The Nonprofit Sector: Myths and Realities

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I have followed the development of CUNY Law School from its founding, and I really have to salute you. I do not know exactly where legal education is going, but I think CUNY is going to get there before other law schools, including my own. Today, I am going to explore some of the myths and realities of the nonprofit sector.

**MYTH NUMBER ONE: THERE IS A UNITARY CONCEPT OF THE NONPROFIT SECTOR**

First, the idea of a singular "nonprofit sector" itself is a myth. There are really many sectors. According to tax law, there are at least twenty-eight types of organizations entitled to tax-exempt status. I will be talking about one of those sectors: the section 501(c)(3) organizations, the charitable nonprofits.

Traditionally, the 501(c)(3)s have been divided into two categories: public charities and private foundations. Private foundations have been described as a pool of money surrounded by people trying to get some of it. But in a tax sense, private foundations are essentially organizations that have failed certain tests of public support. The other portion of 501(c)(3)s are public charities. These are organizations to which contributions are deductible for federal tax purposes. Over one-half of all organizations recognized as exempt by the Internal Revenue Service (IRS) are in this group.

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1. I.R.C. § 501(c)-(28), (d), (e), (f), (k) (West Supp. 2006). See also I.R.C. § 521(a) (West Supp. 2006) (farmers' cooperative organizations).
2. "To author Dwight MacDonald, the Ford Foundation was 'a large body of money completely surrounded by people who want some.'" JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 753 (3d ed. 2006).
3. More specifically, private foundations are organizations that fail the public support tests of I.R.C. § 509.
4. I.R.C. §§ 170(c)(2) (income tax), 2055(a)(2) (estate tax), 2522(a)(2) (gift tax). Only donations to organizations that test for public safety are not deductible.
5. Section 501(c)(3) of the Internal Revenue Code exempts:
Within this category of 501(c)(3), vastly different organizations are treated alike. I believe that the charitable sector needs to be redefined and perhaps narrowed. In the past, public benefit and relief of the poor were the central purposes of public charities. This is no longer the case. Today this sector has become broader and encompasses organizations with assets of billions of dollars, from Harvard and hospital systems to a three-member dance company with no assets. The 501(c)(3) sector is also broad in terms of their sources of funding—government at all levels supports it, and it receives fees for services and funding from foundations, corporations, and private donations. Mark A. Hall and John D. Colombo have suggested that public charities should be limited to organizations that receive a certain amount of their budgets from private donations.  

Also, the scale of activity of some charitable nonprofits is absolutely immense. At some point quantitative differences in size become qualitative ones. One of the justifications for nonprofit organizations—and this was raised during one of the panels this morning—is that nonprofits emerge where there is market failure; that is, where the commercial market does not provide a particular kind of service or good. Despite this rationale for nonprofit activity, many nonprofits compete with and resemble their for-profit counterparts. The prime examples are nonprofit hospitals, which are much closer to their for-profit cohorts than they are to other charitable organizations. I question whether this kind of nonprofit should be allowed to exist as a section 501(c)(3) without the organization demonstrating a tangible community benefit.

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6 Mark A. Hall & John D. Colombo, The Donative Theory of the Charitable Tax Exemption, 52 OHIO ST. L.J. 1379, 1450-51 (1991). Charities would be eligible for public support once the level of private giving signified “a great enough market failure that subsidization through the tax system is warranted to correct the undersupply of a desired good or service, yet not so high that the effect of the subsidy is nil.” Id. at 1451.

7 The affirmative test of exemption for hospitals changed from a “relief of pov-
ganizations exist to benefit the community, especially when they provide virtually no charitable care?

Rulemakers have also lost sight of the diversity of organizations possible within section 501(c)(3), leaving some organizations underrepresented and their needs ignored. Congress has proposed numerous changes for the sector, ostensibly to increase transparency and diminish fraud. Many of the proposals would increase the regulatory burden for nonprofits. These congressional initiatives resulted in the leading representative of nonprofits, the Independent Sector, to create a panel which issued a report to respond to congressional proposals. The process of response engaged the elite players in the nonprofit world, but not the smaller organizations that make up most of the public charity sector. The panel's membership did not reflect the diversity of the charitable nonprofit sector. Small groups, community-based organizations, and rural organizations were not members of this panel. The panel proposed increasing self-regulation and opposed efforts to curtail some potential abuses that would affect some of its primary members, such as foundation trustee compensation. The panel supported proposals that would have the effect of increasing the filing burdens on smaller nonprofits.

