

WHAT'S GOOD FOR THE GOOSE IS NOT GOOD FOR THE GANDER: SARBANES-OXLEY-STYLE NONPROFIT REFORMS

*Lumen N. Mulligan**

In this Article, I contend that the Sarbanes-Oxley-inspired nonprofit reforms currently being put forward in seven states, particularly the costly disclosure requirements, will be of little value in the effort to improve ethical nonprofit board governance. After providing a primer on the oversight of nonprofit organizations and highlighting the unique difficulties facing the nonprofit sector, the Article reviews the recent Sarbanes-Oxley-like nonprofit reforms introduced in seven states. It then contends that the disclosure-focused reforms that form the bulwark of these initiatives will not foster improved ethical nonprofit board governance. It also argues that this failure stems from the inappropriate application of a stockholder-based normative perspective in the nonprofit sector. The Article concludes by noting that appropriating a normative construct more tailored to the nonprofit community, namely stakeholder theory, is essential to drafting effective nonprofit sector reforms in the future.

TABLE OF CONTENTS

INTRODUCTION	1982
I. PRIMER ON NONPROFIT CORPORATE OVERSIGHT	1984
A. <i>Board of Directors Oversight of Nonprofit Corporations</i>	1984
B. <i>Third-Party Oversight of Nonprofit Corporations</i>	1988
C. <i>Governmental Oversight of Nonprofit Corporations</i>	1989
II. STATE REFORMS FOR NONPROFITS—SARBANES-OXLEY-STYLE	1992
A. <i>Disclosure Reforms</i>	1992
B. <i>Governance Reforms</i>	1994
C. <i>Auditing Reforms</i>	1996
III. DUBIOUS EFFICACY OF DISCLOSURE.....	1996
A. <i>Mandatory Disclosures Unlikely to Be Used</i>	1997

* Assistant Professor of Business Law, Stephen M. Ross School of Business, University of Michigan. I am especially grateful to Professor Bridgette Carr; Professor David Hess; Professor Dana Muir; Professor George Siedel; Jeffrey L. Stowell, Esq.; and the participants at the symposium for their helpful thoughts and comments. Additionally, many thanks are due to my wife Emily for her editorial help and continual support.

B. <i>Disclosure as an Instrumental Value</i>	1999
C. <i>Compliance Focused</i>	2001
IV. MISTAKEN MORAL PREMISE	2002
A. <i>Nonprofit Corporations and Stakeholder Theory</i>	2002
B. <i>Stakeholder Theory and Future Nonprofit Reforms</i>	2007
CONCLUSION	2009

INTRODUCTION

The United States boasts the largest nonprofit sector in the world, and that sector continues to grow.¹ The Internal Revenue Service, the primary federal regulator of nonprofit organizations,² currently oversees 1.6 million tax-exempt organizations holding \$2.4 trillion in assets.³ Unfortunately, this huge sector of the economy recently has been pummeled with a spate of now all-too-familiar corporate scandals.⁴ In the seven years preceding 2002, officers and directors of major charitable organizations misappropriated at least \$1.28 billion from 152 nonprofit organizations.⁵ To make matters worse, a recent *Chronicle of Philanthropy* study contends that this figure, which is based upon newspaper reports, significantly underestimates the scope of abuses within the nonprofit community.⁶ Congress responded to similar misdeeds in the for-profit sector with the Sarbanes-Oxley Act, which imposes, inter alia, a series of disclosure, corporate governance, and auditing requirements upon enumerated, publicly traded corporations.⁷ But, with the notable exceptions of the whistleblower and document-retention provisions, Sarbanes-Oxley does not apply to nonprofit corporations.⁸

1. Stephanie Strom, *Accountability; New Equation for Charities: More Money, Less Oversight*, N.Y. TIMES, Nov. 17 2003, at F1.

2. See MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 238-41 (2004).

3. See Internal Revenue Service, Tax Exempt & Government Entities Division At-a-Glance, <http://www.irs.gov/irs/article/0,,id=100971,00.html> (last visited Jan. 26, 2007) (providing listing of services for exempt organizations).

4. See, e.g., James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 219 n.1 (2003) (providing examples of recent scandals involving nonprofit organizations).

5. Brad Wolverton, *Study: Charity Fraud Exceeds \$1-Billion*, CHRON. PHILANTHROPY, Nov. 27, 2003, at 26.

6. *Id.*

7. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C. (Supp. III 2003)).

8. Sarbanes-Oxley, as a general rule, regulates the SEC, issuers of securities that register with the SEC, and professionals (e.g., lawyers and accountants) who work with securities issuers. See generally *id.* § 203 (regulating accountants); *id.* § 301 (regulating issuers of securities); *id.* § 307 (regulating attorneys). Nonprofit corporations, by contrast, are subject to a “nondistribution constraint,” meaning they may not pay out net profits to shareholders or the like. See, e.g., REVISED MODEL NONPROFIT CORP. ACT §§ 13.01, 1.40 (1987); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (providing the definitive discussion of the “nondistribution constraint”). As such, they cannot issue securities and do not generally fall under the scope of

Nevertheless, the recent incidents of nonprofit malfeasance have not escaped state legislative notice. This attention has spawned a host of Sarbanes-Oxley-like proposals for nonprofit organizations, which are the focus of this Article. Immediately following the passage of Sarbanes-Oxley, the New York Legislature led the way by taking up a wide-ranging bill, championed by the state attorney general, that would mandate Sarbanes-Oxley-like reforms for the nonprofit sector.⁹ The Massachusetts attorney general soon proposed his own bill similar to New York's.¹⁰ Neither bill passed. Numerous other states have followed suit by introducing comparable Sarbanes-Oxley-like bills that ultimately failed to pass.¹¹ Several states, however, have passed acts codifying some Sarbanes-Oxley-like reforms for nonprofit organizations—California's Nonprofit Integrity Act of 2004 being, perhaps, the most well-known.¹² The unifying theme of these Sarbanes-Oxley-inspired bills is their reliance upon disclosure mechanisms (e.g., officer-certified financial statements), governance mandates (e.g., audit committees), and auditing requirements (e.g., independent audits performed by CPAs) to induce corporate integrity.¹³

In this Article, I contend that these state reforms, particularly the costly disclosure requirements, will be of little value in the effort to improve nonprofit governance.¹⁴ The Article proceeds as follows. Part I provides a primer on the oversight of nonprofit organizations. Part II reviews the recent Sarbanes-Oxley-like nonprofit reforms introduced in seven states. Part III

Sarbanes-Oxley. See Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205, 244 (2004).

9. See S.B. 4836-A, 2003 Leg., 226th Gen. Sess. (N.Y. 2003). This bill was substantially amended. S.B. 4836-B, 2004 Leg., 227th Sess. (N.Y. 2003). The legislature has yet to pass this bill. See 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, 562–64 (2005) (outlining the legislative history of the New York bill); Brackman Reiser, *supra* note 8, at 244–48 (same).

10. Office of the Massachusetts Attorney General Tom Reilly, An Act to Promote the Financial Integrity of Public Charities, <http://www.ago.state.ma.us/filelibrary/FinancialIntegrityPublicCharities.rtf> (last visited Jan. 26, 2007) [hereinafter Mass. A.G. Proposal].

11. See, e.g., S.B. 1115, 92d Leg., Reg. Sess. (Mich. 2004); H.B. 514, 2004 Leg., Reg. Sess. (Miss. 2004); H.B. 724, Adjourned Sess. Of 2003–2004 Biennium (Vt. 2004); S.B. 153, 125th Gen. Assem., Reg. Sess. (Ohio 2003); H.B. 1019, 187th Gen. Assem., Reg. Sess. (Pa. 2003). The U.S. Senate, spearheaded by Senator Grassley, has also considered Sarbanes-Oxley-like nonprofit legislation, which is beyond the scope of this Article. See CARE Act of 2003, S.B. 476, 108th Cong. (2003); see also PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR (2005), http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf (providing a sweeping series of federal reforms upon request of the Senate Finance Committee).

12. See, e.g., CAL. BUS. & PROF. CODE § 17510.5 (West Supp. 2006); CAL. GOV'T. CODE §§ 12581–12599.7; CONN. GEN. STAT. ANN. § 21a–190b, c, f, h (West Supp. 2006); KAN. STAT. ANN. § 17-1763, 17-6002 (Supp. 2005); ME. REV. STAT. ANN. tit. 9, §§ 5004 (Supp. 2005); N.H. REV. STAT. ANN. § 7:28III-a to -b (Supp. 2005); W. VA. CODE ANN. § 12-4-14 (LexisNexis 2004) (applying only to recipients of state grants).

13. See Brakman Reiser, *supra* note 9, at 562–66, 568, 573; Brakman Reiser, *supra* note 8, at 208–09, 268.

14. This Article will limit its scope to issues of board governance. The exclusion of issues directly involving nonprofit managers is a function of limited space in this symposium edition, not a perceived lack of importance of managers.

contends that the disclosure-focused reforms, which form the bulwark of these bills, will not foster ethical nonprofit board governance. Part IV argues that this failure stems from the inappropriate application of a stockholder-based normative perspective in the nonprofit sector. The Article concludes by noting that appropriating a normative construct more tailored to the nonprofit community, namely stakeholder theory, is essential to drafting effective nonprofit sector reforms in the future.

I. PRIMER ON NONPROFIT CORPORATE OVERSIGHT

The nonprofit corporation, with 501(c)(3) public charity tax-exempt status, is the predominant organizational form for nonprofit organizations.¹⁵ These organizations constitute the focus of this Article. The recently introduced, state-based, Sarbanes-Oxley-like reforms that attempt to affect the governance of these nonprofit corporations are best understood against the backdrop of the current state of nonprofit board governance and regulation. While many of these features will be familiar to lawyers who work in the for-profit corporate sector, there are numerous factors unique to the nonprofit sector that significantly affect nonprofit board governance and the regulation of nonprofits by third parties and governmental authorities.

A. Board of Directors Oversight of Nonprofit Corporations

The legal principles that frame for-profit board governance generally apply to nonprofit corporations.¹⁶ As with for-profit corporations, nonprofit corporations are governed by a board of directors.¹⁷ As with for-profit corporations, the board must monitor management, make decisions regarding the high-level direction of the organization, and approve its major transactions.¹⁸ Again, like for-profit directors, nonprofit directors are subject to the fiduciary duties of loyalty and care, which are applied by the courts with the same rigor (or lack thereof) as is done in the for-profit context.¹⁹

15. FREMONT-SMITH, *supra* note 2, at 116 (explaining that in the United States today the nonprofit corporation is the main form of charitable organization). Of the 1.6 million IRS-registered tax-exempt organizations, 1.05 million are organized as 501(c)(3) organizations, which includes both public charities and private foundations (the overwhelming majority of whom are public charities). See GIVING USA FOUND., GIVING USA 2006: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2005, at 55.

16. See, e.g., *Summers v. Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002) (“[P]rinciples of law governing for profit corporations generally govern the activities of a nonprofit corporation”); JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 63 (2d ed. 2000).

17. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 8.01 (1987) (requiring a board of directors and listing its powers, duties, standards of conduct, etc.).

