

# Accountability in the Nonprofit Sector: What Problems Are Addressed by State Regulators?

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## Introduction

The Nonprofit Coordinating Committee of New York is conducting a two-year study of accountability in the nonprofit sector, aiming toward a draft report with recommendations by September, 1996, and a final report by March, 1997. The focus of this study is on the laws and regulatory schemes that affect charitable nonprofit organizations in the United States. We are mainly looking at "generic" regulation - that is, those laws and regulations that affect charitable nonprofits simply because they are nonprofits. We are not studying, for example, laws which affect both for-profit and nonprofit groups (such as environmental or employment regulations), laws which affect only a specific sector (such as hospitals or higher education regulations), or laws tied to specific government funding systems (such as audit requirements for federal grant recipients).

Our first task, in thinking about accountability, was to find out what the problem is. When people call for accountability, what problems and abuses are they concerned about? To answer this question, we have conducted interviews and focus groups with a wide variety of experts in this field, including attorneys, accountants, scholars, state and federal regulators and enforcement

personnel, representatives of the nonprofit sector, and professional fundraisers. We have concluded, not surprisingly perhaps, that the state charities officials and the staff of the Exempt Organizations Division of the Internal Revenue Service (EO) know more about nonprofit abuses and accountability lapses than anyone else.

This paper summarizes what we conclude from an all-day meeting on Jan. 9, 1996, and related discussions with attorneys in charge of the charities bureaus of their state attorney generals' offices. We are grateful to the following participants for giving generously of their time to talk with us: Sean Delaney (New York), Sheila Fishman (Minnesota), Ross Laybourn (Oregon), and Jan Soifer (Texas). We also thank David Ormstedt of Connecticut and Richard Allen of Massachusetts, who could not attend the meeting (because of the famous blizzard), but talked with us before and after.

All the people with whom we talked share our commitment to the nonprofit sector, believe that most of the time most nonprofits behave responsibly, and that the nonprofit sector is of great value to America and the world. When they (and we) work to prevent, identify, investigate, and punish "the bad stuff," they seek to strengthen the nonprofit sector, not to diminish it.

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## **No One Knows What All the Abuses Are, or How Pervasive They Are**

From our year-long exploration, we have found that no one has a precise picture of what abuses take place and the extent of the abuses. No regulatory office has a staff of sufficient size to do the kind of statistical sampling (with in-depth investigations of those sampled) that would reveal this kind of information. Thorough investigations of statistical samples might also place a politically unacceptable burden on law-abiding charities. Researchers other than government officials who are not authorized to subpoena books and records could not dig deep enough to find hidden abuses (if these exist). Thus it appears to be impossible or impracticable to obtain definitive, empirical answers to the question of what types of problems occur and how pervasive they are. Instead, we gathered substantial anecdotal evidence, relying on the reports of informed observers and most strongly on the reports of thoughtful state charities officials.

Some state charities officials believe that they have a pretty good handle on the types and extent of abuses; others are more agnostic.

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## **How State Officials Learn About Abuses**

It appears that state charity officials learn about nonprofit abuses from three sources. First, they may review the annual reports filed by nonprofits (rules vary from state to state as to exactly which groups, if any, must file). States vary widely in how intensely they review the filed reports, but clearly some review is done and from time to time these reports reveal problems. Second, in some states under various statutes charity officials must oversee certain transactions. These might include incorporation, mergers, dissolution, transfers of substantially all assets, and

charitable bequests; these reviews occasionally reveal problems. Finally, informants such as disgruntled employees, disaffected board members or employees, the general public, other government agencies, and the media are a major source of identifying problems. Indeed, a hard news story about some nonprofit abuse in the papers or an a T. V. almost forces state officials to investigate and become involved. Interestingly, our interviews with officials from the IRS also suggested informants and the media as a major source of leads to abuses.

