WHAT CRITIQUES OF SARBANES-OXLEY CAN TEACH ABOUT REGULATION OF NONPROFIT GOVERNANCE

Ellen P. Aprill *

INTRODUCTION

After a series of well-publicized corporate scandals, most notably Enron and WorldCom, President George W. Bush signed the American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act (SOX), into law on July 30, 2002. It has been called “the most sweeping federal securities legislation since the original laws in 1933 and 1934.” Among SOX’s provisions are increased disclosure to the Securities and Exchange Commission (SEC), establishment of a new oversight board for public accounting firms, limitation of non-audit services that can be provided by a firm’s auditors, required disclosure of internal controls, a prohibition on loans to insiders, a mandate that the audit committee consist solely of independent members, and certification by executives of financial reports.

With the exception of the provisions related to document retention, Congress applied SOX only to publicly traded American companies. Nonetheless, invocation of SOX quickly reverberated across the nonprofit landscape. One after another, nonprofit advisors and trade groups urged voluntary compliance with the principles of SOX. Three examples give a sense of the broad and enthusiastic response. Independent Sector and BoardSource, in their 2003 pamphlet The Sarbanes-Oxley Act and Implications for Nonprofit Organizations, called SOX “a wake-up call to the entire nonprofit community” and directed nonprofit leaders to “look

* John E. Anderson Professor of Tax Law and Associate Dean for Academic Programs, Loyola Law School, Los Angeles.

765
carefully at the provisions of Sarbanes-Oxley" to “determine whether their organizations ought to voluntarily adopt governance best practices, even if not mandated by law.” The National Association of College and University Business Officers issued an Advisory Report in November 2003 (NACUBO Advisory) recommending that institutions of higher education look to SOX as a framework. The Coordinating Committee on Nonprofit Governance of the American Bar Association (ABA) published the Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley, which the ABA sells on its web page.

Given the very different nature of the public companies and nonprofit corporations, this reaction is quite remarkable. According to the Final Report of the SEC Advisory Committee on Smaller Companies, there are fewer than 9500 public companies subject to SOX. The report classified smaller public companies as those with equity capitalizations of $787 million or less. In contrast, the Internal Revenue Service (IRS) reports that for 2003 it received information returns from 211,858 charitable nonprofit organizations, and only 63,327, or 27%, of these organizations had assets over $1 million. The total number does not include the smallest of exempt organizations—those with annual gross receipts less than $25,000, since they are not required to file an information return. Thus, the public companies subject to SOX are a small number of entities, all of which have substantial resources. The Exempt Organization Division

---

11. Id. at 7 n.13 tbl2. Other sources report a somewhat larger number of public companies. In response to an e-mail inquiry, Bonnie C. Dailey, Senior Counsel for the SEC’s Office of Investor Education and Assistance, gave the total number of issuers filing annual reports with the Securities and Exchange Commission (SEC) in the fiscal year ending September 30, 2006, as approximately 13,575, including issuers of mortgage obligations and similar securities but excluding mutual funds, investment companies, and other 1940 Act regulated entities. E-mail from Bonnie C. Dailey, Senior Counsel for SEC’s Office of Investor Education and Assistance (May 24, 2007, 15:21:01 EST) (on file with author).
12. SEC Advisory Committee Final Report, supra note 10, at 1 n.1.
of the IRS regulates an enormous number of entities with relatively few assets.\footnote{15} Nonetheless, many predicted state law versions of SOX for nonprofits.\footnote{16} In January 2003, then–New York Attorney General Eliot Spitzer released a draft bill to apply certain provisions of SOX to New York charities.\footnote{17} After objections from the charitable sector to both the original draft and a revision of it, Spitzer announced in September 2003 that further study was needed before enactment.\footnote{18} The Massachusetts Attorney General also released draft legislation that was never enacted.\footnote{19} In 2004, California passed the Nonprofit Integrity Act, requiring audits of and audit committees for its charities with gross revenues above $2 million.\footnote{20}

Congress also trumpeted the call for improved nonprofit governance. The Senate Finance Committee expressed its interest in corporate governance matters through a White Paper released in connection with a June 2004 hearing and subsequent inquiries into the corporate governance of such prominent nonprofits as the Red Cross and American University.\footnote{21} At the request of the Senate Finance Committee, Independent Sector convened the Panel on the Nonprofit Sector in the fall of 2004 to make recommendations for reform.\footnote{22} The panel issued an interim report in March 2005, a final report in June 2005, and a supplemental report in April 2006.\footnote{23} The Pension Protection Act of 2006, signed into law on August 17,

\begin{footnotes}
\item[17] See Fremont-Smith, supra note 15, at 110.
\item[18] See id.
\item[19] See Brakman Reiser, supra note 16, at 563.
\item[23] Id. The panel itself consisted of twenty-four distinguished leaders from around the country. It established two expert advisory groups (the citizens advisory group and the expert advisory group) and five work groups (governance and fiduciary responsibility; legal framework; government oversight and self-regulation; small organizations; transparency and financial accountability). Panel on the Nonprofit Sector, Participants in the Panel, http://www.nonprofitpanel.org/participants/ Index.html (last visited Sept. 13, 2007). The panel held hearings across the country. Id. Ninety organizations made financial commitments. According to the panel’s web page, as of October 4, 2006, more than 500 groups and individuals had signed onto the final report. See Panel on the Nonprofit Sector, List of Those Who Have Signed on to the Panel’s Final Report, http://www.nonprofitpanel.org/signers (last visited Sept. 13, 2007).
\end{footnotes}
2006, included a number of charitable reforms but did not address matters of corporate governance.\textsuperscript{24}

