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Rethinking Riley: Applying Commensurate and Intermediate Scrutiny Standards to Judicial Evaluation of Charitable Solicitation Regulation

James J. Fishman

Elisabeth Haub School of Law at Pace University

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**Rethinking Riley: Applying Commensurate and Intermediate Scrutiny Standards to
Judicial Evaluation of Charitable Solicitation Regulation***

James J. Fishman**

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**Professor of Law Emeritus, Haub School of Law at Pace University

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I. Introduction

In *Riley v. National Federation of the Blind*,¹ the Supreme Court held that a North Carolina statute requiring professional fundraisers to disclose to potential donors the average percentage of gross receipts they actually turned over to charities for all charitable solicitations conducted in the state within the previous twelve months was unduly burdensome and unconstitutional. The Court applied a strict scrutiny standard of review of the regulated speech, rather than a more deferential standard of review for commercial speech or economic regulation.² The Court’s rationale was that the commercial speech elements of the charity’s message were inextricably intertwined with its fully protected educational portions and was constitutionally

¹ 487 U.S 781 (1988).

² The Charitable Solicitations Act also defined the prima facie “reasonable fee” that a professional fundraiser could charge according to a three-tiered schedule. A fee up to 20 percent of receipts collected was deemed reasonable; a fee between 20 and 35 percent was deemed unreasonable upon a showing that the solicitation at issue did not involve the dissemination of information, discussion, or advocacy relating to public issues as directed by the charitable organization that benefitted from the solicitation. A fee exceeding 35 percent of receipts collected was presumed unreasonable, but the fundraiser could rebut the presumption by showing that the fee was necessary either because the solicitation involved the dissemination of information or advocacy on public issues directed by the charity, or because otherwise the charity’s ability to raise money or communicate would be significantly diminished. Finally, the act provided that professional fundraisers could not solicit without an approved license, whereas volunteer fundraisers could solicit immediately upon submitting a license application. 487 U.S.at 785-787.

protected, even if no money was raised. North Carolina's regulations governing application of the statute were not narrowly tailored to achieve the state's valid interests in preventing fraud, and protecting charities and informing donors how money contributed was spent.

This article disagrees with *Riley*'s rationale that the educational elements in charitable solicitation are always so interwoven with commercial speech that governmental regulation of a charity's message is subject to strict judicial scrutiny as a matter of course, and protected by the First Amendment.³ It suggests that this conclusion does not reflect the realities of much fundraising speech, which is fundamentally commercial in nature, as opposed to educational or charitable, and argues that some charitable solicitation, where costs of fundraising over several years exceed eighty-five percent of the amount raised, more appropriately should be subject to a lesser, intermediate standard of scrutiny of review by the courts.⁴ Examining charitable fundraising from the perspective of the professional solicitor's role, and requiring disclosure of fundraising costs in certain circumstances should pass constitutional muster, because it protects the public from deception and manipulation.

II. Professional Solicitation

Nearly all charities raise funds from the public or from grant making entities in order to survive and thrive.⁵ Most organizations of size conduct their fundraising through professional

³ There is an exception for fraudulent or deceptive solicitation, which does not receive constitutional protection.

⁴ This recommendation was suggested by Professors Espinoza and Inazu in their analyses of an earlier case relating to charitable solicitation, *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980), which was ambiguous on the standard to be applied. *See*, Leslie G. Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 *S. Cal. L. Rev.* 605 (1991); John Inazu, *Making Sense of Schaumburg: Seeking Coherence in First Amendment Charitable Solicitation Law*, 192 *Marq. L. Rev.* 551, 566 (2009).

⁵ Two exceptions are private foundations and certain social services nonprofits, the latter organized separately from but completely funded by government sources. Private foundations are charities that have failed several complicated tests of public support. Most foundations need not fundraise, because they have an endowment from which they cover administrative costs and make grants.

fundraising firms that plan and make the solicitation to the public. Not surprisingly, given the amount of money involved—charities raised \$373 billion in 2015—charitable solicitation has developed into a sophisticated and lucrative business.⁶ Professional Solicitation firms are necessary accompaniments to nonprofit activity. They can be efficient and effective enablers of an organization’s financial solvency and ability to achieve its charitable mission.

Professional solicitors, as is the case in so many occupations, are stratified by client, method of compensation, target audience, ethics and practices, and reputation. Firms may offer their services for a fee or take a percentage of the amount raised. Fee for services is the more reputable approach.⁷ Charitable solicitation is a big business. As in any area of commerce (or life), participants are faced with competition, and abuses by some industry members occur. The criticisms discussed relate to a small and ethically challenged subset, not to the profession as a whole.

⁶ Jean O’Brien, *Giving USA: 2015 Was America’s Most-Generous Year Ever*, June 13, 2016 available at <https://givingusa.org/giving-usa-2016/>.

⁷ According to a report by the Massachusetts Attorney General: “The percentage of monies raised that goes to the charity can vary widely. The terms of each campaign are agreed upon by both the solicitor and the charitable organization and are reflected in the contracts that are filed with the [Attorney General’s Office]. In some contracts, the charity agrees to accept a percentage of funds raised, but it is far more common for the contract to set forth the solicitors’ cost of performing the services involved in the campaign (for example, a per-call or per-contact charge or an hourly charge) and for the charity to agree to pay those costs and then retain the remainder of gross proceeds from the campaign. The percentage of gross proceeds received by the charity in those types of arrangements depends on the cost of the service and the results of the campaign rather than an agreed-upon percentage.

The cost of the solicitation service, in turn, also depends on a number of factors, including the type of campaign the professional solicitors are hired to run. Some firms are hired to run major events; some are hired to conduct telemarketing; some are retained to do face- to-face canvassing. Still others are hired to help with “fulfillment” during a fundraising campaign. This last category includes organizations that maintain 24/7 phone banks to receive calls from potential donors generated by television, radio or other advertisements that may be viewed well outside of normal business hours.

Ultimately, the amount of the funds raised that goes to the charity is a function of the agreement that the charity and the professional solicitor have made and the results of the campaign. As noted above, there is no legally required minimum amount or percentage of funds raised that must go to the charity...” Report on Professional Solicitations for Charity in 2013 6, Office of the Massachusetts Attorney General, Nonprofit Organizations/Public Charities Division (Dec. 2014), available at www.mass.gov/ago/docs/nonprofit/professional-solicitations-reports/pro-solicit-2013.pdf.

When a charitable contribution has been made, there often is no discernible outcome to the donor save the “warm glow” of feeling altruistic.⁸ A contribution is usually an act of faith that money donated is put to its promised use.⁹ Indisputably, some fraudulent or misleading charitable solicitation exists.

Many charities conduct all of their charitable solicitations through professional fundraising firms that plan and actually make the solicitations.¹⁰ If the fundraiser uses its own funds to run a campaign, usually its reimbursement comes from the dollars raised by donors’ contributions. The solicitor is repaid “off-the-top”. In other words, the solicitor receives the first dollars contributed. For smaller charities, the lure for retaining a professional fundraising firm is that the charity seems to be in a win–win situation. The fundraiser assumes the out of pocket costs of the campaign, and every dollar raised for the organization is a dollar that the charity did not previously possess. Most donors are unaware that seventy to ninety percent of their contribution may not reach the organization, but goes to the fundraiser. A surprising number of fundraising campaigns lose money, so the charity receives nothing, and in some circumstances,

⁸The phrase “warm glow” was coined by James Andreoni in his article *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 *Econ. J.* 464 (1990).

⁹ See, Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 *U. Pa. L. Rev.* 497, 505 (1981). Sometimes that faith is unjustified. A Reporter sponsored a girl from Mali through the Save the Children Federation and decided to visit the child. The sponsored child had been dead for four years, and letters to donors purportedly from children were written by the organization. See Lisa Anderson, *The Miracle Merchants*, *Chic. Tribune*, Mar. 15, 1998, at 1. The same type of deception was alleged against World Vision, a charity whose website highlights faces and biographies of children from impoverished places around the world. World Vision advertised one could sponsor a child for \$39 a month. An Australian paid \$1100 over several years to sponsor a Palestinian child, but never heard from him. A reporter tracked down the child. Neither the child nor his relatives knew he had been sponsored. Nor did the child or his family receive any direct support, though the charity had contributed money to the village in which the child lived. See, Diaa Hadid, *Tracking the Mysteries of a Charity’s Sponsored Child*, *N.Y. Times*, Aug. 3, 2016 available at <http://www.nytimes.com/2016/08/03/world/middleeast/worldvision-palestinians-sponsor-a-child.html>

¹⁰ Established charities often have a development office with in-house staff, whose primary functions are to plan the organization’s fundraising campaign, minister to the care and feeding of existing donors, and cultivate new supporters. These employees are not called ‘professional solicitors’ or ‘fundraisers’, but have a more prestigious title of ‘fundraising counsel’. Established charities will likely outsource to a telemarketing firm the actual solicitation of the public.

owes the fundraiser money after the campaign is over¹¹ Inefficient and losing solicitation campaigns still may benefit a charity. Not every fundraising campaign's purpose is raising substantial sums of money. The solicitation may be an effort to educate the solicited about a new, unknown, or controversial cause. In this situation, the charitable solicitation is intertwined with the constitutionally protected free speech.

At the bottom of the solicitation hierarchy are fundraisers and charitable organizations that may be fronts for the solicitor or an organization's officers or directors. Their organizations' primary purpose is self-enrichment of the individuals involved, rather than raising funds for the charity or spreading a particular message. These individuals, a small part of the fundraising and charitable communities, engage in misrepresentation, deceit, and fraud. Such operations are surprisingly difficult to shut down absent a national consent decree to cease their activities, a rare event.¹² Such firms may be driven from one state to another or will change their corporate name and continue in business.

The Problem of Solicitation Fraud

The scenario is common: a charity, typically with a name including an emotive word such as *cancer, children, firefighters, police, or veterans* signs a contract with a professional solicitor to organize and run a campaign to solicit charitable contributions. The charity may be

¹¹ This occurs more often than one would think. In 16.8% of fundraising campaigns or 192 of the 1,143 campaigns in New York in 2015, expenses exceeded revenues raised for a loss of \$16.7 million to the charities involved. Charities Bureau, N.Y. State Law Dep't, Office of the Att'y Gen., *Pennies for Charity Where Your Money Goes: Fundraising by Professional Fundraisers* 1 (2016), available at: https://www.charitiesnys.com/pdfs/Pennies_Report_122216.pdf. Losses can occur when the fundraising contract does not guarantee the charity a specific dollar amount or specific percentage of the gross receipts, including when fundraising is incidental to the telemarketing campaign, or when the contract does not hold the charity harmless for expenses/fees that exceed the gross amount contributed. *Id.* Some of these losing campaigns were not intended to raise money, but focused on finding new and promising donors or educating individuals unaware of the organization and its mission.

¹² See, James J. Fishman, *Who Can Regulate Fraudulent Charitable Solicitation?* 13 Pitt. Tax Rev 1, 2, 5 n. 9 (2015).

legitimate or a sham. The directors of the charity may be allied with or co-conspirators with the professional solicitor, or as likely, well-meaning but naïve individuals. The fundraiser raises millions of dollars through telemarketing, Internet, or direct mail solicitation. The charity receives but a small percentage of the amount raised or nothing.

Abuses by some nonprofits in soliciting funds from the public have been the most persistent problem facing state attorneys general in their regulation of charities.¹³ In the overall context of the nation's charitable giving, the number of charity scams is small, but the amounts raised are surprisingly large, and the betrayal of trust of donors has a carryover effect on future giving, at least on those who learn their gifts were misspent.

In *Federal Trade Commission et al. v. Cancer Fund of America*, a unique example of collaboration between state charity regulators and the Federal Trade Commission (FTC), the FTC and attorneys general of fifty states and the District of Columbia finally shuttered a long existing group of sham cancer charities. Cancer Fund of America, Breast Cancer Society, Cancer Support Services and Children's Cancer Fund of America were cancer charities that raised \$187 million from 2008 to 2012.¹⁴ The organizations told prospective donors they ran national programs, and their contributions would help people with cancer by providing pain medication to children suffering from the disease, transporting cancer patients to chemotherapy

¹³ James J. Fishman, Stephen Schwarz & Lloyd Hitoshi Mayer, *Nonprofit Organizations: Cases and Materials* 219 (5th ed. 2015).

¹⁴ The complaint, *FTC et. al. v. Cancer Fund of America, Inc. et al.*, Case 2:15-cv-00884-NVW is available at <https://a.next.westlaw.com/Link/Document/Blob/If7cb7e5003c411e5bb5cdf14584a6bb.pdf?targetType=Trials&originationContext=filings&contextData=%28sc.Search%29&transitionType=FilingsItem>. The plaintiffs alleged the deceptive conduct violated Section 5 of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 45(a), and the Telemarketing Sales Rule ("TSR"), 16 C.F.R. Part 310, as well as state statutes regarding charitable solicitations and prohibiting deceptive and unfair trade practices. The FTC brought the this action under Sections 13(b) and 19 of the FTC Act, 15 U.S.C. §§ 53(b) and 57b, and the Telemarketing and Consumer Fraud and Abuse Prevention Act ("Telemarketing Act"), 15 U.S.C. §§ 6101-6108, to obtain temporary, preliminary, and permanent injunctive relief, rescission or reformation of contracts, restitution, the refund of monies paid, disgorgement of ill-gotten monies, and other equitable relief for Defendants' violations of Section 5(a) of the FTC Act, 15 U.S.C. § 45(a), and the TSR, 16 C.F.R. Part 310.

appointments, or paying for hospice care for cancer patients. None of this was true. Instead, the overwhelming majority of donated funds supported the organization's fundraisers, the individual defendants, and their families and friends in such activities as tuition payments, dating websites, ski outings, gym memberships and cruises to the Caribbean.¹⁵

The complaint dealt only with four years, 2008 to 2012, and the money raised in that period is probably long gone. The charities were controlled by James T. Reynolds, Sr., who organized the Cancer Fund of America in 1987, and though disciplined by several states in the intervening years, his organization managed to survive. Two of the defendant charities immediately settled with the regulators and dissolved. Members of Reynolds' family and others affiliated with the organizations agreed to be barred from fundraising, charity management, and oversight of charitable assets.¹⁶ Reynolds Senior, the perpetrator of the scheme, initially refused to settle, and the litigation continued against him, Cancer Fund of America, and Cancer Support Services, the fundraising arm, but a few months later he agreed to go out of business.¹⁷

¹⁵ See, Rebecca R. Ruiz, *4 Cancer Charities Are Accused of Fraud*, N.Y. Times, May 20, 2015 at B1; Suzanne Perry, *\$187-Million Fraud Case Puts Charities on the Defensive*, Chron. Phil. June 1, 2015 available at https://philanthropy.com/article/187-Million-Fraud-Case-Puts/230567?cid=pt&utm_source=pt&utm_medium=en.

