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STATE OVERSIGHT OF NONPROFIT GOVERNANCE: CONFRONTING THE CHALLENGE OF MISSION ADHERENCE WITHIN A MULTI-DIMENSIONAL STANDARD

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STATE OVERSIGHT OF NONPROFIT GOVERNANCE:
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Mark S. Blodgett,^{*} Linda J. Melconian,^{**} and Jason H. Peterson^{***}

“Donors generally do not expect to receive benefits from their donations, but they do anticipate their funds will be used to support the mission [adherence] of the organization.”¹

I. INTRODUCTION

Nonprofit governance is a national concern because these ubiquitous organizations comprise a significant part of the U.S. economy and workforce.² For example, in 2010, approximately 1.6 million nonprofits

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¹ Danné L. Johnson, *Seeking Meaningful Nonprofit Reform in a Post Sarbanes-Oxley World*, 54 ST. LOUIS U. L.J. 187, 193 (2009).

² NONPROFITS BY THE NUMBERS, <http://www.councilofnonprofits.org/telling-our-story/nonprofits-numbers> (last visited Aug. 25, 2013). Perhaps a unique aspect of American society as commented by Alex de Tocqueville, “Americans of all ages, all stations in life, and all types of dispositions . . . are forever forming associations” necessary for a democratic form of government where “all citizens are equally independent and cannot rely on a powerful central government to dictate values or dispense charity.” 2 ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 129 (Cambridge: Sever & Francis 1863) (1840). See also AMY S. BLACKWOOD ET AL., *URBAN INST., THE NONPROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING*, 2012, at 2 tbl.1 (2012). See also Mark S. Blodgett, Linda J. Melconian & Jason H. Peterson, *Evolving Corporate Governance Standards for Healthcare Nonprofits: Is Board of Director Compensation a Breach of Fiduciary Duty?*, 7 BROOKLYN J. CORP. FIN. COM. L. 443, 444 (2013) (discussing prevalence of nonprofit associations).

were registered with the Internal Revenue Service (IRS) as public charitable organizations exempt from taxes; forty percent reported assets totaling \$4.49 trillion.³ Today, President and Fellows of Harvard College, the nation's largest public nonprofit charity, report assets of nearly \$60 billion.⁴

Human services, healthcare and education are the three largest categories of nonprofit organizations, representing 34.0%, 12.1% and 18.2% respectively of the total nonprofit sector.⁵ Additionally, foundations, community centers, churches and religious orders, veteran and fraternal organizations, and private golf clubs are among those nonprofits that qualify for tax-exemption.⁶ Their total impact on the U.S. economy is significant: approximately a 24% growth rate for nonprofits in the last 10 years; a growth rate that surpasses the growth rate of both business and government; an impact which contributes \$804.8 billion or 5.5% of National Gross Domestic Product.⁷ Their paid and volunteer workers comprise more than 10% of the total workforce.⁸ Such economic impact requires responsible nonprofit governance committed to the adherence of the nonprofit mission.⁹

This article proposes that nonprofit governance includes three dimensions and that states confront the challenge of mission adherence

³ See BLACKWOOD ET AL., *supra* note 2, at 2 (detailing break down of nonprofits in United States); see also Johnson, *supra* note 1, at 194; Elizabeth T. Boris, Erwin de Leon, Katie L. Roeger & Milena Nikolova, *National Study of Nonprofit-Government Contracting: State Profiles*, URBAN INSTITUTE (Sept. 2009); see also 26 U.S.C. § 501(c)(3) (2012). For example, health care nonprofits include 60% of community hospitals, all community health centers, nearly 30% of nursing homes, approximately 17% of home health care agencies, and 40% of all private health insurance enrollees. See also AMY S. BLACKWOOD ET AL., URBAN INSTITUTE, *NONPROFIT ALMANAC*, 2012 (2012).

⁴ See *Largest Organizations (NCCS, Core 2011 Public Charities File)*, National Center for Charitable Statistics, URBAN INSTITUTE (2011), http://nccsdataweb.urban.org/PubApps/showTopOrgs.php?cat=ALL&amt=ass_eoy.

⁵ See BLACKWOOD ET AL., *supra* note 2, at 4; see also *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, PANEL ON THE NONPROFIT SECTOR 11 (June 2005) (graphically demonstrating "Breakdown of Charitable Organizations by Mission").

⁶ See BLACKWOOD ET AL., *supra* note 2, at tbl.1.1, at 4–5 (noting expansiveness of tax-exempt organizations listed in Internal Revenue Code); 26 U.S.C. § 501(c) (2012) (listing categories of tax-exempt organizations).

⁷ See *supra* note 3 and accompanying text.

⁸ See Johnson, *supra* note 1, at 195.

⁹ EVELYN BRODY, *THE STATE OF NONPROFIT AMERICA* 476 (Lester Salamon ed., Brookings Institution Press 2002) (discussing importance of adhering to donor direction and mission).

within this multi-dimensional standard.¹⁰ This suggested standard must include the often overlooked and unregulated adherence to mission.¹¹ It must also include the highly visible public and scholarly considerations of fiduciary leadership and financial integrity.¹² The importance of financial integrity for nonprofits is indisputable since a nonprofit Board of Directors must govern by conserving and properly managing the organization's assets.¹³ Furthermore, a nonprofit Board maintains a consistent fiduciary responsibility to govern the organization in a manner that accomplishes its mission and state oversight should complement this responsibility.¹⁴ Thus, a multi-dimensional standard sets the tone for enhanced collaboration between State Attorneys General and nonprofit leadership.

The essence of any public charitable nonprofit organization is the *mission statement*, which fully identifies and develops its values, purpose and goals.¹⁵ Once the Articles of Incorporation are filed in the state where the nonprofit is incorporated, it can seek a tax-exempt benefit from the IRS.¹⁶ This benefit presumes an ethical obligation of public trust since the public taxpayer bears the burden of nonprofit support.¹⁷ Consequently,

¹⁰ Gary Kirk & Shabnam Beth Nolan, *Nonprofit Mission Statement Focus and Financial Performance*, 20 *NONPROFIT MANAGEMENT & LEADERSHIP* 473, 477–78 (2010) (“Most authors agree that nonprofit organizational performance is multi-dimensional, but there is no accepted standard of effectiveness [for accomplishing mission].”)

¹¹ See *infra* notes 78–80 and accompanying text.

¹² See Kirk & Nolan, *supra* note 10, at 477–78 (discussing multidimensional approach to nonprofit governance).

¹³ See Panel on the Nonprofit Sector, *Principles for Good Governance and Ethical Practice: Guide for Charities and Foundations*, INDEPENDENT SECTOR (Oct. 2007), <http://www.nacua.org/documents/GoodGovernance.pdf> (discussing legal compliance, governance, financial oversight and fundraising in nonprofit organizational context).

¹⁴ See *id.*

¹⁵ R. Duane Ireland & Michael A. Hitt, *Mission Statements: Importance, Challenge, and Recommendations for Development*, 35 *BUS. HORIZONS* 34, 34 (1992) (discussing importance of mission statement as guiding principle for nonprofits); Kirk & Nolan, *supra* note 10, at 477–78; Ralph Hader, *More than Words: Providing a Clear and Concise Mission Statement*, 37 *NURSING MGMT.* 6, 6 (July 2006) (noting importance of dedication to mission statement).

¹⁶ I.R.C. § 501 (2006); see also National Council of Nonprofits—“How to Start a Nonprofit,” <http://www.councilofnonprofits.org/resources/how-start-nonprofit> (listing five general steps regarding how to start a nonprofit organization).

