

## Comments

# Who's Minding the Nonprofit Store: Does Sarbanes-Oxley Have Anything to Offer Nonprofits?

By JANE HEATH\*

IN JUNE OF 2003, nonprofit public benefit corporation PipeVine, processor of charitable donations for dozens of charities, closed its doors, admitting it did not have enough funds to distribute what it owed to its clients.<sup>1</sup> The California attorney general filed suit and the San Francisco Superior Court appointed a receiver to take over the affairs of the corporation.<sup>2</sup> The receiver's preliminary report indicates PipeVine (formerly known as United Nonprofit Operations or "UNO") likely owed over \$18 million, with cash and assets worth just over \$3 million,<sup>3</sup> placing PipeVine among the most costly nonprofit failures ever. In the post-Enron world, where increased scrutiny of for-profit corporations has attracted judicial and legislative attention, the unique attributes of charitable nonprofit corporations have left those entities largely free to handle extraordinary sums of money intended for a wide variety of charitable and philanthropic ventures with little or no public accountability and virtually no ability to discover problems before they become catastrophic.

---

\* Class of 2005. This Comment is dedicated to the Class of 2005, the law review staff, and editorial board, especially Carolyn Nelson and Jon McMahon, whose tireless editing transformed this Comment from idea to reality.

1. Todd Wallack, *Nonprofit Admits Spending Charities' Money; Donation Processor's Accounting Problems at Least 2 Years Old*, S.F. CHRON., June 5, 2003, at A1 [hereinafter Wallack, *Nonprofit Admits Spending Charities' Money*].

2. CAL. CORP. CODE § 6513 (Deering 2004) ("[U]pon the application of the plaintiff . . . the court may appoint a receiver to take over and manage the affairs of the corporation and to preserve its property pending the hearing and determination of the complaint for dissolution.").

3. Todd Wallack, *PipeVine Owes Charities More; Tally of Donation Center's Debts Revised Upward to \$18 Million, More Than Its Assets*, S.F. CHRON., Oct. 8, 2003, at C1 [hereinafter Wallack, *PipeVine Owes Charities More*].

Themes of transparency and accountability have been hailed as panacea for many of the most pernicious problems faced by nonprofits (and, for that matter, their for-profit counterparts). What the PipeVine case study suggests is that even when information indicating problems is in the public domain, spectacular failures can still occur. Moreover, since nonprofits have no shareholders and very often no valuable assets, in contrast to for-profit enterprises, sources to recover the lost funds are limited or non-existent. A true solution to nonprofit mismanagement therefore lies within the grasp of all nonprofit boards. This Comment argues that an effective solution to nonprofit corporate failings is for the nonprofit sector to voluntarily adopt selected portions of the Sarbanes-Oxley Act (the "Act"), which was recently enacted to increase transparency and accountability in for-profit corporations.<sup>4</sup> Part I of this Comment provides a background of the PipeVine failure and an overview of existing and emergent regulation of nonprofit organizations. Part II discusses the nature of existing accountability schemes concerning nonprofit corporations and describes significant gaps in the system that allow nonprofit corporations to escape the scrutiny required of their for-profit counterparts. Part III discusses the failings of some solutions proposed to date and offers voluntary acceptance of portions of the Sarbanes-Oxley Act as a viable solution to nonprofit mismanagement that does not dismantle the entire present system.<sup>5</sup>

This Comment does not allow for comprehensive treatment of all aspects of the Sarbanes-Oxley Act and its potential for application to nonprofits. Instead, it focuses on several tenets of the Act that illustrate major themes intended by the Act's authors to promote public confidence in, and thus investments in, for-profit corporations. Nonprofits can also benefit from increased public confidence in a similar way, which may lead to increased charitable contributions or, in the

---

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in titles 11, 15, 18, 28 and 29 U.S.C.) [hereinafter, "Sarbanes-Oxley Act" or "the Act"]. As noted by one commentator:

The Act was designed to increase the transparency, integrity and accountability of public companies . . . . The perception that the recent wave of corporate scandals resulted . . . from a failure of behavior by corporate leaders and corporate attorneys, is reflected in the Act's attempt both to capture a broad range of behavior within its provisions and to foster greater self-policing of behavior not specifically captured within its provisions.

Note, *The Good, the Bad and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2123 (2003).

5. *The Good, the Bad and Their Corporate Codes of Ethics*, *supra* note 4, at 2123.

least, the curtailing of their current downward trend,<sup>6</sup> attributed by some to mistrust engendered by governance scandals and the attendant crises of confidence in both the commercial and nonprofit sectors.<sup>7</sup>

## I. Background

### A. The Story of PipeVine

A unique feature of the demise of PipeVine Corporation that makes it a useful example for further study is that, unlike recent financial scandals that rocked the nonprofit world, such as the embezzlement by national United Way Chairman William Aramony<sup>8</sup> or the self-dealing by directors of the Kamehameha Schools Bishop Estate,<sup>9</sup> the receiver has concluded that the PipeVine failure involved no embezzlement or conflict of interest.<sup>10</sup> Though the receiver's report is preliminary, it appears that PipeVine simply suffered from poor accounting practices and well-intentioned but woefully inadequate attempts to keep a sinking ship afloat.<sup>11</sup> Unless new evidence is discovered, PipeVine's failure may be characterized as misfeasance rather than the malfeasance that has become a common feature of recent business scandals.<sup>12</sup>

PipeVine was originally formed as a subsidiary of United Way of the Bay Area ("United Way").<sup>13</sup> In 1993, United Way formed

---

6. See Ian Wilhelm, *Toward a Cautious Optimism*, CHRON. PHILANTHROPY, Feb. 19, 2004, at 37; Editorial, *A Donor's Dilemma*, S.F. CHRON., Nov. 3, 2003, at A22.

7. See Ellen McCarthy, *Lingering Doubts Give Donors Pause*, WASH. POST, Dec. 29, 2003, at E9.

8. See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 593-94 (discussing Aramony's conviction for theft after it was discovered that United Way's assets were funding his extravagant lifestyle).

9. *Id.* (trustees of the charitable trust and their associates were found to have improperly benefited from the administration of the trust, resulting in the resignation or removal of five trustees).

10. Rebecca Vesely, *PipeVine Scrutinized for Monies Owed*, OAKLAND TRIB., Sept. 25, 2003, at A1.

11. *Id.*

12. Misfeasance is defined as "[t]he performance of a lawful act in an unlawful or negligent manner" as contrasted with malfeasance, defined as "[t]he performance of an unlawful or wrongful act, esp. by a public official." THE NEW INTERNATIONAL WEBSTER'S CONCISE DICTIONARY OF THE ENGLISH LANGUAGE 436, 463 (Sidney Landau ed., Trident Press Int'l 2002). In this Comment, malfeasance will be used to refer to criminally culpable conduct. Misfeasance will be used to refer to negligent but not necessarily criminal acts.

13. See Todd Wallack, *Nonprofit Kept Millions it Collected for Charity; PipeVine Siphoned Donations into Company Coffers for 3 Years*, S.F. CHRON., June 26, 2003, at A1 [hereinafter Wallack, *Nonprofit Kept Millions*]; Todd Wallack, *Charities Had Been Wary of PipeVine; United Ways Doubted Nonprofit's Methods*, S.F. CHRON., June 29, 2003, at A21 [hereinafter Wallack,

PipeVine's predecessor, UNO, to handle the day-to-day operations of collecting and distributing funds for United Way employer-based giving campaigns. United Way is the largest director of workplace giving campaigns in Northern California, collecting over \$40 million annually, primarily through payroll deductions from Bay Area companies.<sup>14</sup> United Way provides a structure for workplace giving campaigns where employees solicit other employees to have a percentage of their wages deducted from their paychecks. United Way then distributes the funds to local charities, which provide direct assistance and services to the community. The charities supported by United Way include everything from childcare centers to senior food programs. For many programs, United Way provides the largest single percentage of their operating funds.<sup>15</sup>

In early 1993, United Way employees formed UNO, PipeVine's predecessor corporation as a "nonprofit public benefit corporation . . . organized under the Nonprofit Public Benefit Corporation Law for charitable purposes."<sup>16</sup> UNO's purpose was set forth in its Articles of Incorporation: "to provide cost-effective services to independent United Ways and other nonprofit entities which have established their tax-exempt status under Section 501(c)(3) of the Internal Revenue Code, and to engage in such other activities as may be deemed in the general interest of charity in the State of California."<sup>17</sup>

UNO initially provided services exclusively for United Way. The two nonprofits shared office space and equipment<sup>18</sup> and United Way paid UNO's employees.<sup>19</sup> To the general public, UNO was indistinguishable from United Way. However, effective July 1, 2000, United Way severed its connection with UNO.<sup>20</sup> According to its Amended Articles of Incorporation, UNO thereafter became PipeVine, Incorpo-

---

*Charities Had Been Wary of PipeVine*]; see also Receiver's Status Report and Notice of Interim Request for Payment of Fees (July 3–August 31), *Lockyer v. Pipevine, Inc.* (Super. Ct. S.F. County Sept. 24, 2003) (No. CGC-03-422010).