¹⁶ David Fitzpatrick & Drew Griffin, *Cancer charity targeted by feds agrees to put itself out of business*, CNN, Feb. 15, 2016 available at <http://www.cnn.com/2016/02/15/us/cancer-fund-of-america-dissolution-agreement/>.

¹⁷ Two other leading cases of fundraising fraud in recent years include: the Disabled Veterans National Foundation raised \$116 million using a professional solicitation firm, Quadriga Arts. More than ninety percent of the amount raised went for direct mail solicitation. At the end of the campaign, the charity owed another \$14 million to the solicitation firm that it could not pay. As for any assistance to disabled veterans, it consisted of hand sanitizers, M&M'S candies, chefs' hats, coats, and leftover shoes. In an action brought by the New York attorney general the fundraiser was required to forgive the debt and pay \$10 million in damages. The founding board members were forced to resign. See, Suzanne Perry, *N.Y. Wins \$25-Million in Fundraising Abuse Case*, The Chron. of Philanthropy, (June 30, 2014), <http://philanthropy.com/article/NY-Wins-25-Million-in/147445/>; David Fitzpatrick & Drew Griffin, *Charity Marketing Group Investigated by Two States for Possible Fraud*, CNN, (July 1, 2014), <http://www.cnn.com/2012/09/26/us/senate-charities-investigation/index.html>. See 2014 N.Y. Op. Att'y Gen. 145 (June 11, 2014), www.ag.ny.gov/pdfs/DVNF-Quadriga-Convergence-AOD_14-145.PDF, for the full settlement agreement. In the aftermath of the settlement, the fundraiser, the subject of other complaints over the years, changed its name and remains in business.

U.S. Navy Veterans involved the unfortunately common scheme using a purported veterans' assistance charity. The U.S. Navy Veterans Association raised \$27.6 million in 2009 and an estimated \$100 million in all. It boasted of a membership of 66,000 and offices in 41 states, neither of which existed. The offices were post office

It is not infrequent that by the time the attorney general or other regulator such as the Federal Trade Commission disciplines or shuts down a fraudulent solicitation scheme, the money raised has been spent. Even if the perpetrators are barred from engaging in solicitation or serving on a charity board—criminal prosecution is rare—there is little to deter others. Many regulators, such as the IRS and most attorneys general, are ineffective or passive in this area. The Federal Trade Commission, the principal regulator in the Cancer Fund of America case, has no criminal prosecution authority.

Many nonprofit trade associations preach self-regulation, which often amounts to self-protection. Outliers, such as the organizations discussed above, could not care less about self-regulatory norms. As the following sections demonstrate, Constitutional principles of freedom of speech, press, and religion place restraints on prior regulation of charitable speech and solicitation.

III. Approaches to Regulation of Charitable Solicitation

Regulation of Religious and Charitable Solicitation through Issuance of Permits

Riley did not occur on a blank slate. It was a consequence of differing strands of constitutional development concerning the limits of regulating free speech under the First

boxes, and of the organization's eighty-four purported officers, the only one who could be traced was an individual calling himself Bobby Thompson, whose identity had been stolen from a civilian in Washington State. U.S. Navy Veterans was unmasked not by federal or state charity regulators, but through the investigative reporting of the Tampa Bay Times. Ohio's Attorney General took the lead in pursuing and prosecuting the perpetrator of the fraud, John Donald Cody. Kris Hundley, *Bobby Thompson, Fugitive from Navy Vets Charity, Caught on West Coast*, Tampa Bay Times, (May 1, 2012). After a cross-country search, U.S. Marshals apprehended Cody in Portland, Oregon. A jury ultimately found him guilty of 23 counts of fraud, money laundering, and theft. An Ohio judge then sentenced him to twenty-eight years in prison. Kris Hundley, *U.S. Navy Veterans Association Charity Fraud Trial Ends with Bobby Thompson Guilty on All Counts*, Tampa Bay Times, (Nov. 14, 2013),

Amendment.¹⁸ Supreme Court scrutiny of restrictions on canvassing by religious or charitable organizations has a surprisingly long history with several intersecting threads. The early cases dealt with challenges to local and state ordinances that prohibited soliciting door-to-door, distributing literature, or asking for contributions absent a permit approved by a government official. Some regulations prohibited door-to-door solicitation completely. State courts construed these ordinances limiting house-to-house solicitation as a means of protecting home owners from fraudulent solicitation. They assumed the solicitors were engaged in their activities primarily for profit and therefore were not entitled to constitutional protection. The effect of the earlier efforts at curtailment of canvassing was to limit the distribution of knowledge, obviously a free speech issue. Other cases focused on the amount of discretion vested in a state or local official, who used vague or non-existent criteria when issuing a permit for the distribution of ideas.

A plurality of the early decisions turned primarily, if not exclusively, upon the amount of discretion vested in government officials to grant or deny permits on the basis of vague or even non-existent criteria.¹⁹ Many of the solicitors were members of religious groups, who combined an effort to propagate their faith along with a request for funds.²⁰ Another line of earlier cases

¹⁸ The First Amendment states: Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances. U.S. Constit. Amend. I.

¹⁹ *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620, 640 (Rehnquist, J. dissenting); *See, Lovell v. Griffin*, 303 U.S. 444 (1938); *Schneider v. State*, 308 U.S. 147, 163–164 (1939); *Cantwell v. Connecticut*, 310 U.S. 296, 305–306 (1940); *Largent v. Texas*, 318 U.S. 418, 422, (1943); *Hynes v. Mayor of Oradell*, 425 U.S. 610, 620–621 (1976). *See also*, *Watchtower Bible and Tract Society of New York, Inc. v. Village of Stratton*, 536 U.S. 150, (2002). (Ordinance that prohibited canvassers from “going in and upon” private residential property to promote any cause without first obtaining a permit from mayor’s office and by completing and signing a registration form or be subject to a misdemeanor was violation of First Amendment).

²⁰ *Lovell v. Griffin*, *supra*; *Schneider v. State*, *supra*; *Cantwell v. Connecticut*, 310 U.S. 296 (1940); *Jamison v. Texas*, 318 U.S. 413 (1943) *Murdock v. Pennsylvania*, 319 U.S. 105 (1943).

involved the distribution of information, as opposed to requests for contributions.²¹ The cases also reaffirmed that the distribution of handbills or information for religious purposes did not become a commercial activity because funds were also solicited or the purchase of something, such as a book was encouraged, but remained protected speech.²²

Though protecting the speech interests of solicitation, the Court conceded the “collection of funds” might be subject to reasonable regulation so as to protect the citizen against crime and undue annoyance, but the First Amendment required such controls to be drawn with “narrow specificity”.²³ Even though the earlier cases emphasized that First Amendment principles apply to charitable solicitation even if contained within a request for money or purchase of a religious or political tract, the Court recognized the legitimate interests a town or other governmental unit had in some form of regulation, particularly when the solicitation of money was involved, to protect its citizens, their property, and right to privacy.²⁴ There was a need to balance between these state interests and the effect of the regulations on First Amendment rights.²⁵

Most of the earlier cases rested on the discretion of officials to issue a permit allowing door-to-door solicitation by religious individuals distributing information and disseminating ideas. Door-to-door solicitation as the Court observed is essential to the poorly financed causes

²¹ *Martin v. Struthers*, 319 U.S. 141 (1943), for example, dealt with Jehovah's Witnesses who had gone door to door with invitations to a religious meeting despite a local ordinance prohibiting distribution of any “handbills, circulars or other advertisements” door to door. The Court noted that such an ordinance “limits the dissemination of knowledge,” and that it could “serve no purpose but that forbidden by the Constitution, the naked restriction of the dissemination of ideas.” *Id.*, at 144, 147.

²² *Jamison v. Texas*, 318 U.S. 413,417 (1943) *Largent v. Texas*, *supra*; *Murdock v. Pennsylvania*, *supra*. *Thomas v. Collins*, 323 U.S. 516 (1945).

²³ *Hynes v. Mayor of Oradell*, *supra* note 19 at 620; *Martin v. Struthers*, *supra* note 21, at 540-541.

²⁴ *Watchtower Bible and Tract Society of New York, Inc. v. Village of Stratton*, 536 U.S. 150, 162 (2002); *Cantwell v. Connecticut*, 310 U.S. at 306; *Martin v. Struthers*, 319 U.S. at 144. The Court noted that if the provision in *Watchtower* had been construed to apply only to commercial activities and the solicitation of funds, arguably the ordinance would have been tailored to the Village’s interest in protecting the privacy of the residents and protecting fraud. The ordinance, unquestionably applied to noncommercial canvassers. *Watchtower*, 536 U.S. at 161.

²⁵ *Id.* at 163.

of ‘little people’.²⁶ This article suggests there is a need to recalibrate that balance between government and solicitors to reflect that modern fundraising is overwhelmingly not in person door-to-door by ‘little people’ but through sophisticated telemarketing firms on behalf of charities. Today, the ‘little people’ needing protection are the recipients of the requests, the public.

Cost of Fundraising as a Limit to Charitable Solicitation

The efforts of state governmental bodies to regulate charitable solicitation has resembled a kind of guerrilla warfare where there are no final victories or defeats. After each judicial setback a new initiative or approach is introduced. The flashpoint of regulators’ scrutiny of charitable solicitation became the cost to the charity of its fundraising efforts when it hired professional solicitors on a contingent fee basis. In contingent fee fundraising the charity pays little or nothing up front, but the solicitor receives a percentage of every dollar donated.

State legislators moved from unsuccessful attempts to prohibit solicitation through door-to-door canvassing to enacting legislation that allowed charities to spend only a specified maximum amount on fundraising expenses with some exceptions, in order to qualify for a license to solicit. The theory of cost of fundraising regulation is that such limits assure charitable dollars are spent primarily on an organization’s charitable mission. Cost of fundraising is usually expressed as a ratio between the cost to a charity of raising a certain amount in a solicitation campaign divided by the total amount raised.²⁷ More established charities are likely to have a lower Cost of Fundraising Ratio (CFR), for they can obtain contributions regularly from previous

²⁶ *Id.* at 163 (quoting *Martin v. Struthers*, 319 U.S. at 144-146).

²⁷ The ratio is expressed as a total percentage of contributions received by the charity. If a charity receives \$10,000 in contributions from a solicitation, but spends \$8,000 for a professional solicitor and associated costs, the cost of fundraising is \$8,000/\$10,000 or 80%.

donors familiar their missions and be more attractive to newer sources of support, because of their reputation. For example, a university might receive annual contributions from alumni to endow everything from buildings to bathrooms,²⁸ grants from foundations, governments, or other supporters.

There is distaste and distrust between more established charities and competing organizations that raise money for a similar cause using less efficient means such as mass mailings and telemarketing. Established charities have supported greater regulation of their newer or less prestigious competitors, and the focus has been on their cost of fundraising as an indicator of waste or fraud.²⁹ They also hoped that cost of fundraising regulation would drive out of business unsavory competitors that relied exclusively on mass solicitation techniques.

Traditional or entrenched charities reasonably believe they are harmed when charitable dollars are not used for their intended purposes. Generous donors, whose contributions have been diverted, may give less in the future. Government grant-makers, whose tax dollars are wasted, may cut programs or support. Rightful beneficiaries of charities that use excessively paid solicitors may be denied services. Furthermore, the charitable sector as a whole may be damaged, if the public loses faith in its probity.

Regulators assume that charities with high fundraising costs are more likely to engage in fraud, excessive profit taking and waste. However, a higher CFR may also indicate a charity of a different type than traditional nonprofits. The organization may be recently formed. Its appeal may be for a new or controversial cause, or its primary goal may not be to raise substantial funds

²⁸ In the men's room of the Van Pelt Library of the University of Pennsylvania a urinal is endowed by an alumnus with a plaque: "Relief is provided by [name of alumnus]."

²⁹ Espinosa, *supra* note 4 at 650, 655.

but to transmit an educational message, perhaps unpopular with the public. It may solicit small donors through mass mailings, rather than from funding sources accessible to more established organizations. It may be more difficult for a new charity to raise a dollar from a small donor, than for an established nonprofit to receive \$1,000 from a previous contributor. A newly formed charity has few disincentives to continuous fundraising. Assume a charity spends ninety percent of every dollar raised to pay for the cost of its solicitation. The ten percent remaining is still ten cents more than the organization possessed than before the solicitation.

The belief that increased competition by charities with a high CFR impacts on the fundraising of more established organizations in the same field has not been proven empirically. More likely, the cost is that some donors are misled by similar names to well-established organizations or by an emotive word in the name, such as *cancer*, *children*, or *veterans*. Established charities' fundraising *should* be more efficient than newer charities that have to spend a greater percentage of their dollars contributed to gain recognition and their mission, supported.

The Fallacy of Cost of Fundraising Ratios

A high ratio of expenses to funds raised, though controversial, does not of itself indicate that a nonprofit is mismanaged, corrupt, or inefficient. Cost of fundraising ratios should be but one piece of data used to evaluate a charity. As stated above, a nonprofit's CFR may be high for a number of legitimate reasons. Other factors such as salaries and administrative costs, quantitative measures of mission attainment, and the number of people actually served by the charity compared to other organizations in the same field may be more important than CFR.

A low CFR may not indicate the ethical high ground of reasonable fundraising costs.

Organizations may have an acceptable CFR, yet use their funds wastefully. The Wounded Warrior Project, the country's largest and until recently, fastest growing veterans' charity, had a CFR of forty percent, which is within the acceptable level though at the higher end. However, the organization spent millions of the \$372 million raised in 2015 on staff travel, lavish dinners, hotels and conferences, and hundreds of thousands of dollars on public relations and lobbying.³⁰

³⁰ Former employees accused the organization of high overhead wasteful expenditures. Some of the programs were of questionable effectiveness. The organization claimed it spent 80% of donations on programs, but it arrived at that figure though counting some marketing material as educational. The two top officers were forced out. The board instituted a review of the organization. It remains to be seen when, if ever, the organization will recover from the scandal. Dave Philipps, *Helping Veterans Recover, Spending Lavishly on Itself*, N.Y. Times, Jan. 28, 2016 at A1; Chip Reid & Jennifer Janisch, *Wounded Warrior Project Accused of wasting donation money*, CBS News, January 26, 2016 available at <http://www.cbsnews.com/heroes/>; Timothy Sandoval, *Veterans Nonprofits Seek Separation From Wounded Warrior Project*, Chron. Philanthropy, March 17, 2016 available at https://philanthropy.com/article/Veterans-Nonprofits-Seek/235739?cid=pt&utm_source=pt&utm_medium=en&elqTrackId=0dcec2c1453244359fc31c6249e0028a&elq=02423d02cdee40e1b1ee25c81466f5a6&elqaid=8302&elqat=1&elqCampaignId=2691. Vaughn E. James, *Restructuring Coming for Wounded Warrior Project*, available at: <http://lawprofessors.typepad.com/nonprofit/2016/08/restructuring-for-wounded-warrior-project.html>.