We should be asking some questions about the 501(c)(3) universe. What is the role of nonprofits in a modern economy? What should be the role of government in financing charitable activities, and what sort of control should the government have over these activities? Should charities be allowed to compete with for-profit organizations and under what circumstances? When should state action force private organizations to open their operations to scrutiny? How much community benefit should an organization provide before it is eligible for 501(c)(3) status? Should we require charitable nonprofits to help the poor and provide tangible public benefits?

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<sup>1</sup> Rationale, which required hospitals to treat indigent patients without regard to their ability to pay, see Rev. Rul. 56-185, 1956-1 C.B. 202; to a community benefit standard, where charity care was not a requirement. Rev. Rul. 69-545, 1969-2 C.B. 117. See also Fishman & Schwarz, supra note 22, at 355-77.


<sup>9</sup> Id. at 85-91.

<sup>10</sup> Id.
MYTH NUMBER TWO: THE NONPROFIT SECTOR IS AN INDEPENDENT SECTOR STANDING BETWEEN BUSINESS AND GOVERNMENT

Another myth is the idea that the nonprofit sector stands between government and the public sector. The aforementioned leading association of nonprofits is called the Independent Sector, an oxymoron for the 501(c)(3) world. Nonprofits are far from independent of private enterprise or government. There is an extraordinary degree of interface between government and nonprofits today. Nonprofits mimic for-profit firms, and the private sector plays an enormous role in the nonprofit sector. Many nonprofits engage substantially, if not excessively, in regular business activity. If you have ever been to the Museum of Modern Art or to the Metropolitan Museum of Art and have visited their shops, you have seen that they are like department stores. We need to examine universities and how they profit from the commercialism of higher education: lucrative research, licensing deals, and forays into dot-com businesses. There is a growing trend of nonprofit organizations spawning for-profit subsidiaries. National Geographic and The Children's Television Workshop have for-profit subsidiaries that make tens of millions of dollars. The IRS has become concerned about the enormous increase in joint ventures between for-profits and nonprofits. At the same time, for-profit firms are encroaching upon traditional nonprofit turf, such as healthcare and education.

Government—the public sector—and the private nonprofit sector are elaborately interconnected and affect one another. Congress routinely authorizes, and federal agencies administer, many


12 Stephanie Strom, What's Wrong with Profit?, N.Y. TIMES, Nov. 13, 2006, at Fl. ("[T]he National Geographic Society, a nonprofit group . . . is sustained by sales of everything from magazines to toys"); Stephanie Strom, Nonprofit Groups Reach for Profits on the Side, N.Y. TIMES, Mar. 17, 2002, at A32 ("Tickle Me Elmo, a popular toy from a few Christmases back, still generates a handsome licensing fee for the Children's Television Workshop. . .").

domestic policy programs through nonprofit organizations. Private nonprofit agencies may receive all or nearly all of their revenue from the government. This ranges from social service nonprofits to the Los Alamos Nuclear Laboratory, which is nonprofit and administered by a university. How independent are organizations that are primarily or exclusively funded by the government? Should these organizations be treated as government agencies? Should Freedom of Information mandates apply?

**MYTH NUMBER THREE: THE INTERSECTION BETWEEN GOVERNMENT AND BUSINESS DATES FROM THE END OF THE SECOND WORLD WAR**

Another myth is that the intersection between government and the nonprofit sector arose at the end of World War II with the expansion of funding for higher education and healthcare. In actuality, our history shows that nonprofits and government have always been linked. Harvard College, for example, was chartered as a corporation, governed by administrators of the tax-supported Congregational Church, and had government officials serving as *ex officios* of the board. Its endowment was from private donors, tuition, and other service fees. Until the 1830s, Harvard considered itself a public institution, not a private one. Government has always been closely affiliated with the nonprofit sector.