14. UNITED WAY OF THE BAY AREA, 2003 ANNUAL REPORT 9 (2004), available at [http://www.theunitedway.org/about\\_us/annual%20report.pdf](http://www.theunitedway.org/about_us/annual%20report.pdf) (last accessed Apr. 4, 2004) [hereinafter UNITED WAY, ANNUAL REPORT].

15. UNITED WAY OF THE BAY AREA, ABOUT US, at [http://www.theunitedway.org/about\\_us/about\\_us.htm](http://www.theunitedway.org/about_us/about_us.htm) (last accessed Apr. 4, 2004) [hereinafter UNITED WAY, ABOUT US].

16. UNITED NONPROFIT OPERATIONS, INC., ARTICLES OF INCORPORATION (Feb. 17, 1993).

17. *Id.* at art. II, ¶ B.

18. Todd Wallack, *PipeVine, United Way Fight Over Assets*, S.F. CHRON., Sept. 25, 2003, at B2 [hereinafter Wallack, *Fight Over Assets*].

19. Second Amended Complaint at 3, *Chu v. PipeVine, Inc.* (Super. Ct. S.F. County Sept. 9, 2003) (No. CGC-03-420951) (original complaint filed May 30, 2003).

20. Wallack, *Charities Had Been Wary of PipeVine*, *supra* note 13, at A21.

rated.<sup>21</sup> Former United Way Executive Vice President and thirty year employee of United Way, Frank Melcher, became the president of PipeVine.<sup>22</sup> PipeVine's address remained the same as United Way's and the two companies continued to share at least office equipment and vehicles.<sup>23</sup> While the name change and new board placed some distance between the two companies, a lay observer would have found the distinction difficult to discern.

In the world of large, charitable nonprofits, the details of processing donations can be extraordinarily complex. For nonprofits that raise funds through pledge drives, later collecting the redeemed pledges, there is the additional difficulty of matching payments with pledges. As the internet increasingly became a vehicle for charitable giving<sup>24</sup> and more and more people used credit cards to manage their financial affairs, including charitable giving, the task became more complicated still. The advent of increasingly dedicated and sophisticated software systems also required special expertise to acquire and use.<sup>25</sup> That is the niche PipeVine sought to carve out for itself. If it could provide pledge processing services for companies less expensively than the companies themselves, then it stood to be successful. To do so, PipeVine had to deliver the services at a cost that was a reasonable percentage deducted from the amounts collected for charitable causes. PipeVine's agreements with its clients authorized it to deduct fees averaging seven cents for every dollar collected.<sup>26</sup>

PipeVine entered into contracts with nonprofits to handle all of their pledge matching and donation collection.<sup>27</sup> For some companies PipeVine collected the funds, deducted its fees, and distributed

---

21. UNITED NONPROFIT OPERATIONS, INC., STATEMENT BY DOMESTIC NONPROFIT CORPORATION (2000); UNITED NONPROFIT OPERATIONS, INC., CERTIFICATE OF AMENDMENT OF ARTICLES OF INCORPORATION (May 18, 2000) (changing the corporation name to PipeVine, Incorporated).

22. See NEIGHBOR TO NATION, ABOUT US (2002), at <http://www.shareamerica.org/melcher.htm> (last accessed Apr. 4, 2004) (brief biography of Frank Melcher).

23. See Receiver's Inventory at 5-6, *Lockyer v. Pipevine, Inc.* (Super. Ct. S.F. County Sept. 23, 2003) (No. CGC-03-422010).

24. Network For Good, for example, is a charitable nonprofit formed in 2001 by successful internet companies including Cisco Systems, Inc., AOL, Inc., and Yahoo!, Inc. for the purpose of encouraging the internet as a source of philanthropic activity. See NETWORK FOR GOOD, ABOUT US (2004), at <http://www.networkforgood.org/about> (last accessed Apr. 4, 2004).

25. Shalini Chatterjee, *PipeVine Uses Sun to Grow Philanthropy*, SUN NET WORK MAG., ¶ 3 (July 22, 2003), at <http://www.interbridge.com/chatterbox/PipeVine.html> (last accessed Apr. 3, 2004).

26. See Wallack, *Nonprofit Admits Spending Charities' Money*, *supra* note 1, at A1.

27. *Id.*

the balance directly to the client.<sup>28</sup> For others, they provided the additional service of distributing funds to specific charities designated by the client and then reporting that activity to the client.<sup>29</sup> The United Way of King County, Washington (“UWKC”) was a case in point. Beginning in August of 2001, PipeVine began handling half of UWKC’s pledge processing services in addition to Designation Payout and Reporting Services (distribution of funds to charities designated by UWKC).<sup>30</sup> In January of 2002, after numerous “test files,” UWKC concluded that PipeVine could not adequately perform the services it promised and cancelled that agreement.<sup>31</sup> PipeVine continued, however, to provide the distribution services for UWKC, but under scrutiny by UWKC personnel.<sup>32</sup> Unlike other PipeVine customers, UWKC required that PipeVine open a separate bank account in UWKC’s name and that checks from that account could only be written upon the express authorization of UWKC.<sup>33</sup> United Way of King County was the only PipeVine client to require such an account, demonstrating, as it turned out, an excellent way that the problem could have been avoided or, at a minimum, discovered sooner.<sup>34</sup>

In addition to providing its services to United Way organizations, PipeVine solicited the donation processing business of numerous other nonprofits. Those included Network for Good<sup>35</sup> and several prominent for-profit corporations that administered their own employee giving campaigns including Clorox, Macy’s, Bank of America, and others.<sup>36</sup> When it closed, PipeVine was reportedly handling \$100

---

28. *Id.*

29. *Id.*

30. *See* Declaration of Mike Pete in Support of Motion of United Way of King County for an Order Authorizing and Directing Release of Segregated Funds to United Way of King County at 1–4, *Lockyer v. Pipevine, Inc.* (Super. Ct. S.F. Aug. 15, 2003) (No. CGC-03-422010).

31. UWKC may not have been the only client who had that experience. Other United Way clients around the country complained that they severed relationships with PipeVine because its reports were incomplete and it would not supply an audit of its operations. *See* Wallack, *Charities Had Been Wary of PipeVine*, *supra* note 13, at A1.

32. *See* Declaration of Mike Pete at 3, *Lockyer v. Pipevine, Inc.* (No. CGC-03-422010).

33. *Id.*

34. King County figures prominently in the fight over PipeVine’s residual assets as the segregated account remains intact. The Attorney General has, initially at least, opposed the return of those funds to King County. *See* Declaration of Frank Melcher in Support of Motion of United Way of King County for an Order Authorizing and Directing Release of Segregated Funds to United Way of King County at 1–3, *Lockyer v. Pipevine, Inc.* (Super. Ct. S.F. Aug. 15, 2003) (No. CGC-03-422010).

