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Catharine P. Wells

Boston College Law School, wellsc@bc.edu

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Holding Charities Accountable; Some Thoughts from an Ex-Regulator

Catharine Wells

Introduction

I spent five years as the Director of the Division of Public Charities for the Commonwealth of Massachusetts. The Director is responsible for fulfilling the common law responsibilities of the Attorney General as well as certain statutory functions under G. L. c 12 and c. 68. For reasons which I discuss below, I believe that Office of the Attorney General is, in fact, the correct place for charitable oversight.

As an ex-regulator, I can be forgiven for bristling at the frequent suggestion that state regulation is inevitably inadequate. Certainly, there are some states that devote only a few resources to this important job, but there other states that have active and effective offices. In Massachusetts, from 1979 to 1984, the Division had six lawyers including one lawyer who was also a C.P.A. In addition, there were eight administrative staff members assigned to the Division. This may seem small compared to the tens of thousands registered charities, but the Division was able to set priorities that resulted in significant levels of accountability. While the Division registered about 10,000 charities, many of these had only nominal funding. State law required an audited financial statement from each charity with income in excess of \$100,000 and the Division was active in enforcing this requirement. We examined all audited statements for irregularities and had a regularized system for follow-up. In the course of a year, the Division contacted hundreds of organizations seeking explanations and, in some case, changes in their

practices. In appropriate cases, we filed law suits. In addition, the Division followed up on all disputes and allegations that came to its attention. Typically, these cases involved disputes among various members of the charity's constituency and the Division was often able to play a constructive role in resolving them. It also launched several different initiatives aimed at attacking problems in the non-profit sector. One of these was an on-going effort to address the escalation in health care costs. This initiative included participation in Blue Cross rate hearings, enforcement of hospital Hill-Burton responsibilities, and participation in selected litigation. Another was an initiative aimed at the problems attendant on charitable gambling. This included the drafting and enforcement of regulations, an education campaign for local police and communication with charitable organizations to be sure that they were actually receiving proceeds. All of this may not have constituted an optimum level of regulation – in fact I am sure there were some charities who thought it was overregulation – but neither was it insignificant.

I tell you this in part because I am proud of the Division and what it accomplished. But, more importantly, I believe that my experience provides a somewhat different perspective for thinking about issues of accountability. This presentation is divided into three sections. In the first, I describe four lessons that I learned from daily contact with all segments of the charitable community. Some of them you already know, but they deserve emphasis. In the second section, I will offer some thoughts on how we should model charitable organizations. There has been a tendency in the literature to analogize charitable organizations to for-profit firms and then to try to isolate the differences between them in terms of market imperfections. I disagree with this approach and will offer a somewhat different model. In the third section, I will offer my own thoughts

about the best form of charitable oversight. Not surprisingly, I favor state regulation, but I also have a number of thoughts about how such regulation should be handled.

I. Lessons Learned

Lesson #1: Charitable organizations are properly formed for many different purposes, not all of which are altruistic.

The definition of a charitable organization – one that is formed to benefit the indefinite public – seems to suggest that a spirit of altruism lies at the heart of every charitable gift. However, this is not entirely true. Donors may give to the nameless public, but they may also specify the kind of benefit that should be subsidized. For example, people who give to the Boston Symphony or to their Church, are usually supporting a specialized kind of activity in which they are personally interested. And, of course, there is nothing wrong with this. Such institutions enrich community life, expand the possibilities that are open to its citizens, and allow for the specialized practice of cultural and religious traditions. Nevertheless, it is wrong to see all charities as founded on altruism. Other motivations include the desire for self-expression, a devotion to certain religious practices; a wish to participate in community life, and a need to facilitate minority populations and viewpoints. Exhibit 1 provides a break down of these motivations and some common examples.

Lesson #2: Charities utilize various forms of governance.

The rise of modern not-for-profit incorporation statutes has led to the assumption that most charitable organizations share the same structure. Under such acts, charitable corporations typically have a board of directors and a statutory set of officers. In

addition, some organizations may elect to have certain kinds of membership participation. But, as every lawyer knows, these formal requirements do not effectively control the internal governance of the organization. Each organization has its own norms of participatory decision making and these differ radically. Some charities – hospitals, universities, museums, etc. – resemble for-profit corporations in their decision making practices, but most do not.