18. See Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 835 (2003).

19. See Fishman, *supra* note 4, at 232–39; Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 644 (1998); see also REVISED MODEL NONPROFIT CORP. ACT § 8.30; Denise Ping Lee, Note, *The*

Nonprofit directors have a unique legal fiduciary duty as well. Specifically, nonprofit directors have a duty of obedience to the mission of the nonprofit organization.²⁰ As one court put it, “nonprofit directors . . . must be ‘principally concerned about the effective performance of the nonprofit’s mission.’”²¹ In addition to this duty of obedience to the mission, several other key features of nonprofit corporations differentiate them from their for-profit cousins and significantly affect nonprofit board governance.

First, and most important, nonprofit organizations are subject to a non-distributional constraint. That is to say, nonprofit organizations may earn net profits, but they may not distribute these profits to persons who exercise control over the organization (i.e. directors, officers, employees, and other members of the organization).²² This nondistributional constraint has wide-ranging implications for board governance, not the least of which is the lack of a commonly accepted metric of performance.²³ Because nonprofit organizations lack the sort of financial indicators that provide a measure of success in the for-profit context, nonprofit directors often face considerable difficulty evaluating the performance of their own organizations.²⁴ Further, this inability to distribute profits stymies the creation of market-based regulatory regimes like those found in the for-profit sector.²⁵

Business Judgment Rule: Should it Protect Nonprofit Directors?, 103 COLUM. L. REV. 925, 935–45 (2003) (outlining the application of the business judgment rule for nonprofit directors).

20. FISHMAN & SCHWARZ, *supra* note 16, at 230–32; Brakman Reiser, *supra* note 18, at 837.

21. *Summers*, 112 S.W.3d at 504 (quoting Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 IOWA J. CORP. L. 631, 641 (1998)); *see also* Queen of Angels Hosp. v. Younger, 66 Cal. App. 3d 359,365 (Cal. Ct. App. 1977); *Brown v. Mem'l Nat'l Home Found.*, 329 P.2d 118, 122 (Cal. Ct. App. 1958); *Att'y Gen. v. Hahemann Hosp.*, 494 N.E.2d 1011, 1018 (Mass. 1986); *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (N.Y. Sup. Ct. 1999) (“[T]he duty of obedience . . . mandates that a [nonprofit] Board, in the first instance, seek to preserve its original mission.”).

22. *See generally* REVISED MODEL NONPROFIT CORP. ACT §§ 13.01, 1.40(10) (prohibiting distribution of net profits to insiders); Brakman Reiser, *supra* note 18, at 833–34 (discussing the nondistributional constraint); Hansmann, *supra* note 8, at 838 (providing the definitive discussion of this concept).

23. *See, e.g.*, Judith L. Miller, *The Board as a Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards*, 12 NONPROFIT MGMT. & LEADERSHIP 429, 433 (2002); Katherine O'Regan & Sharon M. Oster, *Does The Structure And Composition Of The Board Matter? The Case Of Nonprofit Organizations*, 21 J.L. ECON. & ORG. 205, 206 (2005). Of course, financial performance is not the sole measure of for-profit performance either. *See, e.g.*, JOHN ELKINGTON, CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS (1998) (introducing the notion of a “triple bottom line” by which corporate performance is governed by its environmental and social impacts in addition to its financial success). *But see* Wayne Norman & Chris MacDonald, *Getting to the Bottom of “Triple Bottom Line,”* 14 BUS. ETHICS Q. 243 (2004) (critiquing the triple bottom line concept).

24. *See generally* RICHARD P. CHAIT ET AL., IMPROVING THE PERFORMANCE OF GOVERNING BOARDS (1996) (finding that university board members had difficulty evaluating the success of their schools in achieving their missions).

25. *See generally* Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227 (describing this problem and proposing the “artificial” creation of a market to regulate nonprofit organizations which would be required by founders of nonprofits and large donor organizations).

Second, while it is possible for nonprofit corporations to have members with voting rights—persons who would hold similar rights and duties as shareholders in a for-profit corporation—the overwhelming majority of nonprofit corporations do not have voting members.²⁶ As a result, most nonprofit boards are self-perpetuating—new members of the board are appointed by the board itself.²⁷ This affects board governance in several dimensions. Most dramatically, the lack of voting members significantly contributes to an accountability vacuum that plagues nonprofit boards.²⁸ A recent study by Professor Judith L. Miller, for instance, found that nonprofit board members had difficulty identifying any group to whom they were accountable.²⁹ This lack of accountability to shareholders (or anyone else) leads nonprofit boards to explain their conduct to a broad range of constituents who often have competing agendas (e.g., donors, governmental authorities, clients, and staff).³⁰ These competing constituencies often push nonprofit corporations to seek differing goals. As nonprofit corporations accommodate these constituencies, articulating and striving toward a coherent mission becomes more difficult.³¹

Third, the lack of both a clear performance metric and board accountability, combined with other factors, has led most nonprofit scholars to note that the role of the nonprofit director is more complex than that of for-profit board members.³² Yet the task of nonprofit director is predominantly performed by volunteers³³ who spend significantly less time at the task than their for-profit counterparts.³⁴ Again, this has ramifications for board gov-

26. Evelyn Brody, *Entrance, Voice, and Exit: The Constitutional Bounds of the Right of Association*, 35 U.C. DAVIS L. REV. 821, 860 (2002) (“[T]he typical nonprofit organization is a corporation that lacks members with power to vote for the board or on policy issues”); Manne, *supra* note 25, at 250 (“Charitable nonprofits, however, rarely have members.”).

27. Brakman Reiser, *supra* note 18, at 830 (“Today, self-perpetuating boards are the norm and members are rare, particularly among charitable or public benefit nonprofits.”).

28. See, e.g., U.S. GEN. ACCOUNTING OFFICE, *TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES* (2002); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465–66 (1996); Mary Frances Budig et al., *Pledges to Nonprofit Organizations: Are They Enforceable and Must They Be Enforced?*, 27 U.S.F. L. REV. 47, 108 (1992); Fishman, *supra* note 4, *passim*; Miller, *supra* note 23, at 439–42.

29. Miller, *supra* note 23, at 439–42.

30. *Id.* at 442 (“Nonprofit boards are answerable to multiple constituencies with differing expectations”); O’Regan & Oster, *supra* note 23, at 206.

31. See O’Regan & Oster, *supra* note 23, at 205–06.

32. See, e.g., *id.* at 206–07; Goldschmid, *supra* note 19, at 632; Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1317.

33. O’Regan & Oster, *supra* note 23, at 215; Szymanski, *supra* note 32, at 1316; David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 970 (1996).

34. O’Regan & Oster, *supra* note 23, at 212 (“In this sample, the mean percent of board meetings attended was 71%; this is low relative to the corporate setting, in which any director of a public company who attends less than 75% of board meetings must be reported in the annual report to shareholders. Similarly the estimate by board members of an average of forty-two hours per year

ernance. For instance, nonprofit directors typically lack sufficient information to make informed decisions.³⁵ This inability to invest directors' time into making informed decisions is exacerbated by the informal, yet ubiquitous, requirement that nonprofit directors do much more than oversee managers. "The common folklore is that board members should bring to an organization the three W's: wealth (donations and fundraising), wisdom (monitoring and oversight), and work (operational duties), a much broader set of responsibilities than with for-profit boards."³⁶ Due in large part to the demands for wealth and work from members of the board, nonprofits tend to have larger boards than for-profit corporations, which in turn affects board performance as larger nonprofit board size correlates with less formal oversight of management.³⁷

Fourth, given that most nonprofit directors sit on large, volunteer-dominated boards that lack concrete measures of success or lines of accountability, it should be no surprise that directors rely heavily on staff. Miller's empirical findings corroborate this phenomenon. Nonprofit board members, she found, often rely exclusively on staff to provide them with information they need to vote on policy initiatives.³⁸ Miller also found that nonprofit board members rubberstamp management's proposals without debating the effect those proposals would have on the organization.³⁹ Miller further found that even when circumstances appeared to mandate a more diligent oversight regime, boards frequently defer to staff and the chief executive officer.⁴⁰ In a recent study, Professor Edward Glaeser confirmed Miller's findings that nonprofit organizations are often "captured" by their staff and tend to evolve towards "worker cooperatives," especially as the net worth of the organization increases.⁴¹ Other empirical studies also confirm that "[l]arge or small, most voluntary agencies are unusually dependent on the quality of their executive leadership, and therefore, more subject to idiosyncratic rather than structural factors."⁴² Furthermore, nonprofit managers

spent on board activity is low relative to a recent survey suggesting that outside corporate directors spend an average of 157 hours per year on board matters." (citation omitted)).

35. Katherine O'Regan & Sharon M. Oster, *Does Government Funding Alter Nonprofit Governance?*, 21 J. POL'Y ANALYSIS & MGMT. 359, 361 (2002); O'Regan & Oster, *supra* note 23, at 215.

36. O'Regan & Oster, *supra* note 23, at 207; *see also* Miller, *supra* note 23, at 430 ("These behaviors and activities [expected from nonprofit boards] include things such as determining the organization's mission and purpose; selecting, supporting, and evaluating the chief executive; engaging in strategic planning; monitoring programs and services; providing sound financial management; advancing the organization's public image; raising money; and assuring that the organization fulfills legal and ethical requirements." (citation omitted)).

37. *See* O'Regan & Oster, *supra* note 23, at 206, 216–19.

38. Miller, *supra* note 23, at 438.

39. *See id.*

40. *Id.*

41. Edward L. Glaeser, *Introduction to THE GOVERNANCE OF NONPROFIT FIRMS 1–44* (Edward L. Glaeser ed., 2003).

42. R. M. Kramer, *Voluntary Agencies and the Personal Social Services*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 244* (W.W. Powell ed., 1987).

have come to expect this deference. Nonprofit managers tend to favor less independent boards and often complain of “meddling” board members.⁴³ In short, there are few internal mechanisms that foster independent board control of nonprofit corporations.

B. Third-Party Oversight of Nonprofit Corporations

The non-board-based governance mechanisms for nonprofit corporations are also notoriously lax.⁴⁴ As noted above, the nonprofit community lacks an efficient, market-based regulatory regime.⁴⁵ Furthermore, there is no existing, effective mechanism for supervision of nonprofits by nongovernmental agencies through the courts. Very few people have standing to sue nonprofit organizations.⁴⁶ In most states, the only nongovernmental entities who have standing to sue nonprofits for mismanagement or breaches of fiduciary duty are members of the board itself.⁴⁷ Board members, however, face significant disincentives that counsel against exercising this power; these disincentives have severely limited the efficacy of this mechanism of board supervision.⁴⁸ Moreover, in most states, donors and recipients, who would appear to have incentives to seek redress from the courts, lack standing to sue.⁴⁹ Finally, even in those few states that allow broader standing,⁵⁰ this mechanism has not been a successful means of regulating nonprofit boards.⁵¹

43. O'Regan & Oster, *supra* note 23, at 208.

44. See Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 657 (1998); Fishman, *supra* note 4, at 268–69; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 606–07 (1981); Dana Brakman Reiser, *Decision-Makers Without Duties*, 53 RUTGERS L. REV. 979, 1020–22 (2001).

45. See *supra* note 25 and accompanying text.

46. See generally Lee, *supra* note 19, at 933 (“Unlike business corporations, which provide for shareholder derivative suits, standing for suits against nonprofits is extremely limited, and few parties are able to sue even if they have legitimate grievances.”).

