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March 2004

Dept. of Labor Increases Union Financial Reporting Requirements

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Recommended Citation
Daniel Lyons. "Dept. of Labor Increases Union Financial Reporting Requirements." *Harvard Law Review* 117, no.5 (2004): 1734-1740.

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RECENT REGULATION

LABOR LAW — DEPARTMENT OF LABOR INCREASES UNION FINANCIAL REPORTING REQUIREMENTS. — Labor Organization Annual Financial Reports, 68 Fed. Reg. 58,374 (Oct. 9, 2003) (to be codified at 29 C.F.R. pts. 403 and 408).

If the 1980s marked a period of excess and greed, the present decade is rapidly becoming an era of accountability. The Enron scandal and those that followed shook the public's confidence in corporate management, driving Washington to enhance disclosure requirements and expand regulation of independent auditors through the Sarbanes-Oxley Act of 2002.[1] The Department of Labor has seized on this momentum to bring a similarly strict level of accountability to labor unions, whose members historically have had little information about how management spends their dues. Since 1998, the Department's Office of Labor-Management Standards has averaged nearly eleven convictions each month for union corruption,[2] reflecting an exceptionally high level of mismanagement due in part to lax financial reporting requirements that allow union officials to shield questionable expenses from public scrutiny.[3] To address this problem, the Department recently adopted a final rule dramatically altering both the way in which unions must report financial information each year and the amount of information they must disclose.[4] This change commendably improves transparency in union reporting, benefiting dues payers and the public alike. It also brings private-sector unions much closer to the level of disclosure that the Supreme Court has mandated for public-sector unions. But as Sarbanes-Oxley recognizes, independent auditing is a crucial component of a robust reporting system.[5] The failure of the Labor Department to adopt an independent audit requirement jeopardizes the effectiveness of its financial accountability regulations for labor unions.

Union disclosure is governed by the Labor-Management Reporting and Disclosure Act, also known as the Landrum-Griffin Act,[6] passed in 1959 in the wake of a series of scandals implicating union leaders in

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[1] Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

[2] *See* Labor Organization Annual Financial Reports, 68 Fed. Reg. 58,374, 58,420 (Oct. 9, 2003) (to be codified at 29 C.F.R. pts. 403 and 408) [hereinafter Final Rule].

[3] *See id.* ("In many cases the broad aggregated categories on the existing forms enabled union officers to hide embezzlements and financial mismanagement.").

[4] *See id.* at 58,374.

[5] *See* 15 U.S.C.A. §§ 7241–7242 (West Supp. 2003).

[6] 29 U.S.C. §§ 401–531 (2000).

organized crime.[7] The law requires union management to report annually to the Labor Department "in such detail as may be necessary accurately to disclose its financial condition and operations."[8] The Labor Department has enforced this mandate through Form LM-2,[9] an annual declaration of receipts and expenses that the Department then makes available to the public.[10] But since the passage of the Landrum-Griffin Act, labor unions have changed dramatically. Today's union landscape is dominated not by small, independent unions, but by large national entities that "resemble modern corporations in their structure, scope and complexity."[11] Modern unions often manage member benefit plans, operate revenue-producing subsidiaries, and participate in political campaigning.[12]

Until the 2003 rule change, however, Form LM-2 had failed to adapt to this increased complexity. The form remained largely unchanged since the 1950s, consisting primarily of a statement of the union's assets and liabilities and a one-page summary of its receipts and disbursements. Disbursements were broken into a handful of broad categories, such as "Professional Fees" and "Contributions, Gifts, and Grants."[13] Unions took advantage of the laxity of these reporting requirements to hide corruption, as accountants simply shifted disbursements from line items that required supporting schedules to those that did not.[14] The old form also failed to account for the in-kind contributions unions often make to political campaigns, such as get-out-the-vote drives or phone bank staffing; these activities dedicate union resources to benefit political candidates, but because no money

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[7] For a discussion of the history behind the Act's enactment, see Michael J. Nelson, Comment, *Slowing Union Corruption: Reforming the Landrum-Griffin Act To Better Combat Union Embezzlement*, 8 GEO. MASON L. REV. 527, 528–42 (2000).

[8] 29 U.S.C. § 431(b).

[9] *See* 29 C.F.R. § 403.2 (2003).