First, there are variations in the activity level of boards. Some are self-perpetuating and function as “rubber stamps” for the organization’s management. Other boards assume an active role. There are even some that are so active that they impede the ability of the organization to function. Second, there is question of which constituency dominates the organization. Some organizations respond primarily to staff interests – functioning as collectives of professional workers. Others may be run by the client community. Still others respond primarily to donors. Third, many organizations have a membership as well as a board. In some cases, the membership is simply a collection of individually small donors who have no governance responsibilities. In other cases, the charity functions more like a private club with members possessing the right to elect all or part of the board. Fourth, many charities have other devices that provide constituency input. There are advisory groups, employee groups, client committees, alumnae associations, visiting committees, and so forth. Such groups serve as a focus for discussion and their input can have a powerful influence on community acceptance, donor activity and board decision making. Thus, while these groups may have no legal authority, their role in charitable governance should not be minimized.

Lesson #3: Charitable programs defy measurement.

Many charities produce goods and services that can be quantified, but this does not mean that the output of the organization can be meaningfully compared with other similar organizations. Should we, for example, compare the average cost of educating one undergraduate at Harvard with the same cost at U. Mass. Lowell? Or even with “peer” institutions such as Princeton or Yale? Or, if we want to think about the effectiveness of a symphony orchestra, should we compare it to other orchestras by looking at the average cost of the events it sponsors? The problem is that values such as student formation, cutting edge programming, and performing excellence are not easily quantified; and, while this fact may lead some people to be skeptical about these values, some people are not and those people have every right to support the organizations that pursue them.

Lesson #4: The ability to undertake charitable activity in one’s own way is an essential aspect of human freedom.

When thinking about charitable accountability, it is easy to forget that those who are involved in charitable activity are exercising fundamental rights – rights to think as they please: to raise their voices; and to attack community problems in whatever way seems best to them. The limits on this freedom are not hard to see. Charities should not harm others; they should not solicit funds with false representations; and the officers of a charity should faithfully discharge their fiduciary duties. Nevertheless, even when a regulator is enforcing these duties, he or she should not forget to ask: Am I interfering with the ability of private citizens to act in accordance with their own particular vision of the public good. For example, while I was at the Division, a routine inspection of an

audited statement disclosed that an organization had its entire endowment invested in South African gold stocks. The issue was whether the board had breached its fiduciary duties by investing in a way that was both risky and undiversified. The organization itself was a politically conservative research institute and argued strenuously that the investment in question represented an investment strategy that was fully in line with their donors' beliefs. After examining their literature and their solicitation materials, we were forced to agree, finally deciding that such an investment strategy was part of the charity's identity, a part of what made it desirable to so many of its donors and participants.

II. Modeling Charitable Activity

If you look at the economic literature, you will see that most discussions of non-profit activity begin with the concept of a not-for-profit firm that is, in every way, like its for-profit analogue except that it is not allowed to distribute earnings. In economic theory, a firm is a black box that internalizes a number of informal arrangements. Internal arrangements are matters of governance and consequently they are the province of those who work inside the firm. For those who are outside the firm, the firm is judged not by its internal governance but by its results. Inputs are compared with outputs and the resulting measures of efficiency are compared with other similar firms. For a market based economist, the inability of a non-profit firm to distribute earnings makes it more difficult to assess efficiency. There is no bottom line, no concept of net earnings.*

Nevertheless, some have tried to assess efficiency by comparison to similar for-profit

* Charitable accounting is fundamentally different from for-profit accounting. Where for-profit firms have profits, not-for profit firms have an excess of revenues over expenses. When a for-profit firm does not distribute earnings, it maintains a retained earnings account. Under similar circumstances the charity books the excess of revenue over expenses to its fund balance. These differences are not merely technical; they represent fundamental differences in function between non-profit and for-profit firms.