35. Todd Wallack, *Charitable Funding Mystery: Firm that Handles Millions a Year Shuts Suddenly*, S.F. CHRON., June 4, 2003, at A1 [hereinafter Wallack, *Charitable Funding Mystery*].

36. *See* Wallack, *Charities Had Been Wary of PipeVine*, *supra* note 13, at A1, A21.

million in donations annually.<sup>37</sup> Based on the average seven cents of every dollar deducted for its services, PipeVine's total revenue should have been approximately \$7 million. However, two years before its closure its revenue was reported on tax returns at over \$11 million, with only \$57,000 of that from passive interest income.<sup>38</sup>

Tax returns for fiscal year 1999/2000, filed with the California Attorney General in 2001, show that the company had negative net assets of \$1,176,580.<sup>39</sup> While there may be some explanation for the figure, owing to the imminent divestiture by United Way (which had previously employed all of UNO's employees) there is no evidence that anyone took any particular notice. A year later, just as PipeVine changed its name, tax returns for 2000/2001 showed net assets of \$250,000, suggesting that things had improved from the year before. Taking a closer look at that same return and comparing it to the previous year's, PipeVine went from no employees earning over \$50,000 per year and two unpaid directors in 1999/2000 to twenty-three employees paid over \$50,000 per year (averaging over \$64,000 each, including benefits) and seven directors, two of whom were paid a total of over \$400,000 per year in salary and benefits by 2001.<sup>40</sup> PipeVine also paid over \$1.1 million to its five highest paid consultants that same year.<sup>41</sup>

A more detailed study of the tax returns strongly suggests that, based on the reported funds collected and paid to PipeVine for its services, as early as 2001 PipeVine may already have been exceeding its reported contractual right to an average of seven cents of every dollar collected.<sup>42</sup> Even if it could not be readily discovered just from the tax returns, PipeVine director Robert Martin, who signed the returns as its Secretary and Treasurer and earned over \$160,000 per year in salary and benefits for his efforts,<sup>43</sup> presumably had access to enough information to conduct a thorough investigation. When it closed less than two years later, PipeVine owed \$18 million to its clients.<sup>44</sup> If PipeVine processed \$100 million per year as reported, and

---

37. *Id.* at A21.

38. OFFICE OF THE ATTORNEY GEN., CAL. DEP'T OF JUSTICE, CHARITY SEARCH, at <http://justice.doj.ca.gov/charitysr/default.asp> (last accessed May 23, 2004) (search engine for the attorney general's charitable trust for public tax filings) [hereinafter OFFICE OF THE ATTORNEY GEN., CHARITY SEARCH].

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. Wallack, *PipeVine Owes Charities More*, *supra* note 3, at C1.

charged processing costs of seven cents on every dollar processed (\$7 million) with actual costs running eight to nine cents per dollar<sup>45</sup> (up to a \$2 million per year deficit), simple arithmetic suggests it took more than two years for the company to owe \$18 million. That analysis, although simplistic, strongly indicates that UNO/PipeVine employees and United Way either knew or should have known there was a money management problem even before PipeVine split off from United Way. While very little about the financial health of the company may be gleaned just from tax returns without access to the documents used to prepare them, the relatively large salaries and consulting fees suggest that, at the very least, some red flags were present with respect to the company's finances, especially when viewed in light of the spectacular failure less than two years later.

It is not absolutely clear when PipeVine's directors or United Way learned that PipeVine was in serious financial difficulty, but it was evidently known by early 2003. Gia Nguyen and Jackson Chu, two PipeVine employees allegedly fired in January of 2003<sup>46</sup> who filed a lawsuit for wrongful termination against PipeVine and United Way, claim they told management about accounting irregularities in the months prior to their termination.<sup>47</sup> Their complaint alleges that after they first complained to management about accounting problems, United Way's own Chief Financial Officer, George Chen, looked into the issue.<sup>48</sup> According to a January 31, 2003 letter attached to the complaint, Mr. Chen allegedly created a hostile work environment for the two employees.<sup>49</sup> Whether or not those allegations are true, if the CFO of United Way was interacting with employees of PipeVine concerning accounting issues in 2002, it strongly suggests that problems were at least suspected at that time. Nguyen and Chen reportedly met with the management of United Way and PipeVine in February of 2003 and, in principle, reached a settlement concerning "whistleblower" claims. The pair filed suit on May 30, 2003, naming as defendants United Way, PipeVine, and attorneys for both companies,

---

45. Wallack, *Nonprofit Kept Millions*, *supra* note 13, at A14.

46. When staff were cut, however, the company claimed "revenue was down because of the economic downturn." Wallack, *Charitable Funding Mystery*, *supra* note 35, at A16.

47. See Plaintiff's Second Amended Complaint at 3 (and letter dated January 31, 2003 attached thereto), *Chu v. PipeVine, Inc.* (Super. Ct. S.F. County Sept. 9, 2003) (No. CGC-03-420951) (original complaint filed May 30, 2003).

48. *Id.*

49. *Id.*



claiming PipeVine and United Way reneged on that agreement.<sup>50</sup> On June 2, 2003, PipeVine shut its doors and ceased all operations.<sup>51</sup>

On June 4, 2003, PipeVine issued a statement “deeply regret[ting]” the shutdown.<sup>52</sup> The statement detailed some of the events leading to the decision to close. According to that document, PipeVine senior management and the Board of Directors (“the Board”) first became aware of a “potential accounting problem” in February and immediately requested its outside auditors, Grant Thornton (also United Way’s auditors<sup>53</sup> and well established in non-profit accounting<sup>54</sup>) to investigate. Finding no evidence of accounting problems, Grant Thornton suggested a second opinion.<sup>55</sup> The Board thus hired accountants Hood & Strong in March of 2003 and brought in new Chief Executive Officer David Curtis, an expert in “turnaround management.”<sup>56</sup> When Hood & Strong reported its preliminary findings that PipeVine’s financial statements did not reflect the full amount owed to its clients, the new CEO turned to United Way and requested a \$5 million loan. This request was rejected.<sup>57</sup> The decision was then made by the Board to close the company and lay off all fifty-five employees.<sup>58</sup>

It is significant that PipeVine’s tax returns, filed with the California attorney general and available on the attorney general’s website, revealed a pattern that could have raised the suspicions of anyone who looked critically at those documents, and certainly the person who signed them should have been aware of the problems.<sup>59</sup> Moreover, since the documents are a matter of public record, the United Way, any interested PipeVine client, or any member of the public, had ready access to the information. That PipeVine’s impending failure was not discovered by virtue of documents in the public domain, as well as the strong implication that the United Way’s Chief Financial

---

50. *Id.*

51. UNITED WAY OF THE BAY AREA, PIPEVINE STATEMENT (June 4, 2003), at [http://www.uwba.org/about\\_us/commitment.htm](http://www.uwba.org/about_us/commitment.htm) (last accessed Dec. 3, 2003) [hereinafter UNITED WAY, PIPEVINE STATEMENT].

52. *Id.*

53. UNITED WAY, ANNUAL REPORT, *supra* note 14, at 10.

54. See GRANT THORNTON, LLP, ABOUT GRANT THORNTON (2004), at <http://www.granthornton.com/content/10786.asp> (last accessed Apr. 4, 2004).

55. See UNITED WAY, PIPEVINE STATEMENT, *supra* note 51; Wallack, *Nonprofit Kept Millions*, *supra* note 13, at A14.

56. UNITED WAY, PIPEVINE STATEMENT, *supra* note 51, at 1.

57. Todd Wallack, *Nonprofit Kept Millions*, *supra* note 13, at A14.

58. UNITED WAY, PIPEVINE STATEMENT, *supra* note 51.

59. OFFICE OF THE ATTORNEY GEN., CHARITY SEARCH, *supra* note 38.

Officer knew of the impending failure several months before it occurred, leads to the inescapable conclusion that any regulatory failure did not stem from information that was beyond public scrutiny. It follows, then, that the problem with nonprofit misfeasance, as illustrated by PipeVine, may not be that not enough is known about what is going on in nonprofits,<sup>60</sup> but rather that not enough is done with the information that is known.