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### **Categorizing the Problems: A "Continuum" of Abuses?**

We have been exploring the notion that there is a "continuum" of abuses, from outright theft or fraud on the one extreme, to waste and inefficiency on the other. Here is a possible list of abuses, presented more or less in order of how similar they are to crimes, and how likely it is that government officials will find out about these abuses and investigate or start legal action.

<b>Fund-Raising</b>	<b>Protecting charitable assets (often related to governance problems)</b>
Severe fundraising fraud (money raised for named charity but never sent to them, money raised for non-existent charity, non-existent sweepstakes prizes) [Note: Cases are rarely "pure" - usually at least a token amount is used for charity]	Stealing, embezzlement
	Egregious self-dealing, private inurement, excessive compensation
Misleading fundraising (misleading solicitations which confuse donors about which charity will receive funds, where charity does its work, etc)	Improper conversion of hospitals and other charities to for-profit status
	Misappropriation of charitable assets through violations of donors' intent
Fundraising compliance issues (failure to comply with charitable solicitation laws and registration and reporting requirements)	Nondisclosure of material facts (failure to make complete and accurate financial and program information available to the public, as required by reporting laws)
	Mismanagement (Waste of assets, letting organization get into financial trouble through neglect and lack of oversight)
Fundraising inefficiency (Excessive fund-raising costs, professional fund-raiser contracts that are unfair to charities)	Inefficient operation (Organization grows "fat and sloppy" and operates inefficiently, wasting public funds)

The Jan. 9 group thought that the extreme offenses at very the top of this list happen rarely, while the less egregious offenses such as mismanagement, waste, or inefficiency are much more widespread. As one attorney said, "there is a tremendous amount of inefficiency but not a tremendous amount of misappropriation or fraud."

The state officials who spoke with us have been shifting attention and resources to these more pervasive problems. In the past five years, they have come to think that the underlying problem, at least on the right-hand column of the chart, is "governance." They believe that when there are problems with misappropriations of funds, or excessive compensation, or mismanagement, or waste, there almost always are also problems with whether the board is providing adequate oversight. The focus on governance is discussed further below.

It strikes us that many of the leading thinkers on nonprofit accountability appear to focus on the problems on only one of the columns on our chart of abuses. Many law professors and practitioners who specialize in nonprofit law focus on the themes listed here under "protecting charitable assets." On the other hand, professional fund-raisers, their attorneys and clients, and many journalists focus attention mainly on fund-raising issues. There seems to be little communication between the two camps.

The state attorneys general with comprehensive state charities offices seem to divide their time equally between fundraising and protecting charitable assets. Some estimated that they spend 25% of their time on each, with the remaining 50% of their staff time on supervising wills and estates, overseeing charitable "births, deaths, and transformations," running the registration and reporting system, and, in some states, supervising charitable gambling. [Caution: These estimates vary widely, depending on how officials categorize their activities.]

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## **Stealing**

Outright theft and fraud might not belong in this report, because the problems are no different in the nonprofit sector from the for-profit sector. But they help define one extreme of the continuum.

Criminal cases, such as embezzlement, are infrequent. A leading accountant suggested that eventually most people who embezzle money get caught - the question is how long it goes on before they are caught. For preventing and identifying embezzlement, internal controls and audits are essential.

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## **Fund-Raising Fraud and Other Fund-Raising Problems**

There seems to have been a consensus among those in the comprehensive state charities offices that fundraising (charitable solicitation) cases loom less large than in the past. But fundraising issues still seem to claim at least 25% of their time, and probably more.

By "severe fund-raising fraud" we mean cases in which fund-raisers raise funds for virtually non-existent charities, or raise funds in the name of reputable charities but do not hand over substantial amounts of money to those charities, or ask for contributions toward a sweepstakes prize when no such sweepstakes exist.