¹⁷ *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, PANEL ON THE NONPROFIT SECTOR 9, http://www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf (June 2005) (highlighting public trust as important factor to success of nonprofit organizations). See generally Arthur W. Page Society, *The Dynamic of Public Trust in Business—Emerging Opportunities for Leaders: A*

society demands that nonprofits fulfill their unique purpose and historic mission, an essential part of their governance.¹⁸

The authors investigated state application of a multi-dimensional standard of nonprofit governance in twelve states with the largest numbers of public charitable nonprofit corporations: California, Florida, Illinois, Massachusetts, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Texas, and Virginia.¹⁹ A review of State Attorneys General websites and nonprofit statutes in each of these states helps to ascertain state oversight of nonprofit governance.²⁰ State Attorneys General in six of the twelve states—California, Massachusetts, Michigan, Ohio, Pennsylvania and Texas—have a separate Charities or Nonprofit Division with limited staffing to carry out their regulatory responsibilities of oversight, accountability and enforcement as well as monitoring nonprofit initiatives.²¹ Moreover, state guidance of nonprofits varies from state to state.²² Most significantly, this regulatory review demonstrates no

Call to Overcome the Present Crisis of Trust in Business, BUSINESS ROUNDTABLE INSTITUTE FOR CORPORATE ETHICS 6 (2009), http://www.corporate-ethics.org/pdf/public_trust_in_business.pdf (discussing importance of trust in businesses generally). As this special report makes clear, “public trust in business” is not only a concern for nonprofit organizations, but rather stretches across all businesses. *See id.*

¹⁸ *See supra* note 15 and accompanying text.

¹⁹ *See* Table 1.

²⁰ *See, e.g.*, State Dep’t of Justice, California Office of the Attorney General, <http://oag.ca.gov/> (last visited Jan. 20, 2014); State Dep’t of Justice, Florida Office of the Attorney General, <http://myfloridalegal.com/> (last visited Jan. 20, 2014); State Dep’t of Justice, Illinois Office of the Attorney General, <http://illinoisattorneygeneral.gov/> (last visited Jan. 20, 2014).

²¹ *See* Office of the Attorney Gen., *Services and Information: Charities*, CAL. STATE DEP’T OF JUSTICE, <http://oag.ca.gov/charities> (last visited Apr. 10, 2013); *The Nonprofit Organizations/Public Charities Division*, ATTORNEY GEN. OF MASS., <http://www.mass.gov/ago/bureaus/business-and-labor/the-nonprofit-organizations-public-charities-division/> (last visited Apr. 10, 2013); State of Mich., *Consumer Protection: Charities*, ATTORNEY GEN. BILL SCHUETTE, http://www.michigan.gov/ag/0,4534,7-164-17337_18095---,00.html (last visited Apr. 10, 2013); *Services for Charities*, MIKE DEWINE: OHIO ATTORNEY GEN., <http://www.ohioattorneygeneral.gov/Business/Services-for-Charities> (last visited Apr. 10, 2013); *Charitable Trusts and Organizations Section*, PA. ATTORNEY GEN., <http://www.attorneygeneral.gov/consumers.aspx?id=227> (last visited Apr. 10, 2013); *Charities and Nonprofits: Registration and Filings*, ATTORNEY GEN. OF TEX. GREG ABBOTT, <https://www.oag.state.tx.us/consumer/nonprofits.shtml> (last visited Apr. 10, 2013) [hereinafter *Charities and Nonprofits*].

²² *See supra* note 21 (citing to states’ charities divisions). For example, California, Ohio and Pennsylvania all have links to nonprofits handbooks that help guide the organization. *See generally* Office of Attorney Gen., *Handbook for Charitable Nonprofit Organizations*, COMMW. OF PA. (Nov. 2011), <http://www.attorneygeneral.gov/uploadedFiles/Consumers/nonprofitbooklet.pdf>; Edmund G. Brown, Jr., *California Attorney General’s Guide for Charities*, ATTORNEY GEN. STATE OF CAL. (2005),

recognition or identification of mission adherence, today's most pressing nonprofit governance challenge.²³

This article concludes by proposing a multi-dimensional standard of governance which confronts the challenge of mission adherence. State Attorneys General through their National Association of State Attorneys General (the National Association) should work with other nonprofit leadership to articulate, enable, and monitor this standard.²⁴ Furthermore, they must collaborate with members of the National Council of Nonprofits to guide nonprofit governance.²⁵ This collaboration should propose a "State Nonprofit Best Practices" initiative to advance a multi-dimensional standard of governance that adequately addresses the challenge of mission adherence.²⁶ The best practices should include the development of mission adherence criteria and a mechanism for communicating the nonprofits' satisfaction of the criteria to the stakeholder community.²⁷

http://oag.ca.gov/sites/all/files/agweb/pdfs/charities/publications/guide_for_charities.pdf?; Charitable Law Section, *Handbook for Nonprofits: An Operational Resource for Members of Charitable Organizations*, OHIO ATTORNEY GEN. MIKE DEWINE'S OFFICE, <http://www.ohioattorneygeneral.gov/OhioAttorneyGeneral/files/4e/4ebbc2fe-b053-427e-8730-de6cbd0244ff.pdf>. Massachusetts, Florida, and Texas, on the other hand, merely provide general guidelines for nonprofit organizations regarding registration, filing, taxes, etc.

²³ See Table 2a.

²⁴ See KEVIN P. KEARNS, *THE STATE OF NONPROFIT AMERICA* 589 (Lester Salamon ed., Brookings Institution Press, 2d ed. 2002) (noting importance of measureable standard).

²⁵ See *Find Your State Association*, NATIONAL COUNCIL OF NONPROFITS, <http://www.councilofnonprofits.org/find-your-sa> (last visited Apr. 11, 2013) (listing all states with an individual state Association of Nonprofits). It may also include such organizations as the National Association of Nonprofit Accountants and Consultants, a national affiliation of independently owned accounting firms who assist nonprofits to improve their governance. *Welcome to NPAC*, NATIONAL ASSOCIATION OF NONPROFIT ACCOUNTANTS AND CONSULTANTS, <http://www.nonprofitcpas.com/public/default.asp> (last visited Mar. 19, 2013).

²⁶ See *supra* notes 12 and 15 and accompanying text.

²⁷ See *infra* note 111 and accompanying text (discussing importance of transparency); see also KEARNS, *supra* note 24, at 589 (discussing dimensions of accountability on behalf of nonprofits). "All stakeholders must embrace the oversight system that accurately tracks compliance or performance relative to the standard as well as reporting procedures that capture the relevant information and convey it in a timely manner to the overseeing authority." *Id.* See also BRODY, *supra* note 9, at 488 (noting movement towards public disclosure on behalf of nonprofits).

II. BACKGROUND

A. Nonprofits: A Unique History

Nonprofit corporations possess distinctive qualities, benefits and obligations, and derive their formation, governance and organizational existence from three historic roots.²⁸ First, the tax-exempt benefit, based on their legal formation and purpose, dates back to sixteen and seventeen century Acts of the British Parliament which granted a tax-exempt status to certain health and educational institutions whose mission benefited the public good.²⁹ To receive this tax benefit today, charitable nonprofit organizations must commit in their legal formation to faithfully carry out a specific, charitable public purpose.³⁰ Additionally, they must commit their profits to this public purpose rather than distribute net earnings to those who control the organization.³¹

Secondly, our tradition of nonprofit governance is one that is largely autonomous from government control as provided by founding charters of colonial America.³² An early example is the establishment of Harvard

²⁸ See *infra* notes 29–38 and accompanying text (discussing history of nonprofit corporations).

²⁹ See Paul Arnsberger, Melissa Ludlum, Margaret Riley & Mark Stanton, *A History of the Tax-Exempt Sector: An SOI Perspective*, INTERNAL REVENUE SERVICE 105 (Winter 2008), see Peter Dobkin Hall, *A Historical Overview of Philanthropy, Voluntary Associations, and Nonprofit Organizations in the United States 1600–2000*, at 32, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (W.W. Powell & R. Steinberg eds., Yale Univ. Press, 2d ed. 2006) (focusing on history of nonprofit organizations in United States). Hospitals have long been tax exempt as provided by the 1597 Charitable Corporations Act. *Id.* Shortly thereafter, the 1601 Statute of Charitable Uses expanded such charitable scope for “maintenance of sick and maimed soldiers, schools of learning, free schools and scholars in universities.” *Id.* See also Blodgett et al., *supra* note 2, at 444.