While nonprofits have been voluntarily adopting provisions like those in SOX and states have been proposing and, in one case, imposing them, SOX itself has been the subject of withering criticism, not only by those being regulated but also by many academics. Several prominent legal scholars recently have published fierce critiques of it.\textsuperscript{25} Some of their criticisms accept the purpose of SOX, but question the efficacy of particular provisions, that is, whether the new laws in fact address the problems at which they aim.\textsuperscript{26} In a similar vein, another set of the criticisms argues that, however lofty the goal of a particular provision, its burdens outweigh its benefits.\textsuperscript{27} Much of the criticism, however, is far more fundamental—that SOX’s governance provisions represent a misplaced and unwarranted federalization, upsetting the proper balance between state and federal regulation by intruding into matters of corporate governance that have been and should remain the province of the states.\textsuperscript{28}

SOX questions the proper allocation and coordination of power between a federal agency, the SEC, and state law regarding for-profit corporate governance. It also questions the allocation and coordination of power between the IRS and state law for nonprofit governance. In neither the for-profit nor the nonprofit context has the mission of the federal agency historically been directed primarily at corporate governance. The SEC regulates public corporations in order to protect investors and the public markets. Historically, it has relied on disclosure requirements rather than substantive regulation. SOX enlarged its role in regulating corporate governance. The IRS regulates nonprofit corporations for compliance with the conditions for the laws regarding tax exemption in order to protect the federal fisc. Statutory and regulatory developments, beginning with the enactment of the private foundation rules and moving through enactment of the intermediate sanctions to recent changes to Form 1023 and proposed changes to Form 990 have enlarged the IRS’s role in regulating corporate governance.\textsuperscript{29} Both of these federal agencies must confront the issue of how far their mandates require or allow them to determine matters of

\begin{enumerate}
\item See generally Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified in scattered sections of the I.R.C. and 29 U.S.C.). At the most general level, corporate governance involves how board members comply with their fiduciary duties of loyalty and of care. For nonprofit boards, a third duty, the duty of obedience to the organization’s mission and purpose, is added. See generally Fremont-Smith, supra note 15, at 187–237.
\item Butler & Ribstein, supra note 2; Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521 (2005); see also Robert Charles Clark, Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too, 22 Ga. St. U. L. Rev. 251 (2005).
\item See infra Part I.
\item See infra Part I.
\item See infra Part I.
\end{enumerate}
corporate governance. The relationship of each of these federal agencies to state corporate law makes recent extensive critiques of SOX useful for examining similar issues, both specific and more general, that arise in regulation of nonprofits.

A caveat as we begin. The critics of SOX whose work is discussed in this essay reject the very premises regarding the nature of the relationship between government and the public corporation upon which SOX rests.30 To these scholars, the critique of SOX is, at bottom, a rejection of federal regulation in favor of free market competition.31 My purpose here is not to criticize these critiques when it comes to the public corporation. For purposes of this essay, I accept the critics’ premises regarding the public corporation in order to ask how their concerns play out in the very different world of nonprofit corporate governance. Such comparison and contrast will clarify our thinking and help give us new ideas of what might work best in this sector and why.

This essay discusses some, albeit not all, of the areas for which SOX has received so much criticism. The first part of this essay discusses two sets of criticisms of SOX. The first set of criticisms examines ways in which SOX could be improved: loosening the required independence of the audit committee, establishing special small firm rules for both certification of financial statements and disclosure of internal controls, and eliminating the prohibition of executive loans. The second set of criticisms attacks the premise of SOX and its so-called federalization of corporate governance: the inadequacy of federal judicial enforcement, the fear of federal regulatory overreaching, and alternatives to federal regulation.

The second part of this essay argues that the critique of SOX, when applied to the nonprofit world, in fact supports some expanded federal presence regarding corporate governance. If the arguments of even the most ardent opponents of federalization of corporate governance flounder when considered in the context of the nonprofit sector, then the position of those who favor federal regulation is vindicated and strengthened. The essay makes several suggestions to that end, in particular suggesting federal incentives for education of nonprofit boards and a form of “cooperative federalism,” in which federal law sets a floor for state regulatory programs.

I. THE CRITIQUE OF SOX

A. Reforming SOX

This section discusses three provisions of SOX that have had an impact on the nonprofit sector and for which critics of SOX have suggested revisions and improvements—an independent audit committee, executive

30. See infra Part I.
certifications, and executive loans. In each of these cases, the essay argues that the criticism of SOX could and should affect practices in the nonprofit sector.

1. Independent Audit Committee

Section 301 of SOX requires an audit committee consisting entirely of independent directors to hire and oversee a firm’s internal auditors. Independence for the purpose of this requirement is defined as not receiving compensation directly or indirectly from the corporation, except for board service. In addition, SOX requires the corporation to disclose whether it has at least one financial expert serving on its audit committee and to disclose why if it does not.

A variety of criticisms have been leveled against this provision. Professors Henry N. Butler and Larry E. Ribstein question the practice of placing confidence in independent board members. Why, they ask, would someone who is not employed full-time have “adequate time, incentives, and information” to conduct effective oversight? Such general skepticism about independent directors applies to independent audit committee members as well.

