

Michigan Law Review

Volume 106 | Issue 5

2008

Confidence in the Nonprofit Sector Through Sarbanes-Oxley-Style Reforms

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Recommended Citation

Joseph Mead, *Confidence in the Nonprofit Sector Through Sarbanes-Oxley-Style Reforms*, 106 MICH. L. REV. 881 (2008).

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NOTE

CONFIDENCE IN THE NONPROFIT SECTOR THROUGH SARBANES-OXLEY-STYLE REFORMS

*Joseph Mead**

Over the past several years, the nonprofit sector suffered a series of highly visible scandals that shook the public's confidence in charitable organizations. Concerned politicians and nonprofit leaders responded with a variety of reforms inspired by the Sarbanes-Oxley Act. The Note focuses on three such reforms: requiring nonprofit officers certify financial statements, mandating audits of nonprofits' financial statements, and imposing independent audit committees on nonprofit boards of directors. This Note argues that, contrary to the conclusions of many commentators, these reforms will provide a net benefit to the nonprofit sector by increasing donor confidence while imposing minimal costs.

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* J.D. May 2007. I am grateful to the entire Notes Office for their tireless efforts and useful comments on previous drafts. In particular, I thank Jeanne Long for her encouragement and Leigh Wasserstrom for her unbounded patience. I also thank Professor Alicia Davis Evans for many helpful suggestions.

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If Americans cannot trust their charities, they will stop giving and those in need will suffer.¹

INTRODUCTION

There are over one million nonprofits in the United States,² and these organizations play a tremendous role in American society. Charities improve the lives of disadvantaged individuals. Religious organizations give people a sense of meaning. Voluntary associations provide opportunities for camaraderie.

Commensurate with the importance of nonprofit organizations, American participation in philanthropy is overwhelming. In recent years, nonprofit organizations reported over \$1.5 trillion in revenue to the Internal Revenue Service (“IRS”).³ Nearly ninety percent of American households donate money to charity, contributing an average of \$1,620 per year.⁴ And in 2000, over eighty-million adults volunteered their time, donating over an estimated \$200 billion in free services.⁵

1. *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing of the S. Comm. on Fin.*, 108th Cong. 7 (2004) [hereinafter *2004 Hearing*] (statement of Mark Everson, Comm’r, Internal Revenue Service).

2. According to the Urban Institute, National Center for Charitable Statistics (“NCCS”), in 2006 there were 1,478,194 nonprofits registered with the Internal Revenue Service within the past two years. NCCS—Number of Nonprofit Organizations in the United States 1996–2006, <http://nccsdataweb.urban.org/PubApps/profile1.php?state=us> (last visited Nov. 10, 2007). Of these, approximately two-thirds (1,014,165) were religious, educational, charitable, scientific, or literary organizations governed by § 501(c)(3) of the Internal Revenue Code. *See id.*

3. *See id.* (follow “501(c)(3) Public Charities” hyperlink); *id.* (follow “501(c)(3) Private Foundations” hyperlink); *id.* (follow “Other 501(c) Nonprofit Organizations” hyperlink).

4. INDEP. SECTOR, GIVING AND VOLUNTEERING IN THE UNITED STATES 3 (2001), available at <http://www.independentsector.org/pdfs/gv01keyfind.pdf>. These data are for the year 2000.

5. *Id.* at 2.

Recently, however, the public has begun to perceive nonprofit organizations as being ineptly or corruptly managed.⁶ Following the lead of federal legislation addressing corporate-mismanagement scandals,⁷ many proposed similar state and federal legislation and voluntary standards for the nonprofit sector. Legal commentators are universally critical of these reforms.⁸ This Note answers many of these criticisms by providing new empirical arguments in support of the legislation.⁹ It reviews and analyzes the reform proposals and concludes that these proposals will improve the nonprofit sector. Part I explains the scandals that undermined public perception of nonprofits and the reforms proposed to restore public confidence. Part II argues that the reforms would impose only modest costs on nonprofits. Finally, Part III contends that the reforms would ultimately improve donor confidence.

I. THE “CRISIS IN CONFIDENCE”¹⁰ AND THE RESULTING REFORMS

Widely publicized scandals over the past several years have led to diminished public confidence in nonprofit organizations. Section I.A describes how scandals involving national organizations such as the Red Cross, the United Way, and the Nature Conservancy shook public perception of nonprofits. Section I.B. discusses how various legislatures and nonprofit leaders proposed reforming financial practices to reassure donors and restore faith in the nonprofit sector. Borrowing heavily from Sarbanes-Oxley, these reforms included mandatory management-officer certification of financial statements, the creation of audit committees, and general auditing requirements by independent auditors.

6. See *infra* Section I.A.

7. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523–24 (2005).

8. Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information be Utilized Effectively?*, 40 NEW ENG. L. REV. 447 (2006); Robert W. Friz & Elizabeth Virgin, *The Sarbanes-Oxley Act—Considerations for Nonprofit Health Care Organizations*, HEALTH L., June 2006, at 1; Lumen N. Mulligan, *What’s Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981 (2007); Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205 (2004) [hereinafter Reiser, *Enron.org*]; Dana Brakman Reiser, *There Ought to be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559 (2005) [hereinafter Reiser, *There Ought*]; Wendy K. Szymanski, *An Allegory of Good (And Bad) Governance: Applying The Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303; Nicole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831 (2007); Jane Heath, Comment, *Who’s Minding the Nonprofit Store: Does Sarbanes-Oxley Have Anything to Offer Nonprofits?*, 38 U.S.F. L. REV. 781 (2004).

9. This Note, as well as the other commentary, raises many empirical questions that can only be resolved with data. Hopefully future research in this field will develop more concrete data that will lead to more informed policymaking.

10. 2004 Hearing, *supra* note 1, at 3 (statement of Sen. Max Baucus, Ranking Member, S. Fin. Comm.).

A. The Scandals

In the years leading up to the proposed reforms, scandals affecting highly visible nonprofits captured the public's interest. One of the most publicized scandals involved the handling of donations by the Red Cross following the terrorist attacks of September 11, 2001. Although many donors intended to help the victims of the terrorist attacks, the Red Cross funneled their donations to other operations.¹¹ After media-fueled outrage over the scandal, the Red Cross apologized and changed the way it used those funds.¹² According to one survey, a higher percentage of Americans paid attention to this scandal than the Enron bankruptcy.¹³

Like the Red Cross, the United Way recently endured widely publicized scandals. The United Way of the National Capital Area (which covers the Washington D.C. area) fell victim to financial mismanagement¹⁴ when the CEO of the organization took \$1.5 million in "questionable payments," including advances on salary and undocumented reimbursements, from 1987 to 2001.¹⁵ Some board members knew of the suspicious behavior but failed to alert the entire board or otherwise correct the situation.¹⁶ When the scandal broke in 2002, donations to the local charity dropped sixty percent, from \$45 million to \$18 million.¹⁷ Contemporary high-profile scandals at other United Way chapters, such as the 2002 discovery of the embezzlement of \$2 million from the chapter based in Lansing, Michigan,¹⁸ led many to question United Way chapters around the country.¹⁹

Other nonprofit financial scandals bombarded the public during this time. For example, Congress began investigating the "world's largest environmental organization," the Nature Conservancy, for improper land deals that benefited "insiders."²⁰ In California, legislators were concerned when Aaron Tonken, a Hollywood fundraiser, pleaded guilty to diverting \$7 mil-

11. Mark O'Keefe, *For charities, bad year beginning to hit home*, CHI. TRIB., Dec. 23, 2002.

12. Paul C. Light, Opinion, *The Red Cross is No Enron*, CHRISTIAN SCI. MONITOR, Mar. 6, 2002, at 9.

13. *Id.* ("According to a Brookings Institution survey conducted in December 2001, 60 percent of Americans said they were following the Red Cross story very or fairly closely, placing it ahead of the death of former Beatle George Harrison and the Enron bankruptcy.")