[10] *See* Employment Standards Administration, U.S. Dep't of Labor, *View Union Annual Financial Reports*, *at* http://union-reports.dol.gov/olmsWeb/docs/formspg.html (last visited Feb. 15, 2003).

[11] Labor Organization Annual Financial Reports, 67 Fed. Reg. 79,280, 79,280 (proposed Dec. 27, 2002) (to be codified at 29 C.F.R. pts. 403 and 408) [hereinafter Proposed Rule].

[12] *Id.*

[13] Some categories required further itemization of expenses, but this additional requirement provided little information on the ultimate destination of expenditures. For example, under the heading "Contributions, Gifts, and Grants," most unions simply broke expenses out into categories such as "labor organizations," "charitable contributions," "scholarships," and "political," without indicating which candidates or charities received the funds. *See, e.g.*, Iron Workers AFL-CIO LU 7, Form LM-2 Labor Organization Annual Report, at 2–11 (Sept. 26, 2003) (reporting $126,348 in "charitable" expenses and $78,501 in "political contributions").

[14] The Labor Department cites an instance in which union officials hid $1.5 million in personal dining, drinking, and entertainment expenses from 1992 to 1999 by shifting disbursements from "Office and Administrative Expense" to "Educational and Publicity Expense." *See* Proposed Rule, *supra* note 11, at 79,282.

changes hands, these in-kind contributions went unrecorded.[15] The form also required little disclosure of union-controlled trusts, a loophole that allowed unions to hide questionable or risky investments by using Enron-like "off the books" accounting procedures.[16]

The revised rule increases the transparency of union financial structures in three ways. First, unions now must itemize within each category all "major" disbursements, defined as all expenditures greater than $5000.[17] Second, to reflect in-kind contributions, the form eliminates the separate categories for disbursements to union officers and employees; now, unions must estimate how each officer or employee divides his time among various activities and allocate that employee's salary pro rata across those categories.[18] Finally, the rule change adds a new form, the T-1, requiring larger unions to report the activities of any trust to which they have contributed $10,000 or more in the fiscal year.[19] Smaller unions with less than $250,000 in annual receipts are exempt from most of these changes.[20] As a result, the more expansive requirements affect only the largest twenty percent of American unions; nonetheless, this largest twenty percent includes almost ninety-three percent of total dollars received annually by organized labor.[21]

Together, these increased disclosure requirements will substantially improve union members' ability to determine the uses of their annual dues. But the Labor Department declined to adopt one additional requirement that would have dramatically improved the credibility of the reporting system as a whole: an independent audit requirement, which many commenters suggested.[22] This decision, the latest in a series of missed opportunities to subject union managers to a level of scrutiny approaching that applied to their corporate counterparts, fails to give union members adequate protection from misuse of union funds.

The Supreme Court has highlighted the policies animating a union disclosure requirement, perhaps most prominently in *Communications Workers v. Beck*.[23] *Beck* involved nonunion private-sector employees

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[15] *See* Final Rule, *supra* note 2, at 58,398.

[16] *See* Proposed Rule, *supra* note 11, at 79,282–83.

[17] Final Rule, *supra* note 2, at 58,381. This requirement also applies to a series of disbursements to the same source totaling more than $5000. *Id.* at 58,385.

[18] *Id.* at 58,471. For example, a union is now required to allocate to "political contributions" the salary it pays an employee while he staffs phone banks for a candidate.

[19] *Id.* at 58,374.

[20] *Id.*

[21] *See* Proposed Rule, *supra* note 11, at 79,290. The proposed rule set the LM-2 threshold at $200,000 in annual revenue; at that figure, 21,000 unions (or "approximately 80%" of all unions) would have been exempt. *Id.* The final rule raised the threshold to $250,000, thereby exempting an additional 500 unions. *See* Final Rule, *supra* note 2, at 58,383.

[22] *See, e.g.*, Final Rule, *supra* note 2, at 58,379.

[23] 487 U.S. 735 (1988).

whom the union required to contribute "agency fees" to cover the costs of collective bargaining from which they benefited as employees.[24] The plaintiffs sought to recover the portion of their fees that went to other activities, such as political contributions.[25] The Court held that the agency fee statute authorized unions to collect fees only to prevent nonmembers from free-riding on union negotiations, and not for purposes unrelated to collective bargaining.[26] But *Beck* has proven difficult to enforce in practice, in part because the Court did not mandate specific procedures to safeguard nonunion employees' rights.[27] Employees must simply trust the disbursement breakdown they receive from union managers — who, after *Beck*, have incentives to define collective bargaining costs as broadly as possible.