In May 2017, Senator Charles Grassley, Chair of the Judiciary Committee, released an investigative report that concluded the Wounded Warrior Project was taking steps to remedy its questionable spending practices, but there remained questionable cost allocation issues. The Senator offered recommendations as to how the organization can be more transparent and honest about its finances and better oversee its spending. WWP claimed that 80.6% of donations were spent on programs for veterans, but the amount included promotional items, donated media and other costs that should have been characterized as program service expenses. For IRS reporting purposes donated media is not a program expense. Without including these figures, the organization spent an estimated 54-60% of donations helping wounded service members. WWP averred it spent more than \$40 million in fundraising in FY 2014 that was educational in nature, and therefore program services. This was questionable under FASB SOP 98-2, "Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities that Include Fundraising." WWP also stated it spent \$65.4 million on long-term support programs. In actuality, the organization transferred the funds to a long term support trust, whose only expenditure was for investment management fees. The Report is available at: https://www.grassley.senate.gov/sites/default/files/constituents/2017-05-24%20CEG%20to%20Judiciary%20and%20Finance%20%28Wounded%20Warrior%20Project%29_fina1.pdf.

Established charities are sensitive to their own CFRs being perceived as too high and have taken several approaches to minimize such expenses: shaving the actual fundraising costs in their publicity, hiding the costs through allocation to other expense categories, or denying they had any such costs at all. The Red Cross, about an establishment a charity as there is, claimed on its website and in public comments by top executives that ninety-one cents of each dollar donated went directly to services, meaning only nine cents of every dollar committed was spent on fundraising. A review of financial statements showed that fundraising costs averaged seventeen cents per donated dollar during the previous five years. One year, its CFR was twenty-six cents of every donated dollar.³¹

Fundraising cost ratios can be hidden by allocating expenses into more donor-acceptable categories, such as public education, program services, general expenses or administration instead of fundraising.³² If a charity signs a contract with a professional fundraiser providing that any funds received by the charity will be after expenses, and costs have been taken out by the fundraiser, can the charity validly claim that it has no fundraising costs? Two studies, several years apart, found a substantial percentage of charities reported on their Form 990 annual informational tax return that they incurred no fundraising costs, while state filing records revealed that in fact the organization spent substantial amounts on solicitation.

The first study, by the Urban Institute's Center on Nonprofit and Philanthropy and the Center on Philanthropy at Indiana University, examined 2000 tax year data and found that more than a third of nonprofit groups that collected \$50,000 or more in contributions claimed on their

³¹ Jesse Eisinger, Justin Elliott, & Laura Sullivan, *Red Cross Misrepresented How Donors' Dollars Are Spent*, ProPublica & NPR, Dec. 4, 2014, available at <http://www.propublica.org/article/red-cross-ceo-has-been-misleading-about-donations>.

³² Fishman, Schwarz & Mayer, *supra* n. 13 at 247.

Form 990 that they spent nothing on fundraising, even though that was often not true. The researchers examined the tax returns of more than 125,000 nonprofit groups, and conducted surveys of overhead costs and accounting practices at 1,500 of them. They concluded that many organizations that receive the best ratings from watchdog groups were not as efficient as they claimed, and a large number lacked the capacity to track such costs accurately.³³

A 2012 analysis by the Scripps Howard News Service of the 2010 Form 990 returns of 37,987 charities and other nonprofits that raised at least \$1 million through fundraising found that forty-one percent of the charities (15,389) receiving a total of \$116.7 billion stated they spent nothing for advertising, telephone solicitations, mailed appeals, professionally prepared grant applications or staff time for face-to-face solicitations. For example, forty-eight of Goodwill Industries' 127 major affiliates reported raising \$387 million at no cost. Of the 22,598 organizations that did report fundraising expenses, the cost of fundraising was but seven cents for every dollar contributed. Robert Ottenhoff, former CEO of GuideStar and the Public Broadcasting Service, quipped: "It is ridiculous to think an organization could raise significant amounts of money without spending money to do it. I must be doing something wrong. I've never seen it growing on trees."³⁴

Normally, nonprofit organizations allocate expenditures functionally, typically program service expenses, management and general administrative expenses, and fundraising expenses. These programmatic allocations reflect general accounting principles.³⁵ They are also desired

³³ See, Nonprofit Overhead Cost Project, What We Know about Overhead Costs in the Nonprofit Sector, Brief # 1, available at nccsdataweb.urban.org/kbfiles/313/Brief%201.pdf.

³⁴ *Where Should You Give? Thousands of Nonprofits Misreporting Fundraising Costs*, Scripps Howard News Service, May 21, 2012, available at <http://nonprofitquarterly.org/?s=scripps+howard>.

³⁵ See American Institute Of Certified Professional Accountants, American Institute of Certified Professional Accountants, Statement of Position 98-2: Accounting for Costs of Activities of Not-for-profit organizations and State and Local Governmental Agencies that Include Fundraising, 20, 456 (March 11, 1998),

by donors and required by governmental agencies such as the Internal Revenue Service in the Form 990 Annual Information Return, one part of which demands that any 501(c)(3) and 501(c)(4) organization present a statement of functional expenses. Failing to have such a standard is at best a soft-core sort of fraud or misrepresentation.

Because the rules for determining overhead costs such as CFR are vague, and every charity seems to interpret them differently, some charity watchdogs, such as the Better Business Bureau Wise Giving Alliance, Guidestar, and Charity Navigator have criticized the emphasis on overhead ratios or cost of fundraising, and suggest donors should focus on the charity's effectiveness measured by impact of the organization on its beneficiaries, a much more difficult task.³⁶ Charity Navigator has deemphasized overhead in its ratings. Other watchdogs disagree.

<http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820927486&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs>. SOP 98-2 establishes accounting standards to assure nonprofit organizations accurately state the amount of fundraising and other costs. This requires allocation of fundraising costs even if they are a joint activity with a programmatic or administrative function. If the fundraising cannot be reasonably allocated in part to another functional classification, it should be reported as fundraising costs. *Id.*

³⁶ See, Press Release, Tim Ogden, Philanthropy Action, The Worst (and Best) Way to Pick a Charity This Year (Dec. 1, 2009), http://philanthropyaction.com/nc/the_worst_and_best_way_to_pick_a_charity_this_year/. Less than two weeks after the publication of the “America’s Worst Charities” report, BBB Wise Giving Alliance, Charity Navigator and Guidestar, three charity rating organizations, commenced a campaign to persuade donors to look beyond overhead costs when deciding which groups to support because overhead is a poor measure of a charities’ performance. The statement concedes “at the extreme” high spending on overhead can tip off donors to fraud or poor financial management. The three organizations did not invite a fourth watchdog, Charity Watch to participate, because it rates charities exclusively on their financial performance. See, Suzanne Perry, *3 Major Charity Groups Ask Donors to Stop Focusing on Overhead Costs*, THE CHRONICLE OF PHILANTHROPY (June 17, 2013), http://philanthropy.com/article/3-Major-Charity-Groups-Ask/139881/?cid=pt&utm_source=pt&utm_medium=en; Suzanne Perry, *Overhead Costs Pose Dilemma for Charities*, THE CHRONICLE OF PHILANTHROPY (May 19, 2013), <http://philanthropy.com/article/Overhead-Costs-Pose-Dilemma/139329/>.

³⁶The Revised Principles for Good Governance and Ethical Practice provide more flexibility for overhead costs. Previously, the Principles stated that charities should spend a significant amount of their expenses on programs with a target of 65% of expenses. The revision says spending 65% of expenses on program activities and more on overhead is sometimes necessary. Alex Daniels, *New Charity Guidelines Deal With Online Fraud, Overhead, and Executive Pay*, THE CHRONICLE OF PHILANTHROPY (Feb. 25, 2015), <https://philanthropy.com/article/New-Charity-Guidelines-Deal/227877>.

One can assume charities that have extraordinarily high fundraising costs over many years are less effective and more likely to have issues of waste or fraud.³⁷ At some point, does a high CFR over many years indicate the charity is serving a private purpose, which would make the organization ineligible for tax exemption? Though every fundraising campaign tries to include some educational speech, which is protected, after years of high CFR and little expenditure on mission, should this indicate the speech component is merely formulaic, or even deceptive rather than meaningful, and demonstrates no one is listening?

Constitutional Limits to Cost of Fundraising Regulation: The Supreme Court Trilogy

Three cases involving maximum allowable fundraising statutes reached the Supreme Court. All were declared unconstitutional, because they were overly broad and impinged on constitutionally protected speech.³⁸ In reaching this conclusion the Supreme Court applied a standard of strict scrutiny to state regulatory efforts.

*Schaumburg v. Citizens for a Better Environment*³⁹

³⁷ See, Suzanne Perry, *3 Major Charity Groups Ask Donors to Stop Focusing on Overhead Costs*, Chron. Philanthropy, June 17, 2013 available at: http://philanthropy.com/article/3-Major-Charity-Groups-Ask/139881/?cid=pt&utm_source=pt&utm_medium=en, www.philanthropyaction.com/documents/Worst_Way_to_Pick_A_Charity_Dec_1_2009.pdf.

³⁸ The overbreadth doctrine holds that a law may be invalidated on grounds that it is overbroad i.e. the statute or ordinance sweeps within its coverage too much. It is an exception to two traditional rules of constitutional litigation. First, it results in the invalidation of a law on its face, as opposed to its application to a particular speaker or plaintiff. Ordinarily, a litigant claims that a statute is unconstitutionally applied to him/her. If the litigant prevails, the courts sever the application of the unconstitutional aspect by invalidating the improper application on a case-by-case basis. If it's inapplicable to that speaker, it is trimmed down only as to similarly situated individuals. Kathleen M. Sullivan & Noah Feldman, *Constitutional Law* 1278 (18th ed. 2013). When the law is invalidated for overbreadth the statute is unenforceable, unless it is rewritten by the legislature or construed more narrowly. *Id.* Second, overbreadth doctrine is an exception to the normal rule of standing that requires challengers to a law to assert their own interests, rather than those of third parties. Overbreadth doctrine allows challengers to assert the rights of third parties, who may be reluctant to assert their rights. *Gooding v. Wilson*, 405 U.S. 518, 521 (1972).

³⁹ *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980).

The village of Schaumburg, Illinois enacted an ordinance prohibiting door-to-door or on-street solicitation of contributions by charitable organizations that did not use at least 75 percent of their receipts for charitable purposes. Such purposes were defined to exclude cost of solicitation, salaries, overhead, and other administrative expenses. After the Village denied a solicitation permit to Citizens for a Better Environment (CBE), a nonprofit environmental-protection organization, because it could not meet the ordinance's 75-percent requirement, CBE sued in Federal District Court, alleging that such a requirement violated the First and Fourteenth Amendments, and sought declaratory and injunctive relief.

The legal issue was whether the Village had exercised its power to regulate solicitation in a manner that did not intrude upon the rights of free speech. The District Court granted summary judgment for CBE, and the United States Court of Appeals for the Seventh Circuit affirmed. The Appeals Court concluded that even if the 75-percent requirement might be valid as applied to other types of charitable solicitation, it was unreasonable on its face because it barred solicitation by advocacy-oriented organizations even where the contributions would be used for reasonable salaries of those who gathered and disseminated information relevant to the organization's purpose.

The Appeals Court distinguished *National Foundation v. Fort Worth*,⁴⁰ which upheld an ordinance authorizing denial of charitable solicitation permits to organizations with excessive solicitation costs, on the ground that although the Fort Worth ordinance deemed unreasonable solicitation costs in excess of 20 percent of gross receipts, it nevertheless permitted organizations that demonstrated the reasonableness of such costs to obtain solicitation permits.⁴¹

⁴⁰ 415 F.2d 41 5th Cir. 1969), *cert. denied*, 396 U.S. 1040, (1970).

⁴¹ 444 U.S.at 627-628.

The Supreme Court affirmed the lower courts' finding that the ordinance in *Schaumburg* was constitutionally overbroad and violated the First and Fourteenth Amendments.⁴² It reviewed prior cases that established charitable appeals for funds involved a variety of speech interests within the protection of the First Amendment. Though solicitation was subject to reasonable regulation, such regulatory efforts had to be undertaken with due regard for the reality that it was characteristically intertwined with informative and persuasive speech, seeking support for particular causes or views on economic, political, or social issues, and for the reality that without solicitation, the flow of such information and advocacy would likely cease. Additionally, since charitable solicitation did more than inform private economic decisions and was not primarily concerned with providing information about the characteristics and costs of goods and services, it could not be considered as a variety of purely commercial speech.⁴³

The ordinance at issue in *Schaumburg* would be unconstitutionally applied to advocacy organizations that not only compensated solicitors, but also paid others to obtain, process, and disseminate the organization's positions on items of interest. Such organizations would necessarily spend more than the 75 percent limit, and such information and advocacy would likely cease.⁴⁴ Unless it served a sufficiently strong, subordinating interest that the Village was entitled to protect, the ordinance could not be sustained. The Village's justification of prevention

⁴² *Id.* at 636. Note for purposes of the Overbreadth Doctrine, the Court held the appellate tribunal was free to inquire whether the ordinance was overbroad, a question that involved no dispute about CBE's characteristics. Even if there was no demonstration CBE was one of the organizations affected, the ordinance purported to prohibit a substantial category of charities to which the 75-percent limitation could not be applied consistently with First and Fourteenth Amendment principles, *Id.* at 634-635.

⁴³ *Schaumburg*, 444 U.S. at 632. The fact that speech was in the form of a solicitation to pay or contribute money did not affect its protection. *New York Times v. Sullivan*, 376 U.S. 254 (1964); *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977).

⁴⁴ *Schaumburg*, 444 U.S. at 635-636.

of the public from fraud, crime and undue annoyance could be sufficiently served by measures more narrowly drawn and less destructive of First Amendment interests.⁴⁵

The Supreme Court seemed to agree with the exception carved out by the Appeals Court for organizations whose primary purpose was not to provide money or services for the poor, the needy, or other worthy objects of duty but to gather and disseminate information about advocacy positions on matters of public concern. Such organizations may pay reasonable salaries, which by the nature of their work would exceed the 75% CFR limit in the statute. Thus, the ordinance was an unjustified infringement of First and Fourteenth Amendment rights.⁴⁶ The Court seemed to accept that CFR limits might be enforceable against more traditional charitable organizations' purely commercial solicitations.

The *Schaumburg* decision did not ignore the interests of the community or state in protecting its citizens from fraud, preventing their access to property, or their rights of privacy. The Supreme Court suggested more narrow means than a direct prohibition of a certain level of CFR might fulfill the Village's interest in preventing fraud. These included: denouncing frauds and criminal offenses punishment through the penal laws; permitting homeowners to bar solicitors from their property by posting signs reading "No Solicitors or Peddlers Invited," and efforts by the Village and the state of Illinois to promote disclosure of charities' finances, so potential donors are informed of the ways their contributions will be employed.⁴⁷

As Justice Rehnquist pointed out in his dissent, *Schaumburg* differed from its precedents, a plurality of which turned on the discretion of the licensing authority to issue a permit. Others

⁴⁵ *Id.*

⁴⁶ *Id.* at 635-636.