14. See generally David C. Johnston, *United Way Official Knew About Abuses, Memo Says*, N.Y. TIMES, Sept. 3, 2002, at A12.

15. Peter Whoriskey & Jacqueline L. Salmon, *Charity Concealed Pilfering: Auditors Had Flagged United Way Ex-Chief*, FORT WAYNE J. GAZETTE, Aug. 17, 2003, at 7.

16. *Id.*

17. *Id.*

18. Chris Andrews, *United Way Recovers Most of its Stolen \$2M*, LANSING ST. J., July 8, 2005, at 1B.

19. For example, a participant in the 2004 federal hearing relayed an anecdote where she told her doctor she was testifying about "charity abuses" and her doctor immediately brought up United Way. *2004 Hearing*, *supra* note 1, at 40 (statement of Ms. MacNab).

20. Joe Stephens & David B. Ottaway, *Senators Question Conservancy's Practices; End to 'Insider' and 'Side' Deals by Nonprofit Organizations Is Urged*, WASH. POST, June 8, 2005, at A3.

lion of charitable donations to himself and his “associates.”²¹ News articles from 1995 to 2002 reported a total loss of \$1.28 billion due to nonprofit scandals during that period.²² Simultaneously, financial scandals in the corporate world, such as Enron, exacerbated the public’s worries.²³

Public trust in nonprofit organizations waned as a result of these scandals. One survey found that confidence in nonprofits dropped from 90% to 60% between 2001 and 2002.²⁴ Most of this distrust stemmed from how nonprofits handled money. In 2006, 71% of those surveyed said that nonprofits waste a great deal or a fair amount of money.²⁵ While 30% of the survey participants thought that charities did a very good job helping people, only 11% thought they did a good job spending money wisely.²⁶ This distrust manifested itself in part in the increasing number of individuals choosing to create private foundations rather than trust preexisting organizations.²⁷

Influenced by media coverage of the “bad apples,”²⁸ many donors concluded that the entire nonprofit sector was corrupt.²⁹ When nonprofits with a strong national name such as the Red Cross are tainted, the effects of the scandal reverberate. Indeed, the two strongest predictors of an individual’s confidence in the nonprofit sector are that individual’s confidence in the Red

21. See Leora Gershenzon, Bill Analysis, SB 1262, at 5–6 (Cal. 2004), available at http://info.sen.ca.gov/pub/03-04/bill/sen/sb_1251-1300/sb_1262_cfa_20040621_122508_asm_comm.html (last visited Nov. 10, 2007). See also Press Release, Office of the Attorney Gen. of Cal., Attorney General Lockyer Unveils Reforms to Toughen Nonprofit Accountability, Fund-raiser Controls (Feb. 12, 2004), available at <http://caag.state.ca.us/newsalerts/release.php?id=584&year=2004&month=2> (last visited Nov. 10, 2007). At the same time in California, the collection agency for the Los Angeles United Way, PipeVine, could not account for all the donations it received. See generally Heath, *supra* note 8, at 787–90.

22. Brad Wolverton, *Charity Fraud Exceeds \$1 Billion*, CHRON. PHILANTHROPY, Nov. 27, 2003, at 26; Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995–2002* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 20, 2003), available at <http://ssrn.com/abstract=451240>.

23. See Carol Graham et al., *Cooking the Books: The Cost to the Economy*, POL’Y BRIEF (Brookings Inst., Wash., D.C.), Aug. 2002, at 1, available at <http://www.brookings.edu/comm/policybriefs/pb106.pdf> (estimating that corporate scandals, including Enron and WorldCom, cost the United States economy \$35 billion in 2002 due to investor panic); Paul C. Light, *Confidence in Charitable Organizations*, RES. BRIEF (Organizational Performance Initiative, New York, N.Y.), Aug. 2006, at 2, available at <http://wagner.nyu.edu/performance/confidence/charities06.pdf> (attributing the decline in confidence to for-profit scandals involving Enron, WorldCom, and Martha Stewart).

24. PAUL C. LIGHT, N.Y. UNIV. & BROOKINGS INST., FACT SHEET ON THE CONTINUED CRISIS IN CHARITABLE CONFIDENCE 1 (2004), available at <http://www.brookings.edu/views/papers/light/20040913.pdf>.

25. Light, *supra* note 23, at 2.

26. *Id.*

27. 2004 Hearing, *supra* note 1, at 40 (testimony of Mr. Adkisson).

28. *Id.* (statement of Sen. Max Baucus, Ranking Member, S. Fin. Comm.) (“Are the good guys getting a bad name? Do you find that confidence in charitable giving is starting to decline because it is known that there are a lot of bad apples?”).

29. A similar phenomenon was observed in the public reaction to corporate scandals. See Graham et al., *supra* note 23, at 2 (“Part of the problem stems from the public perception that the [Enron] scandal is situated at the center rather than the periphery of the system.”).

Cross and United Way.³⁰ Whether justified or not, this perception led to calls for nonprofit-sector reform.

B. *The Reforms*

Over the past four years, state attorneys general and nonprofit-sector leaders have suggested nonprofit reforms. At the federal level, the Senate Committee on Finance produced both a “staff discussion draft” paper to assist the committee in formulating “possible legislation”³¹ and a bill that died in committee.³² Meanwhile, several states considered³³ or adopted³⁴ their own reforms. The nonprofit community simultaneously suggested voluntary reforms, in part to stave off more stringent, mandatory regulation.³⁵

The nonprofit-reform proposals focused primarily on improving disclosure by incorporating Sarbanes-Oxley-style provisions.³⁶ Section I.B.1 describes efforts to improve the accuracy of annual reports. These proposals would make the nonprofit CEO responsible for the accuracy of such reports. Section I.B.2 discusses new proposed requirements that would increase the thoroughness of annual-report audits. Section I.B.3 details the mandates requiring structural or governance changes to the board of directors.