When the same question arose regarding public-sector unions, in contrast, the Court defined employees' procedural rights in more detail. *Chicago Teachers Union, Local No. 1 v. Hudson*[28] involved a teacher who challenged the procedure by which agency fees were determined and levied on nonunion employees. Holding against the union, the Court held that "[b]asic considerations of fairness, as well as concern for the First Amendment rights at stake, . . . dictate that the potential objectors be given sufficient information to gauge the propriety of the union's fee."[29] "[A]dequate disclosure," explained the Court, "surely would include the major categories of expenses, *as well as verification by an independent auditor*."[30] Though *Beck* and *Hudson* addressed formally different legal issues — the former a private union's obligations under the National Labor Relations Act, the latter a public union's obligations under the U.S. Constitution — both cases involved the same concerns about coerced speech and fair representation. In

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24 *Id.* at 738–39. The agency fee requirement is permitted by 29 U.S.C. § 158(a)(3) (2000), a provision of the National Labor Relations Act. States began passing "right-to-work" statutes in the 1950s and 1960s that prevented employers from requiring union membership as a condition of employment. As a result, unions began negotiating agency-shop agreements under which an employee would be free to decide not to join a union, but would have to pay union dues regardless of membership status to avoid free-riding on the union's collective bargaining activities. In *NLRB v. General Motors Corp.*, 373 U.S. 734, 744–45 (1963), the Court held that such agreements did not violate federal law and were legal where state law did not intervene. *See id.* at 744–45.

25 *See Beck*, 487 U.S. at 740. These expenditures, the plaintiffs argued, were impermissible under § 8(a)(3) of the National Labor Relations Act, violated the union's duty of fair representation, and infringed the plaintiffs' First Amendment rights. *Id.*

26 The Court reached this conclusion by analogy to an earlier case, *International Ass'n of Machinists v. Street*, 367 U.S. 740 (1961), which had held that nearly identical language in the National Railway Act prevented unions from assessing agency fees for political activities. *See Beck*, 487 U.S. at 745–46.

27 *See generally* Jeff Canfield, Comment, *What a Sham(e): The Broken* Beck *Rights System in the Real World Workplace*, 47 WAYNE L. REV. 1049, 1051–59 (2001).

28 475 U.S. 292 (1986).

29 *Id.* at 306.

30 *Id.* at 307 n.18 (emphasis added).

both cases, the plaintiff sought an honest and verifiable accounting of how his dues were spent, and nothing about the nature of the union in *Beck* suggests that the remedy should differ from that prescribed in *Hudson*. One might interpret the procedural vagueness in *Beck* as deference to the Labor Department's enforcement of its organic statute. But *Hudson* should guide the Department's determination of the proper mechanisms for verifying a union manager's self-reported financials. If an independent audit is essential to ensure the integrity of public-sector reporting, the same should hold true in the private sector.

Although *Beck* and *Hudson* addressed the rights of nonmember fee payers, the cases implicate issues that arise whenever a self-interested entity is tasked with providing unbiased financial disclosure. The insight guiding *Hudson* is the same one that underlies Sarbanes-Oxley and more than seventy years of corporate financial reporting: independent auditing is crucial to accurate and trustworthy financial disclosure. In the for-profit sphere, this proposition is axiomatic.[31] Public accounting firms serve as corporate watchdogs, preventing managers from hiding bad decisions or mismanaging corporate funds. Auditors tip off the SEC to possible violations, triggering government investigations and penalties.[32] Even absent malfeasance, independent auditors serve a vital role by instilling confidence in the reporting process, a function that the Supreme Court has explicitly recognized: "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information . . . . It is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate."[33]

The case for independent auditing is only stronger in the union sphere, where fewer safeguards exist to ensure the truthfulness of management's financial disclosures. For public corporations, the market demands financial accuracy, because the prospect of inaccuracy dramatically increases the risk of investment. Investors are willing to accept the cost of audits and a lower return on their investments in order to secure more reliable information. But union dues payers have no comparable ability to negotiate for safeguards, because dues or fees are often compulsory conditions of employment.