In a leading critique of SOX, Professor Roberta Romano evaluated in detail sixteen studies of the effect of audit committee composition on corporate performance. Several of the studies she discusses test performance by such financial measures as return on assets and stock market returns and thus are difficult to apply to nonprofit corporations. However, she also describes eleven studies examining the impact of the independence of the audit committee on the probability of financial statement misconduct. Two of these studies support auditor independence, but Professor Romano questions their methodology. The other studies reach a different conclusion. She writes,

The compelling thrust of the literature on the composition of audit committees, in short, does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance. Not only is that the case for the overwhelming majority of studies, but also, and more importantly, that is so for the studies using the more sophisticated techniques.

33. See id.
35. Butler & Ribstein, supra note 2, at 42.
36. Romano, supra note 25, at 1532.
37. See id.
38. See id.
39. See id.
40. Id. at 1533.
Significantly, Professor Romano finds that the studies show that “[h]aving an independent director with financial expertise is, in fact, the sole governance variable that is significantly correlated with the presence of an earnings restatement,” using such restatements as a proxy for identifying corporate financial misconduct. She notes that national stock exchange rules require audit committees to have at least one member with accounting or financial expertise and considers it ironic that SOX mandates full independence, but adopts its traditional disclosure approach regarding expertise of audit committee members.

When it comes to audit committees, nonprofit applications of SOX begin at a much more basic level—the need to have an audit at all. The possible requirement of an audit raises particular concern by and for smaller nonprofits. The BoardSource/Independent Sector pamphlet advises that “it is too onerous to demand that all nonprofit organizations undertake a full audit,” although it recommends an audit for charitable organizations with $1 million or more in total annual revenues. The Senate Finance White Paper proposed an audit requirement for exempt organizations with more than $250,000 in gross revenues; the final report of the Panel on the Nonprofit Sector recommended required audits for organizations with $1 million or more in total annual revenue. California’s Nonprofit Integrity Act requires an audit for organizations with annual gross revenues exceeding $2 million.

Nonprofit adaptations of SOX’s audit committee requirements, however, largely accept the independence mandate of SOX. Although California’s Nonprofit Integrity Act permits the audit committee membership to include persons not on the board, the committee may not include “any members of the staff (employees) of the corporation, whether or not they are unpaid volunteers, including the president or CEO or the treasurer or CFO.” BoardSource/Independent Sector call for the committee to be composed of

42. Id. at 27–28.
43. Fremont-Smith, supra note 15, at 435.
44. BoardSource & Indep. Sector, supra note 7, at 3.
47. Cal. Gov’t Code § 12586(e) (West 2004).
“individuals who are not compensated for their service.” NACUBO directs that “[m]embers of the audit committee must be independent.”

Many nonprofit invocations of SOX address the expertise of audit committee members. California does not. It requires independence beyond that of financial interest, but pays no attention to the knowledge or competence of such members. Moreover, it permits the audit committee to have a single member. In contrast, the NACUBO Advisory directs that there be at least one financial expert on the committee. The BoardSource/Independent Sector pamphlet urges that at least one member of the audit committee meet the criteria for financial expertise as well as that the committee as a whole have the requisite skills and experience.

For this issue, as well as the next two, we have the benefit of a recently released study. The Urban Institute undertook a national survey of nonprofit governance in 2005 as the first national, representative study of nonprofit governance. The study gathered responses from more than 5000 nonprofits of varied size, type, and location and presents preliminary findings on the current extent of nonprofits’ adherence to some major SOX provisions, including the audit committee requirement.

The study found that, although not required, most nonprofits do have an external audit—67% of the nonprofits in the study had such an audit in the past two years. Only 43% of the smallest nonprofits had an outside audit, “but the figure jumps to 70 percent” if those that had their financial statements compiled or reviewed by an outside certified public accountant are included. The combined figure for organizations with expenditures above $100,000 is 89% and 97% for organizations with expenses over $2 million. Of those organizations that did not have any outside review, however, “62 percent said it would be somewhat or very difficult to comply with a law requiring them to have one.” Nonetheless, the study suggests that the requirement of some kind of outside review for all but the smallest nonprofits may not be as much of a burden as feared.

50. NACUBO Advisory Report, supra note 8, at 2.
51. Office of the Cal. Att’y Gen., supra note 48 (follow “FAQ 12: Who may serve on the audit committee?” hyperlink). (“The committee may have as few as one member.”).
52. Id. (follow “FAQ 14: What is the permissible size of the audit committee?” hyperlink). “The committee may have as few as one member.”.
53. See NACUBO Advisory Report, supra note 8, at 9.
54. See BoardSource & Indep. Sector, supra note 7, at 4.
56. See generally id.
57. Id. at 3. “That figure jumps to 91 percent for nonprofits with expenses of over $500,000, and over 96 percent among nonprofits with expenses greater than $2 million.” Id.
58. Id.
59. Id.
60. Id.
61. Note that the study used expenditures rather than revenue for its categories here. See id. at 2 fig.1, 3 fig.2, 5 fig.3.
At the same time, according to this study, a “separate audit committee was the least commonly adopted practice related to Sarbanes-Oxley issues in all size groups.” Only 15% of nonprofits with less than $100,000 in annual expenses had an audit committee, while 58% of nonprofits with over $40 million did have such a committee. Most organizations with an audit committee had created or revised the audit committee since 2002, leading the study’s authors to conclude that the “finding supports the idea that passage of the Sarbanes-Oxley Act spurred many nonprofits to reexamine and revise their practices.” Smaller organizations in particular felt it would be very difficult to comply with the requirement of an audit committee and a slight majority of those without an audit committee believed it would be somewhat or very difficult to satisfy a requirement to have a financial expert serve on the audit committee. The authors conclude on this issue that “a law or best practice guideline calling for nonprofits to establish a separate and independent audit committee would have a widespread impact because most do not currently have such a committee.”

