACT § 8.60(a) (2008).

51 Leff, *supra* note 41, at 762-63.

52 Leff, *supra* note 41, at 780.

53 Mark Sidel, *The "Federalization" Problem and Nonprofit Self-Regulation: Some Initial Thoughts*, 99 KY. L.J. 783, 783-84 (2011).

when scandals eventually occur."[54] It added that the "most significant factor contributing to the effectiveness of any self-regulatory model is legal enforceability of its standards."[55] So, for self-regulation to be effective, it must be backed by legal sanction or accreditation, which can be revoked by the accrediting body.

A problem with self-regulation is that there are always outliers, sometimes in unexpected places. For instance, the land trust community, mentioned by Professor Sidel as a positive example of the self-regulatory model,[56] had a serious scandal involving its largest and most established member, the Nature Conservancy.[57] Professor Sidel also cites the example of community foundations, where self-regulation seems to work well.[58] However, there are a limited number of community foundations, somewhat in excess of seven hundred.[59] They are particularly visible organizations in their communities, and their boards consist of the local worthies.

The securities area, indeed all financial services, is not such a good example of the self-regulatory model. As Professor Sidel mentions, the securities and financial services areas have a long history of self-regulation, and there is a substantial amount of interchange between self-regulatory organizations (SROs) and the Securities and Exchange Commission (SEC).[60] The success of securities and financial services self-regulation is mixed. Self-regulation did not stop the financial crisis, and if one examines the history of the relationship between the SEC and SROs, one finds an ongoing need for Congress to give the SEC enhanced powers over SROs.[61] Too often self-regulation becomes self-protection.

Self-regulation by industry or organizational type typically reflects the norms of the more established and larger groups. One of the curious aspects of the Service's corporate governance initiative is the response of both Independent Sector and many nonprofits that voluntarily adopted certain Sarbanes-Oxley principles, even though that statute only applies to public corporations. This has had a trickle-down effect to smaller organizations

54 NAT'L CTR. ON PHILANTHROPY & THE LAW, STUDY ON MODELS OF SELF-REGULATION IN THE NONPROFIT SECTOR 61 (Draft 2005), *available at* http://www1.law.nyu.edu/ncpl/pdfs/Self%20Regulation%20Final%20Report-040307updates.pdf.

55 *Id.*

56 Sidel, *supra* note 53, at 784.

57 *See* Joe Stephens & David B. Ottaway, *Nonprofit Land Bank Amasses Billions; Charity Builds Assets on Corporate Partnerships*, WASH. POST, May 4, 2003, at A1; Joe Stephens & David B. Ottaway, *Landing a Big One: Preservation, Private Development*, WASH. POST, May 4, 2003, at A9; Joe Stephens & David B. Ottaway, *Senators Question Conservancy's Practices; End to 'Insider' and 'Side' Deals by Nonprofit Organizations Is Urged*, WASH. POST, June 8, 2005, at A3.

58 Sidel, *supra* note 53, at 784.

59 *Id.*

60 Sidel, *supra* note 53, at 788-89.

61 *See generally* Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985).

with all the burdens it entails.[62]

Professor Sidel's discussion of the types and experiments of comparative self-regulation is particularly enlightening. Our nonprofit sector has much to learn from other countries. Although the social science literature has produced interesting work, very little has been published in legal journals. Professor Sidel has been a major contributor in both venues.[63] One issue with adopting some foreign approaches is the question of scale. For instance, Professor Sidel points out that the Philippines has certified 1000 organizations.[64] There may be more than 1000 art museums in the United States. Certainly, nonprofit self-regulation should be nurtured, but it is a complement to effective direct regulation.

CONCLUSION

The issues raised in these four fine papers will be with us for the foreseeable future. Thanks are owed to Professor Nancy McLaughlin of the University of Utah Law School and to Dean David Brennen of the University of Kentucky College of Law for organizing the program on *The Federalization of Nonprofit and Charity Law* at the AALS 2011 Annual Meeting. The extent of the federal regulatory role over nonprofits will be played out in the coming years. Thanks to the *Kentucky Law Journal*, these articles will be part of that discussion.

62 Fishman, *supra* note 3, at 575-78.

63 *See, e.g.*, Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT L. REV. 803 (2005); Mary Kay Gugerty, Mark Sidel & Angela L. Bies, Introduction to Minisymposium, *Nonprofit Self-Regulation in Comparative Perspective-Themes and Debates*, 39 NONPROFIT AND VOLUNTARY SECTOR Q. 1027 (2010), *available at* http://nvs.sagepub.com/content/39/6/1027; Mark Sidel, *The Promise and Limits of Collective Action for Nonprofit Self-Regulation: Evidence from Asia*, 39 NONPROFIT AND VOLUNTARY SECTOR Q 1039 (2010), *available at* http://nvs.sagepub.com/content/39/6/1039.

64 Sidel, *supra* note 53, at 793.