States vary in whether outright fund-raising frauds are handled by charities officials, district attorneys, U.S. attorneys, and/or consumer protection officials. State officials perceived that outright fund-raising fraud is less likely to occur in states with strong prevention and enforcement programs. With justifiable pride, they told us that when FBI agents broke into fraudulent telemarketers' "boiler rooms," the agents found lists tacked on the wall of "don't call" states. In other words, the "bad guys" told their workers not to make calls to states where they were more likely to get caught. State charities officials were gratified to get on the bad guys' "don't call" list.

Observers guess that the "bad guys" of fund-raising fraud simply change their calling patterns away from the states with strong prevention and enforcement programs into states with less oversight. It is, of course, difficult to document this.

Beyond the most extreme cases, state officials face the much more controversial realm in which people allege that fund-raising costs are so excessive, compared to funds devoted to program, that the attorney general or the IRS should intervene. They also spend time enforcing "professional fundraiser compliance" - making sure that fundraisers comply with laws that require registration and reporting about fundraising campaigns.

Fund-raising regulation is a much-disputed area. The "hot" issues include 1) how donors can evaluate whether fund-raising costs are excessive, 2) whether any kinds of ratio analysis are helpful in the evaluation of fund-raising costs, and 3) whether and how to reduce the burdens on charities and professional fundraisers who solicit funds in many states. It is estimated that only 1-2% of all charities are affected by multi-state registration requirements, but these groups often loudly object to the work of the state charities offices. What interested us, though, was that the leaders of the most sophisticated state charities offices were reporting that the fundraising problems in their states seem to have stabilized, and they were able to limit the resources they devote to fund-raising to perhaps 25% of their total staff time (perhaps half of their enforcement work).

The state officials note that the great bulk of inquiries they receive from the public are related to fund-raising. It has been suggested that this is because donors are hungry for easy "litmus test" answers to questions about which charities deserve their donations - questions which state officials know that they are unable to answer. [Note: After reading a draft of this paper, one state official was concerned that we might be downplaying the abuses in this area and wrote: "you might want to point out that our offices spend considerable time on fund-raising problems because the public is outraged by misconduct in this area and demands that its public officials take enforcement action."]

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## **Private Inurement, Egregious Self-Dealing, Excessive Compensation**

These problems, which may be addressed by state or federal officials, take a variety of forms, but they all go to the question of whether individuals are diverting money or other assets to private use that should be devoted to charitable purposes. It includes excessive compensation, excessive

expense accounts (travel and food expenses, payments for apartments for relatives and friends, misuse of the charity's credit card), purchase of goods or services from insiders at above fair market value or sale of goods or services to insiders at below fair market value, or improper private use of corporate opportunities.

We started out trying to get estimates of how many incidents there might be of any particular type of violation in this area. We found, however, that this was an impossible quest. First, these violations don't come one at a time, but rather they appear to come in "syndromes."

In the "Aramony syndrome," a board sits back and relies on a strong executive (often this is a founding executive), and the executive treats himself to excessive compensation, outrageous expense accounts, and other misappropriation of funds, while the board fails in its duties of oversight.

The "self-employment syndrome" is similar to the Aramony syndrome, but this type of nonprofit (familiar to all the officials at our meeting) was created primarily for the benefit of its formerly unemployed executive, and the board, staff, vendors, and contractors include many friends and relatives of the executive.

Second, the databases of state charities officials do not attempt to isolate each separate abuse. Often investigations of specific abuses are disposed of by settlement, in which the charity does not admit to having committed any abuse; thus the files do not show whether or not the allegations were found to be true.

State officials observe that these "private benefit" issues are inextricably interwoven with governance issues, which are discussed below.

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## **Conversion of Hospitals and Other Groups from Nonprofit to For-Profit Status**

State charities officials and the Internal Revenue Service have recently become very concerned about hospitals, health maintenance organizations, and other large charities which are converting to for-profit status, or otherwise transforming their corporate structure into complex new entities. State and federal officials must examine these corporate transformations to see if assets are being transferred out of the nonprofit sector for inappropriate reasons or without fair consideration. While fund-raising cases often involved many small donations, a single hospital conversion transaction can threaten to remove millions of dollars from the charitable sector.