While the Urban Institute’s survey suggests that attempts to establish a separate and independent audit committee may meet resistance, Professor Romano’s work regarding audit committees suggests that any such effort may be misplaced. According to her research, efforts should concentrate not on independence of the full committee but on ensuring expertise. When applied to the nonprofit sector, such research bears on the relative benefit and burden as well, since ensuring a fully independent audit committee can be difficult for small charities. The national survey of nonprofits further supports this conclusion. In addition, California’s acceptance of a single member audit committee, perhaps in response to this difficulty, underscores some of the problems that the requirement of full independence can create, since a single member audit committee without required expertise seems unlikely to be able to exercise effective oversight and monitoring.

62. Id. at 2.
63. Id.
64. Id.
65. Id.
66. Id. at 5.
67. Romano, supra note 25, at 1532.
68. See Ostrower & Bobowick, supra note 55, at 5 (emphasizing “the importance of acknowledging the potentially different impact, cost, and value of applying provisions to nonprofits of different size”).
69. Office of the Cal. Att’y Gen., supra note 48 (follow “FAQ 14: What is the permissible minimum size of the audit committee?” hyperlink) (providing that it is permissible to have a single member audit committee).
2. Certification of Reports and Internal Controls

Section 404 of SOX requires a management report, attested to by an external auditor, assessing the firm’s internal controls. Section 302 mandates that the chief executive officer (CEO) and chief financial officer certify the accuracy of the firm’s periodic reports to the SEC. Under section 302, signatories certify that they have established, maintained, and evaluated the internal controls.

Section 404, the internal controls rule, has been the subject of particular criticism as enormously costly, especially for smaller companies. According to Professors Butler and Ribstein, the SEC estimated the cost of complying with the rule’s requirements at “around . . . $91,000 per company,” not including “additional cost burdens that a company will incur as a result of having to obtain an auditor’s attestation,” but “Financial Executives International estimated compliance costs at $4.36 million per company as of mid-2005.” In response to such criticisms, the SEC delayed reporting by small and foreign companies. It also convened an advisory committee on smaller public companies that has recommended modified requirements for the smallest 1% and 5% of public companies by capitalization. In May 2007, the SEC revised the rules governing reporting on internal controls under section 404. Under new interpretive guidance, management can develop its own process in light of its own assessment of risks. The new rules will make compliance by smaller public companies easier. Compliance, however, will not be further delayed.

Prior to these changes, Professor Romano reviewed two available studies regarding executive certification of financial reports. The first focused on the “price effect for the small number of firms that did not make the certification deadline.” It found that the requirement had no impact. The second study examined the stock market reaction to certification by bank holding companies on the theory that, because such financial institutions are more opaque than nonfinancial firms, the certification or lack thereof may be of particular significance to the market. The second study concluded that the certification requirement provides valuable

72. Id.
73. Butler & Ribstein, supra note 2, at 40 (internal quotation marks omitted).
74. See id.
75. Id. at 91.
77. See id.
78. See id.
79. Romano, supra note 41, at 96.
80. Id.
81. Id. at 98.
information to investors in such companies. Professor Romano concludes that further study is needed, but questions whether the certification requirement will reduce accounting misconduct.

The response of the nonprofit sector to these kind of requirements parallels that of the for-profit sector—acceptance, albeit perhaps skeptical, of officer certification of financial reports. The Senate Finance Committee White Paper, for example, included a proposal that the CEO or equivalent officer of a tax exempt organization sign Form 990, a declaration similar to that required under section 302 of SOX, and the final report of the Panel on the Nonprofit Sector adopted that proposal as a recommendation.

The Urban Institute’s national survey of nonprofit governance finds that the CEOs of 51% of all nonprofits signed the Form 990, although the number was only 29% for the smallest nonprofits. However, of those survey respondents whose CEO did not sign the form, only 13% responded that “it would be somewhat or very difficult” for the CEO to sign a declaration that the CEO “received reasonable assurance of the accuracy and completeness of the IRS Form 990.”

Unlike its acceptance of officer certification, the nonprofit community has objected strongly to the attestation of internal controls because of the costly burdens, especially on smaller organizations. The most telling reaction to this nonprofit extension of SOX is the saga of New York’s proposed legislation. As originally proposed, the New York legislation would have required any nonprofit organization with revenues below $250,000 to have its president and treasurer verify the accuracy of financial information presented to their boards. It also would have required organizations with greater revenues or paid staff “to provide more extensive certifications of the accuracy of the financial data, and the organization’s president and treasurer would have to certify that they reviewed the entity’s financial controls and that any problems had been reported to the audit committee.” According to Professor Dana Brakman Reiser, “The New York Proposals took the relevant provision almost directly from Sarbanes-Oxley.”