⁴⁷ *Id.* at 637-638.

involved the distribution of information as opposed to requests for money.⁴⁸ He noted that from a practical standpoint, the decision offered no guidance as to how a municipality might identify those organizations “where the primary purpose is...to gather and disseminate positions on matters of public concern.”⁴⁹ This, in fact, has become a problem: a dollop of speech in a sea of commercial seeking of funds tilts to the constitutionally protected side of the equation, thereby offering broad access to deceptive fundraising.

Furthermore, by triggering a solicitation as protected speech, *Schaumburg* seemed to make any attempt to regulate such activity as possibly subject to a strict standard of review, but this interpretation of the decision is ambiguous. To pass the strict scrutiny standard, a legislature must have passed the particular law under review to further a "compelling governmental interest," and must have narrowly tailored the law to achieve that interest.⁵⁰

Schaumburg created at least three ambiguities that subsequent cases resolved. The first was the distinction between traditional charitable organizations providing services, which seemingly could be limited by a CFR requirement, and advocacy organizations that could not be so restricted. Second, what was the level of scrutiny that should be applied by a court to legislation that limited the amount of funds an organization could spend on fundraising expenses? *Schaumburg* was unclear whether such statutes should receive intermediate or strict scrutiny. As Professor John Inazu has demonstrated, in the aftermath of *Schaumburg* the federal courts were all over the lot.⁵¹ A third ambiguity was the question whether the deficiency of the ordinance in *Schaumburg* could be rectified by giving a state official authority to waive the flat

⁴⁸ *Id.* at 640-642.

⁴⁹ *Id.* at 642-643.

⁵⁰ Strict scrutiny is a form of judicial review that courts use to determine the constitutionality of certain laws. See *infra* pp. 55-56 for a discussion of the levels of scrutiny

⁵¹ Inazu, *supra* note 4 at 551, 566.

CFR mandate. The uncertainty as to the standard of scrutiny given to statutes regulating CFR solicitation was corrected in *Munson and Riley*.

*Secretary of State of Maryland v. Joseph H. Munson Co.*⁵²

Munson involved a Maryland statute prohibiting solicitations by any charity that did not use seventy-five percent of its receipts for charitable purposes, the same percentage limitation as the ordinance in Schaumburg.⁵³ However, the Maryland statute authorized a waiver of this limitation where it would effectively prevent the organization from raising contributed funds.⁵⁴ The issue in *Munson* was whether the addition of an administrative waiver of the limitation enabled the ordinance to withstand constitutional attack.

Joseph H. Munson Company, Inc. was a professional fundraiser that promoted fundraising events and gave advice on how they should be conducted. Among Munson's clients were several Maryland chapters of the Fraternal Order of Police. Munson regularly charged more than the twenty-five percent of the gross raised for the events it promoted. One of its clients refused to contract with the Munson Company because of the percentage limitation. Munson brought suit claiming the Maryland Secretary of State threatened it with prosecution, if the Munson Company refused to comply with the statute, and the percentage limitation would violate the rights of free speech of Munson's clients under the First and Fourteenth Amendments.⁵⁵ The lower Maryland courts upheld the statute, but the Maryland Court of

⁵² 467 U.S. 947, 104 S. Ct. 2839, 81 L. Ed. 2d 786 (1984).

⁵³ Md. Ann. Code Art. 41 § 103D (1982).

⁵⁴ The waiver section of the statute read as follows: "The Secretary of State shall issue rules and regulations to permit a charitable organization to pay or agree to pay for expenses in connection with a fund-raising activity more than 25% of its total gross income in those instances where the 25% limitation would effectively prevent the charitable organization from raising contributions." Id. at (a).

⁵⁵ Another issue in the case was whether Munson as a third party, rather than Maryland charities that were the direct entities regulated by the Maryland Statute, had standing to challenge the percentage limitation. Any litigant must

Appeals found it was not a narrowly drawn regulation designed to serve the State’s legitimate interests without interfering with First Amendment freedoms.⁵⁶

The Supreme Court rejected the assumption that a high CFR indicated a probability of fraud. It recognized there were organizations with high fundraising costs unrelated to protected First Amendment activity, which could have their activities prohibited. The problem with the Maryland statute was it could not distinguish between such organizations from charities with high costs due to protected First Amendment activities.⁵⁷ The statute’s flaw was that it operated on a fundamentally mistaken premise that high solicitation costs were an accurate measure of fraud. Restricting solicitation costs may do nothing to prevent fraud⁵⁸

The court denied the waiver option as a corrective to constitutional objections to the statute: “while the possibility of a waiver might decrease the number of impermissible applications of the statute, it did nothing to remedy the statute’s fundamental defect: the imposition of a direct restriction on protected First Amendment activity, and the means chosen to

satisfy the “case” or “controversy” jurisdictional requirement of Article III of the Constitution. The “case or controversy” requirement of Article III restricts federal courts to the resolution of concrete disputes between the parties before them, rather than hypothetical situations. Because its contracts called for payment in excess of 25% of the funds raised at a given event, Munson suffered potential civil and criminal liability. As mentioned in the text one of its clients was reluctant to enter into a contract because of the percentage limitation, and Munson had been informed it would be prosecuted if he failed to comply with the statute. The Court found Munson satisfied the case or controversy requirement, because he was threatened with actual and threatened injury as a result of the statute. In addition to the limitations on standing, plaintiffs must normally assert their own legal rights and not the rights of third parties. Where the claim is that the statute is overly broad in violation of the First Amendment, and the statute is directed at persons with whom the plaintiff has a business or professional relationship, and impairs the plaintiff in that relationship, the plaintiff is accorded standing to challenge the validity of the statute, even though Munson’s own activities are not constitutionally protected. The existence of the statute could chill challenge of it by primary parties for fear of punishment. The Court cited *Schaumburg*, at 444 U.S. 634. Note that though Munson was the plaintiff in the lower court cases, since the Secretary of State appealed the highest Maryland court’s decision, Munson became the respondent in the Supreme Court case. Justice Stevens in a concurring opinion felt that while the writ of certiorari should never been issued, there were sufficient reasons for finding Munson’s third party standing was proper. 467 U.S. at 973-974.

⁵⁶ *Joseph H. Munson Co. v. Secretary of State*, 294 Md. 160, 181, 448 A.2d 935, 946 (1982). The Court cited *Schaumburg* at 444 U.S., at 637.

⁵⁷ 467 U.S. at 966.

⁵⁸ *Id.* at 967.

accomplish the state's objectives were too imprecise.⁵⁹ The fact that the Munson statute regulated all charitable fundraising and not just door-to-door solicitation did not remedy the fact that the statute promotes the state's interest only peripherally.⁶⁰

In dissent⁶¹ Justice Rehnquist challenged the majority's use of the overbreadth doctrine for allowing review by the defendant. The dissent considered the Maryland statute functioned as an economic regulation by setting a limit on the fees charged by professional fundraisers, a differentiation from *Schaumburg*, which the dissent interpreted as primarily controlling the nature and internal workings of charitable organizations seeking to solicit in the Village. The *Schaumburg* statute's main failing was it effectively prohibited any solicitation by organizations that were primarily engaged in research, advocacy, or public education and used their own paid staff to carry out those functions as well as to solicit financial support. Such advocacy organizations were likely to have high administrative expenses making it impossible for them to qualify for a permit. In contrast, the Maryland statute in contrast was directed primarily at controlling the external economic relations between charities and professional fundraisers and should be judged under the minimum rationality standard traditionally applied to economic regulation.⁶²

The dissent found that the limitation on fundraiser's fees served a number legitimate and substantial government interests. It insured that funds solicited from the public for a charitable purpose would not be excessively diverted to private pecuniary gain. The limitation encouraged the public to give with confidence that money designated for a charity will be spent on charitable

⁵⁹ 467 U.S. 968.

⁶⁰ Munson was a 5 to 4 decision with a concurrence by Justice Stevens.

⁶¹ Joined by Chief Justice Burger, and Justices Powell and O'Connor.

⁶² 467 U.S. 978-980.

purposes. Moderate fundraising fees coincided with contributors' expectations that their contributions would go primarily to the charitable purpose for which the funds were solicited and protected the charities themselves.⁶³

Riley v. National Federation of the Blind

In *Riley* the state of North Carolina for the first time directly asserted an interest in “ensuring that the maximum amount of funds would reach the charity.”⁶⁴ This goal would be assisted by a three tier sliding scale of permissible contingent fees.⁶⁵ The Court rejected the paternalistic view that charities were unable to negotiate fair and reasonable contracts without governmental assistance or that charities were incapable of deciding for themselves the most effective way to exercise their First Amendment rights. The speakers not the government knew best what to say and how to say it.⁶⁶

North Carolina also maintained that the Act's flexibility, unlike *Schaumburg* and *Munson*, was more narrowly tailored to state interests. The Court rejected the distinction. Permitting rebuttal of the CFR limits by the solicitor did not create a nexus between the percentages and the State's interest. Even if some form of percentage-based measure could be used in part to test for fraud, the Court would not require the speaker to prove the appropriateness of the fee on a case by case basis.⁶⁷

⁶³ Id. at 980-981.

⁶⁴ 487 U.S. 789.

⁶⁵ Fees not greater than 20% of gross receipts were presumed reasonable; fees between 20% and 35% were reasonable unless the challenging party could show that a particular solicitation campaign did not disseminate ideas or information; and fees over 35% were presumed unreasonable, subject to rebuttal by the professional solicitor. *Riley*, 487 U.S. at 784-785.

⁶⁶ 487 U.S. at 790-791.

⁶⁷ Id. at 793.

Riley rejected point of disclosure of financial information. The Court found mandating speech that a speaker would not otherwise make necessarily alters the content of the speech, and was therefore content based regulation.⁶⁸ As a result the statute was subject to exacting First amendment scrutiny. The Court elaborated:

“Our lodestar in deciding what level of scrutiny to apply to compelled statement must be the nature of the speech taken as a whole and the effect of the compelled statement thereon. This is the teaching of *Schaumburg* and *Munson* in which we refused to separate the component parts of charitable solicitations from the fully protected whole. Regulation of the solicitation “must be undertaken with due regard for the reality that solicitation is *characteristically* [emphasis added] intertwined with informative and perhaps persuasive speech..., and the reality that without solicitation the flow of such information and advocacy would likely cease.”⁶⁹

The reality, however, is that many charitable solicitations are primarily commercial, and the speech components are an unimportant, if not formulaic, part of the pitch.

The State argued that the speech regulated was commercial, because it only related to the professional fundraisers’ profit. Therefore, the more deferential commercial speech standard should apply.⁷⁰ The Court responded that speech did not retain its commercial character when

⁶⁸ *Id.* at 795.

⁶⁹ *Id.* 796.

⁷⁰ In 1976 commercial speech received First and Fourteenth Amendment protection, albeit at a lower level than fully protected speech. Though an advertiser's interest in commercial advertisement was purely economic, this did not disqualify it from constitutional protection, for both individual consumers and society in general may have strong interests in the free flow of commercial information. *Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc.* 425 U.S. 748 (1976). In *Central Hudson Gas & Electric Corp. v. Pub. Serv. Comm’n*, 447 U.S. 557, 566 (1980), the Supreme Court established a four pronged, somewhat vague test for permissible governmental restrictions on commercial speech: 1) the commercial speech must concern lawful activity and not be misleading; 2) the government’s interest in restricting the speech must be substantial; 3) the restriction must directly advance the government’s asserted interest; and 4) the restriction must not be more extensive than necessary to serve the asserted

inextricably intertwined with fully protected speech. But what if the commercial component is not intrinsically intertwined? Aside from questions of First Amendment precedent, the Court's conclusion on mandated disclosure made practical sense. Just imagine the chances of success of a solicitation where the solicitor says in the course of the pitch: "85% of the money raised goes to me or my firm."

In *Riley* the Court found that the justifications for CFR disclosure was not as weighty as the state asserted, and the means chosen taken as a whole were unduly burdensome, not narrowly tailored, and endangered the freedom of protected speech.⁷¹ The effect of the compelled statement of CFR changed the content of the speech. The court assumed that charitable solicitation was always intertwined with informative and perhaps persuasive speech, and without the solicitation, the flow of information and advocacy would cease. Consequently, the content based North Carolina statute was subject to exacting First Amendment principles, in other words strict scrutiny.⁷²

Justice Rehnquist with Justice O'Connor in dissent considered the disclosure requirement commercial speech and the statute price control regulation. They interpreted the statute as merely

government interest. The Court has upheld compelled disclosure when necessary to prevent speech which is false, deceptive, misleading, or which proposes illegal transactions. *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626 (1985). The *Central Hudson* test for commercial speech has been applied in a manner that exemplifies "intermediate scrutiny. Robert Post, *Compelled Commercial Speech*, 117 W. Va. L. Rev. 867, 881 (2015); Allen Rostron, *Pragmatism, Paternalism, and the Constitutional Protection of Commercial Speech*, 37 Vt. L. Rev. 527, 530 (2013) but see *Sorrell v. IMS Health Inc.* 564 U.S. 552 (2011). This article does not suggest that charitable solicitation speech is merely or should be considered under commercial speech doctrines, only that the intermediate standard of review be applied to it.

⁷¹ *Id.* at 798-799.

⁷² The statute's licensing requirement was unconstitutional because it required professional fundraisers to await a determination regarding their license application before engaging in solicitation, while volunteer fundraisers or those employed by the charity may solicit immediately upon submitting an application. A speaker's rights were not lost just because compensation is received. The State's power to license professional fundraisers comes with it, unless properly constrained, the power to affect speech they utter. If a license is required, the regulation must provide that licenser will within a brief period get the license or be able to go to court. Here the statute permitted a delay without limit. *Riley*, 487 U.S. 801-802.

requiring that no professional fundraiser can charge an unreasonable fee. Therefore, it had a small, indirect impact upon speech. Unlike fixed percentages in other the cases, here the statute determined reasonableness, and disclosure of the percentage was not a burden on speech.⁷³

The Supreme Court’s jurisprudence clearly demonstrates that charitable appeals for funds, on the street or door to door, involve a variety of speech interests—communication of information, the dissemination and propagation of views and ideas, and the advocacy of causes—that are within the protection of the First Amendment. The trilogy of cases refused to separate the speech involved into component parts of protected and unprotected. As the Court noted in *Schaumburg*:

“Soliciting financial support is undoubtedly subject to reasonable regulation but the latter must be undertaken with due regard for the reality that solicitation is characteristically intertwined with informative and perhaps persuasive speech seeking support for particular causes or for particular views on economic, political, or social issues, and for the reality that without solicitation the flow of such information and advocacy would likely cease. Canvassers in such contexts are necessarily more than solicitors for money. Furthermore, because charitable solicitation does more than inform private economic decisions, and is not primarily concerned with providing information about the characteristics and costs of goods and services, it has not been dealt with in our cases as a variety of purely commercial speech.”⁷⁴

The Court’s rejection of cost of fundraising regulation in the three cases resulted in the demise of that regulatory approach, except through filing of such information with the

⁷³ *Id.* at 804-812.