³⁰ See Arnsberger *supra* note 29, at 106 (noting requirement that “charitable organizations operate for charitable purposes”); see also 26 U.S.C. § 501(c)(3) (2012) (including “[c]orporations . . . organized and operated exclusively for . . . charitable . . . purposes”). This requirement dates back to the Wilson-Gorman Tariff Act of 1894, one of the earliest acts to reference the tax-exempt status of nonprofit, charitable organizations.

³¹ Pamela C. Smith & Kelly A. Richmond, *Call for Greater Accountability Within the U.S. Nonprofit Sector*, 11 ACAD. ACC. & FIN. STUD. J. 75 (2007) (discussing prohibition against distributing profits to individuals in control of organization).

³² See Peter D. Hall, *A History of Nonprofit Boards in the United States*, BOARDSOURCE 3 (2003), <http://beech.ait.fredonia.edu/nfp/ReadingRoom/PDFs/BoardSource-AHistoryOfNonprofitBoardsInTheUnitedStates.pdf> (last visited July 10, 2013) (discussing Massachusetts Bay Company’s charter). See also Carlton Waterhouse, *Avoiding Another Step in a Series of Unfortunate Legal Events: A Consideration of Black Life Under American Law From 1619 to 1972 and a Challenge to Prevailing*

College.³³ In 1650, the Massachusetts colonial legislature initiated governance practices for nonprofits by granting Harvard an independent charter of incorporation with a specific mission to promote the public good.³⁴ Thus, Harvard developed a distinct governance framework promoting Board autonomy within the auspices of the colonial legislature's regulatory oversight.³⁵ From this colonial tradition states inherited the primary responsibility to exercise regulatory authority over nonprofit governance.³⁶

Lastly, a nonprofit's right to exist originates in the U.S. Constitution where the First Amendment's Right to Assemble implicitly allows for this large and powerful area of organizational activity.³⁷ Therefore, nonprofit charitable organizations, committed to serving public needs, maintain a unique and favored status in the United States for four reasons: first, adherence to their charitable public mission and purpose justifies the public policy of a tax-exempt status; secondly, nonprofits are removed from the day to day sway of political influence better enabling them to meet the challenge of their charitable mission; thirdly, nonprofits are distinguished from business entities because their mission is to stakeholders, not profits for shareholders; and lastly, they must adhere to Leonard Bacon's historic

Notions of Legally Based Reparations, 26 B.C. THIRD WORLD L.J. 207, 231 n.126 (2006) ("Colonists in Massachusetts established the Mayflower compact and only two colonies did not include self-governance provisions in their formation: New York and Georgia.").

³³ See Hall, *supra* note 32, at 5-7 (acknowledging challenges in deciding how to govern); The Charter of 1650, Harvard Corporation, <http://library.harvard.edu/university-archives/using-the-collections/online-resources/charter-of-1650>.

³⁴ See Hall, *supra* note 32, at 5; The Charter of 1650, Harvard Corporation, <http://library.harvard.edu/university-archives/using-the-collections/online-resources/charter-of-1650>. In 1636 Harvard College was created as an autonomous self-managing corporation free of control from the Massachusetts Colonial Legislature. See also Blodgett et al., *supra* note 2, at 447 (discussing founding of Harvard for public good).

³⁵ Hall, *supra* note 32, at 6; The Charter of 1650, Harvard Corporation, <http://library.harvard.edu/university-archives/using-the-collections/online-resources/charter-of-1650>.

³⁶ Hall, *supra* note 32.

³⁷ U.S. CONST. amend. I, § 1. "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances. *Id.*; see also Hall, *supra* note 32, at 10 (arguing right to assemble requires that nonprofits operate from the people not the government).

call for the highest standard of morality to assure continued public support for advancement of the nonprofit mission.³⁸

Such unique characteristics distinguish nonprofits from government and for-profit entities and help to explain why the public perceives them differently, generally regarding them as possessing a higher ethical standard of trust.³⁹ However, this perception belies current nonprofit reality.⁴⁰ For example, their historic standard of fiduciary duty has been diluted and today is similar to that of for-profits; yet nonprofits do not receive the same scrutiny as for-profits since state regulation is varied and limited.⁴¹ Additionally, it appears that a void exists in state regulation of nonprofit mission adherence.⁴² Furthermore, Congress generally excluded nonprofits from the Sarbanes Oxley Act leaving to the states the challenge of coordinating a response to this regulatory gap.⁴³

B. Nonprofit Regulatory Environment

The federal government regulates tax compliance of nonprofits through the IRS. The IRS utilizes the federal taxing power to grant to nonprofits a privileged tax-exempt status upon compliance with the tax code and its corresponding suggested governance guidelines.⁴⁴ The IRS

³⁸ Leonard Bacon, *Responsibility in the Management of Societies*, 5 THE NEW ENGLANDER 28, 29, 32, 33 (1847). Bacon asserted that the fiduciary duties of nonprofit Boards require both disclosure to placate the public and a high moral standard of governance as the guardians of others' property. *Id.* See also Blodgett et al., *supra* note 2, at 446 (discussing Bacon's standard of morality).

³⁹ Smith & Richmond, *supra* note 31, at 75 (discussing importance of ethical behavior due to nonprofits' need for public support to survive).

⁴⁰ *See id.*

⁴¹ *See id.* (noting nonprofits potential desire to operate under corporate governance model to remain competitive).

⁴² *See* Table 2a.

⁴³ *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (generally omitting nonprofits from consideration); *see also* Nicole Gilkeson, Note, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831, 844-45 (2007) (noting limited applicability Sarbanes-Oxley has on nonprofit organizations).

⁴⁴ I.R.C. § 7801 (2006). *See also* 26 U.S.C. § 501(c) (2012) (outlining organizations receiving tax-exempt status). Pursuant to this section, all

[c]orporations and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which

maintains a strong and necessary hand in monitoring the tax compliance of nonprofits. For example, in furtherance of its tax compliance, the IRS in 2006 revised its Form 990 requiring more transparency and disclosure from all nonprofits registering for a tax-exempt status.⁴⁵ Moreover, the IRS website identifies its mission consistent with its enabling statute: “[t]he IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.”⁴⁶ Thus, the IRS appears to have restricted its scope of nonprofit authority as one that is limited to tax compliance, not governance.⁴⁷

The IRS exercises jurisdiction over tax-exempt organizations through the Exempt Organizations Division (EOD).⁴⁸ However, the EOD’s capacity

inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

See id. The nine guidelines of good governance for nonprofits proposed by the IRS are

(1) Adoption of a Mission Statement, (2) Adoption of a Code of Ethics and Whistleblower policies, (3) Satisfaction of the Duty of Care/Director Diligence, (4) Satisfaction of the Duty of Loyalty/effective conflicts of interest oversight, (5) Constituent transparency, (6) Oversight of fund-raising activity, (7) Stewardship of financial affairs, (8) Payment of reasonable compensation; and (9) Adoption of a document retention policy.

IRS Releases Suggested Governance Guidelines for Tax-Exempt Organizations, MCDERMOTT WILL & EMERY (Feb. 5, 2007), <http://www.mwe.com/publications/uniEntity.aspx?xpST=PublicationDetail&pub=6137>; INTERNAL REVENUE SERV., GOOD GOVERNANCE PRACTICES FOR 501(C)(3) ORGANIZATIONS [hereinafter GOOD GOVERNANCE], available at <http://www.mwe.com/info/news/IRS0207.pdf>.