The nonprofit community reacted sharply to these provisions. In response, the legislative proposal was revised so that these provisions would apply only to organizations having revenue in excess of $1 million or assets in excess of $3 million. In addition, the certifications could be

82. See id.
83. See id. at 101.
84. White Paper, supra note 45, at 8.
87. Id. at 4.
89. Id.
91. See id. at 574 n.77.
based on the “knowledge” of those certifying and could be made by paid staff members.\footnote{92}{Id. at 584 n.112.}

These changes muted but did not eliminate the objections of the nonprofit community. Although acknowledging that the revised thresholds exempted some 60% of New York nonprofits that file Form 990, the Nonprofit Coordinating Committee of New York expressed its main concern as being “that the certifications will produce confusion and unease as to what they involve, and as to potential liability, and so will prompt nonprofits to hire outside ‘experts’ to give them comfort as to the quality of their financial controls.”\footnote{93}{Nonprofit Coordinating Comm. of N.Y., Sarbanes-Oxley for Nonprofits (Jan. 17, 2006), http://www.npccny.org/info/gti10.htm.} As noted above, New York’s former attorney general, Eliot Spitzer, announced in September 2003 that further study of the draft legislation, including this proposal, was needed.\footnote{94}{See supra note 18 and accompanying text.} However, the attorney general’s office apparently has abandoned efforts to introduce these particular SOX reforms. “The AG’s legislative agenda for nonprofit reform, as announced in March 2005, no longer includes accuracy or reliability certification requirements.”\footnote{95}{Brakman Reiser, supra note 16, at 571.}

The apprehensions expressed about the New York and other nonprofit attestation proposals correspond to those made by the for-profit community. Both sectors ask what additional protection such certification serves when officers of the entity already had been required to sign federal and state reports and, in so doing, attest to the verity of the information provided. Both question whether this requirement will in any way deter wrongdoers.\footnote{96}{Id. at 583–84; Romano, supra note 25, at 1541.} Both sectors ask about the cost as compared to the benefit, since monies expended on these efforts will be unavailable for the ultimate recipients of the organization’s revenues—the investors in the case of for-profits and programs in the case of nonprofits. Both have particular concerns about the smaller members of each sector. If, however, SOX is applied to nonprofits only to require a signature and certification for signing the Form 990, similar to that required for SEC reports by companies under section 302 of SOX, without requiring any of the kind of the certifications required by section 404 of SOX, it seems that there would not be significant burden or opposition. At the same time, it seems equally uncertain how much benefit such a requirement would generate.\footnote{97}{See Brakman Reiser, supra note 16, at 585.}

3. Loans to Insiders

While not addressing executive compensation generally, SOX prohibits loans to insiders.\footnote{98}{Sarbanes-Oxley (SOX) Act of 2002 §402, 15 U.S.C. § 78m (Supp. IV 2004).} This ban was introduced at the end of the SOX legislative process in the Senate as a floor amendment to a provision that
would have required disclosure. Critics argue that a prohibition is overbroad because it calls into question traditional compensation practices, such as advancing indemnification expenses, purchasing split-life insurance policies, or permitting the cashless exercise of stock options. Critics, such as Romano, Butler, and Ribstein, find preferable the flexibility of state provisions, many of which impose either low substantive standards or procedural rather than substantive constraints.

Professor Romano predicts that a prohibition on executive loans will simply lead executives to negotiate for other forms of compensation. She found few studies of executive loans, arguably because the practice was widespread and uncontroversial, but she cites one study that found that most loans were made for stock and stock option purchases with a much smaller amount for relocation. The study found that “executive loans in many cases appear to serve their purpose of increasing managerial stock ownership, thereby aligning managers’ and shareholders’ interests.”

The loan prohibition has had a relatively circumscribed impact on nonprofit SOX applications. BoardSource/Independent Sector observes that, “[b]ecause the practice of providing loans to nonprofit executives has been a source of trouble in the past . . . , it is strongly recommended that nonprofit organizations not provide personal loans to directors or executives.”

The NACUBO Advisory, in contrast, specifies that, while the audit committee should be aware of and review policies on personal loans, “housing assistance included as part of compensation is not a personal loan.” The California Nonprofit Integrity Act has a broader and more general requirement—that the governing board of a nonprofit organization reviews and approves the compensation of the executive director and chief financial officer, upon initial employment and upon renewal, extension, or modification, to ensure that the compensation is just and reasonable.

The Pension Protection Act does include provisions prohibiting loans and other forms of compensation to certain insiders of certain kinds of

99. See Romano, supra note 25, at 1538 (citing Sean A. Power, Sarbanes-Oxley Ends Corporate Lending to Insiders: Some Interpretive Issues for Executive Compensation Surrounding the Section 402 Loan Prohibition, 71 UMKC L. Rev. 911, 924–35 (2003)).
100. See Romano, supra note 41, at 81 n.180.
103. Id. at 1539 (citing Kathleen M. Kahle & Kaldeep Shastri, Executive Loans, 39 J. Fin. & Quantitative Analysis 791 (2004)).
104. Id.
105. BoardSource & Indep. Sector, supra note 7, at 8.
106. NACUBO Advisory Report, supra note 8, at 8.
107. Cal. Gov’t Code § 12586(g) (West 2004). Current California law does permit nonprofit public benefit corporations to make loans to any officers or directors if approved by the attorney general, to advance otherwise reimbursed expenses, to pay life insurance premiums when repayment is secured by the policy, and to make a secured loan to finance the principal residence of an officer. Cal. Corp. Code § 5236 (West 1981).
All supporting organizations are prohibited from making any grant, loan, or compensation to a substantial contributor, a member of the substantial contributor’s family, or an entity that is 35% or more controlled by a contributor or related family member. Similarly, donor-advised funds are prohibited from making a grant, loan, compensation, or other payment to donors, donor advisors, related parties of the foregoing, and certain investment advisors. These provisions, going to all types of compensation, and not just loans, underscore Congress’s particular concern about supporting organizations and donor-advised funds and reflect recommendations of the final report of the Panel on the Nonprofit Sector. As the final report explained regarding donor-advised funds, “Since intermediate sanctions rules often do not apply to a donor or advisor of a donor-advised fund, Congress should enact new prohibitions targeted specifically at the potential abuse of donor-advised funds by their donors or advisors.”