entities. A charitable, hospital, for example, competes with for-profit hospitals and it is possible to compare their per patient costs with those of the for-profit. However, these kinds of comparisons rarely hold up. The charitable hospital may be a research hospital that funds research as well as care; or it may see sicker patients; or it may engage in public education. Indeed, there are a number of ways in which attempts to quantify the value of non-profit activity become frustrated. Imagine, for example, two organizations that seek community support. One proceeds by hiring a professional media consultant; the other by using its own homegrown outreach program. The first charity may do measurably better, but the second may claim that the efficiency of its campaign was less important than the need to train and empower its participants. A quantitative comparison of the two organizations cannot be completed unless we are willing to monetize the second charity's accomplishments; and it is difficult to see how this can be done unless we make a subjective comparison between the value of community empowerment vis a vis the value of community support. Let me give another example that involves our two institutions. Boston College pays its service workers better than Harvard does. While this might appear inefficient to some, it embodies the notion of community that is part of the Jesuit tradition.

Aside from problems of quantification, charities pose a challenge to the very concept of economic efficiency. We determine efficiency by comparing inputs and outputs. This requires that there be a clear distinction between them. Because charitable organizations have no bottom line they reflect a lot of different values. This fact gives rise to real questions as to what should be counted as inputs and outputs of the organization. Should a volunteer's time be treated as an input if the volunteer herself is enriched by the

experience? If we classify financial help for the victims of Katrina as an output, how should we count their need – should we count it as an “input” because it has demonstrable value in stimulating fundraising?

The final problem with thinking about efficiency in the non-profit context comes from asking the question: Efficient for whom? Since Coase, we have recognized that firms are formed because they avoid the information and transaction costs that may distort market pricing. In short, the firm provides a mechanism that facilitates internal and informal exchanges. If we apply this analysis to charitable organizations, should we think of them as solving information and transaction problems for donors? Or should we think of it the other way – starting with the assumption that a firm is a collective of people with needs who wish to avoid the inefficiencies of individual solicitation? Our assessment of the organization’s efficiency will depend upon which starting point we select..

In view of these difficulties, it might make sense to think about charitable organizations as being something that is essentially different from a for-profit firm. My suggestion is that we think of an individual charity as a “consumption group” that is organized around the project of meeting human needs. Because such groups consume rather than produce, they are governed by individual preferences rather than the concept of efficiency. For example, it may be more efficient in some sense to drink milk rather than champagne, but the decision to do the latter is not irrational if one’s preference is, all things considered, champagne. In economic terms, preferences are a given. They provide the basis by which all other things are judged.

I do not mean to suggest that the concept of efficiency is entirely irrelevant to charitable organizations. Efficiency enters the picture in two ways. First, efficiency is relevant to any consumption group on a secondary level – once preferences are decided upon, the rational decision maker will select the most efficient way to satisfy them. Second, charities depend on the kindness of others and these others may well have a preference for efficient management of resources. While these types of efficiency are important, they do not provide a touchstone for charitable accountability. We need a different way to assess the success of non-profits and to think about the circumstances under which state intervention is warranted.

In the next section, I will use the notion of a consumption group to define an approach to charitable accountability. I will do this by beginning with the other, more common, example of a consumption group – the American family. Families play many roles but, as economic entities, they function as a collection of consumers whose individual levels of consumption are determined, not by the market, but by an internal allocation mechanism. Families, like charities, have obligations that extend beyond personal consumption. For example, each family has a responsibility to care for certain of its members who are not able to care for themselves. Since charities have a similar function, I will begin my discussion of charitable accountability by looking at the type of accountability that we impose on families. I will then consider whether there are differences between charities and families that necessitate additional forms of accountability?