## B. The Law

### 1. Overview of Existing Regulation

#### a. State Attorneys General

Every state has some form of oversight of nonprofit charitable organizations, typically through the state attorney general's office.<sup>61</sup> In California, for example, the attorney general's office administers nonprofit regulation through its Charitable Trusts Division.<sup>62</sup> California's regulatory scheme requires, among other things, that every charitable organization register with the attorney general's office before conducting fundraising activities.<sup>63</sup> When a public benefit corporation is formed in California, the secretary of state's office automatically transmits a copy of the company's articles of incorporation to the attorney general's office.<sup>64</sup> Thereafter, any non-exempt organization<sup>65</sup> with assets over \$25,000 is required to file its tax returns annually with

---

60. There is discussion throughout the charitable nonprofit sector concerning a need for and interest in greater "transparency" in operations. *See, e.g.*, INDEP. SECTOR, STATEMENT OF VALUES AND CODE OF ETHICS FOR NONPROFIT AND PHILANTHROPIC ORGANIZATIONS, [http://www.independentsector.org/members/code\\_main.html](http://www.independentsector.org/members/code_main.html) (last accessed Apr. 8, 2004); Media Release, United Way of the Bay Area, United Way of the Bay Area Announces Independent Advisory Board on Financial Accounting and Reporting (Nov. 2, 2003) (on file with U.S.F. Law Review) (announcing United Way's appointment of a Technical Advisory Board on Financial Accounting and Reporting).

61. *See, e.g.*, CAL. CORP. CODE §§ 12580–12599.5 (Deering 2004) (providing the basis for the existence of nonprofit corporations in the state); CAL. GOV'T CODE §§ 5000–6910 (Deering 2004) (covering the Attorney General's jurisdiction over nonprofits).

62. OFFICE OF THE ATTORNEY GEN., CAL. DEP'T OF JUSTICE, ATTORNEY GENERAL'S GUIDE FOR CHARITIES (1998) [hereinafter OFFICE OF THE ATTORNEY GEN., GUIDE].

63. *Id.* at 39.

64. *Id.* at 8.

65. Hospitals and religious organizations are exempt from filing tax returns and are therefore not subject to the attorney general's filing and reporting requirements. CAL. GOV'T CODE §§ 12580–12598 (Deering 2004); OFFICE OF THE ATTORNEY GEN., CAL. DEP'T OF JUSTICE, FREQUENTLY ASKED QUESTIONS, at <http://caag.state.ca.us/charities/faq.htm> (last accessed Apr. 3, 2004) [hereinafter OFFICE OF THE ATTORNEY GEN., FAQ].

the attorney general.<sup>66</sup> In the event of an allegation of malfeasance or misfeasance, the California attorney general has exclusive jurisdiction over actions against nonprofit public benefit or charitable corporations.<sup>67</sup> The office is empowered to investigate and, where appropriate, intervene to protect the public.<sup>68</sup>

### **b. Other Agency Regulation**

In addition to state regulation, nonprofits that contract with the federal government, such as hospitals or social service agencies, may be subject to other statutes, and their mishandling of financial affairs can also result in federal criminal prosecution.<sup>69</sup> As with state regulation, however, it is unlikely that misfeasance will result in criminal prosecution. For example, while the FBI is reportedly investigating the PipeVine failure, there is no evidence to date that any federal law was broken.<sup>70</sup>

Additional oversight of nonprofits occurs through the Internal Revenue Service's ("IRS") policing of tax exempt status.<sup>71</sup> While the IRS is relatively aggressive in enforcing the provisions of section 501(c)(3), the Internal Revenue Code section that confers tax exempt status,<sup>72</sup> there is no basis for IRS oversight if the business activities of a charitable organization do not violate the tax exempt provisions. PipeVine, for example, was unlikely to attract IRS attention as there is no allegation that it ever operated outside its structure as a nonprofit charitable organization.

### **c. Fiduciary Responsibilities of Nonprofit Directors**

In California, as in other states, executives of nonprofit corporations, similar to their for-profit counterparts, are subject to the sword

---

66. See OFFICE OF THE ATTORNEY GEN., GUIDE, *supra* note 62, at 39-40; CAL. GOV'T CODE §§ 12580-12598.

67. See CAL. GOV'T CODE § 12591.

68. *Id.*

69. See, e.g., *Dixon v. United States*, 465 U.S. 482 (1984).

70. See Todd Wallack, *FBI Criminal Probe of Defunct S.F. Firm; It Diverted Millions in Charitable Donations*, S.F. CHRON., Nov. 20, 2003, at A1 [hereinafter Wallack, *FBI Criminal Probe*].

71. See I.R.C. §501(c)(3) (1994).

72. See, e.g., *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540 (1983) (nonprofit lobbying organization not entitled to tax exempt status); *Am. Soc'y of Ass'n Executives v. United States*, 195 F.3d 47 (D.C. Cir. 1999) (disallowing lobbying expenses as tax deductions where nonprofit split itself into two entities to maintain its tax exempt status).

and shield of the business judgment rule.<sup>73</sup> If a nonprofit director exercises judgment based on a reasonable investigation in good faith, which she believes to be in the best interests of the corporation, she will generally not be held personally accountable even if that judgment ultimately proves to be flawed.<sup>74</sup> Since a court will not generally substitute its judgment for that of the corporation's directors where the provisions of the rule apply,<sup>75</sup> it is rare for directors to be found personally liable for negligent business decisions, or even benign neglect.

## 2. The Applicability of Sarbanes-Oxley to Nonprofits

While the Sarbanes-Oxley Act specifically applies to for-profit, publicly traded companies,<sup>76</sup> there are a few provisions that apply to all corporations, including nonprofits. The Act includes a policy concerning document destruction and a provision protecting employee whistleblowers, both of which are not limited to for-profit entities.<sup>77</sup> The document destruction provisions expand the government's ability to criminally prosecute those who destroy documents in an effort to thwart federal investigation or prosecution.<sup>78</sup> The whistleblower provisions protect all employees against retaliation from their employers for cooperating in federal law enforcement efforts.<sup>79</sup> Because the definition of law enforcement is broad, including the IRS and the FBI, the provisions potentially implicate virtually every company in the United States.<sup>80</sup>

Other provisions of the Act are applicable exclusively to publicly traded companies that are subject to the Securities and Exchange Act of 1934.<sup>81</sup> Most other companies, including nonprofits, are formed under the provisions of state law, so an act of Congress would not

---

73. See *Frances T. v. Vill. Green Owners Ass'n*, 723 P.2d 573, 583 n.14 (1986); CAL. CORP. CODE § 7231 (Deering 2004) (setting forth the business judgment rule applicable to directors of nonprofit corporations).

74. See *Finley v. Superior Court*, 96 Cal. Rptr. 2d 128, 132 (Ct. App. 2000).

75. See *Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n*, 980 P.2d 940, 945 (Cal. 1999).

76. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in titles 11, 15, 18, 28 and 29 U.S.C.)

77. See W. Warren Hamel, *It's Not Just About Enron: A Guide to the Sarbanes-Oxley Act for Nonprofit Organizations*, ASS'N MGMT. (Am. Soc'y of Ass'n Executives) (Mar. 2003), reprinted by NAT'L GRANTS MGMT. ASS'N, at [http://www.ngma-grants.org/docs/2003conf/Handout\\_Hamel.doc](http://www.ngma-grants.org/docs/2003conf/Handout_Hamel.doc) (last accessed Apr. 4, 2004).

78. *Id.* at 1-2.

79. *Id.* at 1.

80. *Id.* at 2.