⁷⁴ 444 U.S. 620, 632.

state, which has occurred in many states, and is often available to the public, if it seeks the information online. Nevertheless, the Court offered some more narrowly tailored options: the state itself could publish the detailed forms professional fundraisers file, or it could enforce its antifraud laws.⁷⁵ The problem with the first option suggested, adopted in many states where the forms often are available online, is that the public doesn't utilize the opportunity. The second suggestion is more flawed. Realistically, the cost of investigating and bringing suit pursuant to an allegation of fraud is so expensive and resource consumptive that only a very few state attorneys general have the resources to engage in such litigation on a regular basis.

Riley contains at least two misconceptions and one unintended consequence about charitable solicitation that do not reflect a substantial part of modern fundraising. First, the Court assumed that solicitation is always interwoven with protected speech. In the hypothetical solicitations discussed in this paper—years of 85% CFRs plus administrative expenditures and generous staff compensation—the protected speech component may be an insignificant formulaic part of the solicitation. A cancer charity that in the course of its pitch for money says “eating blueberries contains oxidants to prevent cancer,”⁷⁶ a statement that may be valid, but should not in and of itself be sufficient protected speech interwoven with the solicitation so as to gain entry to the strict scrutiny category of review.

Second, the Court criticized the statute at issue in *Riley* for its paternalism to charities that can protect themselves and know what is in their best interest.⁷⁷ The focus should be on the protection of the public, who may not be as easily able to protect themselves. An unintended

⁷⁵ 487 U.S. 800.

⁷⁶ The author, who has eaten blueberries in that belief for years, was chagrined to learn that it may not be so! See, Gina Kolata, *Food and Exercise Have One Big Problem*, N.Y. Times, August 11 2016, at A3.

⁷⁷ 487 U.S.790-791.

consequence of adopting the strict scrutiny level of analysis means almost all state charitable solicitation regulation that affects some speech will be rejected. In practice what has happened is unless there are blatant allegations of fraud resulting from a number of complaints by the public, attorneys general are unlikely to pursue solicitation cases. However, fraudulent solicitation statements remain constitutionally unprotected.⁷⁸

IV. Regulation of Charitable Solicitation after Riley

Case Developments

In the aftermath of *Riley* lower federal courts voided several state CFR statutes similar to North Carolina's though some allowed mandated disclosure.⁷⁹ States have succeeded in

⁷⁸ Despite the holding in *Riley* finding the organization's solicitation protected speech, the Court suggested that the state can enforce its anti-fraud laws to prohibit professional fundraisers from obtaining money by false pretenses or by making false statements. 487 U.S. 795. The Illinois attorney general sued a professional fundraiser for fraud, contending that the fundraiser knowingly misrepresented to donors that a significant amount of each dollar donated would be paid over to charity when in fact the fundraiser retained eighty-five percent of the gross receipts raised. The Illinois Supreme Court dismissed the complaint, concluding that the state attempted to regulate the fundraiser's ability to engage in protected activity based upon a percentage-rate limitation rejected in *Riley*. In *Illinois ex rel. Madigan v. Telemarketing Associates*, 538 U.S.600 (2003) the Supreme Court unanimously reversed. Treating the case as a fraud action, the Court held fraudulent charitable solicitation is unprotected speech, and the states may maintain fraud actions when fundraisers make false or misleading misrepresentations designed to deceive donors about how their donations will be used. The Court distinguished fraud actions, which focus on representations made in individual cases, from statutes that categorically ban solicitations when fundraising costs run high. In *Riley*, the statute did not depend on whether the fundraiser made fraudulent representations to potential donors. The First Amendment, stated the Court in *Madigan*, did not require a blanket exemption from fraud liability for a fundraiser, who intentionally misled in its appeal for donations. 538 U.S. 612. The Court noted, however, that high fundraising costs by themselves or mere failure to voluntarily disclose the fundraiser's fee when contacting a potential donor do not, without more, establish fraud.

⁷⁹ See, *National Federation of Blind of Texas, Inc. v. Abbott*, 682 F.Supp.2d 700 (N.D. Tex. 2010)(Statute requiring companies that solicited and resold donations of clothing and other household items on behalf of charities to disclose the amount of money received by the charities and specify whether the sum was a set percentage or a flat fee was not narrowly tailored and was an unconstitutional restriction on speech even though receptacles for donations were not staffed, and the solicitors rarely disclosed their names but used the name of a charity); *Nebraska v. Kelley*, 249 Neb. 99, 541 N.W.2d 645 (1996) (statute which required certification in letter of approval from county attorney before charitable solicitation was permitted outside organization's home county constituted unconstitutional prior restraint, overbreadth and vagueness); *Kentucky State Police Prof. Ass'n v. Gorman*, 870 F. Supp. 166 (E.D. Ky. 1994) (Provision of Kentucky Consumer Protection Act prohibiting representation that charity will be recipient of funds if professional solicitor has contract that will allow it to receive more than 50% of gross receipts unduly burdensome and not narrowly tailored to state's interest in preventing fraud, and thus violates First Amendment); *Shannon v. Telco Communications, Inc.*, 824 F.2d 150, 152-54 (1st Cir. 1987) (voiding a Massachusetts statute that limited a solicitor's compensation to 25% of receipts);

expanding the scope of compelled point-of-disclosure in small ways. *Riley* opened the door for this when the Court said in dictum: “[N]othing in this opinion should be taken to suggest that the State may not require a fundraiser to disclose unambiguously his or her professional status. On the contrary, such a narrowly tailored requirement would withstand First Amendment scrutiny.”⁸⁰ The Court suggested more benign and narrowly tailored options. It gave as an example that the State may itself publish the detailed financial disclosure forms it requires professional solicitors to file which would communicate the desired information to the public without burdening a speaker with unwanted speech in the course of his solicitation.⁸¹ States have followed this guidance.⁸²

Mandated Disclosure and Its Discontents

Riley did not prohibit all regulation of charitable solicitation. It held that “The interest in protecting charities (and the public) from fraud is, of course, a sufficiently substantial interest to justify a narrowly tailored regulation.”⁸³ In striking down the restrictions on fundraising fees the

Indiana Voluntary Firemen’s Ass’n v. Pearson, 700 F. Supp. 42, 442-447 (S.D. Ind. 1988) (striking down, in part, an Indiana statute that required both oral and written disclosures of the percentage of funds raised that were paid to the solicitor); Telco Communications, Inc. v. Carbaugh, 700 F. Supp. 294, 296-97 (E.D. Va. 1988) (striking down a Virginia provision that required a point-of-solicitation disclosure of the minimum percentage of funds that would go to the charity), *aff’d in part and rev’d in part*, 885 F.2d 1225 (4th Cir. 1989), *and cert. denied.*, 495 U.S. 905 (1990); People v. French, 762 P.2d 1369, 1374-75 (Colo. 1988) (holding unconstitutional the compelled disclosure by fundraisers if the charity retained less than 50% of gross receipts); WRG Enters., Inc. v. Crowell, 758 S.W.2d 214, 217-19 (Tenn. 1988) (striking down a compensation limit of 15% of gross receipts).⁷⁹

⁸⁰ 478 U.S. at 799 n. 11.

⁸¹ *Id.* at 800.

⁸² *See*, Telco Communications v. Carbaugh, 885 F.2d at 1231-32 (Solicitation code requiring professional solicitors to disclose in writing at the time of solicitation that financial statement for last fiscal available year available upheld as preventing fraud and not inherently incompatible with First Amendment); Tennessee Law Enforcement Youth Found. v. Millsaps, 1991 WL 523878 (W.D. Tenn.1991). (Requirement that professional solicitors disclose in writing at the time of solicitation that a financial statement for the last fiscal year was available consistent with *Riley* based upon a finding of a sufficient state interest in donor education); *See also*, Famine Relief Fund v. West Virginia, 905 F.2d 747, 750 (4th Cir.1990). (Provision requiring charitable expenditures to be “related in a primary degree to [the] stated purpose ... in accordance with reasonable donor expectations” was constitutional. West Virginia statute imposed no actual percentage-based limitations, and thus survived *Riley*). *Id.* at 751-52. This was dictum because the court found the statute defective on independent due process grounds. *Id.* at 754.

⁸³ *Riley* 781 U.S. at 792.

Court did not suggest that states must sit idly by and allow their citizens to be defrauded. It noted that North Carolina (and other states) could constitutionally require fundraisers to disclose certain financial information to the state as it had.⁸⁴

Many states turned to increased mandatory disclosure of financial and other information, not all of which was available to the public in place of CFR regulation.⁸⁵ At the federal level Form 990s, the annual information returns required by the IRS became available on line, providing substantial information for public scrutiny of all section 501(c)(3) tax exempt organizations. Most states require charities to register their contracts with fundraisers, and a few publish the names of charities and professional solicitors that have particularly high percentages of fundraising costs in the eyes of regulators.⁸⁶

Mandated disclosure (MD) is supposed to give individuals information for analyzing their choices, in this case whether to contribute to a particular organization. This information should result in better decision making.⁸⁷ MD assumes the information available will reflect the quality of the charity's work and will influence the potential donor's decision. As the discussion of CFR suggested, there may be a weak correlation, if any at all, between a high CFR and inefficiency, waste, or fraud. Assembling the data is subjective as the organization allocates costs

⁸⁴ *Id.* at 795.

⁸⁵ Three states, Hawaii, California, and New York have required the submission of Schedule B of the Form 990 Annual Information return, which lists substantial donors to the charity and is not available to the public, to be filed with the attorney general. Litigation is pending challenging the California and New York regulations. *See*, *Americans for Prosperity Foundation v. Harris*, 182 F. Supp. 3d 1049 (C.D. Ca. 2016), appeal docketed; *Citizens United v. Schneiderman*, ___F.3d___ 2016 WL 4521627 (Aug. 29, 2016), appeal docketed.

⁸⁶ *See*, "Pennies for Charity" - The Attorney General's Report on Fundraisers in New York (2016) available at https://www.charitiesnys.com/pdfs/Pennies_Report_122216.pdf.

⁸⁷ *See*, Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. Pa. L. Rev. 647, 681-684 (2011).

rather than the regulator, and charities can juggle the numbers through assigning fundraising costs to programming expenses.⁸⁸

Mandated disclosure gives legislators and regulators a pass in the sense that they can comfort themselves that mandated disclosure is an effective weapon against fraud and deceit. However, MD doesn't affect charities' behavior substantially as few donors seek the information. In Ben-Shahar and Schneider's well-crafted prose:

Mandated disclosure is a Lorelei, luring lawmakers onto the rocks of regulatory failure. It is alluring because it resonates with two fundamental American ideologies. The first is free-market principles. Mandated disclosure may constrain unfettered rapacity and counteracts caveat emptor, but the intervention is soft and leaves everything substantive alone: prices, quality, [and] entry. Instead of specifying outcomes of transactions or dictating choices, it proffers information for making better decisions. Second, mandated disclosure...supposes that people make better decisions for themselves than anyone can make for them and that people are entitled to freedom in making decisions.

Mandated disclosure appeals to lawmakers for other reasons. First, it looks cheap. It requires almost no government expenditures, and its costs seem to be imposed on the story's villain, the stronger party who withholds information. Second, mandated disclosure looks easy. It just requires more communication between parties who are already communicating; in hindsight, the information that could have led a trouble-story victim to a better decision seems obvious....

⁸⁸ See, *supra* pp.16-20.

Third, mandated disclosure looks effective. Mandated information often seems relevant to a difficult decision... For all these reasons, lawmakers rarely inquire into the effectiveness or burden of disclosure.”⁸⁹

Mandatory disclosure does little to improve donor knowledge or protection. Information can be difficult to find on line and not readily understandable. The Form 990 Annual Information Return is an example. The length of the form requires a level of knowledge that the average donor neither has, nor desires to attain. For donors contributing small amounts, failure to acquire the knowledge needed to investigate the mandatorily disclosed information may be viewed as rational apathy.⁹⁰ This means the cost of finding the information necessary to make the correct decision to donate is not worth the time expended, particularly when the main benefit small donors receive may be a sense of community or religiosity or the warm glow of doing a good deed.⁹¹

V. A Presumption against Permission to Solicit Where an Organization’s Charitable Activities are not Commensurate with Its Resources, Public Purpose or the 30 Charitable Class Served

Charities Must Serve a Public Purpose and Assist a Broad Charitable Class

⁸⁹ *Mandated Disclosure*, *supra* note 86, at 681-682.

⁹⁰ The concept of rational apathy is often used with retail investors. Assume an investor owns one hundred shares of stock of a company that is involved in a proxy fight. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs. Given the length and complexity of proxy statements, where the shareholder is receiving multiple communications from the contending parties, the opportunity cost entailed in reading the proxy statements before voting is quite high and the consequences of the investor’s vote having an impact on the result is virtually nil. *See*, Julian Velasco, Taking Shareholders Rights Seriously, 41 U. Cal. Davis 605, 622 (2007), Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 526-529 (1990).

⁹¹ In a sense, giving to charity may be like voting. In very few elections does an individual vote matter, and voting is in actuality a statement of responsible citizenship and public morality.

Another route to state regulation of charitable solicitation is through the common law doctrine that a charity must serve a public purpose rather than the private benefit of individuals. A basic assumption of charitable status in the common law of charitable trusts and the statutory law of federal income taxation is that exemption from taxation requires justification in social terms that society is benefitting from the philanthropic entity apart from the value to individual beneficiaries or the moral purpose of the organization.⁹² Another way to express this idea is that the organization must serve a public purpose or benefit one of the broad categories that have been recognized as charitable.⁹³

Charity is an elastic and expansive concept, but activities so considered must benefit a charitable class. In a classic opinion the Massachusetts Supreme Court stated a charitable gift was one that would “benefit...an indefinite number of persons.”⁹⁴ A charitable trust may fail because the class of persons who are to benefit is so narrow that the community has no interest in the performance of the trust. This is a question of degree whether the class is large enough to make the performance of the trust sufficient to benefit the community, so that it will be upheld as a charitable trust.⁹⁵ Thus, a charitable trust must benefit a sufficiently large and indefinite

⁹² Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, IV Research Papers Sponsored by the [Filer] Commission on Private Philanthropy and Public Needs 2027 (1977).; Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 Va. Tax Rev. 291, 303 (1984).