The market has also developed institutional safeguards to enforce managers' fiduciary duty of accurate disclosure, including large institutional investors that can force disclosure through legal action, and

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[31] The Securities Exchange Act of 1934 authorizes the SEC to establish independent auditing requirements for all publicly traded companies, to "provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." 15 U.S.C. § 78j-1 (2000).

[32] *See id.*

[33] United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984).

investment analysts who comb corporate financial disclosures to determine their accuracy. In the union context, significant oversight theoretically might come from the Department of Labor, which has the authority to audit a union's financial statements.[34] But the Department's Office of Labor-Management Standards lacks the resources to perform this duty consistently: the Department itself frankly acknowledges that "[i]n contrast to the reviews the SEC performs on public companies not less than once every three years, labor unions currently can expect, on average, to be audited by the Department of Labor approximately once every 150 years."[35] Indeed, despite controlling vast sums of money, ten of the twenty-five largest labor unions have never faced a Labor Department audit.[36]

In light of these concerns, the arguments against an independent auditing requirement for unions hold little sway. Chief among these is the cost of hiring outside auditors.[37] But because the substance of the rule change applies only to unions with more than $250,000 in annual receipts,[38] the additional cost should be far from crippling. Several unions, in fact, already have constitutional provisions requiring outside audits, demonstrating both the demand for such audits among union members and the ability of larger unions to pay for them.[39] Further, most publicly traded corporations are subject to independent audit requirements, belying any claim that the cost is so insurmountable as to outweigh union members' (and the public's) need for accurate, reliable financial information. Less often mentioned, but perhaps more central to the Labor Department's decisionmaking process, is the concern that no provision of the Landrum-Griffin Act explicitly authorizes the Labor Secretary to require independent audits. The Act does, however, require disclosure "in such detail as may be necessary *accurately* to disclose [the union's] financial condition and operations,"[40] and the Labor Department seems to admit at least the possibility that it has the authority to impose an auditing requirement.[41]

Courts are beginning to awaken to the value of auditing union financial statements in recent efforts to implement *Beck*. In *Ferriso v. NLRB*,[42] a nonunion employee subject to agency dues appealed the NLRB's refusal to compel an independent audit of the union's finan-

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[34] *See* Final Rule, *supra* note 2, at 58,379.
[35] *Id.* (citation omitted).
[36] *Id.*
[37] *See id.*
[38] *Id.* at 58,374.
[39] *See id.* at 58,379.
[40] 29 U.S.C. § 431 (2000) (emphasis added).
[41] *See* Final Rule, *supra* note 2, at 58,379 ("[T]he Department has chosen not to attempt to impose such a requirement . . . .").
[42] 125 F.3d 865 (D.C. Cir. 1997).

cials.[43] The D.C. Circuit overturned the NLRB's decision, holding that for purposes of determining appropriate agency fees, adequate disclosure entails an independent audit of the union's statements.[44] The court reasoned that "nonmembers cannot make a reliable decision as to whether to contest their agency fees without trustworthy information about the basis of the union's fee calculations, and that an independent audit is the minimum guarantee of trustworthiness."[45]

Although limited to the nonmember context, *Ferriso* underscores the parallels between corporate and labor union financial accountability. During the Enron scandal, AFL-CIO President John Sweeney argued that "transparency, accountability and full and accurate disclosure should be central goals of financial regulation."[46] These same goals should drive the Labor Department's regulation of union finances. The new LM-2 requirements go far toward increasing the accountability of union management. But without watchdogs to verify the accuracy of the forms, the Labor Department may be simply generating more paperwork without reducing corruption. An independent audit requirement is the most inexpensive and effective way to ensure that the numbers union managers release are not simply smoke and mirrors.

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[43] *Id.* at 866.

[44] *Id.* at 873. The court held that "the Board's rejection of the 'independent auditor' requirement was not rational, because any rational interpretation of the NLRA's duty of fair representation will necessarily include an independent-auditor requirement." *Id.* at 869.

[45] *Id.* at 869–70 (citation omitted).

[46] David Keene, *Labor Unions Fail "Enron" Test*, THE HILL, June 17, 2003, at 15, LexisNexis Library, The Hill File (quoting John Sweeney) (internal quotation marks omitted).