81. *Id.* at 1.

ordinarily apply to those entities except, as illustrated by the document destruction and whistleblower provisions of the Act, where the issues implicate federal prosecutorial jurisdiction. It is not surprising, then, that state legislatures and attorneys general have begun to examine whether provisions of the Act might be applied or adapted to those companies that are presently subject exclusively to state regulation.<sup>82</sup>

### 3. Proposed Regulation

Since Sarbanes-Oxley was enacted in 2002, over a dozen states have proposed or enacted legislation patterned on the Act to reach state-chartered companies in general and nonprofit companies in particular.<sup>83</sup> In New York, Attorney General Elliot Spitzer was among the first to propose such legislation.<sup>84</sup> The New York proposal originally included a requirement that all nonprofits verify the accuracy of the financial information presented to their boards and that those with paid staff or revenues above \$250,000 comply with even more rigorous requirements.<sup>85</sup> After input from New York nonprofits, the floor for the more extensive (and expensive) reporting was raised to reach companies with over \$1 million in revenue.<sup>86</sup> The law also requires that the majority of New York nonprofits create separate audit committees, similar to the requirements of the Sarbanes-Oxley Act.<sup>87</sup>

California has introduced a similar proposal, called the "Non-profit Integrity Act of 2004."<sup>88</sup> Its version is primarily aimed at companies that conduct fundraising activities in the state and is intended to address what are considered to be significant abuses, including solicitations in a charity's name that actually result in a very small percentage of the funds collected going to that charity.<sup>89</sup> Though much of the bill's text is directed at such commercial fundraisers, it also in-

---

82. Hearings were held in June of 2004 to look into alleged abuses by tax-exempt entities with an eye toward developing federal legislation to address nonprofit governance. Though no bill has yet emerged, the legislative eye has indeed focused on increased scrutiny of nonprofits at the national level. See Charles Storch, Senate Committee Targets Non-Profits' Financial Dealings, CHI. TRIB., June 28, 2004, at 3.

83. See Erik Cummins, *Nonprofit Squeeze: Proposed Legislation Would Add Disclosure and Auditing Rules Similar to Those Faced By Corporate Entities*, S.F. RECORDER, Mar. 30, 2004, at 1.

84. See Fred Stokeld, *Bill to Apply Sarbanes-Oxley to New York Nonprofits Revised*, 100 TAX NOTES 753, at 753 (2003).

85. *Id.*

86. *Id.*

87. See discussion of particular provisions of the Act *infra* Part III.

88. See Cummins, *supra* note 83, at 1.

89. Nonprofit Integrity Act of 2003, S.B. 1262, 2003-2004 Leg. (Cal. 2004).

cludes a number of provisions that parallel aspects of the Sarbanes-Oxley Act.<sup>90</sup> Similar to the New York proposal, California's law would require nonprofits with annual revenues over \$500,000 to be independently audited and to provide copies of those audits to the Attorney General's Charitable Trusts Section, as well as making them available to anyone who requests them.<sup>91</sup> The bill further requires that nonprofits use separate accountancy firms for auditing and other accounting work to avoid conflicts of interest that may arise if the same firm is providing financial services for strategic planning and also determining the financial health of the business to provide to outsiders.<sup>92</sup> As with Sarbanes-Oxley, Senate Bill 1262 would require nonprofit boards of directors to set up dedicated audit committees with board members who sit on no other committees and are not paid for their service.<sup>93</sup> Another aspect of the Act that received attention in the bill concerns increased board and attorney general oversight of executive compensation and loans by the nonprofits to their executives.<sup>94</sup> An especially controversial provision of the bill would require the top executive of a nonprofit to certify the financial statements of the company, allowing for increased personal liability if the statements are found to be at variance from the true financial state of the company.<sup>95</sup>

On the federal front, the IRS is also considering regulatory reforms applicable to nonprofits.<sup>96</sup> Like the state attorneys general, the IRS is looking at modifying regulations to implement some aspects of the Sarbanes-Oxley Act.<sup>97</sup> The IRS is particularly focused on increasing the effectiveness of nonprofit boards of directors to protect organizations' assets.<sup>98</sup> Among the proposals under consideration are recommendations concerning conflict-of-interest policies for all nonprofit boards, encouraging board members to ask questions of the firm's managers, obtaining audit reports, including financially literate people as directors, and ensuring reasonable compensation for nonprofit executives.<sup>99</sup>

---

90. See Cummins, *supra* note 83, at 1.

91. *Id.*

92. *Id.*

93. *Id.* at 6.

94. *Id.*

95. *Id.*

96. See Sherri Begin, *Nonprofits Consider Changes as IRS Weighs New Oversight Rules*, *CRAIN'S DETROIT BUS.*, Feb. 23, 2004, at 16.

97. *Id.*

98. *Id.*

99. *Id.*

Against the backdrop of imminent legislative and regulatory reforms, there is incentive for the nonprofit sector to take a serious look at itself and consider which provisions of the Act can reasonably be adopted and which would likely threaten their very existence. That self analysis will put nonprofits in a better position to implement the provisions most likely to ultimately become law as well as to identify and document the ways in which some provisions impose costs or other burdens disproportionate to their benefits. Nonprofits can then develop credible opposition to certain legislative efforts.

## II. Who's Watching Nonprofits and What Do They See?

The primary problem presented by the current state of regulation of nonprofit charitable organizations is that, as long as the company is operating within its tax-exempt status, there is very little scrutiny of on-going operations. After-the-fact actions by a state's attorney general's office or federal prosecutors are unlikely to result in restoration of funds in situations such as PipeVine's \$18 million shortfall. In California, though the attorney general's office has the authority to investigate and intervene in the affairs of most nonprofit charitable enterprises, the state legislature has never adequately funded that effort.<sup>100</sup> California's attorney general's office receives hundreds of complaints concerning charities and charitable solicitation every year.<sup>101</sup> But, the available resources allow thorough investigation of only a few of the most egregious claims.

In the case of PipeVine, it appears that the press release that PipeVine was closing its doors, owing unspecified amounts of money to dozens of charity and corporate clients, was the first official indication of a problem that the attorney general's office received. While the office acted relatively quickly thereafter, filing its lawsuit for dissolution, accounting, and appointment of a receiver within thirty days after the announcement, the best that could be achieved by regulatory involvement at that point was to stop the bleeding, which arguably had already occurred with the closing of the business. If there is no criminal or civil liability of any culpable party with resources to restore misspent funds, all the attorney general can achieve is to have the costs of the investigation and dissolution borne from the remaining assets of PipeVine, leaving even less money to pay the clients and, ultimately, the beneficiaries of the various charity clients. The applicable

---

100. OFFICE OF THE ATTORNEY GEN., FAQ, *supra* note 65.

101. *Id.*

law provides for the costs of the receiver's investigation, including the receiver's compensation, fees, costs of the receiver's attorney, and the attorney general's costs of enforcement, to be paid out of the remaining assets of the company.<sup>102</sup>

That is not to suggest that the attorney general's office was wrong to take action against PipeVine. It had little choice. The office is responsible for ensuring that charitable organizations act within their stated objectives and for seeing that charitable assets go to their intended beneficiaries.<sup>103</sup> Moreover, before a receiver was appointed and conducted a relatively comprehensive investigation, the attorney general could not know how the failure occurred, whether there was criminal or civil liability, and/or whether some method was available to seek restoration of funds.<sup>104</sup> The receiver has found no evidence of embezzlement, and the directors may well have reasonably relied on data provided by company management. The application of the business judgment rule suggests that, even if one or more directors has some assets which might be tapped, they would not be found sufficiently culpable to ever result in significant recovery of funds.<sup>105</sup>

It appears, then, that when a nonprofit fails, particularly due to negligence by its directors as opposed to criminal acts, the chances of donors' funds reaching their intended recipients is slim, even where some assets remain. The laws governing nonprofits do not include any early warning systems and efforts after the fact are likely to siphon off remaining assets to pay for the orderly winding up of the company's affairs, as may well be the case for PipeVine. Perhaps most importantly, the very real danger that the perception of inadequate oversight will adversely affect the behavior of potential donors to

---

102. See CAL. GOV'T CODE §§ 12597, 12598 (Deering 2004).

103. See CAL. GOV'T CODE § 12591 (Deering 2004).

104. Recent press reports indicate that the FBI has begun a criminal investigation of the PipeVine failure; however, review of the receiver's bills to date make it clear that the Justice Department and the FBI were having discussions with the receiver within days of his appointment and yet his report stated that no embezzlement has been discovered. The question remains open whether some other criminal breach of the public trust occurred. See Wallack, *FBI Criminal Probe*, *supra* note 70, at A1; Receiver's Status Report and Notice of Interim Request for Payment of Fees and Expenses, *Lockyer v. Pipevine, Inc.* (Super. Ct. S.F. County Sept. 23, 2003) (No. CGC-03-422010).