⁴⁵ *See 2010 Forms 990 and 990-EZ: Significant Changes*, IRS (Feb. 15, 2013), <http://www.irs.gov/Charities-&-Nonprofits/2010-Forms-990-and-990-EZ-Significant-Changes-1> (noting specific changes in Form 990, Part VI, regarding governance, management, and disclosure). Several newsworthy controversies led to the changes. *See, e.g.*, *Adelphi University v. Board of Regents of the State of New York*, 229 A.D. 2d 36 (1997) (finding high salary of President indicated that Board failed to achieve its educational mission and breached fiduciary duties); Karen Donnelly, *United Way, Good Governance: Has the IRS Usurped the Best Judgment of Tax Exempt Organizations in the Name of Transparency and Accountability*, 79 UMKC L. REV. 163, 173–74 (2010) (discussing nonprofit scandals including *Aramony v. United Way* involving excessive executive compensation, mismanagement, and misuse of organization’s donated funds); Keith Epstein, *Case Study: American Red Cross*, CONTRIBUTOR (2009) (discussing Red Cross’s failure to disclose withholding of \$200 million from 9/11 donations for administrative costs).

⁴⁶ Internal Revenue Service Homepage, available at <http://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority>. The IRS was created pursuant to a legislative grant within section 7801 of the Internal Revenue Code. I.R.C. § 7801 (2006).

⁴⁷ *See id.*

⁴⁸ Lloyd H. Mayer, *The Much Maligned 527 and Institutional Choice*, 87 B.U. L. REV. 625, 670 (2007).

to monitor the complexities of charitable nonprofit mission adherence is often diminished through other agency objectives that deviate from its own tax compliance authority.⁴⁹ The EOD has only 400 agents with a budget of \$62 million and supervises close to 1.2 million nonprofits.⁵⁰ In contrast, the Securities Exchange Commission has a budget of \$300 million with less than 14,000 publicly traded companies to supervise.⁵¹ Consequently, the director of the EOD has noted that its lack of resources require a self-regulating governance model that precludes the IRS from monitoring nonprofit mission.⁵² Currently, analyzing nonprofit mission adherence is largely a subjective challenge of qualitative and equitable determination.⁵³ Such analysis is contrary to the IRS's statutory authority of restrictive powers illustrating poignantly that nonprofit mission is to stakeholders a quality far more difficult to measure than shareholder profits.⁵⁴ The recent IRS scandal in which officials targeted conservative 501(c)(4) groups provides an apt example of the consequences when the IRS deviates from its stated mission and restrictive powers.⁵⁵

The states inherited our colonial tradition of primary responsibility to regulate nonprofits which are legally formed through filing state Articles of Incorporation.⁵⁶ This state regulation is carried out through State Attorneys General who oversee and supervise nonprofits and enforce the Board and Officer fiduciary duties to the organization.⁵⁷ For example, if a nonprofit

⁴⁹ *Id.*

⁵⁰ Peters Swords, *Tax Exempt Charitable Organizations* (ALI-ABA Course of Study Materials, Dec. 1996).

⁵¹ *Id.*

⁵² Shannon McGhee Hernandez, *Conversions of Nonprofit Hospitals to For Profit Status: The Tennessee Experience*, 28 U. MEM. L. REV. 1077 n.85, 1133 (1998); see also Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345, 1385–86 (2003).

⁵³ Evelyn Brody, *A Taxing Time for the Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 543 (1999); Evelyn Brody, *Book Review: The Twilight of Organizational Form of Charity: Musings on Norman Silber, A Corporate Form of Freedom: The Emergence of the Modern Nonprofit Sector*, 30 HOFSTRA L. REV. 1261, 1268 (2002).

⁵⁴ *Id.*

⁵⁵ Nicholas Confessore, *Uneven I.R.S. Scrutiny Seen in Political Spending by Big Tax-Exempt Groups*, N.Y. TIMES, May 13, 2013; see also *supra* note 45 and accompanying text.

⁵⁶ See *supra* note 21 (listing state attorneys generals' websites); see also Table 1.

⁵⁷ See CAL. CORP. CODE § 5000 *et seq.* (West 2013) (providing extensive statutory guidance for nonprofit organizations); MASS. GEN. LAWS ch. 180 § 1 *et seq.* (2013) (listing sections governing nonprofit organizations).

leader breaches his fiduciary duty, the Attorney General may coordinate the appointment of new fiduciaries.⁵⁸ Additionally, State Attorneys General regulate a variety of business forms and governance initiatives that dovetail with the IRS tax compliance function.⁵⁹ The IRS could therefore play a coordinating role with the state attorneys general to ensure that their respective interests are properly aligned.⁶⁰

The State Attorneys General are the public face of nonprofits and are responsible for consumer protection of donor contributions and oversight of nonprofits' assets.⁶¹ However, the traditional role of State Attorneys General exceeds mere responsibility for nonprofit oversight; it is the most visible and influential state office protecting consumers and fighting crime.⁶² Yet, individual state Attorneys General have competing agendas and interests and they must prioritize their activities utilizing scarce resources as reflected in inadequate staffing and budget allocations.⁶³ Their National Association may be a forum for leveraging resources to address the challenge of mission adherence.⁶⁴

⁵⁸ Brody, *supra* note 53, at 544.

⁵⁹ John Tyler, *Symposium: Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship: Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 150–51 (2010).

⁶⁰ Brody, *supra* note 53, at 591 n.29.

⁶¹ See MASS. GEN. LAWS ch. 180 § 1 *et seq.* (2013) (listing sections governing nonprofit organizations); Press Release, Mass. Att'y Gen. Office, Massachusetts Attorney General Martha Coakley Announces Enhanced Oversight of Nonprofit Executive and Board Compensation (Sept. 2, 2009), available at <http://www.mass.gov/ago/news-and-updates/press-releases/2009/ag-coakley-announces-enhanced-oversight-of.html>; Christine McConville, *Pols Aim to Ban Money for Nonprofit Boards*, BOSTON HERALD (May 23, 2011), http://bostonherald.com/news_opinion/local_politics/2011/05/pols_aim_ban_money_nonprofits%E2%80%99_Boards.

⁶² See generally authors comments, LYNN M. ROSS, STATE ATTORNEYS GENERAL, POWERS AND RESPONSIBILITIES (1990).

⁶³ See Alicia M. Maples, *State Attorney General Oversight of Nonprofit Healthcare Corporations: Have We Reached an Ideological Impasse?*, 37 CUMB. L. REV. 235, 240 (2007) (noting differing opinions regarding attorney general's duties to nonprofits). The author specifically highlights scholars' arguments that attorneys general "lack the [r]esources or expertise to engage in the detailed assessments of the business and health policy issues surrounding the appropriate deployment of charitable assets that such decisions implicate." *Id.*; see also Lumen M. Mulligan, *What Good for the Goose is Not Good for the Gander: Sarbanes-Oxley Style Nonprofit Reforms*, 105 MICH. L. REV. 1981, 1990, n.70 (2007) ("State attorneys general have historically given limited resources, and a low priority, to nonprofit enforcement").

⁶⁴ National Association of Attorneys General homepage, available at www.naag.org.

Limited state resources can impact nonprofit supervision and oversight.⁶⁵ For example, only six (50%) of State Attorneys General offices in the 12-state sample have a Public Charities or Nonprofit Division to enforce their nonprofit laws.⁶⁶ Furthermore, resource support for Nonprofit Charities Divisions vary from state to state.⁶⁷ For example, New York with 62,598 public charitable nonprofits has 14 attorneys in its charities division; Massachusetts with 22,885 public charitable nonprofits has 6.⁶⁸ Those with no attorneys in their charities division are Florida with 51,419 public charitable nonprofits, Michigan with 29,670 public charitable nonprofits, and Virginia with 26,580 public charitable nonprofits.⁶⁹ Consequently, the number of attorneys assigned to the Charities Division or lack thereof may suggest inadequate staffing resources limiting the ability of the State Attorneys General to effectively fill in the nonprofit regulatory gap.

However, in the 12-state sample, a number of State Attorneys General are carrying on a more pro-active effort to prevent financial abuses by drafting legislative proposals to provide reforms of financial integrity for nonprofits.⁷⁰ For example, one state in the sample, California, has enacted these financial reforms into law, the California Integrity Act.⁷¹ Other states in the sample such as New York, Massachusetts, Ohio, and Pennsylvania, have offered initiatives along the same line.⁷² From these proactive

⁶⁵ See *supra* note 63 and accompanying text (referencing lack of resources allocated to state attorneys generals for oversight of nonprofits).