**MYTH NUMBER FOUR: THERE IS A GREAT INCREASE OF CONTEMPORARY WRONGDOING AND SCANDAL IN THE NONPROFIT SECTOR**

We have seen a seeming proliferation of scandals in the nonprofit sector and a growth of press coverage of these scandals. One scandal is one too many. In recent weeks, we found out that the president of the Getty Museum is paid over a million dollars a year and was given a $70,000 Porsche SUV; he and his wife were given first-class travel around the world; and he had a member of the museum staff express mail an umbrella as well as his mail, among

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17 Id. at 17. It was not until the mid-nineteenth century that Harvard could be considered private in the modern sense. *Id.*
other abuses. At the Grolier Club, a club of bibliophiles—and perhaps the most law-abiding, decent people you can imagine—there have been claims of self-dealing. The Nature Conservancy was involved in questionable transactions with insiders, inept stewardship, and evaluation abuses. There has been excessive private foundation compensation. Paul C. Cabot, Jr. of the Cabot Foundation received over one million dollars in annual compensation and took another four million dollars for personal expenses, including his daughter’s wedding.

Attorneys General have been increasingly active, and between 1995 and 2002 there were 152 reported incidents of civil and criminal misconduct. But in the context of 50,000 nonprofits in New York State alone, this is hardly an epidemic. Congress, however, is reacting to this negative coverage and formulating new legislation for nonprofits with demands for improvement in transparency and governance. The Senate Finance Committee supports the federal government as a regulator of nonprofits, which increases the cost of compliance and enforcement. The House Ways and Means Committee offered a more interesting theoretical approach. They focused on the elusive definition of “nonprofit” and the need for more coherent tax exemption qualification standards.

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19 Stephanie Strom, Bibliophiles Disagree over Price of Air Above, N.Y. TIMES, Feb. 8, 2006, at B1.
20 See Joe Stephens & David B. Ottaway, Nonprofit Sells Scenic Acreage to Allies at a Loss, WASH. POST, May 6, 2003, at A1 (detailing pattern of the Conservancy reselling donated land at a loss to trustees and supporters only to have them make cash donations roughly equaling the difference, allowing them to take “significant tax deductions”). The Washington Post’s coverage triggered an IRS audit and an investigation and report by the Senate Finance Committee staff. SENATE FIN. COMM. STAFF, FINANCE COMMITTEE REPORT ON THE NATURE CONSERVANCY, at V (2003), available at http://finance.senate.gov/hearings/other/tncontents.pdf.
House asked, "Is the extent to which charities are providing services to the public commensurate with their favored tax status?""\textsuperscript{25} Unfortunately, they only held a one-day hearing on the matter.\textsuperscript{26}

One needs to apply a historical perspective to charity fraud. This perspective offers a very different view of contemporary wrongdoing in the nonprofit sector. My book \emph{The Faithless Fiduciary and the Quest for Charitable Accountability} is an historical study that examines scandals involving charitable organizations from the year 1200 to 2000.\textsuperscript{27} One thing I can say with assurance is that scandal and fraud have always been rampant among charitable organizations.

For example, one notorious scandal occurred at an almshouse, the Hospital of St. Cross, in Winchester, England.\textsuperscript{28} It was founded in 1132 by Bishop Henri De Blois of Winchester, the grandson of William the Conqueror and the brother of King Steven, one of England's worst monarchs, who offers comparison to our current administration in Washington. St. Cross is still in existence, and if you visit there you will be offered a piece of bread and a draught of beer, even though you are probably not a pilgrim on your way to Canterbury. De Blois, like many modern donors, had mixed motives. He wanted to become an archbishop, and what better way to do so than by founding an almshouse?

This almshouse was an old age home that originally took care of thirteen elderly men and fed many other poor. Every 150 years, St. Cross has faced scandal. Although the fact situations differ, they always revolve around a fiduciary who engages in an excess benefit transaction, a conversion of nonprofit assets to for-profit purposes, unrelated business activities, or just plain theft. For example, the first known resident was a man named Conan (not the barbarian). He was not poor, as the founding charter specified; instead, he was a property owner and money lender. De Blois purchased some property from Conan, who received a payment: The bishop promised Conan that he would be able to reside permanently in this almshouse.