That nonprofit applications of SOX have not generally adopted the loan prohibition is understandable. It is not an issue many nonprofits face. The recent nonprofit survey determined that “[f]ewer than 3 percent [of respondents] made loans to staff members, though the figure [rose] to between 6 and 8 percent among the larger organizations.”

The response of the nonprofit sector to this SOX provision seems also to signal an agreement with the critics of SOX that this provision is unnecessary and ineffective because state laws generally already have provisions regarding loans to nonprofit insiders including, in some cases, prohibitions. Moreover, even before enactment of the Pension Protection Act, nonprofit loans to most insiders were regulated by federal tax law in the form of the self-dealing rules applicable to private foundations and the excess benefits rules applicable to public charities. Finally, the primary purpose of insider loans in the for-profit sector—to acquire stock—does not apply to the nonprofit sector. The very essence of a nonprofit organization is the inability of individuals, whether insiders or not, to obtain an equity interest in the organization.

Criticism of the SOX prohibition on insider loans underscores two important considerations that must inform any application of the federalization critique of SOX to nonprofits, as discussed further below. First, while critics of SOX often prefer no government regulation of nonprofits. All supporting organizations are prohibited from making any grant, loan, or compensation to a substantial contributor, a member of the substantial contributor’s family, or an entity that is 35% or more controlled by a contributor or related family member. Similarly, donor-advised funds are prohibited from making a grant, loan, compensation, or other payment to donors, donor advisors, related parties of the foregoing, and certain investment advisors. These provisions, going to all types of compensation, and not just loans, underscore Congress’s particular concern about supporting organizations and donor-advised funds and reflect recommendations of the final report of the Panel on the Nonprofit Sector. As the final report explained regarding donor-advised funds, “Since intermediate sanctions rules often do not apply to a donor or advisor of a donor-advised fund, Congress should enact new prohibitions targeted specifically at the potential abuse of donor-advised funds by their donors or advisors.”

That nonprofit applications of SOX have not generally adopted the loan prohibition is understandable. It is not an issue many nonprofits face. The recent nonprofit survey determined that “[f]ewer than 3 percent [of respondents] made loans to staff members, though the figure [rose] to between 6 and 8 percent among the larger organizations.”

The response of the nonprofit sector to this SOX provision seems also to signal an agreement with the critics of SOX that this provision is unnecessary and ineffective because state laws generally already have provisions regarding loans to nonprofit insiders including, in some cases, prohibitions. Moreover, even before enactment of the Pension Protection Act, nonprofit loans to most insiders were regulated by federal tax law in the form of the self-dealing rules applicable to private foundations and the excess benefits rules applicable to public charities. Finally, the primary purpose of insider loans in the for-profit sector—to acquire stock—does not apply to the nonprofit sector. The very essence of a nonprofit organization is the inability of individuals, whether insiders or not, to obtain an equity interest in the organization.

Criticism of the SOX prohibition on insider loans underscores two important considerations that must inform any application of the federalization critique of SOX to nonprofits, as discussed further below. First, while critics of SOX often prefer no government regulation of

---

109. See id.
110. See id.
111. Final Report, supra note 46, at 43. The prohibition applicable to all supporting organizations and not just Type III supporting organizations has raised concerns from Independent Sector and others. Such concerns are beyond the scope of this paper.
corporate governance to any regulation, they also prefer state regulation to federal regulation, as noted at the beginning of this essay. This state preference rests in part on the traditional assignment of questions of corporate governance to the states, with the result that states and their courts have experience in addressing these issues. It rests as well on a belief that state law offers valuable flexibility because states compete when it comes to regulation of corporate governance and that corporations choose their state of incorporation on the basis of such competition, to the benefit of corporate investors. As discussed later in this essay, such considerations play out very differently in the nonprofit sector.

Second, many SOX critics see the goal of regulating public companies as helping to align the interests of managers with those of well-diversified investors. Thus, for example, these critics reject the traditional view that separation of ownership and management in the public corporation results in agency costs that require government regulation. They argue instead for a contractarian view—that the corporation is a product of private contractual relationships that respond appropriately to market incentives and monitoring.

This second set of beliefs does not apply to the nonprofit sector. We do not enact laws regulating charities with a well-diversified donor in mind. (In fact, we expect donors, especially foundations, to specialize.) The separation is not between shareholders and managers in nonprofits but between management and the recipients of the nonprofits’ services and products. We do not have an efficient nonprofit market filled with private monitors. As Professor Henry Hansmann has written so influentially, nonprofits demonstrate “a particular kind of ‘market failure,’ specifically the inability to police producers by ordinary contractual devices,” and this “contract failure is the essential factor in the role of nonprofit enterprise.”

These differences between the nonprofit and the for-profit public corporation should influence any nonprofit application of SOX as well as the weight given to the more broad-based criticisms of SOX to which the essay next turns. Tax exempt nonprofit charities must benefit public rather

---

115. See Ahdieh, supra note 31 and accompanying text; Romano, supra note 25, at 1597–99 (discussing “Returning Corporate Governance to the States”); see also Butler & Ribstein, supra note 2, at 65–71.

116. See Butler & Ribstein, supra note 2, at 65–66.


118. See Butler & Ribstein, supra note 2, at 4 (“[I]t is well-accepted in the financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares.”).