1. *Proposed Certification Requirements Mirror Sarbanes-Oxley*

Several nonprofit reforms mimic Sarbanes-Oxley’s officer-certification requirements. SOX mandates that a corporate CEO and CFO certify that the periodic financial reports “fairly present in all material respects the financial condition” of the company.³⁷ The officer must also certify that effective internal controls are in place.³⁸ Similarly, several nonprofit reforms would require an organization principal to certify reports. The Senate Finance Committee Staff proposal closely mirrors Sarbanes-Oxley’s certification provision. It requires that the CEO certify that the nonprofit has “processes

30. Light, *supra* note 23, at 6.

31. Staff Discussion Draft, Senate Fin. Comm. 1 (2004), available at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

32. CARE Act of 2003, S. 476, 108th Cong. (2003).

33. Such reforms were considered in Massachusetts, Michigan, Mississippi, New York, Ohio, Pennsylvania, and Vermont. Mulligan, *supra* note 8, at 1983 nn.9–11.

34. Such reforms were adopted in California, Connecticut, New Hampshire, and West Virginia. *Id.* at 1983 n.12.

35. See BOARDSOURCE & INDEP. SECTOR, THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS 2 (2006), available at <http://www.independentsector.org/PDFs/sarbanesoxley.pdf>.

36. Sarbanes-Oxley does not, by its terms, apply to nonprofit organizations—except in two relatively minor ways. First, all organizations, including nonprofits, are prohibited from retaliating against whistleblowers. Gilkeson, *supra* note 8, at 845 n.100. Second, nonprofits are required to retain documents if needed in a federal investigation. *Id.* at 845 n.101

37. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (Supp. III 2003).

38. *Id.*

and procedures” that ensure accurate reporting and that the CEO “[be] provided reasonable assurance of the accuracy and completeness of all material aspects of the return.”³⁹ Similarly, the Panel on the Nonprofit Sector, a coalition spearheaded by the Independent Sector⁴⁰ at the behest of the Senate Finance Committee, recommended that the IRS require either the CEO or CFO of a nonprofit to sign Form 990 statements⁴¹ under penalty of perjury to attest that they are “true, correct, and complete.”⁴² The Panel stopped short of suggesting a required statement on the sufficiency of internal controls.⁴³ In its voluntary standards, the Independent Sector encourages CEOs and CFOs to “fully understand such reports and make sure they are accurate and complete” but stops short of recommending that they certify them.⁴⁴

State attorneys general have also proposed legislation requiring officer certification. Like the federal government, however, states have been hesitant to adopt this requirement. In 2003, Eliot Spitzer, then attorney general of New York, proposed legislation that adopted the Sarbanes-Oxley officer-certification requirements wholesale for large nonprofits.⁴⁵ The legislation also would have required a statement regarding the sufficiency of internal controls of large nonprofits, while requiring less of officers of smaller nonprofits.⁴⁶ However, when the legislature did not share his enthusiasm, Spitzer removed this provision from his revised proposal.⁴⁷ Instead, the legislation clarifies that a failure to file a “complete and accurate” report would be a violation of the officer’s fiduciary duty.⁴⁸ Likewise, the attorney general of Massachusetts originally proposed a requirement that both the CEO and the chair of the board of directors of nonprofits with revenue over \$100,000

39. Staff Discussion Draft, *supra* note 31, at 8.

40. The Independent Sector is an umbrella organization of over 500 nonprofits with a mission to “lead[], strengthen[], and mobilize[] the charitable community in order to fulfill our vision of a just and inclusive society and a healthy democracy of active citizens, effective institutions, and vibrant communities.” Independent Sector, About Us, <http://www.independentsector.org/about/index.html> (last visited Nov. 10, 2007).

41. Form 990 is a statement of certain financial information that nonprofits must file with the IRS.

42. PANEL ON THE NONPROFIT SECTOR, INDEP. SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 26, 29 (June 2005), available at http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf [hereinafter PANEL REPORT].

43. *Id.*

44. BOARDSOURCE & INDEP. SECTOR, *supra* note 35, at 7.

45. Reiser, *There Ought*, *supra* note 8, at 570; Szymanski, *supra* note 8, at 1304.

46. Reiser, *There Ought*, *supra* note 8, at 570; Szymanski, *supra* note 8, at 1304.

47. See Reiser, *There Ought*, *supra* note 8, at 571; see also LEGISLATIVE BILL DRAFTING COMM’N, NO. 07612-02-5, AN ACT TO AMEND THE NOT-FOR-PROFIT CORPORATION LAW AND RELIGIOUS CORPORATIONS LAW, IN RELATION TO PROTECTIONS AGAINST FINANCIAL FRAUD AND ABUSE (2005), available at http://www.oag.state.ny.us/charities/char_pdf/ag68-05.pdf (drafted at the request of the Attorney General).

48. Assemb. B. 7825, 228th Assemb., Reg. Sess. (N.Y. 2005) (referred to Senate Committee on Rules on June 19, 2006).

certify the accuracy of financial statements.⁴⁹ However, the state legislature rejected this proposed legislation.⁵⁰

2. Proposed Audit-Committee Oversight of Auditing Work also Mirrors Sarbanes-Oxley Requirements

Like Sarbanes-Oxley, proposed nonprofit reforms also address the importance of having a thorough, independent audit. Sarbanes-Oxley dictates independence requirements for the audit committees of public companies.⁵¹ Under Sarbanes-Oxley, the audit committee “plays a critical role in providing oversight over and serving as a check and balance on a company’s financial reporting system.”⁵² The committee is charged with the “appointment, compensation, and oversight” of the company’s auditor.⁵³ Each member of the audit committee must be an independent director.⁵⁴ Additionally, each audit committee must have at least one member who is a financial expert or provide reasons why there is not such an expert.⁵⁵ Finally, an audit committee should establish a mechanism for anonymous reporting of “questionable accounting or auditing matters.”⁵⁶ When no separate audit committee is formed, the entire board is charged with the duties of an audit committee, subject to the stringent audit-committee requirements.⁵⁷

Many nonprofit-reform proposals impose Sarbanes-Oxley-style audit-committee requirements on large nonprofits. Like Sarbanes-Oxley, audit-committee responsibilities under the reforms include decisions regarding hiring, firing, and supervising the auditor and otherwise “satisfy[ing] it[self] . . . that the financial affairs of the corporation are in order.”⁵⁸ Reforms also im-

49. An Act to Promote the Financial Integrity of Public Charities, H.B. 4347, 184th Gen. Court (Mass. 2005).

50. Reiser, *There Ought*, *supra* note 8, at 564.

51. See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (Supp. III 2003); SEC Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3 (2005); SEC Standards Relating to Listed Company Auditing Requirements, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (to be codified at 17 C.F.R. pts. 228–29, 240, 249, 274).

52. SEC Standards Relating to Listed Company Auditing Requirements, 68 Fed. Reg. at 18,789.

53. Sarbanes-Oxley Act of 2002 § 301.

54. *Id.* Independence means not being “affiliated” with the company other than as a director or receiving compensation from the company other than for service on the board. *Id.*

55. *Id.* § 407.

56. *Id.* § 301.

57. SEC Standards Relating to Listed Company Auditing Requirements, 68 Fed. Reg. at 18,790 (“If the entire board constitutes the audit committee, the new SRO rules adopted under Exchange Act Rule 10A-3, including the independence requirements, will apply to the issuer’s board as a whole.”).