47. See Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 40–42 (1993).

48. See, e.g., Garry W. Jenkins, *The Powerful Possibilities of Nonprofit Mergers: Supporting Strategic Consolidation Through Law and Public Policy*, 74 S. CAL. L. REV. 1089, 1120 (2001) (“Since directors make the organization’s decisions, the chances are slim of a dissident director emerging and willing to take on the onerous task of bringing suit against his or her colleagues.”); James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 669 (1985) (“While directors of charitable corporations generally have standing to sue, they rarely bring derivative suits.”).

49. See Developments in the Law, *Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1596 (1992) (“[D]onors to charitable corporations have often been denied the right to enforce the directors’ fiduciary duties.”); Hansmann, *supra* note 44, at 607.

50. See, e.g., CAL. CORP. CODE § 5142(a) (West 1990) (granting standing to nonprofit officers); N.Y. NOT-FOR-PROFIT CORP. LAW § 623(a), 720(b) (McKinney 2005) (granting standing to members of the nonprofit with five percent voting power); Jenkins, *supra* note 48, at 1120 (discussing “special interest” standing).

51. See, e.g., Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1433 (1998) (discussing *Steenek v. Univ. of Bridgeport*, 668 A.2d 688 (Conn. 1995), which denied special interest standing to a life trustee of the defendant university, and arguing that the courts are

C. Governmental Oversight of Nonprofit Corporations

Nonprofit organizations are also subject to both state and federal regulatory authority.⁵² At the state level regulatory authority is vested with attorneys general⁵³ and at the federal level regulatory power is vested with the IRS.⁵⁴ Traditionally, state attorneys general devote their resources toward enforcing fiduciary duties and good governance practices while the IRS focuses on taxation issues (not the least of which is the maintenance of tax-exempt status).⁵⁵ These governmental organizations generally engage in two types of regulatory schemes: *ex ante* disclosure regimes and *ex post* enforcement regimes. Neither set of regimes, however, has met with much success.

The recent legislative focus on Sarbanes-Oxley-like disclosure requirements for nonprofits could lead one to believe that nonprofit corporations are not currently subject to wide-ranging disclosure requirements. Both the states and the IRS, however, impose disclosure rules upon nonprofit corporations.⁵⁶ The states subject nonprofit corporations to a series of disclosure schemes.⁵⁷ First, most states require annual registration before soliciting funds and annual financial reports regarding charitable solicitation efforts.⁵⁸ Indeed, most state attorneys general believe that the oversight of solicitation is the most pressing task they face in the realm of nonprofit regulation.⁵⁹ Second, most state attorneys general require annual reports regarding the status of the nonprofit's assets.⁶⁰ Third, most nonprofit managers, as a matter

not poised to liberalize standing requirements soon); Jaclyn A. Cherry, *Update: The Current State of Nonprofit Director Liability*, 37 DUQ. L. REV. 557, 571 (1999) (arguing that because damages in such suits flow back to the nonprofit corporation itself, there is little incentive to bring derivative actions); *see also* Lee, *supra* note 19, at 935 (discussing the collective action problems facing those who would seek to sue a nonprofit for breach of fiduciary duties by directors).

52. *See* FREMONT-SMITH, *supra* note 2, at 428.

53. *See id.* at 301; Brody, *supra* note 51, at 1406.

54. *See* FREMONT-SMITH, *supra* note 2, at 238–41 (reviewing section 501 of the Internal Revenue Code, which confers tax-exempt status upon numerous organizations).

55. Norman I. Silber, *Nonprofit Interjurisdictionality*, 80 CHI.-KENT L. REV. 613, 618 (2005); *see also* Fishman, *supra* note 4, 265–67. In recent years, however, there has been a much greater overlap of responsibilities, with the IRS taking on more regulation of fiduciary duties and good governance. Silber, *supra*, at 618.

56. *See, e.g.*, 1 MARILYN E. PHELAN, *NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS* §§ 1:04, 2:23 (2000) (reviewing disclosure requirements for nonprofit organizations).

57. *See* Brakman Reiser, *supra* note 8, at 250.

58. *See, e.g.*, CAL. GOV'T CODE §§ 12585–12586 (West 2005); CONN. GEN. STAT. § 21a-190b to -190c; KAN. STAT. ANN. § 17-1760 (Supp. 2005); ME. REV. STAT. ANN. tit. 9, § 5004–5005B (Supp. 2005); MASS. ANN. LAWS ch. 12, §§ 8E–8F (LexisNexis 2000 & Supp. 2006); N.H. REV. STAT. ANN. § 7:28 (2003); N.Y. EXEC. LAW. §§ 172 to 172-b (McKinney Supp. 2006); *see also* The Multi-State Filere Project, The United Registration System, http://www.multistatefiling.org/#yes_states (last visited Jan. 26, 2007) (listing state solicitation regimes that will accept the multi-state unified registration form).

59. Brody, *supra* note 51, at 1405 n.28.

60. *See, e.g.*, CAL. GOV'T CODE § 12586(a) (West 2005); N.Y. EST. POWERS AND TRUSTS LAW § 8-1.4(f)(1) (McKinney 2002); PHELAN, *supra* note 56, §§ 1:04, 2:23.

of state law, must issue financial and activities reports to their directors annually.⁶¹ Finally, much of this state-required documentation is readily available to the public online.⁶²

The IRS also subjects nonprofits to significant disclosure requirements.⁶³ Congress recently required that all nonprofits make their IRS Form 990—a tax-return for exempt organizations—available to the public.⁶⁴ The 990 filing provides substantial amounts of information about each nonprofit organization, including the organization's financial status, expenditures, lobbying activities, top salaries paid, and self-dealing transactions.⁶⁵ Nonprofit organizations must mail copies of these filings to members of the public upon request.⁶⁶ Much more significantly, 990 filings are available to the public online at www.guidestar.org.⁶⁷ Congress hoped that these disclosure requirements would foster public oversight of nonprofit organizations.⁶⁸

Congress's perception of a need for increased public oversight of nonprofits was driven, in large part, by the failings of the ex post enforcement regime. A key aspect of this failure on both the state and federal level is a lack of funding. Although the numbers of nonprofit organizations have dramatically increased, as have donations to those organizations, "state and federal money spent monitoring [nonprofits from 1992 to 2002] remained flat or declined."⁶⁹ This is not a new phenomenon. State attorneys general have historically given limited resources, and a low priority, to nonprofit enforcement.⁷⁰ The federal government faces a similar lack of funding. In-

61. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 7.01(d)(1) (1987).

62. For example, both California and New York have searchable databases of state annual reporting requirements. California Department of Justice, Charities Search, <http://partners.guidestar.org/partners/cadoj/index.jsp> (last visited Jan. 26, 2007); Office of New York State Attorney General, Charities Bureau Registry Search, http://fairchild.oag.state.ny.us/online_forms/search_charities.jsp (last visited Jan. 26, 2007); see also Internet Prospector, State Charities Databases on the Web, <http://www.internet-prospector.org/charities.htm> (last visited Jan. 26, 2007) (collecting links to state, on-line nonprofit databases accessible to the public).

63. See Ellen W. McVeigh & Eve R. Borenstein, *The Changing Accountability Climate and Resulting Demands for Improved "Fiduciary Capacity" Affecting the World of Public Charities*, 31 WM. MITCHELL L. REV. 119, 120 (2004); Szymanski, *supra* note 32, at 1311.

64. I.R.C. § 6104(d)(1)(A) (2000).

65. See Peter Swords, How to Read the IRS Form 990 and Find Out What It Means, http://www.npcny.org/Form_990/990.htm (last visited Jan. 26, 2007) (providing a nontechnical overview of the 990 Form).

66. I.R.C. § 6104(d)(1)(B).

67. The IRS has directly provided GuideStar's sponsors with millions of Form 990 filings. GuideStar, Frequently Asked Questions, http://www.guidestar.org/help/faq_990.jsp#get990s (last visited Jan. 26, 2007).

68. STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 80 (Comm. Print 2000), available at <http://www.house.gov/jct/s-1-00vol2.pdf>. (last visited (Feb. 13, 2007)

69. Strom, *supra* note 1.

70. See Brody, *supra* note 51, at 1431 ("[A]ttorneys general rarely pursue their rights [against charities] with the same zeal that private parties exhibit."); Hansmann, *supra* note 8, at 873–

deed, a “former IRS Commissioner [recently] observed that the IRS had fewer resources than ever before with which to monitor nonprofit returns.”⁷¹ In fact, the IRS has only 800 agents to monitor 1.6 million tax-exempt organizations.⁷²

A second major factor in the lack of effective governmental enforcement is the narrow scope of interest of, and inadequate remedies available to, regulators. State attorneys general tend to focus their limited enforcement efforts upon nonprofit asset protection.⁷³ As Professor Dana Brakman Reiser recently illustrated, this focus on nonprofit financial accountability, while laudable in many respects, fails to address other pressing issues facing nonprofit corporations, namely, mission accountability (i.e., the shifting from charitable purpose *x* to charitable purpose *y*) and organizational accountability (i.e., the ability of the nonprofit to function formally as a corporation).⁷⁴ Many serious fiduciary violations simply fail to pique the interest of state attorneys general.⁷⁵ In addition to this narrow focus, enforcement agencies have traditionally been saddled with inadequate enforcement tools. For example, until the last decade, revocation of tax-exempt status was the only enforcement tool available to the IRS to regulate 501(c)(3) public charities and to enforce the private inurement doctrine.⁷⁶ Because this draconian penalty was its lone option, the IRS rarely sanctioned wayward organizations except in the most egregious cases.⁷⁷

Given these systemic barriers to effective nonprofit board governance and to the oversight of nonprofit boards both by private and public actors, it is little wonder that Professor Marion Freemont-Smith observes in the

74 (“[I]n most states neither the office of the attorney general nor any other office of the state government devotes any appreciable amount of resources to the oversight of nonprofit firms.”); Szymanski, *supra* note 32, at 1310 (“[A]ttorneys general have limited time and resources, and . . . with their other significant duties to the public, monitoring charities often ranks low on their lists of priorities.”).

71. Silber, *supra* note 55, at 614.

72. Strom, *supra* note 1.

73. Brakman Reiser, *supra* note 8, at 208.

74. *Id. passim*. Some states, however, do attempt to regulate “mission accountability” at least in limited circumstances. See H.B. 1408, 2004 Leg., 2004 Sess. (N.H. 2004) (“Every health care charitable trust shall . . . conduct a community needs assessment to assist in determining the activities to be included in its community benefits plan . . . [which shall] identif[y] and prioritiz[e] . . . community needs that the health care charitable trust can address directly, or in collaboration with others.”).

75. This is not to say that the recent nonprofit scandals have not stirred attorneys general to step up their enforcement role, but the reaction has received mixed responses from scholars. See, e.g., Brakman Reiser, *supra* note 8, at 207 (noting the mixed reception); Mark Sidel, *Law, Philanthropy and Social Class: Variance Power and the Battle for American Giving*, 36 U.C. DAVIS L. REV. 1145, 1151 (2003) (expressing concern for political pitfalls in enforcement).