121. Hansmann, supra note 114, at 845.
than private interests. In short, nonprofit corporate governance is public law in a way that for-profit governance is not.\textsuperscript{122}

**B. Rejecting SOX**

The critics of SOX would not be content even if the provisions of SOX were revised. These critics’ unhappiness with SOX goes far deeper. At the very least, they believe, its provisions should be optional.\textsuperscript{123} Even better, they believe, would be repeal of SOX and removal of the federal government from regulation of corporate governance because they object to the federalization of corporate law.\textsuperscript{124} This section of the essay discusses three aspects of that objection—the fear of expanding federal regulatory authority, the difficulties of federal judicial enforcement, and the alternatives to federal regulation.

1. Expansive Claims of Federal Regulatory Authority

Critics of SOX’s federalization of corporate governance are concerned not only with the substance of the federal legislation, but also with the possibility of overly expansive claims of authority by the federal agency charged with carrying out the congressional mandate.\textsuperscript{125} In particular, these critics worry about attempts by the SEC to extend its dominion into substantive corporate governance, fearing that SOX will encourage the agency to do so.

Critics of SOX look to *Business Roundtable v. SEC*\textsuperscript{126} for the proposition that, even if federal securities law limits the ability of the SEC to directly regulate corporate governance, the SEC will attempt to extend its dominion into that arena.\textsuperscript{127} The court in *Business Roundtable* reviewed an SEC rule that would have barred national securities exchanges and national securities associations from listing the stock of a corporation that had taken corporate action that had the effect of reducing the per share voting rights of the existing common shareholders.\textsuperscript{128} The SEC had promulgated the rule pursuant to its authority to amend on its own initiative the rules of organizations, such as the New York Stock Exchange, in furtherance of the purposes of the Securities Exchange Act of 1934.\textsuperscript{129}

\textsuperscript{122} For-profit governance has an important public dimension as well, as some scholars emphasize. See generally Progressive Corporate Law (Lawrence E. Mitchell ed., 1995); David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 Geo. L.J. 61 (2003).

\textsuperscript{123} See infra notes 125–55 and accompanying text.

\textsuperscript{124} See infra notes 125–55 and accompanying text.


\textsuperscript{126} 905 F.2d 406 (D.C. Cir. 1990).

\textsuperscript{127} See Ribstein, supra note 120, at 11 n.64; Romano, supra note 25, at 1523.

\textsuperscript{128} See Bus. Roundtable, 905 F.2d at 407–09.

\textsuperscript{129} See id.
The court held, however, that “the SEC’s assertion of authority directly invades the ‘firmly established’ state jurisdiction over corporate governance and shareholder voting rights.”130 It quoted the Supreme Court in *Santa Fe Industries, Inc. v. Green* that, “except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”131 *Business Roundtable* found the rule controlling the substantive allocation of powers among classes of shareholders to exceed the SEC’s authority.132 Relying on this precedent and the general nature of bureaucracies, the SOX critics fear that SOX will embolden the SEC to attempt to extend its authority further than the explicit provisions of SOX itself.

Federal regulation of nonprofit governance by the IRS could confront similar judicial limitations. In *United Cancer Council, Inc. v. Commissioner*,133 the U.S. Court of Appeals for the Seventh Circuit rejected the IRS’s argument that an arm’s length contract negotiated in good faith between United Cancer Council (UCC) and its fund-raiser rendered the fund-raiser an insider whose violation of the inurement prohibition required revocation of UCC’s tax exemption.134 For our purposes, what is of particular interest is the court’s discussion of the possible validity of the IRS’s alternative ground for revoking exemption, which the U.S. Tax Court had not reached and thus was not before the court of appeals.135

Under this alternative ground, the charity became ineligible for exemption on the basis that, as a result of the contract’s favorable terms, the UCC was no longer being operated exclusively for charitable purposes but rather for the private benefit of the fund-raiser.136 The court stated,

[T]he board of a charity has a duty of care, just like the board of an ordinary business corporation, and a violation of that duty which involved the dissipation of the charity assets might (we need not decide whether it would—we leave that issue to the Tax Court in the first instance) support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity. This, for all we know, may be such a case.137

Judge Richard Posner’s language gives a sense of how carefully the IRS will have to tread to make such arguments sound in the tax law rather than in state law regarding nonprofit governance. The opinion suggests the possibility, but no guarantee, of success.

130. *Id.* at 413.
131. *Id.* at 412 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977)).
132. *Id.* at 418–19.
133. 165 F.3d 1173 (7th Cir. 1999).
134. See *id.* at 1175–76.
135. See *id.* at 1179.
136. See *id.* at 1179–80.
137. *Id.* at 1180 (emphasis added) (citations omitted).
The opinion also vividly illustrates how difficult it can be to decide where to draw the dividing line between issues of corporate governance and enforcement of tax law. Judge Posner allows that, even if the UCC had hired a host of service suppliers rather than a single one, there could be no possible inurement claim, “[b]ut there might still be a concern” that “charitable enterprises that generate so little net contribution to their charitable goals do not deserve the encouragement that a tax exemption provides.”138 He speculates that “maybe tax law has a role to play in assuring the prudent management of charities,”139 but questions empowering the IRS to yank a charity’s tax exemption simply because the Service thinks the charity’s contract with its major fundraiser too one-sided in favor of the fundraiser, even though the charity has not been found to have violated any duty of faithful and careful management that the law of nonprofit corporations may have laid upon it.140

Even Judge Posner finds uncertain what kind of causal connection between failures of nonprofit governance and violation of tax rules must be demonstrated to permit the IRS to act.141