105. While the receiver is reportedly continuing to pursue potentially culpable parties including, possibly, the audit firm that performed outside audits of PipeVine for years prior to the failure, a settlement has been reached with United Way of the Bay Area. United Way will pay \$3.45 million to the receiver and forego \$6 million in contributions it never received from PipeVine in exchange for being absolved of responsibility for the remaining shortfall. See Todd Wallack, *Charity Settles in PipeVine Fiasco*, S.F. CHRON., Feb. 19, 2004, at B1 [hereinafter Wallack, *PipeVine Fiasco*].



nonprofit charitable organizations is itself sufficient justification to consider solutions.

### III. Solutions

#### A. Proposed Solutions from Outside the Nonprofit Sector

Legal scholars have suggested a number of approaches to solving the lack of oversight of nonprofit operations. All of them focus almost exclusively on avoiding, preventing, or addressing malfeasance. None focuses primarily on the prevention or avoidance of misfeasance. The following section discusses why none of those approaches are adequate to address the most likely sources of problems in charitable nonprofit companies, illustrated so strikingly by PipeVine's \$18 million shortfall.

##### 1. Solution One: Modify the Business Judgment Rule

The first proposed solution suggests increased liability and scrutiny of nonprofit directors, who enjoy some measure of protection from liability by virtue of the business judgment rule.<sup>106</sup> Some suggest removing or significantly weakening such shields.<sup>107</sup>

Even if state legislatures could be persuaded to pass this kind of legislation, such a proposed solution is likely to result in the inability of nonprofit corporations to attract qualified directors. Successful business professionals who could do the most good as board members of nonprofits may not be willing to lend their expertise if their own assets are placed in jeopardy by errors in judgment. The inability to attract talent on their boards of directors is likely to lead to fewer nonprofits. Such a result is especially undesirable at a time when shrinking government funding often places essential social services in the nonprofit market.

Moreover, qualified, experienced directors are essential to prevent misfeasance. If problems such as PipeVine can occur under the noses of apparently qualified directors, a proposal that results in more difficulty securing the services of competent members of the business community to serve on nonprofit boards seems to be a cure that could ultimately be worse than the disease. In the PipeVine case, for example, it is doubtful that such increased liability would have had a measurable effect. Unless the directors were extraordinarily wealthy

---

106. See MODEL NONPROFIT CORP. ACT, §§ 8.42, 8.52 (Revised 1988).

107. See Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 270-71.

individuals, they are unlikely to be able to restore over \$18 million. Furthermore, if they did have such wealth and were held liable for the loss due to negligently failing to discover financial irregularities, no person of means would ever again agree to serve in such a capacity. As the proposed legislative reforms suggest,<sup>108</sup> nonprofit boards are likely to need more qualified directors in the future, not fewer, in order to meet requirements for separate audit committees comprised of individuals with financial expertise.

## 2. Solution Two: Independent Oversight Boards

It has also been suggested that independent boards or commissions could be used to oversee nonprofit operations.<sup>109</sup> That is, in fact, similar to one feature of the Sarbanes-Oxley Act applicable to for-profit enterprises.<sup>110</sup> Sarbanes-Oxley mandated the creation of the Public Company Accounting Oversight Board ("PCAOB"), under the direction of the Securities and Exchange Commission ("SEC").<sup>111</sup> The PCAOB consists of five members, none of whom may be currently employed by an accountancy corporation, to oversee the work of accountants providing audit services to public companies.<sup>112</sup> The PCAOB, however, has been subject to significant criticism for creating an additional and potentially conflicting layer of oversight beyond states' accountancy boards and the SEC.<sup>113</sup>

The sheer number and variety of nonprofits and the already challenging prospect of attracting qualified individuals to manage them makes such a solution practically untenable. There is simply insufficient incentive for community members to serve in such a capacity when the demand for volunteers to provide direct service to needy community members often goes unmet due to lack of human resources. Increased regulation of any kind also has the unintended consequence of heightening public skepticism, producing a chilling effect on all donations, hurting every charitable cause regardless of its relative lack of culpability.<sup>114</sup> Most importantly, the proponents of volunteer citizen advisory boards to monitor nonprofits concede that

---

108. See discussion *supra* Part I.B.3.

109. See James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 272-87 (2003).

110. See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 7 (2002).

111. *Id.*

112. *Id.*

113. *Id.*

114. See Cummins, *supra* note 83, at 6.

funding increases for state or federal oversight is doubtful.<sup>115</sup> Yet citizen boards are contemplated to operate under the ultimate authority of state attorneys general.<sup>116</sup> It is difficult to imagine how such a structure could be accomplished without a commensurate budget increase for the state agencies. While what proponents of oversight boards contemplate may be delegation of current responsibilities by the attorneys general, the prospect of that, as well as the view that citizen boards can be convened and supervised without a commensurate increase in enforcement funds for the agencies, seems overly-optimistic. None have suggested how such programs, or even the results they supply, could be paid for without significantly increasing the enforcement budget of the attorneys general, something that has not happened to date and is unlikely to occur in a climate of public sector fiscal crisis.

### 3. Solution Three: Pay to Play

A third approach suggests the development of private, for-profit companies charged specifically with evaluating and ensuring compliance by nonprofits, paid for by the companies themselves.<sup>117</sup> Though the structure of such companies is not completely developed, it appears that what is envisioned are businesses that contract with a nonprofit for the right to sue the company under certain predetermined conditions.<sup>118</sup> The most significant problem with this approach is that many, if not most, nonprofits do not have the assets to pay to participate. There simply are not sufficient discretionary funds available in most nonprofit corporations to pay watchdog companies. While it has been suggested that smaller, more innovative programs might be exempt and others would probably cease to exist rather than bear the costs,<sup>119</sup> such an approach raises concerns about who decides which nonprofits are exempt or determines which nonprofits should go out of business because they cannot pay the costs of regulation. Even more disturbing is the prospect that allocating substantial costs to governance issues or suing a charitable nonprofit diverts funds intended by the donors for the charity's work. This is a prospect that is not palatable for either the nonprofit or its donors.

---

115. See Fishman, *supra* note 109, at 272.

116. *Id.*

117. See Manne, *supra* note 107, at 229.

118. *Id.* at 231-40.

119. *Id.*

#### 4. Solution Four: Broadened Standing to Sue Nonprofits

The fourth approach recognizes that the exclusive authority of state attorneys general deprives most others of standing to sue nonprofit corporations.<sup>120</sup> It has therefore been suggested that allowing other classes besides members, attorneys general, and sitting directors the right to sue a nonprofit increases accountability.<sup>121</sup> Like companies formed for the purpose of suing nonprofits, however, increasing the potential for lawsuits diverts charitable funds from their intended purposes. Moreover, if nonprofits are forced to defend against anyone who takes issue with the company's activities, including, presumably, their political or social message or the populations they serve, many innovative programs or even controversial social and political causes may be unable to survive as nonprofit entities. The nonprofit sector at its best is a mecca of entrepreneurship and creativity, sometimes operating within or serving the fringes of the social strata. Relaxing the requirements for standing to sue, unless quite narrowly drawn, would likely have a significant chilling effect on that spirit of innovation, depriving society of all but the most mainstream options. Such an approach also requires legislative action to change laws currently limiting standing to sue a nonprofit, which may be difficult or impossible to obtain in the political arena. It seems unlikely, for example, that the attorney general of California would support any legislation interfering with that office's exclusive jurisdiction over actions against nonprofits. When legislation removed some healthcare oversight in the not-too-distant past, California's attorney general did not go quietly, testing that loss of jurisdictional oversight in the courts.<sup>122</sup> Finally, in California at least, a procedure already exists for an interested party to seek leave of the attorney general's office for "relator status" and obtain its consent to file suit in its stead.<sup>123</sup> This suggests that authorizing members of the public to sue directly could be viewed as superflu-

---

120. See Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 657 (1998).

121. *Id.*

122. See *Van de Kamp v. Gumbiner*, 270 Cal. Rptr. 907 (Ct. App. 1990) (Attorney General's challenge to Corporations Code sections 10821-10826, transferring authority over Health Maintenance Organizations from the Attorney General's office to the Department of Corporations).