⁶⁶ See *supra* note 21 and accompanying text (noting states with specific charity/nonprofit division within attorney general's office).

⁶⁷ See *infra* notes 68–69 and accompanying text.

⁶⁸ Boris et al., *supra* note 3.

⁶⁹ *Id.*

⁷⁰ See Jamieson Baker, *Nonprofits, Sarbanes-Oxley, and the States*, GUIDESTAR (Aug. 2005), <http://www.guidestar.org/rxa/news/articles/2005/nonprofits-sarbanes-oxley-and-the-states.aspx?articleId=779> (noting states' attempts to pass legislation due to major corporate scandals). See also Blodgett et al., *supra* note 2, at 458 (discussing proposed Massachusetts legislation to limit nonprofit Board compensation).

⁷¹ See California Nonprofit Integrity Act of 2004, 2004 Cal. Stat. 919 (codified as amended in scattered sections of CAL. BUS. & PROF. CODE and CAL. GOV'T CODE); see also Gilkeson, *supra* note 43, at 834 (discussing California Act and its similarity to Sarbanes-Oxley regarding "independent audits and audit committees").

⁷² See Baker, *supra* note 70 (discussing briefly states' proposed legislation following major corporate scandals); see also Tom Reilly, Office of Massachusetts Attorney General, *An Act to Promote the Financial Integrity of Public Charities*, http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/Mass_AG.Act_to_promote_fin_integ_pub_charities.pdf (last visited Apr. 16, 2013).

initiatives State Attorneys General appear to prioritize nonprofit financial integrity as the number one issue. Mission adherence is not included in these legislative initiatives; hence a multi-dimensional standard of governance remains elusive.

In the 12-state sample, all but one Attorneys General are elected, a political reality which imposes certain considerations in carrying out their supervisory, oversight and enforcement duties.⁷³ Elected State Attorneys General are first and foremost responsible to electoral politics, facing periodic reelection campaigns which require prioritizing issues that appeal to voters and the media.⁷⁴ Consequently, our electoral process may encourage a public perception of strong state government nonprofit leadership; however, in reality the focus of State Attorneys General remains almost exclusively on donor and nonprofit asset protection, financial fraud and abuse.⁷⁵ State Attorneys General must lead the way in a collaborative effort with other nonprofit leadership to articulate a multi-dimensional standard of governance.⁷⁶

III. ANALYSIS

A. Mission Adherence

Overall, this article proposes a multi-dimensional standard for nonprofit governance that includes: 1) mission adherence; 2) fiduciary leadership; and 3) financial integrity. All three must work in tandem to be most effective and they must be tailored to the nonprofit sector, not mere juxtapositions of for-profit concepts and practices.⁷⁷ Likewise, each dimension requires an ethical focus since nonprofits are deeply rooted in ethics; they benefit the public and are dependent on public trust.

⁷³ See National Association, *supra* note 64, at www.naag.org/current-attorneys-gen.php (listing current Attorneys General as elected and appointed). New Jersey is the only state in the sample where the Attorney General is not elected. *Id.*

⁷⁴ ROSS, *supra* note 62. It creates smart political perception and makes attention-grabbing headlines when State Attorneys General pursue various forms of financial malfeasance and conflicts of interest. *Id.*

⁷⁵ See *supra* notes 61 and 63 and accompanying text.

⁷⁶ *Id.*

⁷⁷ See Kirk, *supra* note 10, at 477–78.

The first important dimension for nonprofit governance is mission adherence which embodies the organization's values, purpose and goals.⁷⁸ Beyond mere statements of charitable purpose, mission statements have an important and unique role in nonprofits.⁷⁹ These inspirational statements comprise organizational values, purposes, and goals.⁸⁰ More importantly, they empower employees to act, clarify objectives and set an ethical tone.⁸¹

Peter Drucker suggests that organizations are not defined by name, statutes, or articles of incorporation; rather they are defined by business mission.⁸² Likewise, nonprofits must be vigilant in adhering to their unique charitable mission. Philosophical and operational commitment to the accomplishment of mission begins at the top level.⁸³ That commitment determines the shared vision to which everyone in the organization adheres.⁸⁴ Nonprofits can build a culture that advances mission adherence within a multi-dimensional standard of governance.⁸⁵ "A clearly articulated mission statement adopted by the Board of Directors serves to explain and popularize the charity's purpose and guide its work," and it also addresses "why the charity exists, what it hopes to accomplish, and what activities it will undertake, where and for whom."⁸⁶ The charitable mission justifies the public policy of granting nonprofits a tax-exempt status.⁸⁷ Therefore, the IRS has issued suggested guidelines for good governance practices.⁸⁸ However, these guidelines are not an assertion of nonprofit governance leadership; rather, they were created to enhance tax compliance. Thus

⁷⁸ See *supra* note 38 and accompanying text; see also Ireland, *supra* note 15, generally see also *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 587 (N.Y. Sup. Ct. 1999) (discussing attorney general's role as *parens patriae* where nonprofit has no shareholders).

⁷⁹ See Kirk, *supra* note 10, at 477–78.

⁸⁰ See Ireland & Hitt, *supra* note 15, at 34 (acknowledging importance of strong mission statement).

⁸¹ See *id.* at 35.

⁸² See generally at pp. 89–90 Peter F. Drucker, *What Business Can Learn from Nonprofits*, 67(5) HARV. BUS. REV. 88 (1989).

⁸³ See Ireland & Hitt, *supra* note 15, at 34.

⁸⁴ See *id.*

⁸⁵ See *Governance and Related Topics–501(c)(3) Organizations*, I.R.S. (Feb. 4, 2008), http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

⁸⁶ See Kirk, *supra* note 10, at 474.

⁸⁷ See *supra* note 29 and accompanying text.

⁸⁸ See *supra* note 44 and accompanying text.

nonprofit governance including mission adherence remains the state's responsibility consistent with our colonial tradition.⁸⁹

Yet, none of the State Attorneys General in the 12-state sample appears to enforce mission adherence.⁹⁰ The legal formation requirement of a "statement of charitable purpose" as required by state Articles of Incorporation does not alone constitute state nonprofit best practices.⁹¹ A narrow statement of charitable purpose is merely a starting point. This is not a mission statement, and often it lacks the holistic expression of values, purpose and goals necessary for nonprofit mission adherence. Consistent adherence to the nonprofit mission throughout its existence promotes state best practices for nonprofits. Furthermore, congressional action culminating in two recent Panel reports on nonprofit leadership initiatives correctly recognized a regulatory gap where limited Federal or IRS oversight ends and state regulation must begin. State leadership of nonprofits is consistent with their legal formation, the authority of the State Attorneys General, and our colonial heritage; states must place more emphasis on mission adherence within a multi-dimensional standard of governance.

B. Fiduciary Leadership

Board of Directors and principal officers of nonprofits must adhere to a high standard of trust in the governance of the organizations they lead.⁹² This standard of trust or fiduciary duty includes: a duty of care and good faith, whereby conflicts of interest are to be avoided; diligence and attention, requiring attendance and active participation at Board meetings;

⁸⁹ See *supra* note 36 and accompanying text.

⁹⁰ See Table 2a.

⁹¹ See Kirk, *supra* note 10, at 474; see also Jon Austin, *Good Governance Practices & 501(c)(3) Organizations*, McAlister & McAlister Law Firm (2012), available at <http://www.mmmmlaw.com/articles/IRSGoodGovernance.asp> (noting importance of mission statements).