The most recent scandal occurred in 1853. The assets of St. Cross had greatly increased. There developed a tradition that the master of the hospital\textsuperscript{29} would pocket the increase. Uncovering

\textsuperscript{25} \emph{Id.}
\textsuperscript{26} \emph{Id.}
\textsuperscript{28} \emph{Id.} at 50–51.
\textsuperscript{29} The "master" or "warden" is the title of the cleric in charge of the hospital.
and ending this practice became a cause célèbre throughout the country. For twenty years prior, Parliament had tried to introduce a bill to regulate charities. This scandal enabled the creation of a charity commission, which is the model for all Anglo-American regulatory bodies. That was one good thing which happened from the 1853 incident. It also inspired the novelist Anthony Trollope to write his first successful novel, *The Warden.*

In the United States, scandal also goes far back in our history to the first years of European settlement. The first that I have found involved Edward Hopkins. He was one of the earliest settlers of Connecticut and had been either deputy governor or governor of the state for fourteen years. Hopkins was one of the wealthiest men in the state. His first fortune was obtained the old fashioned way: He married into it. He died in England in 1657 and left a bequest to found some schools in Connecticut and a college to train the clergy. There was a clerical dispute. One of the trustees of Hopkins’s estate moved to Massachusetts. When the dust finally cleared, where did this bequest go? To Harvard. Yale has always claimed that the money belonged to it, although it was founded later.

Another early scandal involved John Hancock, who signed his name in large handwriting on the Declaration of Independence. He had been chosen treasurer of Harvard College in 1773. After he became President of the Continental Congress, Hancock took the books and assets of Harvard College with him to Philadelphia and refused to give them back—or to give an accounting of the College’s assets. The Board of Overseers finally ousted him. He eventually gave back some of the money, but neither he nor his heirs ever returned the full amount.

In the nineteenth century, war and economic depression encouraged all kinds of charity frauds. In 1879, a “Ponzi scheme” occurred nearly fifty years before Charles Ponzi, a Boston swindler, gave his name to this particular scam. A Ponzi scheme works by taking funds of later investors to pay the earlier investors an extraordinarily high rate of interest, attracting new dupes; eventually, the number of new investors declines, and inevitably the scheme collapses. 

**Footnotes:**

31 See Fishman, supra note 27, at 247–56.
32 Id. at 257–59.
33 A Ponzi scheme works by taking funds of later investors to pay the earlier investors an extraordinarily high rate of interest, attracting new dupes; eventually, the number of new investors declines, and inevitably the scheme collapses. *Mitchell Zuckoff, Ponzi’s Scheme: The True Story of a Financial Legend* 314 (2005) (biography of Ponzi). Neither Mrs. Howe nor Ponzi were innovators. These types of swindles occurred frequently in Europe in the nineteenth century.
of 8% per month, paid quarterly in advance on deposits of $200 to $1000. Only single working women of modest means were eligible for such spectacular returns. The Ladies Deposit described itself as a charitable institution for single ladies, old and young. The principal could be withdrawn upon call any day except Sunday. No deposit would be received from persons owning a house. A group of anonymous Quaker philanthropists supposedly paid the interest.\textsuperscript{34} There were no such philanthropists, and, after the inevitable crash, Mrs. Howe was sent to jail.

In the early 20th century came the first telemarketing scam. An apocryphal Senator Peter Justice Fogerty called, on behalf of an imaginary political club, for donations of Christmas baskets for the poor. As this demonstrates, charity fraud is nothing new. I believe that with the invention of the Internet, the sensitivity of most nonprofit managers, and the increasing scrutiny of the press, there is more probity today in the sector than ever before.

\textbf{MYTH NUMBER FIVE: TOO MANY NONPROFITS ARE UNACCOUNTABLE, AND THERE IS TOO LITTLE TRANSPARENCY}

We live in an age where there are continuing demands for greater accountability. Good governance facilitates well-run charities and dissuades improper behavior. Transparency sheds light on organizational practices, which in turn should enhance ethical and effective operations and facilitate oversight. There are several aspects to the concept of accountability: one is financial accountability; another is mission accountability. It is a lot easier to determine whether an organization is spending its money properly than to measure the quality of the charity’s activities. What are the appropriate benchmarks to use when it comes to social values and services, along with a heavy emphasis on quantification of such measures? How do you assure consistency between organizations? What measures are used?