76. FISHMAN & SCHWARZ, *supra* note 16, at 495.

77. *Id.* With the introduction of “intermediate sanctions,” the Service may now penalize nonprofit officers and directors in their personal capacity for reaping excess benefits from transactions with their nonprofit organizations and, for more egregious violations, impose an excise tax on the organization. See I.R.C. § 4958 (2000); BRUCE R. HOPKINS, *THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS* (2003) (providing a thorough review of Intermediate Sanctions). As a result, the Service has stepped up its enforcement efforts.

opening to her treatise on nonprofit organizations that “[a] distinguishing feature of the nonprofit sector is the freedom within which its component entities are allowed to operate.”⁷⁸

II. STATE REFORMS FOR NONPROFITS—SARBANES-OXLEY-STYLE

The coupling of ineffective governance regimes with recent nonprofit scandals led the nonprofit community, almost from the moment the Sarbanes-Oxley Act was passed, to push for voluntary adoption of many of the applicable provisions of the Act.⁷⁹ Seeing voluntary adoption as insufficient, however, numerous states have passed or considered legislation that mandates Sarbanes-Oxley-like disclosure, governance, and auditing requirements.⁸⁰ This Part briefly reviews the sweeping Sarbanes-Oxley-style reforms proposed in New York and Massachusetts (which are the most aggressive Sarbanes-Oxley-inspired nonprofit reforms introduced to date) and the more limited—but enacted—reforms from California, Connecticut, Kansas, Maine, and New Hampshire.

A. Disclosure Reforms

Following the model of Sarbanes-Oxley, recent nonprofit legislation has focused on enhanced disclosure of financial data as the key element of regulatory reform. Certification of financial statements by top corporate officers is one of the most widely publicized of the Sarbanes-Oxley reforms.⁸¹ This requirement mandates that officers of corporations subject to the Act sign their financial reports as a means of certifying the accuracy of the data and the soundness of the methodology used to obtain the data.⁸² This certification process is also a key disclosure feature of many recent, Sarbanes-Oxley-like nonprofit reforms. One version of the New York bill, for example, employed almost identical language to that found in Sarbanes-Oxley. It required top managers of nonprofit organizations with more than \$1 million

78. FREMONT-SMITH, *supra* note 2, at 1.

79. See, e.g., Jeannie C. Frey, Duties and Rules of Nonprofit Corporation Directors in Today's Environment: Has Sarbanes-Oxley Changed Anything, http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/03spring/24/protecting_directors.pdf; Thomas Silk, *Ten Emerging Principles of Governance of Nonprofit Corporations*, 43 EXEMPT ORG. TAX REV. 35 (2004) (outlining principles of good nonprofit governance post Sarbanes-Oxley); Szymanski, *supra* note 32, at 1305 (“Even if [state] reforms do not come to pass, it can nonetheless be expected that there will be pressure on nonprofit institutions to borrow some of the principles of good governance espoused by the Act for their own purposes.”); BoardSource & Independent Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, http://www.guidestar.org/news/features/sarbanes_oxley.jsp (last visited Jan. 26, 2007).

80. Szymanski, *supra* note 32, at 1312; see Brakman Reiser, *supra* note 9, at 560–61, 567, 573; Brakman Reiser, *supra* note 8, at 208–09, at 268.

81. See Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1200 (2003) (reviewing this requirement and noting its wide notoriety).

82. Sarbanes-Oxley Act of 2002 § 302(a)(1)–(3), Pub. L. No. 107–204, 116 Stat. 745 (codified at 15 U.S.C. § 7241 (Supp. III 2003)).

in annual revenues (or \$3 million in assets) to verify both the soundness of the data in mandated internal financial reports and the reliability of procedures used to obtain the data, and to disclose any deficiencies in these controls and any relevant frauds.⁸³ Under this New York proposal, nonprofit organizations with smaller annual revenues would be subject to a less rigorous verification regime.⁸⁴ Proposed Massachusetts legislation also relies upon executive certification. Under the Massachusetts approach, nonprofit officers would make certifications similar to those required by the New York bill in regard to annual fiscal reports due to the attorney general.⁸⁵ Again, like the New York bill, the Massachusetts bill would offer a less demanding certification regime for nonprofit organizations with less than \$500,000 in annual revenues.⁸⁶

Several states have actually enacted Sarbanes-Oxley-like disclosure reforms. Connecticut, for instance, requires nonprofit organizations with over \$200,000 in annual revenues (excluding government grants) to submit to the attorney general annual, audited financial statements signed by two officers who attest to the veracity of the information.⁸⁷ Kansas law, like the proposed Massachusetts bill, now requires annual financial statements signed by two officers from all nonprofit organizations, and requires that these statements be audited if the organization has over \$500,000 in annual revenues.⁸⁸ Maine, taking a tougher stance, requires signed or sworn audited financial statements from all but the smallest nonprofit organizations.⁸⁹ Other states have adopted disclosure regimes without requiring officer certification. New Hampshire, for instance, has adopted a system wherein larger nonprofits, based on annual revenues, must submit annual financial statements to the attorney general.⁹⁰ Finally, in California, nonprofit organizations with annual gross revenues of \$2 million or more must make audited financial statements available to the attorney general and the public.⁹¹ In sum, the disclosure-focused approach adopted in Sarbanes-Oxley has had a strong

83. Compare S.B. 4836-B, 2004 Leg., 227th Sess. § 1(e)(1)–(4) (N.Y. 2004), with Sarbanes-Oxley Act of 2002 § 302(2)–(3); see also Brakman Reiser, *supra* note 8, at 251 (discussing the similarity between the New York proposal and Sarbanes-Oxley in detail). The latest nonprofit reforms put forward by the New York Attorney General have omitted certification requirements. Brakman Reiser, *supra* note 9, at 571.

84. S.B. 4836-B, 2004 Leg., 227th Sess. § 1(d) (N.Y. 2004).

85. Mass. A.G. Proposal, *supra* note 10, § 3(g) (adopting Sarbanes-Oxley-like certification requirements with a two-tiered level of certification that, like New York's bill, requires a more vigorous level of certifications from officers of nonprofits with larger annual revenues).

86. *Id.*

87. CONN. GEN. STAT. §§ 21a-190b, 21a-190c (Supp. 2006).

88. KAN. STAT. ANN. § 17-1763(b)(15), (c) (Supp. 2005).

89. ME. REV. STAT. ANN. tit. 9, §§ 5004(3), (4)(C)(1), (4)(D)(1). Section 5006(1)(D) exempts organizations with less than \$10,000 in revenue from these requirements. *Id.*

90. N.H. REV. STAT. ANN. § 7.28(III-a) to (III-b) (Supp. 2005).

91. CAL. GOV'T CODE § 12586(e)(1) (West 2005).

appeal for state-based nonprofit reforms, constituting the bulk of the recent initiatives.⁹²

B. Governance Reforms

Sarbanes-Oxley also imposes a series of governance reforms that have spawned similar initiatives in the nonprofit community. The Act mandates that publicly traded corporations form audit committees,⁹³ that directors who sit on these audit committees be independent⁹⁴ (i.e., they may not receive extra benefits for serving on the committee and they may not be officers of the corporation),⁹⁵ and that at least one member of the audit committee be a financial expert.⁹⁶ The Act also tasks audit committees with new responsibilities.⁹⁷ Beyond structural board issues, Sarbanes-Oxley prohibits publicly traded corporations from making personal loans to directors or top officers,⁹⁸ and the Act envisions the adoption of a financial officer's code of ethics.⁹⁹

Many states have enacted, or are considering, similar reforms for nonprofit organizations. While audit committees have been a required feature of for-profit board governance in publicly traded companies since 1999, they have not been a prominent component of nonprofit governance.¹⁰⁰ The recent Sarbanes-Oxley-style nonprofit reforms change this landscape. In California, nonprofit corporations with more than \$2 million in gross annual revenues must establish an audit committee composed of independent members who, in accordance with Sarbanes-Oxley, may not be employees of the corporation or receive additional compensation for service on the audit committee.¹⁰¹ Additionally, under California law, nonprofit corporation audit

92. See, e.g., Brakman Reiser, *supra* note 9, *passim*.

93. Sarbanes-Oxley Act of 2002 § 205(a), Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 78c(a) (Supp. III 2003)) (requiring either the adoption of an audit committee or that the functions of the audit committee be performed by the board as a whole).

94. *Id.* § 301.

95. *Id.* (“In order to be considered to be independent . . . a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.”).

96. *Id.* § 407 (“[E]ach issuer [must] . . . disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert . . .”).

97. *Id.* §§ 202, 204.

98. *Id.* § 402(a).

99. *Id.* § 406 (requiring the SEC to issue disclosure rules regarding whether or not covered corporations have adopted said ethical codes, and if not, why not).

100. See New York Stock Exchange, Listed Company Manual, <http://www.nyse.com/Frameset.html?nyseref=&displayPage=/listed/1022221393251.html> (last visited Jan. 26, 2007) (providing that listed companies must have audit committees in compliance with SEC rules in Section 303A.06); National Association of Securities Dealers, Bylaws of The National Association of Securities Dealers, Inc., art. IX, § 5., http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000085 (last visited Jan. 26, 2007).

101. CAL. GOV'T CODE § 12586(e)(2) (West 2005). The Act allows for non-director members of the audit committee but excludes “members of the staff, including the president or chief executive

committees are charged with responsibilities very similar to those imposed under Sarbanes-Oxley, such as hiring CPAs, reviewing and accepting audit reports, and approving nonaudit services offered by accounting firms.¹⁰² Under the New York bill, similar Sarbanes-Oxley-like reforms would be imposed. Nonprofit corporations with \$1 million in annual revenues or \$3 million in assets would be required to establish audit committees¹⁰³ composed of independent members¹⁰⁴ with duties similar to those imposed in California. The proposed Massachusetts bill would impose similar requirements for nonprofit corporations with \$750,000 in annual revenues.¹⁰⁵

The states have added some governance reforms different from those found in Sarbanes-Oxley as well. The California Nonprofit Integrity Act, for instance, requires boards to review and approve CEO and CFO compensation to ensure it is just and reasonable.¹⁰⁶ Under the New York bill, large nonprofit boards would be required to form executive committees.¹⁰⁷ Moreover, many states have been ahead of Sarbanes-Oxley in terms of prohibiting loans to officers and directors.¹⁰⁸

officer and the treasurer or chief financial officer." *Id.* Further, "[i]f the corporation has a finance committee, it must be separate from the audit committee . . . and members of the finance committee shall constitute less than one-half of the membership of the audit committee." *Id.* Finally, "[m]embers of the audit committee shall not receive any compensation from the corporation in excess of the compensation, if any, received by members of the board of directors for service on the board and shall not have a material financial interest in any entity doing business with the corporation." *Id.* This definition of independence closely follows the Sarbanes-Oxley Act. *See* Sarbanes-Oxley Act of 2002 § 301 (audit committee members may not "(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof:").

102. *Compare* CAL. GOV'T CODE § 12586(e)(2) (West 2005) (making the audit committee responsible for the following: recommending the hiring and firing of CPAs and negotiating their compensation, conferring with the auditor to ensure that the nonprofit's financial affairs are in order, reviewing and accepting the audit, approving any non-audit services offered by the CPA's accounting firm subject to the U.S. Comptroller's Yellow Book), *with* Sarbanes-Oxley Act of 2002 § 202(a)(1) (requiring audit committees to preapprove all auditing and non-auditing services), *id.* § 204 (requiring audit committees to review the reports of auditors), *id.* § 301 (holding audit committees "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm").