⁹² See *Beard v. Achenbach Mem'l Hosp. Ass'n*, 170 F.2d 859, 862 (10th Cir. 1948) (upholding Directors' decisions as long as they are made "honestly and in good faith"). The court discussed that simply because Directors make a bad judgment call, they may still not have violated their duty so long as they are not "so reckless or extravagant as to amount to bad faith or gross or willful negligence on the part of Directors in the discharge of their duties." *Id.*; see also *Attorney Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1020–21 (Mass. 1985) (addressing breach of director's fiduciary leadership); *Adelphi Univ. v. Bd. of Regents of the State of N.Y.*, 652 N.Y.S.2d 837, 839 (N.Y. App. Div. 1997) (discussing appropriateness of removing trustees for misconduct, incapacity, neglect of duty").

and a level of skill that requires reasonable care.⁹³ Often forgotten but critical in the nonprofit context, fiduciary duty also requires a duty of obedience that assures commitment and adherence to mission and a duty of loyalty which requires avoidance of personal gain and conflict of interest.⁹⁴

Thus, the ethical underpinnings of fiduciary leadership are care, loyalty, and obedience.⁹⁵ The preservation of these ethical values is the responsibility of the nonprofit Board of Directors.⁹⁶ A nonprofit Board fulfills its fiduciary leadership through effective governance of the organization's mission and resources.⁹⁷ This fiduciary responsibility is based on trust requiring the fiduciary to act unselfishly by providing the organization with the benefit of his or her knowledge and skill, and by always keeping a nonprofit's interests paramount.⁹⁸ Thus the standard of performance for Board nonprofit governance is necessarily high and operates within the context of trust.⁹⁹ Such fiduciary leadership must begin

⁹³ See Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43 (2008); see also Gary R. Pannone, *Board Governance and the Nonprofit Organization*, PANNONE LOPES DEVEREAUX & WEST LLC, <http://www.pldw.com/Knowledge-and-Resource-Center/PLDW-Board-Governance.pdf> (last visited Apr. 21, 2013) (defining nonprofit Board management structure and responsibilities); R.I. GEN. LAWS § 7-6-22 (2012) (outlining the duties of the Board of Directors); see also *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575 (Sup. Ct. 1999).

⁹⁴ See *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 587 (N.Y. Sup. Ct. 1999) (acknowledging nonprofit Directors duty to adhere to organization's purposes and goals); see also Atkinson, *supra* note 93; Margaret E. McLean, *Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPS by Corporate Officers and Directors to Avert Hostile Takeovers*, 10 PEPP. L. REV. 731, 761 (1983). Disclosed conflicts of interest and other self-serving acts may be acceptable under both the nonprofit best judgment rule and the for profit business judgment rule if not contrary to the best interests of the corporation see also Hall, *supra* note 32, at 22.

⁹⁵ See Pannone, *supra* note 93 (defining nonprofit Board management structure and responsibilities); R.I. GEN. LAWS § 7-6-22 (2012) (stating Board of director responsibilities); see also *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575 (Sup. Ct. 1999). See generally Pamela C. Smith, Kerry McTier & Kelly R. Pope, *Nonprofit Employees' Machiavellian Propensities*, 25 FIN. ACCOUNTABILITY & MGMT. 335 (2009) (asserting that preservation of nonprofit mission can be achieved through appropriate attention to disclosure, financial management and the public good) at 336-38 and 347-50 generally.

⁹⁶ Mark S. Schwartz, Thomas W. Dunfee & Mark J. Kline, *Tone at the Top: An Ethics Code for Directors?*, 58 J. BUS. ETHICS 79 (2005).

⁹⁷ See Harry J. Friedman & Tracy Green Landauer, *How to be a Responsible Nonprofit Director: Do's and Don'ts—Avoiding Punishment for Good Deeds*, GREENBERG TRAURIG, LLP (2005), <http://www2.gtlaw.com/pub/alerts/2005/1102.pdf>.

⁹⁸ BLACK'S LAW DICTIONARY (9th ed. 2009) (defining "fiduciary").

⁹⁹ See *supra* notes 92-94 and accompanying text (discussing high level of trust owed by Directors).

at the top of the organization where fiduciary duty and other ethical values are communicated first at the highest level and then fully implemented throughout the organization by training in the appropriate policies.¹⁰⁰

The states within the sample are following a less rigorous fiduciary standard by following the 1987 revised Model Nonstock Corporation Statute.¹⁰¹ It permits charitable nonprofits to follow the Best Judgment Rule, a flexible and lenient fiduciary standard.¹⁰² It generally mirrors the fiduciary standard required for business corporations under the Business Judgment Rule.¹⁰³ The Best Judgment Rule dilutes the previously more rigorous standard for nonprofits, called the Prudent Man Rule, which “strictly prohibited self-dealing and conflicts of interest.”¹⁰⁴ It was based on the historic ethical foundation of nonprofits as articulated by Leonard Bacon who set the ethical and moral tone for nonprofit associations to receive continued public support.¹⁰⁵ He noted that nonprofit governance must reflect trust in a higher sense of ethics and morality to assure public support “as a security against mismanagement and gradual perversion of the trust.”¹⁰⁶

Consequently, under the current Best Judgment Rule, such transactions as self-dealing and conflicts of interest are permitted as long as a “fully informed” Board acts in a way that is not manifestly “contrary to the nonprofit’s best interests.”¹⁰⁷ However, these lower standards of fiduciary responsibility coupled with public revelations of nonprofit malfeasance

¹⁰⁰ See Smith et al., *supra* note 95, at 335; Schwartz et al., *supra* note 96.

¹⁰¹ See REV. MODEL NONPROFIT CORP. ACT §§ 1.02, 8.12, 8.30–8.33 (1987) (amended 2008). The Revised Model Nonprofit Corporation Act is an ABA-sponsored model statute for uniform nonprofit governance that states may adopt. See *id.* §§ 1.01, 1.02; Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors’ Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1694 (2009) (noting similarity between the two rules).

¹⁰² *Id.*

¹⁰³ McLean, *supra* note 94, at 761. Disclosed conflicts of interest and other self-serving acts may be acceptable under both the nonprofit best judgment rule and the for profit business judgment rule if not contrary to the best interests of the corporation. See also Hall, *supra* note 32, at 22.

¹⁰⁴ See *Harvard College v. Amory*, 26 Mass. 446 (1830); see also Hall, *supra* note 32, see generally *Harvard Coll. v. Amory*, 26 Mass. 446 (1830) (applying Prudent Man Rule which exonerated diminished estate’s trustees of any mismanagement). This act abandoned the Prudent Man standard. Rev. Model Nonprofit Corp. Act § 8.30 cmt.

¹⁰⁵ See *supra* note 38 and accompanying text.

¹⁰⁶ Bacon, *supra* note 38, at 28–32.

¹⁰⁷ See also Hall, *supra* note 32, at 22, www.boardsource.org/dl.asp?document_id=11 (2003).

have raised serious concerns about Board commitment to the “exercise of wisdom and ethical conduct in fulfilling its fiduciary duties.”¹⁰⁸ These nonprofit concerns are poignant reminders of well-publicized corporate for-profit malfeasance where similar disclosed acts met with BOD approval.¹⁰⁹

While Congress enacted the Sarbanes Oxley Act as a way of promoting fiduciary duty of for-profits, such governance standards promoting financial accountability can also enhance fiduciary duty of *nonprofits*.¹¹⁰ Consistent with the limited scope of federal regulation of nonprofits described *supra*, Congress has urged the states to articulate a nonprofit governance initiative for better “accountability, disclosure, and transparency.”¹¹¹ Perhaps it is most important that nonprofits cultivate “a culture of financial understanding,” rather than expanding this financial

¹⁰⁸ See *supra* note 92 and accompanying text; see also Ray Bauschke, *A Director's Duty Is to Act Prudently*, CREDIT UNION TIMES (May 3, 2010), <http://www.cutimes.com/2010/03/03/a-DirectorsDirectorsDirectorsDirectorsDirectorsDirectorsDirectorsDirectors-duty-is-to-act-prudently>. See REV. MODEL NONPROFIT CORP. ACT Official Comment to Section 8.12 (1987) (asserting that when setting Board compensation, compliance is necessary with sections 8.30–8.33 that include the fiduciary duties of loyalty and due care). In contrast with for-profits, the Congress has taken no affirmative action on revelations of nonprofit fiduciary breaches such as excessive executive compensation exemplified by United Way and Adelphi University, or of violation of mission adherence through Board profit-making schemes and conflicts of interests as exposed in *Phoebe-Putney Memorial Hospital*. See *supra* note 45 and accompanying text.