III. Providing for Accountability

Families are accountable for providing care for their members. The accountability imposed by the state in this respect is does not take the form of regulation. The state does not mandate that certain steps must be taken. Nor does it attempt to second guess the soundness of particular decisions. Rather, the approach is more holistic. The state must decide whether the parents are so failing in their responsibilities to the child that an extreme remedy – the severing of parental rights – should be imposed. Poor or inefficient parents rarely lose their children. What is required is a fundamental inability or unwillingness to meet the child’s basic needs. One reason for this high standard is that we understand the damage that is done when families are torn apart. Another reason is the fact that parents have a right to raise their children in whatever way they think fit so long as there is no significant and demonstrable damage to the child. Similar arguments apply to charities as well. First, the charity may perish in the face of state intervention. Volunteers, donors, and even trade creditors are unlikely to support an organization that is “having trouble with the state.” Second, like parents, charitable organizations have a right to address human needs in whatever way that they see fit. For this reason, accountability should not take the form of weighing efficiency or mandating certain forms of preferred behaviors. What is needed is not regulation, but oversight. As with families – the state is there primarily to be sure that no real harm is done.

In addition to this kind of oversight, there are at least two aspects of charitable activity that deserve special attention. Charities are different from families in that there is a separation between control and beneficence. In a family, the decision makers – the parents – are the same people who produce the funds and effort that are used for

consumption. But, in a charity, the resources come from donors who may have little control over its operations. This means that those who run charities have fiduciary obligations that must be enforceable through the courts. Nor should we forget that donors have an autonomous right to direct the use of their property. To facilitate this right, it is important that charitable organizations maintain a certain level of transparency. This means that financial information should be readily available from the charity itself or from government actors. It is also important that charities be held to a strict level of honesty in the materials it uses to solicit funds from the public.

The comparison between the regulation of families and the regulation of charities highlights three areas that should be subject to regulation. The first is the requirement of functionality. Taken as a whole, is the charity so dysfunctional that it requires state intervention despite the costs of such intervention? Second, there is the requirement of transparency. Do donors, volunteers, members, customers, and beneficiaries have enough understanding of the organization to make their own autonomous decisions about how to participate? Third, there is the related question of honesty. Is the charity misrepresenting itself or its activities in order to obtain support?

Those who are familiar with charities law will note that these three areas track the types of actions that may be maintained by the Attorney General against charitable trustees. For those who are not, I have set out these parallels in Exhibit 2. It is this similarity that forms the basis for my recommendation that charitable regulation should remain with the state attorneys general.[†] In addition, there are two other considerations that support this result. First, state oversight is better than national oversight because

[†] In addition, the Internal Revenue Service should play an important but limited role in protecting the tax system from abuse of the charitable deduction. .

most charities are local and therefore best understood in the local context. For example, there are a large number of charities in Massachusetts that provide social services under contract with the state. Understanding the financing of these organizations requires knowledge of state contracting practices. Second, when the state moves to cut off parental rights, it must do so in a court of law because only the judiciary can terminate such fundamental rights. The same is true of charitable oversight. The Attorney General has no inherent power to change the officers of a charitable organization or to order its dissolution. Such powers are reserved for the courts. This means that the Department of the Attorney General is the correct location for state oversight because the Attorney General is the only state actor who is empowered to represent the public interest in a court of law.

So far, all I have done is to endorse the status quo. I do, however, have three suggestions for new initiatives.

Specific Proposals

1. Creation of a consortium of State Attorneys General

State Charities Officials have always collaborated through the offices of the National Association of Attorneys General and the National Association of State Charities Officials. I would suggest that this collaboration be intensified in area of national charitable organizations. Effective oversight requires the creation of a centralized office that can receive and monitor financial reports. This will not only improve effectiveness; it will also reduce duplication of efforts.

2. Creation of a National Foundation to Provide Support Services to State Attorneys General

One of the difficulties of decentralizing charitable oversight is that local offices may not have the experience and expertise that are necessary to undertake this important function. It is possible, however, to provide services to individual offices that will enable them to expend their own limited resources in a more effective way. For example, in the 1980's the National Charities Information Bureau had one person on staff that traveled from state to state assisting with computerization of charitable information. This provided useful assistance to individual offices and, at the same time, facilitated nationwide coordination among them.