58. CAL. GOV’T CODE § 12586(e)(2) (West 2005).

pose independence requirements on audit-committee members identical to those of Sarbanes-Oxley.⁵⁹

Despite these similarities, there are a few notable differences between the nonprofit audit committees and those required by Sarbanes-Oxley. First, no nonprofit reform requires that a financial expert be placed on the audit committee,⁶⁰ though one reform suggests “includ[ing] individuals with some financial literacy . . . as a matter of recommended practice.”⁶¹ Second, the New York law, for example, would have allowed a nonprofit to opt out of the audit-committee requirements by amending its bylaws—the reforms do not require an audit committee if the certificate of incorporation or bylaws prohibit the creation of such a committee.⁶² Third, the reforms depart from Sarbanes-Oxley by not requiring that members of the audit committee be members of the board, provided that at least half of the audit committee is composed of board members.⁶³ Finally, as Table 1 illustrates, all audit-committee reforms are only mandatory for large nonprofits.

TABLE I

Reform	Threshold to Implicate Audit Committee Requirements (Annual Revenue)
Independent Sector voluntary standard	All organizations that conduct outside audits ⁶⁴
California Nonprofit Integrity Act	\$2 million ⁶⁵
Massachusetts bill	\$500,000 ⁶⁶
New York bill	\$2 million ⁶⁷

Despite important differences, both Sarbanes-Oxley and the nonprofit reforms require an independent audit committee to ensure that the auditor is not

59. *See id.* § 12586(e)(2) (“The audit committee may include persons who are not members of the board of directors, but the member or members of the audit committee shall not include any members of the staff, including the president or chief executive officer and the treasurer or chief financial officer.”).

60. Reiser, *Enron.org*, *supra* note 8, at 261 & n.213.

61. PANEL REPORT, *supra* note 42, at 79.

62. S.B. 4836-B, § 4, 2004 Leg., 227th Sess. (N.Y. 2004) (proposing N.Y. EXEC. LAW § 712(g)).

63. *E.g.*, Nonprofit Integrity Act of 2004, S.B. 1262, § 7, 2003–04 Leg., Reg. Sess. (Cal. 2004) (codified at CAL. GOV’T CODE § 12586); An Act to Promote the Financial Integrity of Public Charities, H.B. 4347, § 4(a), 184th Leg., Reg. Sess. (Mass. 2005).

64. BOARDSOURCE & INDEP. SECTOR, *supra* note 35, at 4.

65. CAL. GOV’T CODE § 12586.

66. Mass. H.B. 4347, § 3(g); *see also* MASS. GEN. LAWS ch. 12, § 8F (2002).

67. N.Y. S.B. 4836-B, § 4 (proposing N.Y. EXEC. LAW § 712(g)(1)). An earlier version of the New York bill would have set the standard at \$1 million in revenue or \$3 million in assets. Mulligan, *supra* note 8, at 1992–93 (citing N.Y. S.B. 4836-B, § 4).

beholden to staff and effectively scrutinizes the financial condition of the organization.⁶⁸

3. Proposed Requirements Reflect Sarbanes-Oxley's Emphasis on the Importance of Auditing

The proposed nonprofit reforms reflect the importance of auditing by calling for regular audits by independent auditors.⁶⁹ Sarbanes-Oxley does not impose an auditing requirement on for-profit corporations because these corporations were required to prepare audited statements before Sarbanes-Oxley.⁷⁰ However, many of Sarbanes-Oxley's reforms were motivated by the importance of thorough, accurate audits by impartial auditors in avoiding financial mismanagement.⁷¹ Auditing requirements strive to improve nonprofit governance by applying Sarbanes-Oxley-style concerns to nonprofit organizations, in particular large organizations. For example, California law imposes auditing requirements *and* requires that the auditor maintain its independence as defined by the Comptroller General's Government Auditing Standards and regulations promulgated by the Attorney General.⁷² Many nonprofit reforms are based on a two-tiered auditing requirement; depending on the size of the organization, requirements differ.

TABLE 2

Reform	Threshold to File a Report from an Independent Accountant	Threshold for a Full Audit of Financial Statements
Nonprofit Panel proposed reform ⁷³	\$250,000	\$1 million
Committee Staff proposed reform ⁷⁴	\$100,000	\$250,000
Independent Sector voluntary standard ⁷⁵	\$250,000	\$1 million
California Nonprofit Integrity Act ⁷⁶	—	\$2 million

68. See Cal. S.B. 1262, § 6.

69. Massachusetts had this idea long before Sarbanes-Oxley, imposing a two-tiered auditing requirement on nonprofit organizations since the late 1970s. Ch. 12, § 8F. Organizations with annual revenue over \$500,000 must undergo a full audit, while organizations with annual revenue between \$100,000 and \$500,000 must obtain an "independent certified public accountant's review report." *Id.*

70. See Reiser, *There Ought, supra* note 8, at 573 (citing SEC Regulation S-X, 17 C.F.R. §§ 210.3-01 to 210.3-20 (2004)).

71. See, e.g., Sarbanes-Oxley Act of 2002 § 201, 15 U.S.C. § 78j-1 (Supp. III 2003) (legislating auditor independence).

72. Cal. S.B. 1262, § 7(e)(1); see also PANEL REPORT, *supra* note 42, at 80.

73. PANEL REPORT, *supra* note 42, at 5.

74. Staff Discussion Draft, *supra* note 31, at 9.

75. BOARDSOURCE & INDEP. SECTOR, *supra* note 35, at 3-4.

76. Cal. S.B. 1262, § 6.

Table 2 illustrates the centrality of the auditing requirements to the reform proposals: organizations with revenue as low as \$100,000 would have to file a report on their financial statements prepared by an independent accountant, while full audits would be required of organizations with revenue as low as \$250,000.

II. THE REFORMS ARE NOT EXCESSIVELY COSTLY

This Part responds to common criticisms of proposals calling for the adoption of Sarbanes-Oxley-style reforms in the nonprofit sector. Section II.A argues that Sarbanes-Oxley-modeled reforms generally may be justified in the nonprofit sector because, perhaps unlike the corporate sector, the benefits of such reforms may outweigh the costs. Section II.B details how the potential costs of each of the reforms actually proposed—officer-certification, audit-committee, and auditing requirements—are insignificant compared with potential benefits. This Part concludes that neither Sarbanes-Oxley-style reforms generally nor nonprofit-reform proposals specifically are likely to impose excessive costs.