⁹³ See, Restatement (Third) of Trusts §28cmt .a (2003). Charitable trust purposes include: (a) the relief of poverty; (b) the advancement of knowledge or education; (c) the advancement of religion; (d) the promotion of health;(e) governmental or municipal purposes; and (f) *other purposes that are beneficial to the community* [emphasis added]. The expectation that charities must serve a public benefit and cannot violate public policy was expressed in *Bob Jones v. United States*: “Charities were to be given preferential treatment because they provide a benefit to society.” 461 U.S. 574, 589 (1983).

⁹⁴ *Jackson v. Phillips*, 96 Mass. (14 Allen) 539, 556 (1867) (Gray, J.).

⁹⁵ Restatement (Second) of Trusts §375; 6 Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, *Scott & Ascher on Trusts* §38.9 (5th ed. (2009)). If the purpose of the trust is to relieve poverty, promote education, advance religion, or protect health, the class need not be as broad as it must be where the benefits to be conferred have no relation to any of these purposes [i.e., particularly purposes under Restatement §28, clause (f).] On the other hand, the class of persons to be benefitted may be so limited that the trust is not charitable even though the purpose of the trust is to relieve their poverty, to educate them, to save their souls, or to promote their health.” And in. § 375.2 it is observed that even though “the purposes of the trust are charitable in character, the trust is not a valid charitable trust if the benefits are limited to too small a class of persons.” *Id.* at cmt. a.

charitable class, rather than specific private individuals.⁹⁶ A similar rule applies to charitable corporations.⁹⁷ Even if a trust is for a valid charitable purpose, the class of persons benefitted may be so narrow that the trust is not charitable.⁹⁸ An undertaking conducted for private profit is not charitable even if the purpose is such that if it were not conducted for private profit, it would be charitable.⁹⁹

The Federal Income Tax Standard that a Charity Must Serve a Public Purpose Rather than Private Interests

Under the section 501(c)(3) of the Internal Revenue Code and the Treasury Regulations promulgated thereunder “[a]n organization will be regarded as ‘operated exclusively’ for one or more exempt purposes only if it engages primarily in activities which accomplish” one of the purposes specified in I.R.C. §501(c)(3).¹⁰⁰ Those purposes include activities that are religious, charitable, scientific, literary or educational purposes. These organizations must ensure that no part of their net earnings from contributions inures to the benefit of any private shareholder or individual.¹⁰¹ The charitable organization must be operated primarily to advance the purposes for which the organization has obtained tax-exempt status, and must serve a public rather than a private interest.¹⁰²

⁹⁶ Restatement (Third) of Trusts §28, cmt. a.

⁹⁷ Despite their different legal forms, common law courts subjected charities that were corporations and those that were trusts to the same limitations on their purposes and operations, and each also benefited from the same privileges. Restatement of the Law of Charitable Nonprofit Org. § 1.01 TD No 1 cmt. a (2016).

⁹⁸ Restatement (Second) of Trusts § 375 cmt. a (1959).

⁹⁹ 6 Scott and Ascher, *supra* note 94, at §38.10.

¹⁰⁰ Treas. Reg. §1.501(c)(3)-1(c)(1).

¹⁰¹ *See*, §170(c)(2)(C); *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969)(Church that provided many benefits for founder and his family not exempt), cert. denied, 397 U.S. 1009 (1970).

¹⁰² [A]n organization is not organized or operated exclusively for one or more [charitable purposes] ... unless it serves a public rather than a private interest. ... [I]t is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family,

In order to be exempt under section 501(c)(3), an organization must qualify under both an organizational and an operational test.¹⁰³ The organizational test relates to the language used in the organization's governing document, a trust instrument, articles of incorporation or association, or charter. The language must limit the purposes of the organization to one or more exempt purposes in § 501(c)(3) and not expressly empower the organization to engage, except to an insubstantial degree in any activities which do not further one or more exempt purposes.¹⁰⁴ Upon dissolution the organization's assets must be distributed to another §501(c)(3) organization in furtherance of an exempt purpose.¹⁰⁵

The operational test requires an organization's activities to be primarily those which accomplish one or more exempt purposes as specified in section 501(c)(3) and not, except to an insubstantial part, those which do not further an exempt purpose.¹⁰⁶ A substantial nonexempt purpose will disqualify an organization from tax exemption despite the number or the importance of its exempt purposes.¹⁰⁷ The operational test focuses on the purpose and not on the nature of the activity. An organization may engage in a trade or business as long as its operation furthers an exempt purpose and its primary objective is not the production of profits. An organization is not operated exclusively for one or more exempt purposes, unless it serves a public rather than a private interest.¹⁰⁸ Whether an organization satisfies the operational test is a question of fact.

shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

¹⁰³ Treas. Reg. §1.501(c)(3)-1(a)(1).

¹⁰⁴ Treas. Reg. §1.501(c)(3)-1(b)(2)(i). *See also*, Fishman, Schwarz & Mayer, *supra* note 13, at 291-292.

¹⁰⁵ Treas. Reg. §1.501(c)(3)-1(b)(1)(iv).

¹⁰⁶ Treas. Reg. § 1.501(c)(3)-1(c)(1).

¹⁰⁷ *See*, Better Business Bureau v. United States, 326 U.S. 279 (1945)

¹⁰⁸ Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

The Commensurate Standard

A basic question is whether a charity provides services to the public comparable to its favored tax status. In a 1964 revenue ruling, the Service introduced the “commensurate” test, which holds that a charitable organization that raises funds for an exempt purpose must carry on a charitable program commensurate with its resources and cannot confer an impermissible private benefit to individuals or entities associated with the charity.¹⁰⁹ This standard merely states that an organization must carry on a charitable program commensurate in scope with its financial resources. The Service has not been consistent in its application of the doctrine, but fundamentally seems to use a facts and circumstances test.¹¹⁰

Although the 1964 revenue ruling did not refer to charitable solicitation, the IRS later attempted to apply the test to police what it perceived as abusive contingent-fee fundraising where an organization used most of its funds to pay professional fundraisers. It would seem an organization that raised over a long period of time most of its funds from professional solicitors, devoted the great majority of these funds pay their contingent fees, and used a large percentage of the amounts remaining for administrative expenses as opposed to programmatic costs, the charitable program would not be commensurate with the funds contributed to the organization.

Private Inurement and Private benefit

¹⁰⁹ Rev. Rul. 64-182, 1964-1 C.B. 186. The one paragraph revenue ruling was primarily about whether an organization could qualify for exemption despite substantial unrelated business if its primary purpose was charitable by giving grants to other charitable organizations. The revenue ruling held that the organization could since it was organized and operated for charitable purposes where it was shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.

¹¹⁰ See, Fishman, Schwarz & Mayer, *supra* note 13 at 544-546. The Service’s use of a facts and circumstances test as applied to excessive fundraising costs was criticized by Judge Posner in *United Cancer Council v. Commissioner*, 165 F.3d 1173, 1179 “That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS.”

The Service has several ways to deal with excessive payments to insiders of charities or others associated in some way with the organization such as their fundraisers: the prohibitions against private inurement, IRC § 4958, and the commensurate standard. To qualify for exempt status under Internal Revenue Code section 501(c)(3) no part of an organization's net earnings may inure to the benefit of any private shareholder or individual. In other words the organization cannot engage in transactions that primarily benefit insiders.¹¹¹ A related private benefit doctrine denies exemption when persons other than insiders receive more than an incidental "private benefit."

While the inurement prohibition is part of the statute; the private benefit limitation is a product of the Treasury Regulations. It holds that an organization must serve a public purpose and cannot be operated for the private benefit of certain individuals or interests such as a founder, shareholders, or entities controlled directly or indirectly by such private interests.¹¹² These private interests may not strictly be insiders, but could extend to a charitable solicitation firm that controlled a charity through its operation of a fundraising campaign or received so much of the money donated that the charitable organization for all practical purposes was not operated exclusively for exempt purposes.

In *United Cancer Council v. Commissioner*,¹¹³ the Service sought to extend the private inurement and private benefit doctrines to deal with what it considered excessive contingent fee fundraising. One can also view the Service's theory in the case from a commensurate perspective: because the fundraising firm's control over the charity's resources, the latter did not

¹¹¹ IRC § 501(c)(3) provides in part: "no part of the net earnings of which inures to the benefit of any private shareholder or individual". Treas. Reg. § 1.501(c)(3)-1(c)(2).

¹¹² Treas. Reg § 1.501(c)(3)-1d(iii). Fishman, Schwarz & Mayer, *supra* note 13, at 429-430.

¹¹³ 165 F.3d 1173 (7th Cir. 1999).

provide commensurate public services compared to its overall resource. Its tax exemption, therefore, should be revoked.

The United Cancer Council (UCC)¹¹⁴ entered into an agreement with a fundraising firm, Watson & Hughey (W & H).¹¹⁵ Because of its perilous financial condition, UCC wanted W & H to “front” all the expenses of the fundraising campaign, though it would be reimbursed by UCC as soon as the campaign generated sufficient donations to cover those expenses. W & H agreed, but it demanded in return that it be UCC’s exclusive fundraiser during the five-year term of the contract, that it be given co-ownership of the list of prospective donors generated by its fundraising efforts, and that UCC be forbidden, both during the term of the contract and after its expiration, to sell or lease the list, although it would be free to use it to solicit repeat donations. There were no restrictions on W & H.¹¹⁶

Over the five-year term of the contract, W & H raised \$28.8 million of which \$26.5 million went to W & H for expenses. UCC received \$2.3 million, which was spent on services to cancer patients and research.¹¹⁷ The IRS revoked UCC’s charitable exemption alleging it was not operated exclusively for charitable purposes, but also for the private benefit of the

¹¹⁴ UCC was a charity that sought, through affiliated local cancer societies, to encourage preventive and ameliorative approaches to cancer, as distinct from searching for a cure, the emphasis of the better-known American Cancer Society.

¹¹⁵ W & H had a long history of conflict with state regulators. *See*, *Commonwealth v. Watson & Hughey Co.*, 563 A.2d 1276 (Pa. Commw. Ct. 1989). Over a two year period from 1989 to 1991, W & H was found guilty of violations of charitable solicitation laws in fourteen states and paid fines and restitution of \$ 2.1 million. *See* America’s Worst Charities, TAMPA BAY TIMES & CTR. FOR INVESTIGATIVE REPORTING, (2013), available at <http://charitysearch.apps.cironline.org/detail/watson-hughey-12448>. Despite this history, W & H remains in business under a different name, Direct Response Consulting Services.

¹¹⁶ *United Cancer Council*, 165 F.3d at 1175. W & H mailed eighty million letters soliciting contributions to UCC. Each letter contained advice about preventing cancer, as well as a pitch for donations; seventy percent of the letters also offered the recipient a chance to win a sweepstakes. *Id.*

¹¹⁷ UCC did not renew the contract when it expired by its terms in 1989. Instead, it hired another fundraising organization with disastrous results. The following year, UCC declared bankruptcy, and within months the IRS revoked its tax exemption retroactively to the date on which UCC had signed the contract with W & H. The effect was to make the IRS a major creditor of UCC in the bankruptcy proceeding. *Id.* at 1176.

fundraising company. The Service also claimed that part of the charity's net earnings inured to the benefit of a private shareholder or individual, W & H. UCC appealed to the Tax Court, which upheld the revocation on the ground of private inurement, but did not reach the private benefit issue.¹¹⁸ There followed an appeal to the Seventh Circuit Court of Appeals.

The Court in a decision by Judge Richard Posner found no private inurement.¹¹⁹ The Service had not contended that any part of UCC's earnings found its way into the pockets of any members of the charity's board, or that any members of the board were owners, managers, or employees of W & H, or relatives or even friends of any of W & H's owners, managers, or employees. It conceded that the contract between charity and fundraiser was negotiated at an arm's length basis.¹²⁰ The Service argued that the contract was so advantageous to W & H and so disadvantageous to UCC that the charity must be deemed to have surrendered the control of its operations and earnings to its professional solicitor.

As far as the high fundraising costs, the Seventh Circuit found that W & H got a "charitable bang" from the mailings, which contained some educational materials in support of its educational goals. Importantly, it said that the cost of fundraising, that is, the ratio of expenses to net charitable receipts, was unrelated to the issue of inurement.¹²¹ W & H's favorable contract was due to the desperation of UCC, rather than disloyalty by the board. Nor was there any diversion of assets to insiders.

¹¹⁸ UCC v. Commissioner, 109 T.C. 17 (1997).

¹¹⁹*Id.* at 1178-79.

¹²⁰A committee of the board picked W & H, and another committee of the board was created to negotiate the contract between the charity and the professional solicitor. *Id.* at 1175.

¹²¹*Id.* at 1178.

Judge Posner then suggested that the private benefit doctrine, in certain situations, could be used to deal with particularly harsh agreements. Under that theory, UCC would be considered operating for the private benefit of the fundraiser. The Court remanded the private benefit issue to the Tax Court.¹²²

UCC was a case of statutory construction, but it could be looked at as a question of constitutional law too. UCC might have argued that the statutory private inurement prohibition and the Treasury Regulation containing the Private Benefit doctrine impermissibly impinged upon the protected speech of their solicitation campaign. The fundamental issue in response to that argument would be whether the resources spent for UCC's charitable programs after payment of fundraising fees were commensurate with the total resources raised.

The Prohibition against Excess Benefit Transactions IRS §4958

The unsuccessful effort of the UCC case to link excess fundraising costs to private inurement aside, the IRS rarely used the revocation of exemption penalty for violations of the private inurement or private benefit proscriptions. Because of the doctrines' ineffectiveness in curbing abuses, the disproportionate nature of the penalty, and the fact it targeted the organization, rather than the individual wrongdoers, made it unsuitable in many cases.

As a result Congress enacted IRS § 4958, the so-called intermediate sanctions legislation, which imposes an excise tax on individuals, termed "disqualified persons", who engage in excess

¹²²*Id.* at 1179. See also Lisa A. Runquist, *How to Keep Your Nonprofit out of Trouble with the IRS*, NONPROFIT RESOURCES (Oct. 1, 2015), <http://runquist.com/how-to-keep-your-nonprofit-out-of-trouble-with-the-irs> (On remand the private benefit issue was never reached, for the case was settled. UCC, which had filed for bankruptcy, conceded it was not entitled to exemption for the years 1986-1989, and the I.R.S. restored UCC's exemption for 1990 forward. As a condition of the settlement, UCC agreed to cease raising funds from the general public and to limit its activities to accepting charitable bequests and transmitting them to local cancer counsels for direct care of patients.).

benefit transactions, either of the inurement or private benefit variety.¹²³ There is a possible tax on the charity's executives as well.¹²⁴ Theoretically, IRC § 4958 could be used against a fundraiser guilty of excessive financial benefits, where the solicitor controlled the charity or the contract between them was egregious. There has been minimal enforcement under § 4958, though charities have used the complicated procedures in the regulations to sanitize compensation and other transactions so as to avoid the "excessive benefit" designation. Using the legislation to police excessive fundraising expenses is also hindered by what is called a "first bite" or initial contract exception.