3. Reevaluation of Various Forms of Specialized Regulation

Certain types of charitable organizations offer services that affect the health or safety of the public and are therefore subject to more substantive regulation by state or federal agencies. Hospitals, for example, have their facilities and procedures regulated by state boards of health; their finances regulated by state rate setting commissions, and their ability to do business controlled by state licensing boards. They are also subject to numerous private requirements from health insurance companies, professional groups, and other interested parties. In such instances where charitable status overlaps with substantive regulation, those who are enforcing substantive regulation need to be better informed about the charitable context. State Charities Officials should therefore think about training programs for appropriate federal, state and local officials.

Conclusion

I recognize that I am advocating a position that looks very much like the status quo. While this does not seem very innovative, my five years of experience with the

Massachusetts Attorney General did not convince me that fundamental changes were needed. Certainly, more resources would be helpful but the amounts involved are relatively small and well within the means of most state legislatures.

The charitable sector is extremely important and it deserves the right type and level of oversight. Regulation will not deter for-profit enterprises so long as they are able to bear the cost of regulation and still return a competitive rate to invested capital. It is the compelling force of human greed that guarantees this result. Charities, on the other hand, are more vulnerable to the risks of overregulation. They depend on motivations that are more subtle than greed. Compassion, the desire to be involved and the need for creativity can be easily derailed by well meaning attempts at accountability. But a lack of accountability is not the answer either. There is danger in ignoring charitable abuses. If mismanagement becomes apparent, the public becomes reluctant to continue giving. Personality disputes, contentious boards, and failures to communicate inevitably lead to a dissipation of interest in the affected organization and the charitable cause it represents. These two sets of concerns form the Schylla and Charybdis of charitable oversight and those who seek to regulate charities must walk the fine line between them and avoid both damaging interference and damaging neglect.

Exhibit 1

Breakdown of Charitable Purposes

Purpose	Examples
Vehicles For Generosity And Compassion For Others	The American Red Cross United Way Habitat for Humanity
Forums For Religious Practices	The Catholic Church The American Friends Service Comm. Andover-Newton Theological Seminary
Opportunities For Self-Expression	The Charles Peirce Society The Boston Historical Society
Opportunities For Community Participation	The Parent-Teacher Association The Friends of the Framingham Hospital Alcoholics Anonymous
Resources For Community Life	The Boston Symphony National Public Radio Harvard University
A Platform For Minority Populations And Minority Views To Flourish	Hellenic College The Jewish Community Center The United Negro College Fund

It can be argued that some of these organizations serve more than one purpose. For example, Hellenic College provides a community resource (an educational institution) as well as a platform for a minority population (the Greek-American community). Charities often defy easy categorization and this is part of the reason why the issue of accountability seems so intractable.

Charitable Oversight

Type of Accountability	Common Law Actions against Charitable Trustees	Actions against Modern Charitable Corporations
<p style="text-align: center;">Functionality</p> <p>Taken as a whole, is the charity so dysfunctional that it requires state intervention despite the costs of such intervention?</p>	<p>Petition for Removal – A trustee can be removed when his derelictions are so egregious as to impede the fulfillment of the trust.</p> <p>Petition for <i>Cy Pres</i> – The purpose of a trust can be amended when the original purpose is no longer capable of fulfillment. ‡</p>	<p>Actions for Appointment of a Receiver</p> <p>Petition for Dissolution</p> <p>Action for <i>Cy Pres</i></p>
<p style="text-align: center;">Transparency</p> <p>Do donors, volunteers, members, customers, and beneficiaries have enough understanding of the organization to make their own autonomous decisions about how to participate?</p>	<p>Action for an Accounting</p>	<p>Annual Registration and Financial Disclosure</p>
<p style="text-align: center;">Honesty</p> <p>Is the charity misrepresenting itself or its activities in order to obtain support?</p>	<p>Action for Breach Of Fiduciary Duties – The trustee has a duty of loyalty and a duty of care and these may be enforced in a suit by the Attorney General.</p>	<p>Action for Breach Of Fiduciary Duties</p> <p>Action for Fraudulent or Deceptive Solicitation Practices</p>

‡ An action for *Cy Pres* can be initiated either by the trustee or by the Attorney General. If it is initiated by the trustee, the Attorney General is a necessary party.