A. In General, the Benefits of Sarbanes-Oxley-Inspired Reforms Outweigh the Costs in the Nonprofit Sector

Critics of the reforms lament the financial costs that the reforms will impose, but such concerns are misguided.⁷⁷ Pointing to the expense of Sarbanes-Oxley, critics argue that the financial costs to a resource-scarce sector will be crippling, diverting funds away from the nonprofit's mission and potentially reducing its provision of services.⁷⁸ As evidence that Sarbanes-Oxley-style reforms are too expensive for the nonprofit sector, one commentator notes that Sarbanes-Oxley caused many smaller corporations to go private to avoid the costs of compliance⁷⁹ and argues that "[i]f small for-profit companies find the Act's burdens to be prohibitively expensive, it can be predicted that many smaller nonprofits would reach the same conclusion."⁸⁰

77. Sarbanes-Oxley, for example, has been strongly criticized as being far too expensive, perhaps even causing some smaller corporations to withdraw from public stock markets. Szymanski, *supra* note 8, at 1318. One study places the net private cost of complying with Sarbanes-Oxley at \$1.4 trillion. *Special Report: A Price Worth Paying?: Auditing Sarbanes-Oxley*, *ECONOMIST*, May 21, 2005, at 82. Others suggest that large firms spend an average of 70,000 additional man-hours to comply with Sarbanes-Oxley's requirements. *Id.*

78. John Boudreau, *Bill Expands Accountability for Charities*, *SAN JOSE MERCURY NEWS*, Sept. 2, 2004, at 3C (noting criticism of California's bill by nonprofits); Signing Statement, Governor Arnold Schwarzenegger (Oct. 1, 2004) (on file with author) ("[W]hile I support transparency, accountability and curbing unscrupulous activities, I encourage the Legislature to ensure the non-profit community is not subjected to needless bureaucracy thereby potentially hampering the work and contributions made by non-profits who are serving California communities in need.").

79. See generally Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 4 *J. ACCT. & ECON.* 116 (2007) (discussing the benefits of going private).

80. Szymanski, *supra* note 8, at 1318. Another commentator has noted that for-profit corporations have the option of going private to avoid regulation, an option not available to nonprofits. Gilkeson, *supra* note 8, at 849–50.

In contrast to the corporate sector, the benefits of such proposals may outweigh the costs in the nonprofit sector, and many nonprofits are voluntarily assuming additional obligations.⁸¹ For-profit corporations' responses to Sarbanes-Oxley, with the singular goal of improving their financial condition, do not necessarily imply that similar nonprofit reforms are prohibitively expensive. The nonprofit sector does not share the same market-driven, self-executing accountability mechanisms as the for-profit sector. Nonprofits lack three accountability reinforcements, thus rendering the usual market forces inadequate: stakeholder self-interest (and therefore incentives to monitor); intense, efficiency-forcing competition; and a common metric of success (profit).⁸² Because existing accountability measures have failed to deter violations or bolster their image, nonprofits have found additional accountability measures necessary in order to meet the demands of their donors and stakeholders alike. Recognizing that they are more vulnerable to mismanagement than the corporate world and that they are accountable to a greater number of stakeholders,⁸³ nonprofits are voluntarily incorporating Sarbanes-Oxley principles at a rate higher than for-profit organizations not directly covered by the law.⁸⁴

Not only does voluntary compliance suggests that the cost-benefit analysis in the nonprofit sector is different than in the corporate sector, but nonprofits' access to lower-cost labor evidences the extent to which the cost of reform proposals may be limited. Nonprofits have access to a key resource that for-profit corporations do not: pro bono professionals.⁸⁵ While nonprofits may not have a preexisting infrastructure for regulatory compliance,⁸⁶ they may have access to free or reduced-price professional assistance to improve their organizational accountability. With the ability to harness the work product of charitably minded professionals, nonprofits can undertake

81. Unfortunately, providing a net benefit to the sector does not necessarily mean that each individual nonprofit will benefit. It is possible that some will have to bear costs that exceed their own benefit. This imbalance may cause some nonprofits to reduce services or shut down completely. For example, nonprofits that do not generally receive donations will not benefit from a boost in donor confidence. Whether some nonprofits are more severely impacted than others is a concern, and legislatures should monitor such effects.

82. J. GREGORY DEES ET AL., *ENTERPRISING NONPROFITS: A TOOLKIT FOR SOCIAL ENTREPRENEURS* 105 (2001).

83. Stakeholders include donors, beneficiaries, and the general public. The conventional wisdom is that corporations are accountable primarily to shareholders only.

84. PAUL D. BROUDE, *THE IMPACT OF SARBANES-OXLEY ON PRIVATE & NONPROFIT COMPANIES* 10 (2006), available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/3511/ndi%202006%20private%20study.pdf (attributing nonprofits' willingness to incorporate Sarbanes-Oxley principles to the fact that they have a "greater number of stakeholders to whom they are accountable"). The study found, for example, that ninety percent of nonprofits surveyed implemented or planned to implement independent-director requirements and ninety-seven percent of nonprofits utilize audit-committee oversight of auditors. *Id.*

85. See, e.g., Ariz. Soc'y of Certified Pub. Accountants, ASCPA: Find a CPA: Request a CPA for Pro Bono Nonprofit Work, http://www.ascpa.com/public/findacpa/request_for_pro_bono.aspx (last visited Nov. 10, 2007) (offering to connect nonprofits with volunteer CPAs).

86. See Gilkeson, *supra* note 8, at 848-49; see also *id.* at 835-43 (discussing the limited prereform nonprofit-accountability mechanisms).

some tasks at much lower cost than their for-profit counterparts. This further compels the conclusion that Sarbanes-Oxley accountability measures are more appropriate in the nonprofit sector than for some businesses.⁸⁷

*B. The Benefits of the Specific Nonprofit-Reform Proposals
Similarly Outweigh the Costs*

Critics overstate the potential costs as compared to the benefits of the proposed reforms detailed in Section I.B. They point out that certification provisions require officers to spend more time verifying their financial information and less time on their other duties.⁸⁸ Some argue that such constraints on an officer's time may necessitate additional staff.⁸⁹ Alternatively, the officer may be required to work longer hours and may demand additional compensation for this additional work. The nonprofit may have to choose between paying the officer more for his or her increased workload and paying an additional employee to perform the job functions the officer is no longer able to perform.

However, it is not clear that the additional time commitment will create a dearth of individuals willing to accept positions as officers in nonprofit organizations. In fact, many nonprofits have voluntarily adopted officer-certification requirements for their organizations, suggesting that the costs imposed by the reforms are outweighed by benefits. One recent survey found that eighty-one percent of surveyed nonprofits had either their board chair or CEO sign Form 990 statements.⁹⁰

Charging board members on an audit committee with greater responsibility will not scare away all individuals from board service. Some have argued that the increased responsibility the audit-committee reforms would impose "may make it more difficult to recruit volunteers" for nonprofit boards.⁹¹ In the for-profit world, the added responsibility imposed by Sarbanes-Oxley led to large increases in director pay.⁹² In the nonprofit world,

87. There is an intuitive argument that for-profit organizations "can more readily absorb additional costs because they can pass on compliance costs to customers or raise capital in other ways" not available to nonprofits. *Id.* at 849. Yet costs do not just disappear for a for-profit entity. A business that cannot justify the costs of its existence to investors or consumers will shut down as readily as a nonprofit that cannot similarly convince donors and foundations.

88. Reiser, *There Ought, supra* note 8, at 586. An officer of a nonprofit already has to sign Form 990 under perjury. The reforms differ in that they place the burden on senior management—the CEO, CFO, or chair of the board of directors.

89. *See id.*

90. Lester M. Salamon & Stephanie L. Geller, *Nonprofit Governance and Accountability*, COMMUNIQUE (Ctr. for Civil Soc'y Studies at the John Hopkins Univ. Inst. for Policy Studies, Baltimore, Md.), Oct. 2005, at 1, 5 (2005), available at http://www.allianceonline.org/publications/listening_post_communique_2.file.