123. See, e.g., *Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932, 934 (Cal. 1964).

ous,<sup>124</sup> although, as a practical matter, it appears that the California attorney general does not frequently grant that standing.<sup>125</sup>

## 5. Solution Five: Legislative Reform

The final approach suggests increased legislative regulation of nonprofit corporations.<sup>126</sup> The primary flaws in that proposal are: (1) state legislatures are unlikely to act en masse to effect structural reform, making nonprofit regulation spotty; (2) federal action is undesirable due to the diversity and regional character of the nonprofit sector; and (3) federal legislation raises sovereignty issues concerning an area that has traditionally been exclusively within state control. As with the similar proposal to remove the shield of the business judgment rule, there is also a substantial danger of regulating marginally solvent nonprofits out of existence.

The current proposal in California is subject to all of those concerns. Industry experts point out that nonprofits with \$500,000 in annual revenue are operating on a very short financial leash.<sup>127</sup> The proposals for using different accounting firms for audit and other financial services ignores the market reality that the way accountancy services are priced would keep nonprofits from benefiting from discounts offered for bundled services, thus significantly increasing the cost of audits.<sup>128</sup> Requiring annual scrutiny of compensation packages for nonprofit managers restricts boards' ability to enter into meaningful long-term contracts that allow them to attract management talent and raises the specter of breach in the event annual reviews suggest premature termination of such contracts.<sup>129</sup> Among the most controversial proposals is the certification of financial statements by top executives. Chief executives already sign annual tax returns under penalty of perjury<sup>130</sup> and, as suggested above, even if executives were held liable, it is unlikely they would be able to cover any serious shortfalls from personal funds. Finally, nonprofits already have serious problems finding qualified volunteers to serve on their boards. Those with financial expertise have few incentives to take unpaid positions in

---

124. *Id.*

125. In *Holt*, one of few such reported cases, the attorney general's office actively opposed an interested party's efforts to obtain relator status. *Id.*

126. See Manne, *supra* note 107, at 229.

127. See Cummins, *supra* note 83, at 6.

128. *Id.*

129. *Id.*

130. *Id.*

a regulatory environment focused on greater personal financial as well as potential criminal liability.

## B. Toward an Industry-Driven Solution

In light of the interest in accountability issues borne primarily of the difficulties encountered in the for-profit corporate community, the time may never be better to confront this problem and move forward with solutions that do not tap the resources of nonprofit organizations or the government to an unacceptable extent. The ideal solution will allow for the self-governance and entrepreneurship essential to healthy nonprofit companies. Such a solution should also have as its goal increasing public confidence in charitable organizations' ability to handle donations in a way that maximizes money going to those needs served by the organization. To have the best chance of reaching all of those goals, the solution must come from the nonprofits themselves.

Nonprofits must be willing to voluntarily divulge their financial dealings, in a level of detail similar to that required of for-profit corporations post-Enron. The professionals who deal with nonprofits must voluntarily undertake some of the oversight responsibilities now imposed upon them when serving the financial and legal needs of for-profit corporations. In that regard, analysis of some general principles of the Sarbanes-Oxley Act applicable to for-profit corporations is appropriate.

The nonprofit industry has demonstrated a significant interest in implementing new best practices to increase their credibility in the donor market and avoid the modern specter of weekly front-page stories of corporate wrongdoing in both the nonprofit and for-profit sectors.<sup>131</sup> In a recently published work, BoardSource and the Independent Sector (an organization formed in 1980 to promote the interests of "charitable, educational, religious, health and social welfare organizations"<sup>132</sup>) looked at how charitable nonprofits might adopt selected provisions of Sarbanes-Oxley to achieve the same goal of "rebuild[ing] public trust in America's corporate sector" as their

---

131. See, e.g., Jessica Mitchell, *Nonprofits Implement New Accountability Standards*, J. REC. (Oklahoma City), Jan. 30, 2004, at 1; Stephen G. Greene, *One in Five Charity Boards Changed Policies in Past Year*, CHRON. PHILANTHROPY, Dec. 11, 2003, at 30.

132. INDEP. SECTOR, ABOUT US (2004), at <http://www.independentsector.org/about/about-is.htm> (last accessed Apr. 3, 2004).

for-profit corporate brethren.<sup>133</sup> The concept of selective voluntary adoption of Sarbanes-Oxley has also been discussed among other nonprofits, especially in the healthcare sector, an area particularly sensitive to the burdens of legislatively imposed regulation.<sup>134</sup>

## 1. Financial and Audit Committees

One particularly portable feature of the Act concerns the composition of financial committees of the board of directors that already exist in most large nonprofits, as well as the board's role in the conduct of annual audits. The Act requires that internal financial and audit committees include individuals with financial expertise and that no member have any financial interest in the firm's business.<sup>135</sup> This provision is wise for nonprofits as well.

In the case of PipeVine, financial expertise may well have existed on the board, but financial oversight by a salaried, interested director simply does not achieve the desired effect. Both the CEO of PipeVine and the officer who signed its tax returns were salaried employees of the company. Having the financial health of a nonprofit overseen by those who are not directly dependent upon revenue from the company is just good sense. For example, at least one client of PipeVine reportedly requested an audit of its contract with the company well before the financial problems were discovered. This request was rejected as not being justified by the value of that particular contract.<sup>136</sup> Since there was no separate audit committee and the officer who signed the tax returns received a substantial salary from PipeVine, it may never be known if an independent audit committee might have prevented PipeVine's demise. But the fact that at least one client requested and was denied an audit of its accounts handled by the company, suggests that having a committee comprised of individuals who are not compensated by the company might not be a bad idea.

All medium to large-sized nonprofits should also conduct annual outside audits under the watchful eye of an audit committee, consisting of board members with no financial or other connection to the management of the nonprofit, at least one of whom is a financial expert. Such a committee, if discharging its responsibilities properly, will

---

133. BOARDSOURCE & INDEP. SECTOR, *THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS* (2003), available at <http://www.independentsector.org/PDFs/sarbanesoxley.pdf> (last accessed Apr. 3, 2004).

134. Andrew Marks, *Coming Down With Sarbanes; Hospitals Taking Preventive Steps in Case Compliance Rules Spread*, CRAIN'S N. Y. BUS., Oct. 27, 2003, at 30.

135. See BOARDSOURCE & INDEP. SECTOR, *supra* note 133, at 4-5.

136. Wallack, *Charities Had Been Wary of PipeVine*, *supra* note 13, at A1.

ensure that the financial information provided by management to the auditors is as complete and accurate as possible. The outside auditing firm, or at least the responsible personnel at the firm, should be rotated at least every five years to ensure financial practices are closely examined by fresh eyes.<sup>137</sup> Such a provision would likely have discovered problems at PipeVine much sooner. When PipeVine's auditors were unable to find the problems even after being informed of them, the second look auditors found them immediately, suggesting that the "fresh look" was beneficial. While it may be increasingly difficult to find interested community members with financial expertise to serve as volunteer board members, if nonprofits independently require annual audits by a rotating outside auditing firm, this will help the nonprofits themselves control decisions regarding how many individuals, and with what expertise, are needed to suit their specific situation. Legislative imposition of standards necessarily imposes a one-size-fits-all approach that nonprofits can avoid if they design audit committees and other board oversight themselves to meet their own particular needs.