¹⁰⁹ See *In re Enron Corp. Securities Derivative & “ERISA” Litigation*, 529 F. Supp. 2d 644 (S.D. Tex. 2006); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Well-known and egregious scandals such as Enron and World-Com in the for-profit sector have resulted in enhanced Federal scrutiny and reform efforts culminating in Congress’ enactment of the Sarbanes-Oxley Act. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Its purpose is to strengthen the standard of fiduciary duty by improving corporate governance, financial controls and audits for business corporations. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (“An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes”). Although Congress generally excluded them from SOX, many advocate that nonprofits should fall under or comply with the principles of SOX; albeit this challenge may be limited to nonprofits in the largest asset class. See Mark S. Blodgett & Linda J. Melconian, *Health-care Nonprofits: Enhancing Governance and Public Trust*, 117:2 BUS. & SOCIETY REV. 210–12 (2012); Gilkeson, *supra* note 43, at 832 (referencing United Way scandals).

¹¹⁰ *Id.*

¹¹¹ *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, PANEL ON THE NONPROFIT SECTOR 9, http://www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf (June 2005). Two nonprofit reports to Congress confirm urgency of nonprofit reforms and lack of Congressional oversight. *Id.* Blodgett & Melconian, *supra* note 109, at 197–219. “Lack of transparency in their regulation of charities makes it impossible to assess whether regulators truly improve charity governance” BRODY, *supra* note 9, at 480.

regulation to include nonprofits.¹¹² Congressional reluctance to extend the Sarbanes-Oxley Act to nonprofits may have been intended to send a strong message of urgency to the states to legislate such governance and financial principles. The quest for nonprofit financial integrity does not require compliance with the Sarbanes-Oxley Act; rather, it requires an ethical focus on similar and complementary principles and values as they relate to governing the culture of nonprofit financial integrity.

C. Financial Integrity

States are taking numerous approaches to nonprofit financial integrity. Several Attorneys General in the 12-state sample focus on financial transparency that requires financial disclosure and audit committees.¹¹³ Another approach is to increase external State Attorneys General oversight of accounting disclosure provisions including independent CPA audits, officer certification of financial statements, and Board executive compensation approval.¹¹⁴ Eleven of the State Attorneys General offices provide consumer donor protection. For example, California's Attorney General requires registration and financial reporting for all charitable solicitation.¹¹⁵ However, Texas is the only state in the sample where this office fails to protect donors as consumers.¹¹⁶ "Donors generally do not expect to receive benefits from their donations, but they do anticipate their funds will be used to support the mission [adherence] of the organization."¹¹⁷

¹¹² See Jane Crawford, *Profiling the Nonprofit Leader of Tomorrow*, IVEY BUS. J. 4, <http://www.iveybusinessjournal.com/topics/leadership/profiling-the-nonprofit-leader-of-tomorrow#.UUsvBlvSNH0> (2010).

¹¹³ See Table 2b.

¹¹⁴ See State Departments of Justice, *supra* note 20; see also Blodgett, *supra* note 2, at 465–66 (discussing State Attorneys General initiatives).

¹¹⁵ FLA. STAT. ANN. § 496.402 (West 2010); §§ 496.404(20), 496.406, 496.409, 496.410, 496.411. See State Departments of Justice, *supra* note 20.

¹¹⁶ See *Charities and Nonprofits*, *supra* note 21. Texas requires registration and reporting of professional solicitors only. TEX. BUS. & COM. CODE ANN. 22. Most states mirror the language of Florida's Statute by clearly stating that the intent of the state legislature is to "protect the public by reviewing full public disclosure of the identity of persons who solicit contributions from the public." FLA. STAT. ANN. § 496.402 (West 2010).

¹¹⁷ See Johnson, *supra* note 1, at 193.

California is the model for financial integrity through the California Integrity Act.¹¹⁸ This leading state response provides “oversight of fundraising activity, stewardship of financial affairs, and payment of reasonable compensation.”¹¹⁹ More specifically, it requires nonprofit corporations with gross revenues of \$2 million or more to file financial reports with the State’s Attorney General.¹²⁰ Additionally, it requires Boards of nonprofits with annual revenues over \$500,000:

1. “To engage an independent CPA to perform an audit according to GAAP accounting principles;”
2. “to submit audit inspection by the Attorney General and the public for three years;”
3. “to appoint an audit committee, with a detailed outline of responsibilities”¹²¹

Other states in the sample, New York, Massachusetts, Ohio and Pennsylvania, have proposed legislation mirroring the financial focus of California’s Integrity Act.¹²² Certainly, the California law and these other state proposals embrace good state best practices that promote financial integrity. However, notwithstanding these lofty financial initiatives that also support fiduciary leadership, none will satisfy the proposed multi-dimensional standard of governance absent a holistic approach that considers mission adherence.¹²³

¹¹⁸ CAL. GOV. CODE ANN. § 12586 (West 2005).

¹¹⁹ CAL. GOV. CODE ANN. § 12586 (West 2005).

¹²⁰ CAL. GOV. CODE ANN. § 12586 (West 2005). Furthermore, no uniformity exists from state to state on the gross revenue threshold requirements for filing an audited financial statement. The range is \$200,000 to \$2 million. See State Departments of Justice, *supra* note 20.

¹²¹ CAL. GOV. CODE ANN. § 12586 (West 2005) (mirroring fiduciary principles of SOX).

¹²² Michael Klausner & Jonathan Small, *Failing to Govern? The Disconnect Between Theory and Reality in Nonprofit Boards, and How to Fix It*, STANFORD SOCIAL INNOVATION REV. (2005), www.lhc.ca.gov/studies/198/cirm/KlausnerNov08.pdf. These proposals would impose a duty on the Board to exercise financial oversight: (1) requiring CEO and CFO certification of accuracy and completeness of financial statements; (2) mandating public reporting of financial results to maintain appropriate financial controls; and (3) requiring Board disclosure to auditors and audit committee of deficiencies, weaknesses or fraud in these controls. *Id.*

¹²³ See Tables 2a and 2b.

D. Recommendations

Legislative reforms that address fiduciary leadership and financial integrity are important but they do not encompass a holistic approach to nonprofit governance.¹²⁴ “The need for mission and organizational accountability is based on subtler arguments than financial accountability, but it is no less powerful.”¹²⁵ Legislative initiatives concerning nonprofit governance require a multi-dimensional standard with more focus on mission adherence and corresponding values, purpose, and goals. Such a mission statement clarifies an ethical focus in each dimension: uncompromising loyalty to mission, accountability in fiduciary leadership, and creation of a culture of financial integrity. State oversight of nonprofit governance confronts the challenge of mission adherence through collaborative efforts of the National Association and the nonprofit leadership including the National Council of Nonprofits to write a self-policing, multi-dimensional “Nonprofit State Best Practices.”

This article first recommends the establishment of a task force within the National Association to develop mission adherence criteria for inclusion in the nonprofit state best practices. The State Attorneys General within the sample, which represents over one half million nonprofits and their numerous stakeholders, could spearhead this effort. The criteria would permit the State Attorneys General to measure the ongoing achievement of mission by reviewing the achievement of values, purpose, and goals. For example, a nonprofit may establish the goal of serving a threshold number of clients within a targeted population. A nonprofit that feeds the homeless might include a target of increasing the population served by five percent annually; that target could represent a measurable criteria.