91. Reiser, *There Ought, supra* note 8, at 596.

92. One survey finds between a fifty-eight percent and seventy-one percent increase in director pay over the period between 2001 and 2005. THOMAS E. HARTMAN, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY 10 (2006), available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/3420/ndi%202006%20public%20study%20FINAL.pdf.

by contrast, directors are typically unpaid volunteers recruited more for their fundraising potential than financial prowess.⁹³ Without being compensated for their work, they may be especially sensitive to new burdens placed on their time, particularly tedious audit-oversight duties.⁹⁴ However, the fact that these directors contribute time with minimal or no expectation of payment may suggest an especially strong commitment to the organization's mission and a lack of sensitivity to additional burdens on their time. Moreover, the accompanying prestige and other rewards of serving as a director for a well-respected nonprofit offset worries about an additional time commitment. Thus nonprofit directors will not decline to serve merely because they may be required to serve on an audit committee with increased responsibility.⁹⁵

Finally, the auditing requirements are tailored to the ability of the nonprofit to afford such audits.⁹⁶ One commentator estimates that it will cost "close to \$10,000" to comply with the auditing requirements, or approximately 4% of a smaller organization's annual revenue.⁹⁷ However, the auditing requirements only apply to relatively large nonprofits.⁹⁸ Nonprofits choosing to voluntarily undergo an audit spend no more than 1% of overall revenue on the audit, and most spend far less. Nonprofits with annual revenue between \$2 million to \$3.8 million spend an average of 0.37% of revenue on audits, while nonprofits with revenue between \$4 million and \$9 million spend only 0.26%.⁹⁹ And perhaps the strongest evidence of the relative cost of the audit requirements is that 97% of nonprofits audit their financial reports, "even though only 40 percent of the organizations reported being aware of a state requirement to be audited."¹⁰⁰

III. THE REFORMS CREATE SIGNIFICANT BENEFITS FOR THE NONPROFIT SECTOR

The reforms will benefit the nonprofit sector by increasing financial accountability and improving donor confidence.¹⁰¹ Section III.A argues that the

93. Mulligan, *supra* note 8, at 1987–88.

94. See Reiser, *There Ought*, *supra* note 8, at 596.

95. One commentator actually advocates granting standing to a greater number of people to increase the number of lawsuits against nonprofit directors. Gilkeson, *supra* note 8, at 853. This approach would undoubtedly exacerbate the worry that directors would decline positions because exposing them to additional liability will certainly cause more fear than the simple imposition of additional duties.

96. Szymanski, *supra* note 8, at 1318; Reiser, *There Ought*, *supra* note 8, at 594.

97. Szymanski, *supra* note 8, at 1318.

98. See *supra* Section I.B.

99. PANEL REPORT, *supra* note 42, at 36, n.3 (citing a United Way survey).

100. Salamon & Geller, *supra* note 90, at 5.

101. Some critics argue that the reforms are inappropriate because they focus too narrowly on financial accountability instead of mission accountability. Mulligan, *supra* note 8, at 1991; Reiser, *Enron.org*, *supra* note 8, at 212–15. However, the focus on financial accountability over mission accountability is appropriate. After all, the reforms are trying to alleviate a perceived *financial* crisis in the sector. See *supra* Section I.A. Further, it is easier to create legislative enactments targeting financial

reforms will benefit the nonprofit sector by improving nonprofit financial practices, either through donor enforcement of best practices or by reminding nonprofit actors of their duties to run financially sound organizations. Alternatively, Section III.B argues that even if the reforms do not actually improve financial practices at any particular firm, they will nevertheless allay the concerns of nonprofit donors, thereby increasing revenue. Finally, Section III.C suggests that voluntary compliance by some nonprofits is insufficient to solve the problems of the nonprofit sector and that legislation is the most effective means to accomplish these ends.

A. *The Reforms Will Enhance Financial Management*

The reforms will improve financial management of nonprofit organizations in several ways. Section III.A.1 argues that the reforms will improve financial management by arming donors with better information.¹⁰² Section III.A.2 argues that donors will use this enhanced information to monitor nonprofits and demand better financial practices. Even if donors do not actually use the information, Section III.A.3 argues that the reforms will improve financial management because nonprofit actors will either miscalculate the risk of donor enforcement or voluntarily improve their behavior.

1. *The Reforms are Tailored to Improve Data Disclosure*

Assuming that nonprofits comply with them,¹⁰³ the reforms will likely lead to the release of more accurate financial data.¹⁰⁴ The reforms provide a series of safeguards designed to improve financial data, even catching willfully bad acts. The CEO-certification requirement encourages officers to ensure that financial data are accurately reported and ensures that sufficient internal-control processes are in place to catch financial mismanagement at lower levels of the organization.¹⁰⁵ Requiring the CEO's signature on financial

accountability than other forms of accountability. *Cf. Reiser, Enron.org, supra* note 8, at 227–28 (noting that attorneys generally avoid enforcing mission accountability because mission creep is subtler and less concrete and therefore more difficult to detect and prevent). Finally, financial abuse is easier to hide than straying from one's mission. While financial data can be evaluated by objective standards, missions are subjective, with one nonprofit's mission appealing to one person but not another. As a result, nonprofits lack the same incentive to misstate their mission as to misstate their finances.

102. This requires both that nonprofits comply with the reforms' requirements and that the requirements are tailored to make disclosure more accurate rather than a pointless obstacle. A reform that requires annual reports to be printed on pink sheets, for example, may be complied with and yet will utterly fail to improve the data disclosed.

103. It will be relatively easy for state attorneys general to determine whether a nonprofit is in compliance with these reform and to force compliance if not. Ascertaining whether a nonprofit complied with the auditing requirement is as simple as checking for an auditor's report. *See Reiser, There Ought, supra* note 8, at 594.

104. Some have criticized the officer-certification requirements as providing no protection against willfully misbehaving actors. *Id.* at 584, 590. Similarly, if the auditor is complicit with management, abuses may not come to light. *Id.* at 594. Finally, a innocent yet financially inexperienced CEO or audit committee may comply with the additional duties but still fail to catch mistakes. *Id.* at 596.

105. *See supra* Section I.B.1.

documents may increase enforcement by aiding prosecution against a malevolent CEO.¹⁰⁶ Having a separate audit committee clarifies the financial-oversight responsibility of the committee's members. Finally, absent complicity, the outside auditor "should unearth at least some inaccuracies and abuses that otherwise would go unnoticed."¹⁰⁷

2. Donors Will Use the Improved Data to Force Improved Financial Management

Despite critics' assertions to the contrary,¹⁰⁸ donors are likely to use the enhanced data to force improved financial management. Sarbanes-Oxley is premised on the view that the market for corporate shares is a sufficient regulator of corporate governance if investors have sufficient financial information. In contrast to the suggestion of critics,¹⁰⁹ the available evidence suggests that donors *do* use financial data, and nonprofit organizations are complying with this practice to increase fundraising capacity.¹¹⁰ Although industry analysts are absent from the nonprofit world, organizations do collect and share nonprofit financial data. The existence of these organizations suggests demand for their services. GuideStar, for example, is a nonprofit that runs a database that contains financial information on more than

106. See Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 953 (2003) ("[T]he executive certification requirement [of Sarbanes-Oxley] will make it easier to establish fraudulent conduct if its effect is to eliminate the defenses of lack of knowledge or good faith.").