Sarbanes-Oxley also requires that corporate officers certify the financial data used to prepare annual audits. The intention of the provision is to make officers more accountable in the event improprieties are detected. However, it has the additional benefit of encouraging them to become familiar with the company's financial data to allow for meaningful certification. There are potential negatives for the nonprofit charitable organization due to the voluntary service by most nonprofit officers and directors and the potential reluctance of community members to serve in that capacity if faced with significant liability. This exemplifies, however, one of the benefits to nonprofits resulting from voluntary adoption of provisions of the Act. Those nonprofits with paid directors and officers or particularly large organizations could adopt such requirements for their highly compensated directors and financial officers, consistent with each organization's unique needs. Smaller nonprofits need not incur the additional expense or potential liability. If such a provision were to be imposed by statute, however, it is likely to apply to many more and smaller organizations than a reasonable, voluntary approach would. If the nonprofit sector can demonstrate relatively widespread voluntary adoption of financial accountability standards, its representatives might have more

---

137. See BOARD SOURCE & INDEP. SECTOR, *supra* note 133, at 5.



success convincing state legislators that a full legislative response is as unnecessary as it is unwise.

## 2. The Corporation's Advisors

Nonprofits might also consider, as the Act mandates, requiring attorneys and accountants hired by the companies to render financial and legal services to be proactive whenever and wherever they discover facts leading them to believe there are problems.<sup>138</sup> Uniting all interested parties in the goal of illuminating potential problems and encouraging the dissemination of "bad news" to the decision makers is the best deterrent to the kinds of catastrophic financial problems exemplified by the PipeVine failure. Professionals may need the client's encouragement to ask the tough questions and pursue the answers. If not, a climate may develop in which professionals are subtly (or even overtly) discouraged from pursuing or delivering bad news. Had PipeVine's outside auditors discovered and alerted PipeVine's board of directors of the accounting irregularities of which at least some PipeVine employees were plainly aware,<sup>139</sup> it is doubtful that reasonably responsible directors would have allowed the deficits to continue.

If caught early enough, there are few financial problems that cannot be kept from becoming worse, even where they may not be immediately solved. If Sarbanes-Oxley accomplishes nothing else, it has certainly increased the vigilance of professionals who render assistance to corporations.<sup>140</sup> Nonprofit companies might benefit from that increased vigilance by including clauses tailored to their particular needs for oversight in consulting and other agreements for legal and financial services, thus sending the important message to their consultants that they need and want the whole truth.

## 3. Executive Compensation

Few facts incite public ire more than hearing that the chief executives of a failed company continued to draw six or seven figure salaries while "Rome burned." It is therefore worthwhile for nonprofits to con-

---

138. *Id.*

139. See Second Amended Complaint at 3, *Chu v. PipeVine, Inc.*, No. CGC-03-420951 (Super. Ct. S.F. County Sept. 9, 2003) (original complaint filed May 30, 2003).

140. Chad Terhune, *KPMG Resigns as Lancer Auditor After Finding 'Likely Illegal Acts'*, WALL ST. J., Feb. 4, 2004, at B2 (reporting a company's outside auditor's withdrawal of its audit opinions on the company's financial results, claiming that the company had "not taken timely and appropriate remedial actions with respect to the illegal acts" discovered after investigation of a whistleblower's allegations).

sider a regular schedule for reviewing executive compensation. While concerns are properly raised about the propriety of requiring such review by law due to contractual and other concerns,<sup>141</sup> the sector, or even individual nonprofits, can voluntarily undertake the task. If, for example, executive compensation packages were routinely tied to the fundraising, financial, philanthropic, or any other articulated goals of the nonprofit, then failure to meet those objectives would already be a legitimate reason to revisit compensation. Boards would have the flexibility to continue or even sweeten the agreement if any of those goals were adequately met without fear of liability where they were perhaps not all met. In other words, the boards could demonstrate their reasonable business judgment and adequate oversight just by undertaking a comprehensive review as long as there was a reasonable, articulated basis for their actions. Moreover, consideration of the parameters of compensation, at the time compensation agreements are entered into, will allow companies to build in the specifics of the review process and avoid unpleasant surprises for the executives or the board.

#### 4. Transparency

While disclosure of financial statements, audits, and tax returns does nothing in itself to prevent or solve financial crises, disclosure is a step that all nonprofits with a website or a copy machine can reasonably implement. The mere willingness to do so tells the giving public that the company has nothing to hide. It also speaks loudly of the firm's integrity. If imposed by legislation, disclosure will likely require nonprofits to report to federal and/or state agencies, imposing an additional, costly administrative burden beyond the disclosure itself. For-profit corporations in the wake of Sarbanes-Oxley complain of the crippling increased costs of the reporting requirements, both in compliance and lost productivity.<sup>142</sup> Moreover, imposed transparency is unlikely to have as strong a positive effect on the trust of the giving public as voluntary disclosure would, where the company is telling the world on its own terms that it can be trusted as opposed to being viewed as merely complying with law.

Some will ask: why should nonprofits voluntarily adopt practices that will make it more cumbersome and expensive to operate? There are two reasons. First, if nonprofits do not step up and take visible and

---

141. See Cummins, *supra* note 83, at 6.

142. See Deborah Soloman, *Companies Complain About Cost of Corporate-Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1.

demonstrable steps toward self-governance, the result of recent failures is likely to be increased government regulation—a result the sector seeks to avoid. Second, a solution the industry itself proposes is a more lasting and meaningful one. One of the primary reasons to improve nonprofit governance is to increase credibility with the giving public. If the nonprofit sector finds and implements its own solutions, it will be seen as a healthy, proactive group with watchful management and therefore more deserving of public trust and confidence. As the BoardSource report concludes: “Self-regulation and proactive behavior will always prove more powerful than compulsory respect of laws.”<sup>143</sup> In order for that commitment to have meaning, however, and ultimately lead to the increased credibility and restoration of public trust that nonprofits desire, the efforts must be more than just a window-dressing public relations campaign.<sup>144</sup>

## Conclusion

Those close to the situation knew, and others should have known, that PipeVine’s accounting procedures were hopeless. To the extent that PipeVine’s accountants claimed they did not know, someone in the company failed in their responsibility to tell the auditors that the company regularly commingled operating funds and donations in the same bank account and then voided checks without adjusting the ledgers. Directors, including the one who signed the tax returns, plainly had access and should have known that the commingling of operating and trust funds in a single bank account was an accident waiting to happen. While that information alone might not have kept PipeVine afloat, it could have stopped the practice, prevented the deficit from growing at such an alarming rate, provided responsible parties with a basis to renegotiate agreements with clients to meet increased operating costs, or, at a minimum, led to a decision to fold the company before the deficit became so large.

If the nonprofit sector wants to continue enjoying the benefits of tax exemption and autonomy allowed under current law, it must voluntarily get its own house in order, lest one or more of the other

---

143. BOARDSOURCE & INDEP. SECTOR, *supra* note 133, at 10.

144. While it is too soon to tell and therefore unfair to judge, the technical advisory board for financial matters recently announced by United Way of the Bay Area needs to quickly develop and implement policies before such efforts can be credibly claimed to go beyond mere public relations. See UNITED WAY OF THE BAY AREA, OUR COMMITMENT OF ACCOUNTABILITY, at [http://www.uwba.org/about\\_us/commitment.htm](http://www.uwba.org/about_us/commitment.htm) (last accessed Apr. 4, 2004).

approaches to the problems of nonprofit failures be legislatively adopted and imposed. The only solution that can be immediately and successfully implemented is a concrete and attainable strategy that each and every nonprofit organization can employ with little government intervention—that is, one of their own making. Much of the work remaining to be done by nonprofits is in designing a viable strategy, anticipating and addressing its potential pitfalls, and implementing it. The Sarbanes-Oxley Act is a reasonable place to start.

Those aspects of Sarbanes-Oxley most likely to benefit nonprofits might have prevented, or at least foretold, the PipeVine disaster. Of course, the beneficial effects of Sarbanes-Oxley depend upon its ultimate efficacy, even for its targeted for-profit entities. Such analysis is left to others. What is suggested by this Comment is that what is good for the for-profit goose may also, with appropriate modification, benefit the nonprofit gander.