103. S.B. 4836-B § 4(g)(1), 2004 Leg., 227th Leg. (N.Y. 2004). As Sarbanes-Oxley requires, *see* Sarbanes-Oxley Act of 2002 § 205(a), if a nonprofit corporation does not form an audit committee, the entire board becomes charged with these duties. S.B. 4836 § 4(g)(2), 2003 Leg., 227th Sess. (N.Y. 2003).

104. N.Y. S.B. 4836-B § 4(g)(3)(A). To qualify as independent, directors may not "accept any consulting fee, advisory fee, or other compensation or other benefits from the corporation," except compensation received as a member of the board or its committees, *id.* § 4(g)(3), or have engaged in an interested transaction with the corporation within the last year, *id.* § 4(g)(3)(B).

105. Mass. A.G. Proposal, *supra* note 10, § 8P (closely following the New York bill). New Hampshire's act does not require audit committees. H.B. 1408, 2004 Leg., 2004 Sess. (N.H. 2004).

106. CAL. GOV'T CODE § 12586(g). The requirement of reasonable pay for nonprofit managers is also required under the I.R.C. *See* I.R.C. § 4958 (2000). Sarbanes-Oxley itself does not speak directly to concepts such as just and reasonable compensation, but it does deal with executive compensation in many other respects. *E.g.*, Sarbanes-Oxley Act of 2002 § 304 (prohibiting certain types of executive bonuses).

107. N.Y. S.B. 4836-B.

108. *E.g.*, CAL. CORP. CODE § 5236 (requiring that loans be approved by the attorney general); N.H. REV. STAT. ANN. § 7:19-a (2003) (prohibiting loans); N.Y. NOT-FOR-PROFIT CORP. LAW § 716

C. Auditing Reforms

Finally, Sarbanes-Oxley requires a host of auditing reforms.¹⁰⁹ Once again, recent nonprofit reform proposals were inspired by Sarbanes-Oxley.¹¹⁰ Many nonprofits, however, do not share the same level of auditing sophistication that one expects of publicly traded companies.¹¹¹ Thus, state proposals for nonprofits tend to focus simply on requiring audited financial statements. This is the case for nonprofit organizations that meet minimum annual revenues under the California, Connecticut, Kansas, Maine and New Hampshire legislation.¹¹²

III. DUBIOUS EFFICACY OF DISCLOSURE

As noted above, the Sarbanes-Oxley-like nonprofit reforms closely mimic the disclosure, governance, and auditing reforms designed for for-profit organizations. Most nonprofit law scholars contend, however, that reflexive, wholesale importation of for-profit regulatory regimes into the nonprofit community is ill advised.¹¹³ The Sarbanes-Oxley-like nonprofit reforms have received a similar reception. Commentators have argued that these acts would be too costly, disincentivize donations, and make it

(2005) (prohibiting loans); REVISED MODEL NONPROFIT CORP. ACT § 8.32 (1987) (prohibiting loans). The majority of states still allow 501(c)(3) public charities (private foundations are prohibited from making such loans under the I.R.C.) to make loans to directors and officers, which continues to be seen as a problem in the nonprofit community. Harvy Lipman & Grant Williams, *Assets on Loan: Nonprofit groups lend millions to officials, Chronicle study finds*, CHRON. PHILANTHROPY, Feb. 5, 2005, at 1 (reporting that between 1998 and 2001, 501(c)(3) charitable organizations made \$142 million in personal loans to top officers).

109. *E.g.*, Sarbanes-Oxley Act of 2002 §§ 101–209.

110. *See* Brakman Reiser, *supra* note 9, at 573.

111. *Id.*

112. CAL. GOV'T CODE § 12586(e)(1) (requiring audits for organizations with more than \$2 million in revenue); ME. REV. STAT. ANN. tit. 9, §§ 5004(4)(d)(1), 5006 (2005) (requiring audits for organizations with more than \$10,000 in annual revenues); S.B. 946, 2005 Gen. Assem., Jan 2005 Sess. (Conn. 2005) (requiring audits for organizations with more than \$200,000 in annual revenues); S.B. 121, 2005 Leg., 2004–2005 Sess. (Kan. 2005) (requiring audits for organizations with more than \$500,000 in annual revenues); H.B. 1408, 2004 Leg., 2004 Sess. (N.H. 2004) (requiring audits for organizations with more than \$1 million in revenue). New York and Massachusetts required auditing under certain circumstances prior to the introduction of the Sarbanes-Oxley-like reforms. MASS. ANN. LAWS ch. 12 § 8F (LexisNexis 2000); N.Y. EXEC. LAW § 172-b(1), (2).

113. *E.g.*, Jeffrey A. Alexander & Bryan J. Weiner, *The Adoption of the Corporate Governance Model by Nonprofit Organizations*, 8 NONPROFIT MGMT. & LEADERSHIP 223, 223 (1998) (“[T]he adoption of structures and practices from the for-profit sector is neither a feasible nor even a desirable solution to problems facing many nonprofit organizations.”); Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations—The American Bar Association’s Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 759 (1989) (“[N]onprofit laws are the poor stepchild of the state business statutes.”); Manne, *supra* note 25, at 229 (“[S]traight application of for-profit corporate fiduciary law would be unsuitable.”); Howard L. Oleck, *Mixtures of Profit and Nonprofit Corporation Purposes and Operations*, 16 N. KY. L. REV. 225, 243 (1989) (arguing that development of the Nonprofit Model Act by the ABA’s business section is inappropriate “because that section is the wrong one for planning law for altruistic, voluntaristic, *pro bono* organizations.”).

more difficult to attract qualified directors.¹¹⁴ In addition to such costs, others have noted that these reforms are often duplicative and fail to focus upon nonprofit-specific issues of corporate governance such as mission creep and organizational unaccountability.¹¹⁵ While the Sarbanes-Oxley-style governance and auditing reforms may bear fruit, as discussed below,¹¹⁶ this Part contends that the disclosure-focused reforms that form the bulk of these state initiatives will not assist in fostering improved nonprofit governance. We lack institutions in the nonprofit sector that would make use of such mandated information and legal compliance schemes seldom inspire moral conduct without concomitant shifts in organizational culture.

A. Mandatory Disclosures Unlikely to Be Used

As currently situated, it appears doubtful that increased disclosure of financial data will foster stronger governmental oversight of nonprofit governance. First, as noted above, state nonprofit regulators are significantly underfunded given the scope of their regulatory mission.¹¹⁷ Yet none of the states' Sarbanes-Oxley-like reforms come with increased funding for state attorneys general.¹¹⁸ Without funding, these disclosure documents seem fated to languish in the basements of state attorneys general's offices. Second, historically most government nonprofit enforcement efforts have been initiated by affiliates of the nonprofit, or by investigative journalists.¹¹⁹ Nevertheless, these disclosure-focused acts do not protect such whistleblowers, who are already protected under Sarbanes-Oxley itself.¹²⁰ Nor does journalistic access to this newly disclosed information, given the information already accessible online, appear worth the cost of providing it. Finally, because there is not a market-based regulatory system to act as a buffer to prevent the capture of state attorneys general by politically powerful nonprofit actors, even increased activity by attorneys general may be unhelpful.¹²¹

114. Szymanski, *supra* note 32, at 1316–20.

115. *See e.g.*, Brakman Reiser, *supra* note 9, at 561; Brakman Reiser, *supra* note 8, at 208.

116. *See infra* notes 186–194 and accompanying text.

117. *See supra* notes 70–71 and accompanying text.

118. *See e.g.*, CAL. BUS. & PROF. CODE § 17510.5; CAL. GOV'T CODE §§ 12581–12599.7; CONN. GEN. STAT. § 21a-190b to 190c, 190f, 190h (2005); KAN. STAT. ANN. 17–1763, -6002 (2005); ME. REV. STAT. ANN. tit. 9, § 5003–5005, 5007–5009, 5011–5012, 5017–5018; N.H. REV. STAT. ANN. § 7:28, :32-f (2004).

119. Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 953 & n.60 (2004).

120. Sarbanes-Oxley Act of 2002 § 1107, Pub. L. No. 107–204, 116 Stat. 745 (codified at 18 U.S.C. § 1513(e) (Supp. III 2003)).

121. *See, e.g.*, Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 MICH. L. REV. 1312, 1334–35 (2002) (reviewing NORMAN I. SILBER, *A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR* (2001)) (providing this “capture” argument).

It is also doubtful that donors or other members of the public will make use of greater mandatory disclosure of financial data. One assumption underlying these legislative efforts appears to be that donors will use this information when making gifts. Empirical studies, however, do not support this assumption. The data shows that small donations made by individuals are the backbone of the nonprofit sector. Donations by individuals account for 76.5% of all nonprofit contributions.¹²² The majority of these individually donated funds are given by households earning less than \$100,000 annually.¹²³ Based on 2003 tax returns, the median amount given to nonprofit organizations per household is \$700 annually.¹²⁴ While reliable data is not available, the median donation per charity may be close to \$100 per gift.¹²⁵ Thus, the median household likely engages in seven \$100 gift transactions annually. Perhaps as a result of the relatively small scale of these transactions, most donors do not investigate the financial or governance practices of nonprofit organizations before donating.¹²⁶ Large donors will not benefit from a strengthened, mandatory financial disclosure regime either. Nonprofits that seek to obtain large grants must provide the grantors with all the information the grantor desires, which is accomplished without legally imposed transparency rules. Federally funded nonprofit organizations, for example, must provide significant amounts of financial documentation to

122. GIVING USA FOUND., *supra* note 15, at 14.

123. *Id.* at 2 (based on 2003 tax returns).

124. CTR. ON PHILANTHROPY AT IND. UNIV., AVERAGE AND MEDIAN AMOUNTS OF HOUSEHOLD GIVING AND VOLUNTEERING IN 2002 FROM THE CENTER ON PHILANTHROPY PANEL STUDY (COPPS) 2003 WAVE (March 2006), <http://www.philanthropy.iupui.edu/Average%20Amounts-Household%20Giving%20&%20Volunteering-2002.pdf>. (last visited) The average amount given was \$1,872, but this figure is greatly increased by a small number of huge gifts at the top end.

125. This is a difficult statistic to establish. Most data regarding donations to charities comes from two sources: (1) IRS itemized tax returns, and (2) the Center on Philanthropy Panel Study (COPPS) (which is attached to the University of Michigan's Panel Study of Income Dynamic). Neither data set includes information regarding per charity donations. Letter from Patrick M. Rooney, Professor of Economics and Philanthropic Studies and Director of Research for The Center on Philanthropy at Indiana University (Sept. 6, 2006) (on file with author). As a crude proxy for the median donation per charity, I am relying upon the median donation to the United Way in 2003, which was approximately \$100. United Way, Non-Itemized Deduction Would Substantially Boost Charitable Giving, <http://national.unitedway.org/news/statements/Non-itemized%20Flyer1.pdf>. As the United Way is a top-five charity when measured either by revenues or by assets, this organization was picked to provide a crude proxy of per charity giving across the nation. William P. Barrett, the 200 Largest U.S. Charities, http://www.forbes.com/2005/11/18/largest-charities-ratings_05charities_land.html (follow "Revenues" hyperlink for revenue rankings; follow "Net Assets" hyperlink for net asset rankings) (last visited Jan. 26, 2007). The key point, I hope, is not lost here. The median family engages in several relatively modest gift transactions totaling \$700 per annum.