When a hospital or other nonprofit converts to for-profit status, there are complex problems related to how to ensure that the nonprofit's assets, including assets and endowments which had been donated for restricted charitable purposes, shall continue to be devoted to their charitable purposes. These cases are complex and can require significant commitment of state officials' resources, and are complicated by the problem that too often the charity has not kept adequate records of restricted funds and restricted assets. Conversion cases often also raise questions about excessive compensation and self-dealing.

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## **Misappropriation of Funds**

Misuse of funds is an area that has roots in the past; much work in this area stems from the attorney general's age-old responsibility for charitable trusts. Here we have, for example, cases of not honoring restrictions put on gifts, borrowing money from endowments, and pledging restricted funds.

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## **Governance**

The state officials who spoke with us believe that many of the problems they deal with are inextricably related to governance problems. Especially when they encounter problems related to protecting charitable assets (the right column on our chart), they ask, "Does the board meet regularly? Does it make sure there are internal controls, and adequate books and records? Does it hire and fire the executive director, oversee his/her compensation, and approve the budget?"

As mentioned above, the more experienced state charities officials are focusing their sights more and more on issues of efficiency and board governance.

There seemed to be a strong consensus that you cannot separate the two: inefficiency grows out of inadequate board governance. Inadequate board governance also creates the conditions that make embezzlement, misappropriation of funds and self-dealing possible. The case of the domineering executive director and the weak board seems to be quite typical across the country. It was noted that boards are made up of good people who want to do a good job but for one reason or another too many boards do not do very well. One respondent seemed to catch the change of direction very well in saying:

If you look at the evolution of our office -- five years ago we were doing nothing but solicitation. As we have had some amount of success, and we have started to learn about governance issues, we have started to gravitate our energies in that direction, simply because we think, at least at the moment, that there are much bigger problems in the governance field.

It was conceded that fraud and fundraising matters were easier to deal with because the wrongs were clearer and did not raise substantial subjective evaluation questions such as, "is the board doing its job?" Complaining against volunteer board members is tough as a political reality.

The attorney generals' offices use both the "carrot and the stick" to influence governance. They write pamphlets, run educational programs, and give speeches. They bring legal actions as in the Aramony case where specific financial abuses were linked to a "sleeping" board. They issue press releases and talk to journalists. They investigate and negotiate with groups formally or informally, even when the evidence might not be strong enough for litigation. In legal actions or settlements, they can force the removal of some board members, insist on conflict of interest policies, require that a full board oversee executive compensation, require regular board

meetings and minutes, require certified audits and better internal controls. States vary in how aggressively they sue individual board members for breaches of the duty of care, and whether they try to hold individuals financially responsible for their negligence.

The state officials struggle with the tension between not wanting to discourage volunteers from serving on boards, and yet wanting to scare inattentive board members into taking their fiduciary duties seriously.

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## **Conclusion**

As we have studied the work of the attorneys general, the biggest surprise for us, perhaps reflecting our academic and practitioner backgrounds, has been the extent to which fundraising matters appear to occupy state charity officers. A number of offices are expanding the scope of their interests to emphasize other accountability issues, and have developed effective means for dealing with and therefore containing fundraising abuses. Yet fundraising continues to take up a good part of their efforts.

Whether this suggests that those interested in helping to strengthen nonprofit accountability mechanisms should focus more of their attention on fundraising abuses, or whether state charity officials should readjust their workload to place more attention on non-fund-raising accountability issues is an open question that at the present we are not prepared to answer.

We encourage citizens who are concerned about nonprofit accountability to find out what problems their state charities officials are attending to. In many states, we expect that state officials would do well to shift some resources away from fund-raising, and pay more attention to governance and protecting charitable assets.

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