107. Reiser, *There Ought*, *supra* note 8, at 594.

108. Mulligan, *supra* note 8, at 1997–98; Reiser, *There Ought*, *supra* note 8, at 603–05.

109. Critics question whether either donors or state attorneys general will use this data. This Section concedes that reliance on state attorneys general for enforcement of better financial practices would be misplaced. State attorneys general are burdened by a "legendary" lack of manpower and a limited budget. Reiser, *There Ought*, *supra* note 8, at 598. For example, ten attorneys in California's Office of the Attorney General are charged with overseeing 90,000 nonprofits across the state. Erika Torres, *Nonprofit audit act brings high-profile clash to O.C.*, ORANGE COUNTY REG. (Santa Ana, Cal.), June 11, 2005. Even with proper funding, there remains the danger of "agency capture" by relatively powerful nonprofits. Mulligan, *supra* note 8, at 1997.

Two studies cited by critics of the reforms provide only extremely weak support for the proposition that donors do not want better information. One study surveyed twenty-two individuals who collectively donate \$50 million per year to charities and found that only four were "strongly interested" in getting better data on *performance* (not financial information) from nonprofits. Katie Cunningham & Marc Ricks, *Why Measure?*, STAN. SOC. INNOVATION REV., Summer 2004, at 44, 46. Although limited by its small sample size, the survey found that participants might reject an ill-fated attempt at quantifying *mission* success (for example, one metric defined success by an increase in the number of volunteers) but still desire more objective financial information. See *id.* at 46, 49. Another study cited by critics, DAVID M. VAN SLYKE & ARTHUR C. BROOKS, CMTY. FOUND. FOR GREATER ATLANTA, *THE POWER OF ONE: 2001 REPORT ON PERSONAL CHARITABLE GIVING IN GREATER ATLANTA* (2001), available at <http://www.atlcf.org/Webdata/Documents/35/GivingStudyFinal.pdf>, was not intended to investigate this issue, and the little relevant evidence found in the study is contrary to the critics' claim. For example, the study found that sixty-two percent of those who received information on how a donation is used were likely to donate. *Id.* at 18. The study actually recommends that nonprofits take *more* steps to share enhanced financial information with potential donors, for example, by creating a web-based nonprofit registry. *Id.* at 22.

110. One critic of nonprofit reforms notes the effectiveness of informal donor regulation, even suggesting it as an alternative to other forms of regulation. Gilkeson, *supra* note 8, at 842, 853–54.

1.7 million nonprofit organizations and is visited eight-million times annually.¹¹¹ Similarly, the Better Business Bureau Wise Giving Alliance certifies nonprofits that meet its governance standards.¹¹² In fact, 90,000 nonprofits have voluntarily uploaded *additional* financial information to these databases to reach out to prospective donors.¹¹³ Ensuring the integrity of this data is vital for the thousands of donors who rely on it when making decisions.

3. *Nonprofit Financial Management Would Improve Even if Donors Do Not Use Enhanced Disclosures*

Even if donors and state actors do not rely on enhanced disclosure, the reforms may still be beneficial. First, even if there is no *real* risk that the financial data will lead to donor or government sanction, nonprofit actors may mistakenly *perceive* such a risk and alter their behavior accordingly.¹¹⁴ Thus even a willfully malicious actor may improve her behavior if she overestimates the likelihood of enforcement.¹¹⁵

Absent an actual risk, the reforms have an underappreciated communicative aspect that signals the importance of financial-data integrity. The laws may be effective by causing nonprofit actors to internalize the concerns underlying the reforms.¹¹⁶ Diligent managers, cued by the reforms to treat bookkeeping with heightened care, will avoid inadvertent mismanagement.¹¹⁷ The publicity generated by these laws, with the resulting dialogue on the importance of solid finances, should inspire better financial oversight by nonprofit managers.

B. *The Reforms Will Alleviate the Concerns of Donors*

Regardless of the extent to which these reforms enhance financial practices at a given nonprofit, the reforms will alleviate donors' concerns and

111. GuideStar.org, About GuideStar and Philanthropic Research, Inc., <http://www.guidestar.org/about/index.jsp?source=dnabout> (last visited Nov. 10, 2007). Note that this is despite the often incomplete and inaccurate data sought to be cured by the reforms.

112. Give.org, National Charity Seal Program, <http://www.give.org/seal/abouttheseal.asp> (last visited Nov. 10, 2007).

113. Todd Cohen, *Financial Disclosure Takes Root, Although Some Still Balk*, NONPROFIT TIMES, July 1, 2005, at 1, available at <http://www.nptimes.com/Jul05/npt3.html>.

114. Risks are often inaccurately estimated, and *perceived* risks drive behavior more than *actual* risks. See, e.g., Rae M. Lamb et al., *Hospital Disclosure Practices: Results of a National Survey*, HEALTH AFF., Mar.-Apr. 2003, at 73, 80 (discussing the litigation risks involved with hospitals' voluntary disclosure of unexpected treatment outcomes).

115. See Reiser, *There Ought, supra* note 8, at 585 ("In the absence of clear and effective penalties for noncompliance, a nonprofit officer envisioned as a Holmesian "bad man"—who follows only law that predictably will be enforced against him—likewise would not change his behavior . . .").

116. This argument is bolstered by a common-sense notion that people who devote their time and energy to nonprofit organizations are "good guys."

117. See Reiser, *Enron.org, supra* note 8, at 276-77 (proposing programs to train managers of nonprofits on the importance of accountability).

therefore increase willingness to donate to nonprofits.¹¹⁸ A mistake often made by the commentators is to conclude that donors will make donations regardless of a nonprofit's financial integrity because they lack the incentive to investigate the financial health of an organization prior to donating.¹¹⁹ To the contrary, *as a result of* the information costs associated with determining an individual nonprofit's financial integrity, some donors may stop donating to even well-managed nonprofits because malfunctioning nonprofit organizations are most prominent in their minds.¹²⁰ Just as defenders of corporate reforms contend that Sarbanes-Oxley buoyed the investor confidence shaken by Enron and other contemporary scandals,¹²¹ so too the nonprofit reforms may improve donor confidence by improving access to financial data.

News stories surrounding the consideration and adoption of reforms will combat the negative press that created the public distrust of charities.¹²² Further, nonprofits can utilize the reforms in fundraising material, noting the systems in place to ensure sound financial management.¹²³ Most importantly, the reforms—particularly those mandated by legislation—provide a way for “good” nonprofits to limit the damage caused by the “bad.” By binding themselves and nonprofits resistant to disclosure to sound practices, they may avoid future scandals.¹²⁴ News stories about a small number of actors can taint the entire sector, and nonprofits concerned about donor distrust need to demonstrate not only that *they* are trustworthy but that *other* non-

118. One critic downplays the benefits that nonprofit reforms bestow. Gilkeson, *supra* note 8, at 852. Essentially she argues that donors part with their money voluntarily and so have less interest in how the money is spent than an investor in a business. *Id.* Further, “[b]eneficiaries may be deprived of a benefit, but it is not a benefit to which they are legally entitled.” *Id.* Even assuming that such a cramped definition of interest is appropriate, it overlooks the benefits raised in this Part.