126. *E.g.*, Katie Cunningham & Marc Ricks, *Why Measure?*, STAN. SOC. INNOVATION REV., Summer 2004, at 44 (finding donor interest in financial accountability negligible); William F. Meehan III et al., *Investing in Society*, STAN. SOC. INNOVATION REV. Spring 2004, at 34, 35–36 (reviewing studies that find that donors do not investigate the financial and governance practices of organizations before donating).

the federal government,¹²⁷ as do recipients of funds from private grant-making institutions.¹²⁸

B. Disclosure as an Instrumental Value

These many failures illuminate broader insights about disclosure as a tool of corporate governance. At least since future Supreme Court Justice Louis Brandeis wrote his groundbreaking book in 1914,¹²⁹ disclosure has come to be seen as a preeminent value of corporate governance amongst public intellectuals,¹³⁰ business ethicists,¹³¹ legal academics,¹³² and within the nonprofit community.¹³³ This high regard for transparency has a venerable philosophical lineage that reaches back to the pantheon of Western political

127. *E.g.*, OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR A-110, UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND AGREEMENTS WITH INSTITUTIONS OF HIGHER EDUCATION, HOSPITALS, AND OTHER NON-PROFIT ORGANIZATIONS §§ 51–53 (1999), available at <http://www.whitehouse.gov/omb/circulars/a110/a110.html> (last visited Jan. 26, 2007). In light of these requirements, the California Nonprofit Integrity Act, for example, exempts nonprofits funded by government grants from its requirements. CAL. GOV'T CODE § 12583 (West 2004). Further, hospitals, educational institutions and religious organizations are not subject to the Act as these sectors are already heavily regulated under other bodies of law. *Id.*

128. *E.g.*, Paul N. Yivisaker, *Foundations and Nonprofit Organizations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 360, 365 (Walter W. Powell ed., 1987).

129. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT 92 (1914) ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

130. *See, e.g.*, DON TAPSCOTT & DAVID TICOLL, THE NAKED CORPORATION 62–93 (2003) (arguing that transparency is, in effect, a panacea to cure all corporate ills).

131. *See, e.g.*, David S. Gelb & Joyce A. Strawser, *Corporate Social Responsibility and Financial Disclosures: An Alternative Explanation for Increased Disclosure*, 33 J. BUS. ETHICS 1 (2001) (arguing that disclosure regimes are valuable even though empirical data does not suggest that such regimes have any financial benefits); Eleanor R. E. O'Higgins, *Corruption, Underdevelopment, and Extractive Resource Industries: Addressing the Vicious Cycle*, 16 BUS. ETHICS Q. 235 (2006) (contending that increased transparency by transnational corporations will assist in the reduction of international corporate corruption in the mineral extraction industry).

132. Matthew F. Gorra, *On-Line Trading and United States Securities Policy: Evaluating the SEC's Role in International Securities Regulation*, 32 CORNELL INT'L L.J. 209, 210 n.4 (1998) ("By imposing anti-fraud and disclosure requirements . . . the Commission preserves marketwide transparency and, hence, fosters efficient domestic securities markets"); Jonathan R. Macey & Maureen O'Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 31 (1999) ("[The SEC] has long believed that transparency . . . plays a fundamental role in the fairness and efficiency of the secondary markets . . . and improves the price discovery, fairness, competitiveness and attractiveness of U.S. markets." (quoting UNITED STATES SECURITIES AND EXCHANGE COMMISSION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, IV-1 (1994), <http://www.sec.gov/divisions/marketreg/market2000.pdf>); Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1044 (2005) ("The fundamental goal of securities law is to make markets more efficient by providing transparency to investors, thereby reducing asymmetric information.").

133. *See, e.g.*, Mordecai Lee, *Public Reporting: A Neglected Aspect of Nonprofit Accountability*, 15 NONPROFIT MGMT. & LEADERSHIP 169 (2004) (arguing that nonprofits should adopt a scheme of public reporting as one method to increase citizen confidence in their activities and in the sector as a whole).

thought.¹³⁴ Nevertheless, it would be a mistake to make a fetish of disclosure. It is cliché nowadays to state that having vast amounts of data without the resources to intelligently review and employ it is of no value, but that does not detract from the veracity of this insight as it relates to corporate disclosure regimes.¹³⁵ This insight suggests, then, that disclosure is only of instrumental value. That is to say, corporate disclosure, either in the for-profit or nonprofit sector, is normatively valuable only when institutions are established, or soon will be established, that enable interested parties to make use of the data to further some other ends (e.g., improved financial returns, improved environmental performance, or improved human rights enforcement).¹³⁶ It follows that disclosure regimes not coupled with public or private institutions that enable interested parties to make use of the information are normatively valueless.¹³⁷ But this is exactly what the Sarbanes-Oxley-inspired nonprofit regimes intend to impose.

Of course, the availability of more financial information as envisioned by the Sarbanes-Oxley-like nonprofit reforms could change the donative environment. Indeed, some have suggested it is a lack of easily accessible data that causes this dearth of interest in nonprofit financial practices and that donors would review the data if it were readily available.¹³⁸ This view

134. See, e.g., JEREMY BENTHAM, POLITICAL TACTICS 29–44 (Michael James et al. eds., 1999); IMMANUEL KANT, *Eternal Peace*, in THE PHILOSOPHY OF KANT 470 (Carl J. Friedrich ed., 1949); JOHN STUART MILL, CONSIDERATIONS OF REPRESENTATIVE DEMOCRACY 262 (H.B. Action ed., 1972); JOHN RAWLS, A THEORY OF JUSTICE 16, 454 (1971); JEAN JACQUES ROUSSEAU, *Dedication to the Republic of Geneva*, in DISCOURSE ON THE ORIGIN OF INEQUALITY 32–33 (G.D.H. Cole trans., 1988).

135. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787 (2001) (describing how corporate disclosure partially works in the United States “through a complex set of laws and private and public institutions that give investors reasonable assurance that the issuer is being (mostly) truthful.”); Nicole Dando & Tracey Swift, *Transparency and Assurance: Minding the Credibility Gap*, 44 J. BUS. ETHICS 195 (2003) (arguing that increasing levels of disclosure of social, ethical and environmental performance by corporations and other organizations is not being accompanied by simultaneous greater levels of public trust and that a common metric for deciphering this data is needed to enhance the value of disclosures); Miriam Miquelon Weismann, *Corporate Transparency or Congressional Window-Dressing? The Case Against Sarbanes-Oxley as a Means to Avoid Another Corporate Debacle: The Failed Attempt to Revive Meaningful Regulatory Oversight*, 10 STAN. J.L. BUS. & FIN. 98 (2004) (contending that Congress’s goal of increasing corporate transparency by passing Sarbanes-Oxley is pointless because it is not coupled with effective SEC regulatory reform).

136. I am using the term institution quite broadly to include informal social practices or market forces. That is, I would label wide-spread, individual, unorganized, accessing of Form 990 filings by the public as an institution that makes use of disclosed data.

137. Of course, corporate disclosure might be inherently valuable—that is to say, corporate transparency might be normatively valuable regardless of the consequence that flows from such disclosures. See James J. Brummer, *Accountability and the Restraint of Freedom: A Deontological Case for the Stricter Standard of Corporate Disclosure*, 5 J. BUS. ETHICS 155 (1986) (arguing, from a Kantian point of view, that corporate transparency is a good per se). A full refutation of this argument is beyond the scope of this Article, but I would ask the reader to engage in the following thought experiment: To be inherently valuable, one would have to agree that corporate transparency has normative force even in an environment where no one could make use of the information. While it is possible that this could be valued as adding authenticity to business endeavors or somehow recognizes the value of other moral agents, I find the concept of corporate transparency as inherently valuable untenable.

138. David Bornstein, *Let’s Make Sure Worthy Groups Get Aid*, CHRON. PHILANTHROPY, Jan. 22, 2004, at 37 (offering this opinion).

strikes a sour note, however. First, as outlined above, vast amounts of non-profit financial information is already available to the public online.¹³⁹ Yet the majority of individual donors do not reference this material. There is little reason to think that adding more data to the public sphere will change that attitude. Indeed, increasing publicly available data may have the opposite effect because donors may reach a point of information overload and fail to make use of new data.¹⁴⁰ This problem would appear all the more pressing in the nonprofit sector because it lacks a well-developed market of financial experts to filter data for donors.¹⁴¹

C. Compliance Focused

The Sarbanes-Oxley-like disclosure reforms also suffer from an overly legalistic approach to ethical governance. Sarbanes-Oxley, and nonprofit reforms modeled upon it, by and large take a compliance approach to the production of ethical board governance.¹⁴² These reforms are premised upon the belief that forcing nonprofit leaders to produce certain documents will lead to superior behavior in the future. The empirical data we have suggests that the mere production of compliance documents or ethics codes, without a concomitant change in the “ethical climate” in the organization, will not result in improved ethical behavior.¹⁴³ Disclosure regimes that lack effective review by donors, government, or other market-based forces, such as those created under the Sarbanes-Oxley-like reforms, are unlikely to foster such a change in the ethical climate of wayward nonprofit organizations.¹⁴⁴ Such legalistic regimes, instead of inspiring a renewed sense of ethical obligation, may lead to a preoccupation with fulfilling mandated processes and the loss of freedom to make innovative decisions required by an ethically sound organization.¹⁴⁵ In light of this overwhelming evidence, one participant in this symposium

139. See *supra* note 62 and accompanying text.

140. E.g., Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 419 (2003) (arguing that greater disclosure lacks value without improved means of using the information by for-profit investors and experts because the average investor experiences “information overload”).

141. Cf. *id.* at 432 (“As a practical matter, a company’s disclosures are largely ‘filtered’ through experts—various securities professionals and financial intermediaries—who research and process the information and whose trades and recommendations ultimately set securities prices.”).

142. Surendra Arjoon, *Corporate Governance: An Ethical Perspective*, 61 J. BUS. ETHICS 343, 345 (2005).

143. See generally Mark S. Schwartz, *Effective Corporate Codes of Ethics: Perceptions of Code Users*, 55 J. BUS. ETHICS 323 (2004); Mark S. Schwartz, *The Nature of the Relationship between Corporate Codes of Ethics and Behaviour*, 32 J. BUS. ETHICS 247 (2001); Linda Trevino et al., *The Ethical Context in Organizations: Influences on Employee Attitudes and Behaviors*, 8 BUS. ETHICS Q. 447 (1998); Linda Trevino et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, 41 CAL. MGMT. REV. 131 (1999); Linda K. Trevino & Gary R. Weaver, *Organizational Justice and Ethics Program “Follow-Through”: Influences on Employees’ Harmful and Helpful Behavior*, 11 BUS. ETHICS Q. 651 (2001).

144. E.g., Brakman Reiser, *supra* note 9, at 583–87.

145. William H. Donaldson, *Corporate Governance: What Has Happened and Where We Need To Go*, BUS. ECON., July 2003, at 16, 18.

contends that standard legalistic approaches to corporate governance are “constitutionally incapable of producing socially responsible corporations in this current age of complexity and value pluralism . . . [because] corporations are not being encouraged to develop new solutions to existing (or potential) problems, but only to meet a certain minimum level of behavior.”¹⁴⁶ Such damning critiques appear all the worse in the nonprofit context. Because they are not accompanied by either increased funding for state regulators or an efficient non-governmental regulatory regime for nonprofits,¹⁴⁷ Sarbanes-Oxley-inspired reforms will impose the large costs of disclosure and verification procedures onto nonprofit organizations¹⁴⁸ without any realistic hope that these rules will act as a deterrent.