The Initial Contract Exception

The tax on excess benefit transactions does not apply to an initial written agreement with fixed payments between an organization and an individual, who will become a disqualified person upon signing the contract.¹²⁵ This removes from the intermediate sanctions regime the initial contract between the fundraiser and the tax-exempt organization. Neither the statute, the legislative history, nor the proposed regulations to § 4958 contained an initial contract exception. It emerged in the fallout from the Service's defeat in *United Cancer Council*, where the court held that private inurement couldn't result from a contractual relationship negotiated at arms-length with a party having no prior relationship with the exempt organization, regardless of the relative bargaining strengths of the parties. The initial contract exemption removed certain fixed

¹²³ The 'intermediate sanctions' refer to the excise tax penalty, which is intermediate to revocation of tax exemption.

¹²⁴ In egregious situations the Service can still revoke an exemption, after making a determination of all relevant facts and circumstances, taking into account a number of factors including the size and scope of the organization's regular and ongoing activities that further exempt purposes before and after excess benefit transactions occurred. Treas. Reg. §1.501(c)(3)-1(f)(2)(ii).

¹²⁵ Initial contract or agreement means a binding written contract between an applicable tax exempt organization and a person, who was not a disqualified person within the meaning of I.R.C. § 4958 and Treas. Reg. § 53.4958-3 prior to entering the contract. Treas. Reg. 53.4958-4(a)(3) (2002).

payments made pursuant to an initial contract between an organization and the third party.¹²⁶

However, there may be a loophole in the initial contract exemption that allows such contracts to come under section 4958.¹²⁷

Ideally, the Service would enforce excessive, deceitful or fraudulent charitable solicitation, but at present that is wishful thinking. Because of budget cuts, the political hostility of Congress, and a seeming lack of willpower, the IRS has retreated from its oversight responsibilities.¹²⁸ This means that the states or some other federal agency such as the Federal Trade Commission should step into the breach to apply the legal doctrines discussed above. A problem is that few states have proactive and vigorous enforcement against charity fraud, but through the use of common law doctrines such as the requirement of commensurate charitable purpose, combined with a lesser standard of judicial scrutiny of impingement on speech, misleading charitable solicitation can be curtailed.

Reconfiguring the Facts of Riley

It is clear from the Supreme Court trilogy that a statute mandating a solicitor to disclose the amount of funds raised that will be turned over to the charity is content-based speech and will

¹²⁶Staff of J. Comm. on Tax'n, 109th Cong., Rep. on Options to Improve Tax Compliance and Reform Tax Expenditures, at 268 (Comm. Print 2005).

¹²⁷ A fixed payment does not include any amount paid to a person under a reimbursement or similar arrangement where any person with respect to the amount of expenses incurred or reimbursed exercises discretion. Treas. Reg. § 53.4958-4(a)(3)(ii)(A) (2002). The standard fundraising agreement contains a percentage of receipts from the campaign that belong to the solicitor. Nevertheless, the solicitor also has the right of reimbursement of expenses and manages the campaign. It can control the amount of expenses incurred, the primary reason that many fundraising campaigns wind up with the charity not only failing to obtain additional resources, but still owing the solicitor for expenses beyond the amount raised. In the course of running the campaign, the solicitor controls the expenses. This would seem to be a non-fixed liability and one could argue not subject to the initial contract exception. For an elaboration of this argument, see, *Who Can Regulate Fraudulent Charitable Solicitation?*, *supra* note 12 at 31-34.

¹²⁸ There have been calls by serious scholars to remove the Service from the oversight of charities. See, Evelyn Brody, & Marcus Owens, *Exile to Main Street: the I.R.S.'s diminished role in overseeing tax-exempt organizations*, 91 Chi.-Kent L. Rev. 859-893 (2016); Lloyd Hitoshi Mayer, 'The Better Part of Valour Is Discretion': Should the IRS Change or Surrender Its Oversight of Tax Exempt Organizations?, 7 Col. J. Tax L. 80 (2016).

not pass constitutional muster. The discretionary power of an official to deny or delay a permit when protected speech is involved, likely will not be upheld as well. The North Carolina statute in *Riley* was also flawed as it did not create a sufficient nexus between the state's interest and the statutory regulation of permissible fees.¹²⁹

Let us reconfigure facts of *Riley*, so that the cost of fundraising is not directly regulated, nor is the impact on the charity's speech. The official or state disapproval reflects an organization's lack of charitable activity over a period of time given its resources, and this creates a rebuttable presumption that the charity is not serving a charitable purpose that is commensurate with its means.¹³⁰ Assume that a charity over a period of eight years or more spends at least eighty percent of funds raised in the name of the charity to pay its solicitation firm, and after allocation of general overhead expenses the charity spends an average of less than fifteen percent of its budget on activities toward the attainment of its mission.¹³¹ Further assume

¹²⁹ 487 U.S. 793 n.7.

¹³⁰ A rebuttable presumption is an inference drawn from certain facts that establishes a prima facie case about the inference, which may be overcome by the introduction of contrary evidence.

¹³¹ Long after this hypothetical was conceived, a real world example offered a similar fact pattern. The Illinois Attorney General forced a telemarketer, Safety Publications, to cease operations in the state because the firm misled donors to raise millions on behalf of veterans and did not properly report the funds it raised for charity. One of the co-founders, who had failed to disclose his felony arson conviction when registering as a fundraiser, was barred for life. The other co-founder agreed to a three year ban.

Safety reported raising \$4.9 million for VietNow, the primary charity, and some other organizations from 2008 through 2014 but gave the nonprofits only about 15 cents of every dollar raised in those seven years and kept the rest for itself. Many of those charities in turn spent large sums on administrative overhead, leaving pennies for those in need. Safety did not properly report the funds it raised for the VietNow, among other breaches of state charity laws. It violated Illinois law against using felons to raise funds for charity by employing since 2007 at least ten callers, who served prison terms for bank robbery, forgery child rape and other felonies. This was the attorney general's third enforcement action against the fundraiser.

VietNow was one of the respondents in the Supreme Court case of *Illinois ex rel. Madigan v. Telemarketing*, *supra* note 78, where the fundraisers made knowingly deceptive and materially false statements to potential donors that each dollar donated would be used for charitable endeavors, when in fact 85% went to the fundraisers. The Supreme Court unanimously held that fraudulent charitable solicitation was unprotected by the First Amendment. Other actions have been brought against VietNow in Michigan and Missouri. VietNow has changed its name to Veterans Now. *See*, David Jackson, *Chicago telemarketer is shut down after Tribune investigation of charity law violations*, Chicago Trib. (June 1, 2017) available at <http://www.chicagotribune.com/news/watchdog/ct-telemarketer-charity-met-20170531-story.html?elqTrackId=b481acea41254d3ba73beecf7131fc37&elq=7f6627d219874744b435fab657066854&elqaid=14148&elqat=1&elqCampaignId=5934> .

a state enacts legislation that similarly situated charities create a presumption that the organization is serving the interests of either its insiders, directors, officers and key employees or benefitting external contractors, such as a professional solicitation firm, and therefore its delivery of charitable services is not commensurate with the common law and federal or state tax requirements that charities must serve a public purpose.

What this hypothetical suggests is that tax exemption of charities be judged under a standard that would condition continued exemption on whether the charity, given its resources and programs, provides a public service commensurate with its size. If not, the charity could lose its exemption from state or federal taxation. The organization's donors would not receive the normal charitable deduction as provided by law.

In *Bob Jones v. United States*, the Court quoted the legislative history of the charitable exemption statute of 1917 where Senator Hollis articulated its rationale: "For every dollar that a man contributes to these public charities, educational, scientific, or otherwise, the public gets 100 percent."¹³² In the presumption used in the hypothetical, the reverse is true. For all of the money contributed, the public gets a paltry percentage that benefits society or the charity's beneficiaries. Unlike the cost of fundraising legislation in the Supreme Court trilogy, denial of exemption does not directly restrict charities' protected speech. Any impact on speech is indirect and tenuous. It removes a tax benefit to a third party. There is no constitutional right to preferential tax treatment.

¹³² 461 U.S. at 590 quoting 55 Cong. Rec. 6728 (1917).

Would such legislation pass constitutional muster, and under what standard would it be reviewed by a court? Oregon has enacted a statute that fits the hypothetical.

The Oregon Approach to Excessive Fundraising Costs

Oregon has introduced a novel approach to states' repeated efforts to control the high administrative and fundraising costs of charities. It enacted legislation that allows the attorney general to disqualify charities from receiving tax-deductible contributions for Oregon income state tax purposes. If an Oregon charity fails to expend at least thirty percent of the organization's "total annual functional expenses" on program services as that phrase is used on IRS Form 990 when those expenses are averaged over the most recent three fiscal years, it will lose its state tax exemption though remain federally exempt from taxation under IRC §501(c)(3).¹³³

The statute is a variant application of a commensurate test to contingent fee fundraising. Unlike *Riley* and the other Supreme Court CFR cases, there is no attempt to prohibit a charity that fails the standard from soliciting for contributions. The Oregon statute implies that the state will not subsidize donors through the charitable deduction or the organization's continued exemption from taxation until its charitable activities are commensurate with the resources it receives.

Exempted from the legislation are private foundations, community trusts or foundations, qualified charitable remainder trusts, charities that do not have to file the Form 990, and charities that have operated for less than four years. The attorney general can exempt organizations that were accumulating money for a specific purpose such as a capital campaign or present "other mitigating circumstances." Affected charities must disclose to their donors that they cannot deduct their contributions for state tax purposes or face fines up to \$25,000.

¹³³ Or. Rev. Stat. §§ 128.760 to 128.769 (2017).

Unlike the Supreme Court cases that struck down attempts to limit the cost of fundraising through statutory limits, this legislation regulates the availability of charities to use the state subsidy provided by tax exemption. There is no licensing requirement or other restriction on soliciting. If the attorney general disqualifies a charity it may continue to solicit funds, but must disclose to potential donors that there is no charitable deduction for their Oregon taxes, though the federal deduction under IRC §170 would remain. Apparently, many Oregon charities would fail to keep their state tax exemptions.¹³⁴

Oregon's approach is arguably similar to the challenge to section 501(c)(3) that was upheld in *Regan v. Taxation with Representation*.¹³⁵ There, an organization, Taxation With Representation (TWR), was denied exemption under §501(c)(3) because it appeared that a substantial part of its activities consisted of attempting to influence legislation which is not permitted by §501(c)(3).¹³⁶ TWR claimed the prohibition against substantial lobbying was unconstitutional under the First Amendment and the equal protection component of the Fifth Amendment's Due Process Clause. The alleged equal protection violation was that taxpayers could deduct a certain percentage of contributions to veterans' organizations, some of which had unlimited lobbying privileges in furtherance of their exempt purposes.¹³⁷

The Supreme Court in a decision by Chief Justice Rehnquist held that that section 501(c)(3) did not violate the First Amendment or the equal protection clause of the Fifth

¹³⁴ Using the Guidestar data base, the Chronicle of Philanthropy scanned the Form 990s of more than 100,000 nonprofits and found that more than one-fifth would not have met the guidelines of the Oregon bill. Of that group, nearly 96 percent would have failed the 30 percent requirement because they left blank or filled in zero on the line where they were to report how much they spent on programs. Lisa Chiu, *Many Charities Don't Tell IRS How Much They Spend on Programs*, Chron. Philanthropy, May 1, 2011, at <http://philanthropy.com/article/Many-Charities-Don-t-Tell/127302/>.

¹³⁵ 461 U.S. 540 (1983).

¹³⁶ TWR could create a §501(c)(4) organization to pursue its lobbying goals though such organizations are not eligible to receive tax deductible contributions.

¹³⁷ *Regan*, 461 U.S. at 548.

Amendment, since it was rational for Congress to decide that, even though it would not subsidize substantial lobbying by charities generally, it would subsidize lobbying by veterans' organizations.¹³⁸ The Court concluded that Congress in granting tax exemption to certain nonprofit organizations that did not engage in substantial lobbying activities simply chose not to pay for nonprofit corporation's lobbying and did not regulate any First Amendment activity.¹³⁹ Additionally, legislatures had especially broad latitude in creating classifications and distinctions in tax statutes.¹⁴⁰

Even though IRS §501(c)(3) might have impinged upon speech, it was not intended to suppress any ideas nor was there any demonstration that it had that effect, and thus the statutory provision did not employ any suspect classification that warranted a higher level of scrutiny to determine whether the prohibition against substantial lobbying was invalid under the equal protection component of Fifth Amendment. The standard applied by the Court was whether the statute had a rational relation to a legitimate governmental purpose.¹⁴¹ Significantly, the Court also stated that the legislature's decision not to subsidize the exercise of a fundamental right did not infringe on that right and was not subject to strict scrutiny.¹⁴²

The Oregon statute has been challenged by the Car Donation Foundation, a charity that averaged spending only 20.7% on its program services over its three most recent fiscal years.¹⁴³ The organization claimed the statute violated Article 1 of the Oregon Constitution and the First Amendment of the United States Constitution and operated to chill its solicitation speech.

¹³⁸ *Id.* at 550-551.

¹³⁹ *Id.* at 546.

¹⁴⁰ *Id.* at 547.

¹⁴¹ *Id.* at 548-54.

¹⁴² *Id.* at 549.37

¹⁴³ *Matter of Car Donation Fdn.*, Ore. Dept. Justice, Agency Case No. 137300/XCT0031-15 (April 3, 2017).

Rejecting a motion to dismiss, an administrative law judge upheld the statute, concluding it did not restrict the organization's rights to engage in protected charitable speech, but affected the result of its solicitation efforts as it related to the donor's ability to deduct contributions for purposes of Oregon's income tax.¹⁴⁴ The requirement of disclosing the lack of state charitable exemption was necessary to prevent misleading potential donors. As in *Regan*, the administrative judge held that Oregon can determine which organizations it wished to subsidize through state tax-exemption. The Order may be appealed to the Oregon Court of Appeals.¹⁴⁵ Presumably, if the Oregon statute comes under the holding of *Regan*, and an intermediate scrutiny standard is applied, it will pass constitutional muster

VI. Application of an Intermediate Standard of Review for Judicial Evaluation of Charitable Solicitation Regulation

The various attempts to regulate excessive charitable solicitation costs have foundered on the protections afforded speech that contains any educational element. The Supreme Court has applied a standard of strict scrutiny when reviewing such legislation that directly impinges upon constitutionally protected speech. This section proposes that content neutral charitable solicitation regulation should be evaluated under an intermediate standard of review when the

¹⁴⁴ *Matter of Car Donation Fdn.*, Ore. Dept. Justice, Agency Case No. 137300/XCT0031-15 (Ruling on Motion to Dismiss 9 (June 10, 2016).