119. See Mulligan, *supra* note 8, at 1998–99.

120. For example, consider how public perception of the entire sector depended so much on the image of a handful of high-profile nonprofits. See *infra* Part I.

121. See John Paul Lucci, *Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 246–48 (2003); David Henry, *Not Everyone Hates SarbOx*, BUSINESSWEEK, Jan. 29, 2007, at 37 (“SarbOx and related reforms have produced much more reliable corporate financial statements, which investors rely on when deciding whether to buy or sell shares. For them, SarbOx has been a godsend.”).

122. A search on LexisNexis “News, All” database for references to the California Nonprofit Integrity Act showed forty-five hits that mention the act. Among these hits are an article in the *New York Times*, which has a circulation over one million, and an article in the *NonProfit Times*, which claims a readership of over 85,000 nonprofit executives. *NonProfit Times*, <http://www.nptimes.com/main/subscribe.html> (last visited Nov. 10, 2007) (providing *NonProfit Times* circulation data); New York Times Company: Revenue & Circulation Data, <http://www.nytc.com/investors/financials/nyt-circulation.html> (last visited Nov. 10, 2007) (providing *New York Times* circulation data); see also Mark Hrywna, *Special Report: The Sky Isn't Falling: Fear of SOX is Waning*, NONPROFIT TIMES, Apr. 1, 2006, at 19; Bernard Stampler, *After a Spate of Scandals, A Debate on New Rules*, N.Y. TIMES, Nov. 15, 2004, at F25. The press accounts tend to assume the benefit of the reforms yet bemoan the cost.

123. For example, United Way and Red Cross have posted statements on accountability on their web pages. Red Cross, Governance, http://www.redcross.org/services/governance/0,1082,0_234_00.html (last visited Nov. 10, 2007); United Way, Accountability, <http://national.unitedway.org/about/accountability.cfm> (last visited Nov. 10, 2007).

124. See *infra* Section III.C.

profits are as well.¹²⁵ That some of the reforms are addressed only to larger nonprofits suggests the importance of boosting confidence in the most visible charities to maintain confidence across the entire sector.¹²⁶

*C. Legislation Is the Most Effective Way
to Accomplish These Goals*

The best way to accomplish the cost-effective reforms laid out above is through mandatory regulation.¹²⁷ If widely adopted, voluntary reforms will prevent financial mismanagement but will not be fully effective in preventing fraud or restoring donor confidence.¹²⁸ If left as a best-practices suggestion, the reforms may only be adopted by those nonprofits that are already concerned about financial integrity. Those nonprofits that most need tighter financial management are unlikely to adopt the voluntary proposals because financial management is not a priority for them. Even “good” nonprofits may suffer from an agency problem where the best-intentioned nonprofit managers will be especially sensitive to the burdens of reforms that accrue to them personally but less sensitive to the benefits that flow to the organization as a whole.¹²⁹ When a scandal develops at one of these

125. Cf. Gilkeson, *supra* note 8, at 842 (noting that the media “focus[es] only on the largest and most well-known charities and the worst offenders”). For example, the public’s perception of the nonprofit sector at large is tied closely to its perception of just a few, large charities. See *supra* note 29 and accompanying text.

126. Thus it is really the smaller nonprofits that have yet to establish a reliable name for themselves that will benefit from increased confidence in the sector, without having to endure the same costs as larger nonprofits.

127. Further, state-level regulation (as opposed to federal regulation) is more appropriate here than it is in corporate reform. First, like for-profit entities, nonprofits are inherently creatures of state law and have historically been regulated at the state level. Unlike for-profit entities, however, nonprofits are less associated with commerce. (In fact, extensive federal regulation of nonprofits could raise constitutional issues about exceeding federal authority under the commerce clause if such regulation was not tied to the taxing power.) Moreover, unlike centrally managed corporations, nonprofits tend to have a decentralized structure, with local affiliates in states possessing some degree of autonomy from the national organization. Finally, although the scandals affecting the corporate world were national in scope, many of the nonprofit scandals affected local nonprofit affiliates and were covered primarily by the local press. In states where scandals have not been a big concern, the legislature could enact reforms tailored to the fears of the local population.

128. See *supra* Section II.B.

129. This is analogous to Supreme Court cases that establish qualified immunity for certain public officials for civil-rights violations but decline to extend immunity to municipal entities. The Court reasoned that personal liability would distort decision making because although it amplifies the cost of certain actions, the benefits of compliance are not directly experienced by the official. Compare *Scheuer v. Rhodes*, 416 U.S. 232, 240 (1974) (denying personal liability because of the “danger that the threat of such liability would deter his willingness to execute his office with the decisiveness and the judgment required by the public good”), with *Owen v. City of Independence*, 445 U.S. 622, 653 n.37 (1980) (“[I]mposing personal liability on public officials could have an undue chilling effect on the exercise of their decision-making responsibilities, but that no such pernicious consequences were likely to flow from the possibility of a recovery from public funds.”). But see *Owen*, 445 U.S. at 668–69 (Powell, J., dissenting) (arguing that “responsible” public officers will be deterred the same regardless of whether the judgment comes from personal or municipal funds).

nonprofits, the resulting media attention damages the entire sector.¹³⁰ Mandatory legislation provides a way to prevent these nonprofits from tainting the entire sector.¹³¹

Further, legislatively imposed reforms are a more effective way of assuaging the public's fears. It appears that the media is willing to focus its attention on the bad acts of a single nonprofit, yet it apparently takes a gesture as dramatic and widespread as the California Nonprofit Integrity Act to paint the sector in a positive light. The public may take better notice of legislation that changes the rules for a whole class of nonprofits than merely a single nonprofit that changes policy.¹³² Legislation can be a tool for the nonprofit sector to mitigate the damage caused by the "bad apples" while generating increased confidence among potential donors.

CONCLUSION

Nonprofits serve a role far different from their corporate counterparts, yet both the nonprofit and corporate sectors suffer from similar effects of financial mismanagement. Preserving the vibrancy of nonprofits through targeted reforms is vital to the millions of Americans who benefit from this sector every day.

State legislatures should enact regulations to improve confidence in the nonprofit sector because such trust is crucial for the sector's vitality and its ability to obtain donations. The reforms modeled on Sarbanes-Oxley improve the accuracy of financial disclosure and appease the concerns of donors without imposing insurmountable burdens on the sector. The reforms provide a net benefit to the sector, increasing donations and ensuring that the donations received are not inappropriately diverted to the unlawful benefit of a few corrupt insiders.

130. See *supra* Section II.B.iii.

131. See *supra* notes 27–29 and accompanying text.

132. See *supra* Section II.B.iii.