IV. MISTAKEN MORAL PREMISE

Assuming these many critiques of the recent Sarbanes-Oxley-like reforms are sound, they beg the question: How have so many legislative proposals gone awry? This Part argues that these legislative proposals start with an ethical framework that is inapplicable in the nonprofit context. Sarbanes-Oxley posits a stockholder conception of business ethics, yet nonprofit corporations are quintessentially stakeholder organizations. Because nonprofit organizations have no stockholders to protect, the Sarbanes-Oxley-like nonprofit reforms are mislaid. I contend that, with a clearer understanding of the appropriate ethical regime in which nonprofit corporations operate, future effective nonprofit reforms will be more easily crafted.

A. *Nonprofit Corporations and Stakeholder Theory*

Scholars of organizational ethics have formulated numerous theories regarding the moral dimensions of business endeavors. Two of the leading normative theories¹⁴⁹ of business ethics that are particularly relevant here are stockholder

146. David Hess, *Regulating Corporate Social Performance: A New Look at Social Accounting, Auditing, and Reporting*, 11 *BUS. ETHICS Q.* 307, 310 (2001).

147. Cf. Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 *ST. JOHN'S L. REV.* 671, 675–76 (2002) (describing, in the for-profit context, how strict rules work as deterrents only if there is some belief that they will be enforced).

148. See, e.g., Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 *COLUM. BUS. L. REV.* 71, 117 (2002) (discussing disclosure in the for-profit sector and noting that “[m]onitoring-based systems have unexpectedly serious (and probably immeasurable) costs, which society should not impose without strong reason.”).

149. The following families of theories are often used in reference to descriptive claims, instrumental claims, and normative claims of business organizations. For example, stakeholder theory is often used in reference to all three types of assertions. See Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 *ACAD. MGMT. REV.* 65, 69–73 (1995). There is a similar dual empirical and normative use in the literature of stockholder (or agency) theory. See Norman E. Bowie & R. Edward Freeman, *Ethics and Agency Theory: An Introduction*, in *ETHICS AND AGENCY THEORY* 3, 3–4 (Norman E. Bowie & R. Edward

theory and stakeholder theory.¹⁵⁰ From the stockholder theory perspective, corporations are merely arrangements by which investors advance funds to managers in return for an equity interest in the venture.¹⁵¹ Under this view, directors and officers are agents of the stockholders and are bound as fiduciaries to pursue only the ends established by the stockholders.¹⁵² Milton Friedman, often portrayed as a standard bearer for this view, sums up the corporation's moral duties well: "The social responsibility of business is to increase its profits . . . [constrained by law and] ethical custom."¹⁵³ It is worth noting, as Friedman makes clear, that stockholder theory does not condone the pursuit of stockholder value by any means without moral constraints, as some detractors imply, but rather the pursuit of stockholder value via normatively permissible means.¹⁵⁴ While some commentators remain proponents of

Freeman eds., 1992). In this Article, unless I specifically so delineate, I will use these terms to refer only to normative claims.

150. See John Hasnas, *The Normative Theories of Business Ethics: A Guide for the Perplexed*, 8 BUS. ETHICS Q. 19 (1998). Hasnas also identifies a third leading family of theories, namely, social contract theory. This family of normative business values is of great importance in current business ethics scholarship. See, e.g., THOMAS DONALDSON & THOMAS W. DUNFEE, *TIES THAT BIND* (1999); Thomas Donaldson & Thomas W. Dunfee, *Toward a Unified Conception of Business Ethics*, 19 ACAD. MGMT. REV. 252 (1994). The root idea expounded upon by Donaldson and Dunfee is that normative duties for business entities may be established via the integration of a set of hyper-norms—formulated in a Rawlsian manner—with extant contracts (including implied contracts) between members of specific economic communities. A full discussion of Integrative Social Contract Theory, as it is styled, is beyond the scope of this Article. Nevertheless, the work of social contract theorists such as Donaldson and Dunfee is an attempt to outline normative duties owed by business entities to persons beyond stockholders. As such, most, if not all, of the following discussion of the inapplicability of stockholder theory to nonprofits—and thus the applicability of stakeholder theory—could very well be reconstituted in terms of social contract theory. Finally, this focus on normative duties of business entities themselves in this Article is not to say that business ethicists do not discuss other families of normative theories as well, most notably virtue ethics. See Robert C. Solomon, *Victims of Circumstances? A Defense of Virtue Ethics in Business*, 13 BUS. ETHICS Q. 43 (2003). Virtue ethics, however, is more focused on the character of individuals than on the normative duties of organizations themselves. As such, this family of theories will not be a focus in this Article.

151. Hasnas, *supra* note 150, at 24.

152. *Id.*

153. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES (Sept. 13, 1970) (Magazine), reprinted in BUSINESS ETHICS 153, 153 (W. Michael Hoffman and Jennifer Mills Moore eds., 2d ed. 1990); see also MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962) ("[T]here is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.").

154. Hasnas, *supra* note 150, at 22.

stockholder theory,¹⁵⁵ the majority of thinkers in the business-ethics field consider it passé.¹⁵⁶

By most accounts, stakeholder theory is the preeminent contemporary normative theory of business ethics, especially among business practitioners.¹⁵⁷ The basic view is that, regardless of the potential to increase returns to investors, corporate managers morally ought to make decisions that benefit all stakeholders in the corporation, not just stockholders.¹⁵⁸ In short, “[s]takeholder theory stands . . . against th[e] univocal view of shareholders *über alles* [represented by stockholder theory.]”¹⁵⁹ Stakeholders, pursuant to this conception of business ethics, include many different people, such as stockholders, creditors, employees, the local community, clients, and suppliers.¹⁶⁰ The moral imperative for corporate managers is to balance the often competing, yet morally equal, needs and desires of this diverse set of interests.¹⁶¹

155. See, e.g., John Dobson, *Defending the Stockholder Model: A Comment on Hasnas, and on Dunfee's MOM*, 9 BUS. ETHICS Q. 337 (1999) (arguing that the stockholder theory allows for the translation of ethical concerns of the public into readily identifiable market pressures to which corporate managers can react); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1–39 (1991) (presenting an economists perspective of stockholder theory); Hasnas, *supra* note 150 (arguing that stockholder theory is capable of deontological foundations traditionally thought to be the sole domain of stakeholder theory); Alexei M. Marcoux, *A Fiduciary Argument Against Stakeholder Theory*, 13 BUS. ETHICS Q. 1 (2003) (arguing that stockholder theory furthers the special moral status of investors in a business venture).

156. THOMAS DONALDSON, *THE ETHICS OF INTERNATIONAL BUSINESS* 45 (1989) (arguing that stockholder theory is an outmoded view of business ethics); Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65, 81–82 (1995) (similar); William M. Evan & R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation: Kantian Capitalism*, in *ETHICAL THEORY AND BUSINESS* 75, 76–77 (Tom L. Beauchamp & Norman E. Bowie eds., 4th ed. 1993) (similar); ROBERT C. SOLOMON, *ETHICS AND EXCELLENCE* 45 (1993) (similar).

157. See Kevin Gibson, *The Moral Basis of Stakeholder Theory*, 26 J. BUS. ETHICS 245 (2000) (noting the overwhelming dominance of stakeholder theory in scholarly writings).

158. Eric W. Orts & Alan Strudler, *The Ethical and Environmental Limits of Stakeholder Theory*, 12 BUS. ETHICS Q. 215, 216–20 (2002) (providing overview of stakeholder theory); Hasnas, *supra* note 150, at 25 (same).

159. Orts & Strudler, *supra* note 158, at 216.

160. Determining who ought to be a stakeholder has been a source of much debate in the business ethics community. See, e.g., Ronald K. Mitchell et al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. MGMT. REV. 853, 857 (1997). Very grossly speaking, there are two camps. Many look to a narrow view of who a stakeholder is, based upon having some asset at risk. See, e.g., Max B. E. Clarkson, *A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance*, 20 ACAD. MGMT. REV. 92, 105–07 (1995). Others seek a broader conception of stakeholder, which would include “any group or individual who can affect or is affected by the achievement of an organization’s purpose.” R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* 55 (1984). We need not troll the depths of these waters for the purposes of this Article.

161. See R. Edward Freeman, *Stakeholder Theory of the Modern Corporation*, in *ETHICAL ISSUES IN BUSINESS: A PHILOSOPHICAL APPROACH* 314 (Thomas Donaldson & Patricia H. Werhane eds., 6th ed. 1998) (“The task of management in today’s corporation is akin to that of King Solomon. The stakeholder theory does not give primacy to one stakeholder group over another, though there will surely be times when one group will benefit at the expense of others. In general, however, management must keep the relationships among stakeholders in balance.”).

As every nontrivial activity assumes a philosophical perspective, corporate governance reforms also presuppose a particular normative view, such as a stockholder or stakeholder view. Sarbanes-Oxley is no exception. I contend that Congress employed a stockholder conception of business ethics when it passed the Act. Congress made this clear in the Preamble, stating its goal as “protect[ing] investors by improving the accuracy and reliability of corporate disclosures.”¹⁶² Legal scholars also agree that the Act is focused almost exclusively upon the needs of stockholders.¹⁶³ Moreover, the stockholder perspective exemplified in the Sarbanes-Oxley Act is not aberrational, but rather a continuation of the long-standing focus of corporate law on the protection of stockholder interest.¹⁶⁴ Even if this attribution of a stockholder normative perspective to Sarbanes-Oxley is too strong, there can be little argument that the Act assumes that investors are far and away the most important stakeholders in corporations either as a normative matter¹⁶⁵ or for other efficiency reasons.¹⁶⁶

This stockholder-focused normative approach adopted by Sarbanes-Oxley—and derivatively by the nearly identical disclosure-based reforms imposed by the Sarbanes-Oxley-like nonprofit legislation—is completely inapposite in the nonprofit sector. Simply put, nonprofit corporations lack stockholders and they overwhelmingly lack voting members who would have interests similar to stockholders.¹⁶⁷ A nonprofit reform regime based upon a normative principle of protecting stockholders’ interests is not only inapplicable but it also violates the venerable moral principle of “ought implies can.”¹⁶⁸ That is to say, because nonprofits cannot protect stockholder interests (as these stockholders do not exist), they ought not be morally

162. See *supra* note 7.

163. See, e.g., Arjoon, *supra* note 142, at 345; Brakman Reiser, *supra* note 8, at 239; Szymanski, *supra* note 32, at 1316.

164. See, e.g., John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1326 (1992) (“[T]he fundamental goal of corporate law is so theoretically and historically obvious that it need not be explicated: the goal is to maximize corporate—and thus shareholder—welfare.”).

165. See, e.g., Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 BUS. ETHICS Q. 53 (1991) (arguing that corporations owe special moral duties to shareholders); Kenneth E. Goodpaster and Thomas E. Holloran, *In Defense of a Paradox*, 4 BUS. ETHICS Q. 423 (1994) (same). But see John R. Boatright, *Fiduciary Duties and the Shareholder-Management Relation: Or, What's So Special About Shareholders?*, 4 BUS. ETHICS Q. 393 (1994) (arguing against the uniqueness of stockholder interests); R. Edward Freeman, *The Politics of Stakeholder Theory: Some Future Directions*, 4 BUS. ETHICS Q. 409, 413 (1994) (same).