The Oregon statute has been the subject of three administrative hearings: 1) a ruling on a motion to dismiss and notice of intent to issue disqualification, which focused primarily on the constitutionality of the Oregon statute under the First Amendment of the U.S. constitution; and notice of opportunity for a hearing (Ruling on Motion to Dismiss Notice); and 2) Proposed Order Final (Proposed Order), which examined whether the statute violated the Commerce Clause under Article I, §8, clause 3 of the United States' Constitution or Article I, § 8 of the Oregon Constitution. Both hearings upheld the Oregon statute, denied the motion to dismiss and required the Car Donation Foundation to disclose to Oregon donors that contributions to it are not deductible for Oregon income tax purposes. *Matter of Car Donation Foundation*, Agency Case No. 137300/XCT0031-15, Ruling on Motion to Dismiss (June 16, 2016) and Final Order (April 28, 2017). Respondent Car Donation Foundation then proceeded to a contested hearing on its motion to dismiss, which it lost. An appeal to the Oregon Court of Appeals is pending.

¹⁴⁵ The administrative hearings are not publicly available. A copy of the decisions are on file at the George Mason Law Review.

scrutinized organization conducts fundraising campaigns over several years that offer minimal educational content in their solicitations, incur high costs, and deliver an insubstantial amount of services in the attainment of the organization's charitable mission.

The level of scrutiny applied to a statute ultimately is an issue of judicial discretion. When a legislature enacts a law, it gives the officials and judges who interpret it, directives or legal principles as to how they are to exercise their discretion. These directives or principles are commonly classified as rules or standards.¹⁴⁶

Rules

Rules are restrictive for decision makers for they confine them to facts, leaving arbitrary and subjective choices to be worked out elsewhere.¹⁴⁷ Rules bring stability and certainty. Individuals affected by rules should know the consequences of their actions and can plan to avoid them. They promote equal treatment, minimal information costs in decision making and predictability.¹⁴⁸

A legal directive that is a rule captures a background principle or policy in a form that operates independently and may be over- or under-inclusive in its application. Decision makers follow rules even when direct application of the background principle to the facts at hand would

¹⁴⁶ Kathleen Sullivan, *The Supreme Court—1991 Term—Foreword: The Justices of Rules and Standards*, 106 Harv. L. Rev. 22, 58-59 (1991) [hereinafter, *Foreword*]. The template discussed herein is based on the framework of Kathleen Sullivan in several articles, particularly: *Foreword*, and *Post-Liberal judging: The Roles of Categorization and Balancing*, 63 U. Colo. L. Rev. 293 (1992) [hereinafter, *Post-liberal judging*].

¹⁴⁷ *Foreword*, supra Note 146, at 58.

¹⁴⁸ Factors that justify rules include promotion of fairness in that decision makers act consistently and provide certainty. Rules are efficient for the decision maker compared to fact-based standards because there are minimal informational costs to reaching a decision and predictability of outcomes. Rules bind the governmental decision so that individuals can plan. They also limit the scope of decision makers' jurisdiction, which provides equality of treatment. Cass R. Sunstein, *Problems with Rules*, 83 Cal. L. Rev. 953, 960-977, Philip T. Hackney, *Charitable Organization Oversight: Rules v. Standards*, 13 Pitt. Tax Rev. 83, 109-110 (2015).

produce different results. Rules eliminate subjective actions of officials against unpopular individuals, organizations, or causes as in the arbitrary refusal to grant a solicitation permit, at issue in many of the earlier cases involving door-to-door fundraising.¹⁴⁹ For judges, rules provide for restraint, and the separation of the law from the malleability of the use of facts.¹⁵⁰ However, rules can mask bias. They may not fit every situation and may lead to unfairness or injustice in a particular case. Strict scrutiny is a rule.

Standards

A legal directive is standard-like when it collapses decision making into the direct application of a background principle or policy to a specific fact situation. A rule offers less discretion than a standard. Standards allow for a decrease in errors of under- and over-inclusiveness by giving the decision maker more discretion than do rules. Standards enable the decision maker to examine the totality of the circumstances and apply them to the case at hand. Another case with different facts may lead to a different decision.¹⁵¹ Thus, standards provide more flexibility and may be more likely to achieve justice in a particular case. Standards promote fairness in similar factual situations and are less arbitrary. Whereas rules remain fixed, standards are more flexible and permit decision makers to adapt to changing circumstances. They force judges to be more accountable to the facts of a particular case.¹⁵²

Another way to frame these concepts is the distinction commonly found in constitutional law between *categorization* and *balancing*. Categorization corresponds to rules, balancing to

¹⁴⁹ Cf. Hackney, *supra* note 148, at 103.

¹⁵⁰ *Id.* at 105.

¹⁵¹ Foreword, *supra* 146, at 58-59.

¹⁵² Foreword, *supra* note 146, at 66-69.

standards. Categorization is taxonomic. Balancing weighs competing rights or interests.¹⁵³

Categorization defines bright line boundaries and then classifies fact situations as falling on one side or the other. For example, if strict scrutiny of a statute is applied, the government likely loses. If rational scrutiny applies, say with an economic regulation, the government usually wins.

Levels of Scrutiny

When a court applies strict scrutiny to a law, the legislature must either have significantly abridged a fundamental right with the law's enactment or have passed a law that involves a suspect classification such as race or religion. Where government attempts to regulate the content of speech, the Supreme Court requires the government to provide substantial justification for the interference with the right of free speech. The noted constitutional scholar, Gerald Gunther, quipped that strict scrutiny is "strict in name, but fatal in practice."¹⁵⁴ In other words, the government almost always loses if a court finds a strict scrutiny standard of review.

Under a rational review standard the challenged law must be rationally related to a legitimate government interest. This is the most lenient standard. Rational basis review generally is used in cases where no fundamental rights or suspect classifications are at issue, such as economic legislation. Recall in *Riley*, the state and the dissent categorized the statute as economic legislation, but the majorities applied the strict scrutiny standard.

Intermediate scrutiny, the third approach between strict and rational review, is used in some contexts to determine a law's constitutionality. To pass the intermediate scrutiny standard, the challenged law must further an important government interest by means that are substantially

¹⁵³ Post-Liberal judging, *supra* note 146, at 293-294.

¹⁵⁴ Gerald Gunther, *The Supreme Court, 1971Term--Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection*, 86 Harv. L. Rev. 1, 8 (1972).

related to that interest. Intermediate scrutiny is less rigorous than strict scrutiny and involves a balancing based upon the facts before the court. Both strict and rational reviews are categories or rules, whereas intermediate scrutiny involves a balancing based upon the facts before the court.

Balancing gives judges more discretion. It occurs where the judge places competing rights and interests on a scale and weighs them against each other. The judge may apply a multitude of factors to reach a result.¹⁵⁵ A criticism of balancing is that judges become legislators because of their exercise of the use of discretion in deciding cases. There are valid arguments for categorization and for balancing.¹⁵⁶

Effects of the Strict Scrutiny Standard on Regulation of Charitable Solicitation

A problem with the strict scrutiny standard of review for charitable solicitation regulation is that the spirit of the rule and sometimes its substance can be evaded.¹⁵⁷ Thus, a strict scrutiny rule that assumes that the educational component of the solicitation is always intertwined with the non-educational parts of the message, the mere pitch for funds, may not be empirically correct. It ignores the fact that the educational component may be an insignificant and even irrelevant to the solicitation part of the message. This can allow unprincipled fundraisers and charities to elude the strictures against deceptive fundraising.

Regulation of charitable solicitation that impinges on speech is almost always reviewed under the strict scrutiny standard. This allows the unscrupulous fundraiser or sham charity to evade meaningful review of its activities. Strict scrutiny discourages regulators from oversight of questionable and inefficient organizations. Since it is almost impossible for a speech regulation

¹⁵⁵ Post-Liberal judging, *supra* note 146, at 292-294.

¹⁵⁶ *Foreword*, *supra* note at 146, at 62-64.; Sunstein, *supra*, note 145, at 972-977.

¹⁵⁷ Sunstein, *supra* note 148, at 995.

to overcome the strict scrutiny standard absent outright fraud, which is difficult of proof and a substantial consumer of scarce resources, rational regulators may be dissuaded from pursuing cases with a Sisyphean chance of success.

Applying the Intermediate Scrutiny Standard to Charitable Solicitation Regulation

Intermediate scrutiny would enable attorneys general to more easily to challenge the activities of charities that exist for the organization’s fundraisers or insiders. High fundraising costs over a period of time may indicate that the organization is not serving a charitable purpose, but is benefiting insiders (private inurement), serving a private benefit to others, or assisting no recognized charitable class.

It is extremely difficult for a content or viewpoint based law to pass judicial scrutiny. If a statute is neither content nor viewpoint based, it need not be analyzed under the strict scrutiny standard.¹⁵⁸ When a court applies an intermediate scrutiny lens, governments are afforded a wider leeway to regulate features of speech unrelated to its content. However, it is not so easy to get a court to apply an intermediate review standard.

For a law to meet the requirements of intermediate scrutiny, it “must be ‘narrowly tailored to serve a significant governmental interest.’”¹⁵⁹ This inquiry recognizes that the First Amendment “does not simply guard against an impermissible desire to censor.” A government may attempt to impermissibly restrict speech purely as a matter of convenience.¹⁶⁰ While governments are afforded a wider leeway to regulate features of speech unrelated to its content

¹⁵⁸ *McCutcheon v. FEC* ___ U.S. ___ 134 S. Ct. 1434, 1445-1446 (2014).

¹⁵⁹ *McCullen v. Coakley*, ___ U.S. ___, 134 S. Ct. 2518, 2534 (2014) (quoting *Ward v. Rock against Racism*, 491 U.S.781, 796 (1989)).

¹⁶⁰ *Id.* *Billups v. City of Charleston*, 194 F.Supp.3d 452 (D.S.C.2016).

or viewpoint, even if it is content neutral, "...[b]y demanding a close fit between ends and means, the tailoring requirement prevents the government from too readily 'sacrific[ing] speech for efficiency.' ”¹⁶¹ Ultimately, for a content-neutral regulation “to be narrowly tailored, it must not ‘burden substantially more speech than is necessary to further the government's legitimate interests.’ ”¹⁶² While this does not require that a subject regulation “ ‘be the least restrictive or least intrusive means of’ serving the government's interests...the government still ‘may not regulate expression in such a manner that a substantial portion of the burden on speech does not serve to advance its goals.’ ”¹⁶³

In *McCutcheon v. FEC* the Court noted that in the First Amendment context, even if strict scrutiny is not required, a reasonable fit is necessary: “The fit must represent not necessarily the single best disposition but one whose scope is ‘in proportion to the interest served,’ ... that employs not necessarily the least restrictive means but ... a means narrowly tailored to achieve the desired objective.”¹⁶⁴ Thus, the burden is on the government enacting any speech-impinging law to present evidence that supports its need for the regulation, and the speech restriction materially advances an important or substantial interest and demonstrates that the harms that generated the regulation are real, and the regulation will alleviate these harms in a direct and material way.¹⁶⁵

An argument unsupported by evidence favoring a speech restriction will not carry the government’s burden. Courts demand evidence that the regulated conduct actually threatened

¹⁶¹ *McCullen* 137 S. Ct. at 2534–35 (quoting *Riley v. Nat'l Federation of Blind of N.C., Inc.*, 487 U.S.at 795).

¹⁶² *Id.* at 2535 (quoting *Ward*, 491 U.S. at 799).

¹⁶³ *Id.* (quoting *Ward*, 491 U.S. at 798, 799).

¹⁶⁴ 134 S. Ct. 1456-1457; *Board of Trustees of State Univ. of N.Y. v. Fox*, 492 U.S. 469, 480 (1989) (quoting *In re R.M.J.*, 455 U.S. 191, 203 (1982)).

¹⁶⁵ *Reynolds v. Middleton*, 779 F.3d.222, 227-228 citing *Ross v. Early*, 746 F.3d 546, 555 (4th Cir. 2014), *cert. denied* ___U.S.___, 135 S. Ct. 183 (2014).

the government's interests, and will assess the viability of alternative means of advancing such interests. The regulation in question must be properly calibrated to its justifying purpose. This element of calibration goes to the very heart of the constitutional requirement that the regulation “not ‘burden substantially more speech than is necessary to further the government's legitimate interests.’”¹⁶⁶

In *McCullen v. Coakley* the Court applied an intermediate scrutiny standard to conclude that the statute in issue was not narrowly tailored. The Court grounded its conclusion in the fact that the Commonwealth of Massachusetts provided no evidence supporting its arguments. It was not sufficient justification to state that other approaches had not worked.¹⁶⁷

The Need for Empirical Data on the Educational Content of Charitable Solicitations

In reviewing the fiduciary appeals in the *Cancer Care* case, it is surprising how insignificant were the educational components of the solicitation message. Remember that the litigation was not against the fundraising firms, but the sham charities that presumably, ultimately control the content of the message. The lesson of *McCullen* and other cases is that empirical data or other evidence will be necessary to convince a court to apply an intermediate scrutiny standard and to uphold the legislation.

There is a need for social scientists to devise studies that can measure and evaluate the educational content of solicitations as well as the attitudes of recipients who receive them. Surveys are necessary to analyze the speech, measuring its content, whether recipients reacted,

¹⁶⁶*Id.*, at 228 quoting *McCullen*, 134 S.Ct. at 2535 (quoting *Ward*, 491 U.S. at 799).

¹⁶⁷ *McCullen*, 134 S. Ct. 2539-2540. (Regulation that made it crime to knowingly stand on a public way or sidewalk, other than a hospital, where abortions were performed was not narrowly tailored to serve governmental interest, and therefore violated free speech guarantees).

read or even noticed the educational components. Studies of donors and recipients of requests for funds may enable the introduction of credible and persuasive evidence that in the context of the total solicitation, the educational part of the message is irrelevant. Such empirical evidence could be used to reinforce the fact that the purported charity is using the solicitation for the private benefit of the insiders of the insiders, the fundraising firm or others. It may be that the results of such research will force charities and their fundraising firms to provide more serious educational content in their solicitations. That would be a positive result.

VII. Conclusion

This article has maintained that the realities of much fundraising speech is primarily commercial in nature as opposed to educational. This contrasts with the Supreme Court's view that the educational component of a solicitation is always intertwined with the commercial part of the message, justifying a strict scrutiny of review whenever a regulation impinges on fundraising speech. If a tax exempt organization does not carry on a charitable program commensurate in scope with its financial resources, regulators should be able to withdraw the benefits of exemption to the organization or its donors. One approach should be to disallow the donors' deductions for their contributions normally permitted by law, which under *Regan* would not run afoul of constitutional requirements.

In reviewing regulatory efforts, courts should apply an intermediate standard of review that will allow a balancing of the state's interest in assuring the honesty of charities with the impact on the charity's rights of speech. Application of an intermediate standard of scrutiny allows regulators to oversee more easily those few charities and professional solicitors, who consciously evade the law, and will enable the courts more easily to reach a just result, which will benefit the nonprofit sector, the donating public, and the beneficiaries of charities' activities.