The demand for greater accountability has been followed by imposing more record-keeping and filing requirements and has

led some states and some larger charities to adopt the Sarbanes-Oxley requirements, a very expensive regulatory scheme. A study by John Hopkins University showed that over half of the 247 largest charities had adopted these requirements.\textsuperscript{35} If smaller nonprofits are mandated to adopt these requirements it will divert money that would be better applied to the mission of the organization. Is there any evidence that creating more complex filing requirements or imposing more burdens on board members, who are overwhelmingly volunteers, will create greater accountability?

**MYTH NUMBER SIX: ENFORCEMENT EFFORTS TO ASSURE INCREASED ACCOUNTABILITY SHOULD COME FROM THE FEDERAL GOVERNMENT**

The demand to improve the accountability of charitable organizations is nothing new. As far back as 1305, Pope Clement V drew attention to the waste and misappropriation in hospitals.\textsuperscript{36} He ordered an annual inventory. This early effort is perhaps the historical forebear of Form 990, the Annual Report that 501(c)(3) charities must file if they have revenues over $25,000.\textsuperscript{37} For much of our history, accountability has been a local matter. In the nineteenth century, fraud was handled by district attorneys and local agencies. The district attorneys' approach was to shut down organizations and send fiduciaries that breached their trust to jail. At the same time, organizations such as the Charity Organization Society advised people not to give money to certain organizations. Accountability and fiduciary standards on the federal level are relatively recent. In 1969, foundations were placed under a very rigorous regulatory regime, which has begun to migrate toward public charities.\textsuperscript{38}

The IRS cannot be an efficient and effective regulator of nonprofits. There is a need for a new template. I think we ought to create a close nonprofit corporation, similar to close for-profit corporations. In corporate law, close corporations differ from public corporations in that they are smaller and less regulated.\textsuperscript{39} If a non-

\textsuperscript{35} \textsc{Lester Salamon \& Stephanie L. Geller}, \textit{Nonprofit Governance \& Accountability} 9, 15 n.5 (2005), available at \url{http://www.jhu.edu/listeningpost/news/pdf/comm04.pdf}.

\textsuperscript{36} \textsc{Ira Fishman}, supra note 27, at 44.


\textsuperscript{38} \textsc{Fishman \& Schwarz}, supra note 22, at 751.

\textsuperscript{39} In New York, close corporations are corporations that are not listed on a securities exchange or the over-the-counter market. See N.Y. Bus. Corp. Law §§ 620(C), 1104(A) (McKinney 2003). In some jurisdictions, Delaware, for instance, there are
profit has revenues of less than $100,000, I would exempt it from regulations concerned with conflicts of interest and filing requirements. I would treat such arrangements essentially as incorporated partnerships.

There are two broad approaches or theories of regulation: one advocates increasing the number of rules; another advocates increased enforcement. I am in favor of increasing enforcement. I would provide additional funding for the IRS and for state attorneys general to hire more auditors instead of writing more rules, which seems to be the current approach. When you have a large number of rules, the burden of adhering to them falls unequally on smaller nonprofits. For a large nonprofit hospital, for example, added recordkeeping and filing requirements are just a cost of doing business. Smaller organizations have difficulty complying with increased mandates because of a lack of technical sophistication and resources to hire experts.

State regulation is also inefficient, ineffective, and, in some cases, capricious. Enforcement should be locally controlled. I suggest that we return to the charity commissions which were established in the seventeenth century under the English Statute of Charitable Uses. The purpose of that statute was to set up commissions in every parish so people could complain about how charitable funds were being misused. The commissioners would determine if there was probable cause and would impanel a jury, who would reach a decision, appealable to Chancery.

These are challenging times for charities, and the sector is under enormous criticism. We are going to see some new regulations. I do not think that we need new regulations or burdens, particularly those that impact smaller organizations. We need some new ideas.


40 1601, 42 Eliz. c. 4. See Fishman, supra note 27, at 105–07.