166. See, e.g., Dobson, *supra* note 155, at 339 (“Within financial-economic theory, therefore, the stockholder model is not praised as a normative ideal because stockholders are viewed as in any way morally superior to other stakeholders, but rather because a focus on stockholders—or more specifically on stock price—leads to a minimum of agency costs, which in turn benefits all stakeholders.”).

167. See *supra* note 26 and accompanying text.

168. Kant is generally credited with the first published exposition of this principle—although in true Kantian fashion his discussion is not quite so pithy. IMMANUEL KANT, *CRITIQUE OF PRACTICAL REASON* 149–53 (Lewis White Beck trans., 3d ed., Macmillan 1993) (1788).

obliged to do so.¹⁶⁹ Thus, the Sarbanes-Oxley-like nonprofit reforms start not merely with an inapplicable moral premise but with an impossible moral imperative.

Adopting a stakeholder view as an initial normative premise, by contrast, is the appropriate moral framework for nonprofit reforms. First, as a descriptive matter, nonprofit corporations are archetypal stakeholder organizations. As discussed above,¹⁷⁰ nonprofit corporations lack stockholders. The board has responsibilities to promote the nonprofit's mission and is responsible to a wide range of stakeholders, including donors, clients, employees, and taxpayers.¹⁷¹ This list of stakeholders is nearly identical to the standard list of stakeholders of for-profit corporations.¹⁷² As with stakeholders in for-profit corporations,¹⁷³ these nonprofit stakeholders have differing expectations of the nonprofit corporation, which in turn affects the board's concept of accountability.¹⁷⁴

Second, the normative principles that ground for-profit stakeholder theory map nearly one-to-one with standard normative principles offered for nonprofit governance. Professors Evans and Freeman—leading proponents of stakeholder-style for-profit corporate governance—have condensed ethical governance practices into two principles. The first axiom, the “principle of corporate legitimacy,” posits that “the corporation should be managed for the benefit of its stakeholders: its customers, suppliers, owners, employees, and the local communities.”¹⁷⁵ The second principle, the “stakeholder fiduciary principle,” states that:

[M]anagement bears a fiduciary relationship to stakeholders and to the corporation as an abstract entity. It must act in the interests of the stakeholders as their agent, and it must act in the interests of the corporation to ensure the survival of the firm, safeguarding the long-term stakes of each group.¹⁷⁶

Commentators on ethical nonprofit governance have coalesced upon similar principles. John Carver, for instance, argues that nonprofits should be governed for the benefit of “the various stakeholders to whom the board owes its primary allegiance,” much like Evans and Freeman's principle of legitimacy.¹⁷⁷ Professor David Smith presents another standard principle of ethical, nonprofit board governance when he asserts that the board should be loyal to the mission of the corporation and that directors should “attend to

169. Of course, this is merely the contrapositive formulation of the same principle.

170. See *supra* note 26 and accompanying text.

171. Miller, *supra* note 23, at 442 (“Nonprofit boards are answerable to multiple constituencies with differing expectations”); O'Regan & Oster, *supra* note 23, at 206.

172. See *supra* note 160 and accompanying text.

173. See *supra* note 161 and accompanying text.

174. Miller, *supra* note 23, at 442–43.

175. Evan & Freeman, *supra* note 156, at 82.

176. *Id.*

177. JOHN CARVER, BOARDS THAT MAKE A DIFFERENCE: A NEW DESIGN FOR LEADERSHIP IN NONPROFIT AND PUBLIC ORGANIZATIONS 15 (2d ed., Jossey-Bass 1997).

the goals, values, and expectations of the larger community.”¹⁷⁸ This principle is much like Evans and Freeman’s stakeholder fiduciary principle¹⁷⁹ and the fiduciary duties imposed upon nonprofit directors by law.¹⁸⁰ As with for-profit stakeholder theory,¹⁸¹ Smith notes that a key ethical function of the nonprofit board is to balance the competing needs and desires of various stakeholders.¹⁸² Stakeholder theory, rather than the stockholder theory upon which the Sarbanes-Oxley-style reforms are based, is the superior rubric for formulating and evaluating ethical nonprofit governance.

B. Stakeholder Theory and Future Nonprofit Reforms

Adopting a stakeholder approach would have a substantial effect upon future nonprofit reforms. By focusing on the numerous hurdles that stakeholder organizations must overcome instead of reflexively imposing a for-profit reform regime, future legislation could be more effective in improving ethical board governance.

First, future nonprofit reforms should focus less on disclosing data to uninterested parties and more on the difficulty nonprofit corporations find in communicating with various interested stakeholders. One means of accomplishing this goal is through the increased use of advisory boards, which would allow nonprofit organizations to bring in larger and more diverse stakeholder representatives without imposing the full burden of being a formal board member upon these individuals or further enlarging the board of directors.¹⁸³

Additionally, nonprofit reforms should strive to address the accountability vacuum within which many nonprofit boards operate. Empirical data suggests that nonprofit boards that can identify lines of accountability have superior abilities to monitor activity by management because these boards are able to identify performance and evaluation criteria.¹⁸⁴ As such, state

178. DAVID H. SMITH, *ENTRUSTED: THE MORAL DIMENSION OF TRUSTEESHIP* 11 (1995).

179. Evan & Freeman, *supra* note 156, at 82.

180. *See Summers v. Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002) (holding that director’s fiduciary duties are owed to the nonprofit corporation itself and not to particular persons).

181. *See supra* note 161 and accompanying text.

182. SMITH, *supra* note 178, at 22 (arguing that nonprofit boards must balance competing stakeholder interests in a manner that is “faithful to the core intention of the donor or founding group or to the human needs [the board is] meant to address”).

183. Judith R. Saidel, *Expanding the Governance Construct: Functions and Contributions of Nonprofit Advisory Groups*, 27 *NONPROFIT AND VOLUNTARY SECTOR Q.* 421, 421 (1998) (arguing that advisory groups are a critical instrument of governance for many nonprofits because such groups “link nonprofits to key stakeholder groups in the environment . . . strengthen ties of cooperation and shared purpose with other community actors . . . supplement governance activities carried out by non profit boards of directors . . . establish new ties to various elites . . . [and] others connect nonprofits to grassroots community constituencies”). *See generally* LISA A. RUNQUIST, *THE ABCS OF NONPROFITS* 21–22 (2005) (recommending increased use of advisory boards).

184. Miller, *supra* note 23, at 447.

reforms that facilitate this process of building accountability may be welcome.¹⁸⁵

This is not to say that the Sarbanes-Oxley-like reforms entirely miss the normative mark.¹⁸⁶ The imposition of independent audit committees, for example, may go a long way toward fostering improved stakeholder-style board governance. As noted above, a key issue confronting nonprofit board performance revolves around poorly informed directors and their overly supine attitudes toward management.¹⁸⁷ Further, empirical data indicates that large board size, a ubiquitous phenomenon in nonprofits, is associated with lower levels of formal monitoring by the board.¹⁸⁸ In the for-profit arena, however, “larger boards are not as susceptible to managerial domination as their smaller counterpart [T]hese boards will be more actively involved in monitoring and evaluating CEO and company performance, normally through specialized committees.”¹⁸⁹ Perhaps the imposition of small, specialized, and independent audit committees and executive committees will bring similar results in the nonprofit context. The data suggests that more active nonprofit board oversight can prevent the harm that managerial malfeasance can inflict on constituents, communities, and overall organizational reputation.¹⁹⁰ Finally, structural reforms such as the imposition of audit committees lay the groundwork for ethical corporate governance, not just for a particular metric that is measured in a disclosure form but for a wide array of issues that may come before the board.¹⁹¹

Of course, no reform scheme is perfect. Unlike Sarbanes-Oxley, the nonprofit reforms do not require that audit committees have financial experts as members.¹⁹² This may come as a mixed blessing. On the one hand, nonprofit accounting practices are substantially different from those employed by for-profit firms and may well leave audit committee members,

185. Cf. H.B. 1408, 2004 Leg., 2004 Sess. (N.H. 2004) (“Every health care charitable trust shall . . . conduct a community needs assessment to assist in determining the activities to be included in its community benefits plan [which shall] identif[y] and prioritiz[e] . . . community needs that the health care charitable trust can address directly, or in collaboration with others . . .”).

186. See Szymanski, *supra* note 32, at 1326.

187. See *supra* notes 36, 41 and accompanying text.

188. O’Regan & Oster, *supra* note 23, at 216–19.

189. S.A. Zahra & J.A. Pearce, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15 J. MGMT. 291, 309 (1989).

190. See Margaret Gibelman et al., *The Credibility of Nonprofit Boards: A View from the 1990s and Beyond*, 21 ADMIN. SOC. WORK 21 (1997) (reviewing the boards’ oversight role of five large nonprofit organizations).

191. See Josef Wieland, *The Ethics of Governance*, 11 BUS. ETHICS Q. 73 (2001) (arguing that the fostering of ethical corporate behavior must start with formal corporate structure).

192. Compare Sarbanes-Oxley Act of 2002 § 407, Pub. L. No. 107–204, 116 Stat. 745 (codified at 15 U.S.C. § 7265(a) (Supp. III 2003)) and 17 C.F.R. § 229.401(h) (2006), with CAL. BUS. & PROF. CODE § 17510.5 (West Supp. 2006), S.B. 4836-B, 2004 Leg., 227th Sess. (N.Y. 2003), and Mass. A.G. Proposal, *supra* note 10.

even those who are veteran businesspeople, in the dark.¹⁹³ This opacity could thwart any attempt at meaningful board oversight of financial matters. But on the other hand, recruiting dedicated nonprofit directors is already a difficult enough task without the added requirement of finding a nonprofit director with substantive knowledge of nonprofit accountancy.¹⁹⁴ Thus, the requirement that nonprofits (at least those with substantial resources) obtain professional audits makes sense from the stakeholder perspective. Given the specialized nature of nonprofit accounting, an audit requirement will force nonprofit boards into obtaining a clear understanding of their organization's financial health. All this is to show that, by adopting a stakeholder normative framework, reformers of the nonprofit sector will more likely adopt legislation that will positively change nonprofit board governance.

CONCLUSION

An increased appreciation of the problems of nonprofit board governance, which the Sarbanes-Oxley-like nonprofit reforms embody, is a positive step away from the traditional neglect of the nonprofit community by public and private supervisory institutions. Indeed, as the nonprofit sector continues to grow, issues of board governance will become more pressing, thus increasing the need for effective oversight institutions. Such efforts, however, should be based upon a normative perspective that is apropos to the nonprofit sector instead of a knee-jerk application of for-profit regulatory structures to the nonprofit sector. Unfortunately, the bulk of the recent Sarbanes-Oxley-like nonprofit reforms do not adopt this philosophy.

193. See generally, Martha L. Benson et al., *Coping With NPO Standards—It's Not Difficult*, J. ACCT., Sept. 1998, at 67 (discussing the impact of new rules governing the accounting of contributions).

194. See generally Szymanski, *supra* note 32, at 1316 (“Commentators have frequently described the difficulty many nonprofits encounter when searching for qualified directors and board members.”). The California act does allow for nondirectors to serve on the audit committee; inducing experts in nonprofit accountancy to serve may be less demanding as they need only serve in this one capacity. CAL. GOV'T CODE § 12586(e)(2) (West 2005).