Second, this article recommends that State Attorneys General require nonprofits to submit a one-time comprehensive mission statement of values, purpose and goals and that they annually submit a descriptive narrative of mission adherence. In the above example where a nonprofit feeds the poor, the nonprofit’s narrative would describe how it has *satisfied* or *failed* to satisfy the five percent target. The appropriate State Attorneys General

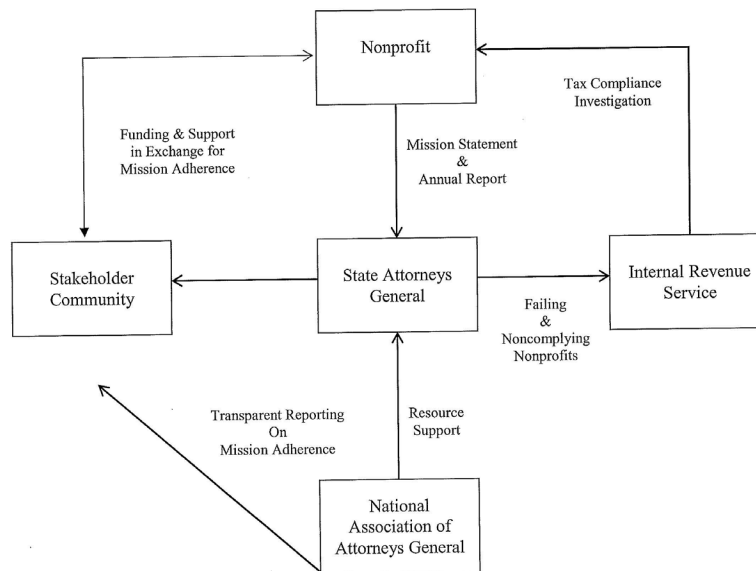
¹²⁴ See Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205 (2004).

¹²⁵ *Id.*

Office would then apply the aforementioned criteria to the annual reports, flagging those that fail in two respects; (1) failing to comply with the reporting altogether; or (2) failing to satisfy the State Attorneys General qualitative assessment mechanism by not explaining its success or lack thereof in meeting its target of mission adherence. Flagged nonprofits could then be forwarded to the IRS for tax compliance analysis to further the IRS's regulatory mandate.

Third, reflecting statewide absence of mission as outlined in Table 2a, this article recommends that each State Attorney General office publish on its respective website a narrative on mission adherence. Within the section, nonprofits could upload their mission statements and annual narratives to match a list of nonprofits maintained by the State Attorneys General's website. The National Association could also provide a descriptive section on its website regarding the importance of mission adherence and could also provide a link to the appropriate section on each State Attorneys General website. These connections are highlighted in Figure 1. This transparent approach would allow the stakeholder community, to which nonprofits owe the highest moral standard of governance, to fully internalize and process mission adherence.¹²⁶

¹²⁶ Bacon, *supra* note 38, at 28–32.

Figure 1—Recommended Approach**IV. CONCLUSION**

State oversight of nonprofit governance must confront the challenge of mission adherence within a multi-dimensional standard. Mission adherence, often overlooked and unregulated, requires greater attention to ethically and holistically govern nonprofits. State best practices that encompass a multi-dimensional standard for nonprofit governance should include explicit guidelines for mission statements comprising values, purpose and goals. Reporting of mission adherence should include some qualitative standard of measurement reportable to the State Attorneys General office for public dissemination and review. This process will ensure the “accountability, transparency, and disclosure” consistent with Bacon’s historic call for a higher sense of morality. Applying such a multi-dimensional standard of governance to nonprofits will sustain their unique position in American society.

Exhibits:

State	Number of Nonprofits
California	107,852
Texas	65,870
New York	62,598
Florida	51,419
Ohio	38,615
Pennsylvania	38,139
Illinois	37,304
Michigan	29,670
North Carolina	28,013
Virginia	26,580
New Jersey	26,477
Massachusetts	22,885

Source: National Center for Charitable Statistics

Table 2a: Multi-Dimensional Governance Standards of Performance within State Statutes			
State	Mission Core Values	Fiduciary Leadership	Financial Integrity
California	x	✓	✓
Florida	x	✓	x
Illinois	x	x	✓
Massachusetts	x	✓	✓
Michigan	x	x	✓
New Jersey	x	✓	x
New York	x	✓	✓
North Carolina	x	✓	✓
Ohio	x	✓	x
Pennsylvania	x	✓	✓
Texas	x	✓	✓
Virginia	x	✓	x

Table 2b: Multi-Dimensional Governance Standards of Performance within State Statutes		
State	Fiduciary Leadership	Financial Integrity
California	§ 12599.6(a) A charity must “establish and exercise control” over its fundraising activities conducted for its benefit, including approval of all written contracts and agreement.	§ 12586(e)(1) A \$2 Million Charity must prepare annual financial statements using generally accepted accounting principles.
Florida	§ 617.0830 A director shall discharge his or her duties as a director, including his or her duties as a member of a committee (a) In good faith; (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (c) In a manner he or she reasonably believes to be in the best interests of the corporation.	

State	Fiduciary Leadership	Financial Integrity
Illinois		<p>§ 109.10(d)(3)(e) The board of directors may base a determination that a distribution may be made under subsection (d) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.</p>
Massachusetts	<p>§ 6C A director, officer or incorporator of a corporation shall perform his duties as such, including, in the case of a director, his duties as a member of a committee of the board upon which he may serve, in good faith and in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position.</p>	<p>§ 6C The auditor shall state that he has examined the statement of assets and liabilities included in such certificate, that his examination was made in accordance with generally accepted auditing standards, and that in his opinion said statement of assets and liabilities presents fairly the financial position of the corporation as of the date thereof, in conformity with generally accepted accounting principles.</p>
Michigan		<p>§ 450.2105(3) Properties and rights entered upon the books of a corporation in accordance with generally accepted accounting principles, or the current fair market value of such properties and rights.</p>
New Jersey	<p>§ 15A:6-14 Trustees and members of any committee designated by the board shall discharge their duties in good faith and with that degree of diligence, care and skill which ordinary, prudent persons would exercise under similar circumstances in like positions.</p>	
New York	<p>§ 521 Failure of the corporation to comply in good faith with the notice or disclosure or reporting provisions of section 501 . . . shall</p>	<p>§ 719 All financial transactions shall be ordered in conformity with generally accepted accounting principles or other</p>

State	Fiduciary Leadership	Financial Integrity
	make the corporation liable for any damage sustained by any person in consequence thereof.	applicable criteria in a manner to maintain instability for assets. The recorded accountability for assets shall be compared with the existing assets at reasonable intervals and appropriate action shall be taken with respect to any differences.
North Carolina	§ 55A-8-30 A director shall discharge his or her duties as a director, including his or her duties as a member of a committee (a) In good faith; (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (c) In a manner he or she reasonably believes to be in the best interests of the corporation.	§ 55A-16-20 If financial statements are prepared for the corporation on the basis of generally accepted accounting principles, the annual financial statements shall also be prepared on that basis.
Ohio	§ 1702.30 A director shall perform the duties of a director, including the duties as a member of any committee of the directors upon which the director may serve, in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances. A committee of the directors upon which the director does not serve, duly established in accordance with a provision of the articles or the regulations, as to matters within its designated authority, which committee the director reasonably believes to merit confidence.	
Pennsylvania(1)	§ 5712 A director of a nonprofit corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his	§ 5701 All financial transactions shall be ordered in conformity with generally accepted accounting principles or other applicable criteria in a manner

State	Fiduciary Leadership	Financial Integrity
	duties as a member of any committee of the board upon which he may serve in good faith	to maintain instability for assets.
Texas	§ 22.226 A director shall discharge the director's duties, including duties as a committee member, in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation.	§ 22.352 A corporation shall maintain current and accurate financial records with complete entries as to each financial transaction of the corporation, including income and expenditures, in accordance with generally accepted accounting principles.
Virginia	§ 13.1-870 A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with is good faith judgment of the best interests of the corporation.	
Note: (1) Pennsylvania was the only state statute to have a subchapter for Fiduciary Duty (Chapter 57, Subchapter B, § 5711-15).		