The IRS has begun to establish a relationship between good corporate governance and eligibility for tax exemption. Conflicts of interest, the thinking seems to go, encourage violations of the intermediate sanction rules of the Internal Revenue Code’s section 4958 and the self-dealing rules of section 4941. Indeed, the conditions for establishing the section 4958 regulations’ rebuttable presumption of reasonableness require that the compensation arrangement or terms of transfer be approved only by “individuals who do not have a conflict of interest . . . with respect to the [transaction].”142

Establishing a conflict of interest policy, however, is a matter of internal corporate governance and not traditional tax law.143 To encourage this practice without exceeding its authority, the IRS has drafted the Form 1023, the Application for Recognition of Exemption, to include a question under the section of the form devoted to compensation and other financial arrangements asking whether the organization has adopted a conflict of interest policy.144 If so, the form requests a copy of the policy and an explanation of how it was adopted. The instructions to the form also

138. Id. at 1178.
139. Id. at 1179.
140. Id.
141. See id.
143. The Urban Institute finds that overall 50% of nonprofits in the survey had a conflict of interest policy, but that only 23% of the smallest had one, while 95% of the largest did. Moreover, of those that had a conflict of interest policy, 47% had created or revised it since 2002. Ostrower & Bobowick, supra note 55, at 4.
include a sample conflict of interest policy.\textsuperscript{145} The form, however, is careful to note, “A conflict of interest policy is recommended though it is not required to obtain exemption.”\textsuperscript{146} To require adoption of a conflict of interest policy might risk the IRS exceeding its authority.

The IRS has continued to address issues of corporate governance. In February 2007, it released a discussion draft of preliminary guidelines designed to encourage good governance practices.\textsuperscript{147} The draft guidelines make a valiant attempt to tie these guidelines to the IRS role in regulating tax exempt entities: “While adopting a particular practice is not a requirement for exemption, [we believe that] an organization that adopts some or all of these practices is more likely to be successful in pursuing its exempt purposes and earning public support.”\textsuperscript{148} The draft guidelines call for a mission statement; a code of ethics and whistle-blower policies; exercise of due diligence consistent with a duty of care; exercise of the duty of loyalty that avoids conflicts of interests; transparency about the organization’s mission, activities, and finances; adoption of fund-raising policies; use of obtaining financial audits or other financial review; payment of only reasonable compensation; and a written policy regarding document retention.\textsuperscript{149}

A June 2007 discussion draft of a revised Form 990—the annual information report required of most tax exempt entities—substitutes detailed required disclosure for suggested guidelines.\textsuperscript{150} An addition to the form asks a number of questions with subparts on governance, management, and financial reporting.\textsuperscript{151} The new section asks, for example, the number of members of the governing body and number of independent directors.\textsuperscript{152} It asks not only whether the organization has a conflict of interest policy, but also how many transactions the organization reviewed under the policy during the year.\textsuperscript{153} It requires answers to questions about a written whistle-blower policy, written document retention and destruction policy, contemporaneous documentation of meetings, whether the organization has an audit committee, whether the organization’s governing body reviewed the Form 990 before filing, and which documents are made available to the public.\textsuperscript{154} In commenting on the draft form, Suzanne Ross McDowell, a well-known exempt organization practitioner, observed, “It is relevant to both ask whether the

\textsuperscript{146} I.R.S. Form 1023, supra note 144, at 4.
\textsuperscript{148} Id. at 1.
\textsuperscript{149} See generally id.
\textsuperscript{151} See id. at 4.
\textsuperscript{152} See id.
\textsuperscript{153} See id.
\textsuperscript{154} See id.
IRS should be incentivizing behavior which is not required by the Internal Revenue Code and for which there is no direct connection to requirements of the Internal Revenue Code.”

The Senate Finance Committee’s White Paper had offered a number of suggestions for federal action to encourage strong board governance. These included not only expansion of the self-dealing rules now applicable to private foundations to all public charities, but also requirements that the charity establish a conflict of interest policy and that it have at least three and no more than fifteen members as well as a minimum number or percentage of independent board members. The final report of the Panel on the Nonprofit Sector in some cases strengthened the recommendations. For example, the final report recommended that at least one-third of the board of a public charity be independent. The Pension Protection Act of 2006, however, did not give the IRS authority to impose any of these requirements. Nonetheless, Senate Finance Committee Chairman Max Baucus and ranking minority member Senator Chuck Grassley praised the discussion draft of the revised Form 990 for facilitating an increase in exempt organization transparency. If Congress wishes the IRS to have some authority over corporate governance of exempt organizations, however, it should give the agency explicit congressional authority to do so to avoid the kind of questions Judge Posner asked in United Cancer Council.

2. Judicial Enforcement

Critics of SOX question the ability of federal courts to adjudicate issues of corporate governance. Professors Butler and Ribstein quote the observations of two prominent Delaware judges:

In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make for demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe—a reality that limits the capacity of judges to delegate very much of the work to law clerks.

As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. . . . In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the

156. See Senate Finance Issues Discussion Draft on Reforms for EOs, supra note 21.
157. See id.
160. See Senate Finance Issues Discussion Draft on Reforms for EOs, supra note 21.
burden of adjudicating corporate governance disputes now handled by state courts.\textsuperscript{161}

Such disputes regarding corporate governance require courts to exercise equity jurisdiction. In 1975, Alvin D. Lurie, an assistant commissioner of the IRS, announced in a speech that the “ability to invoke the jurisdiction of an equity court, with its broad and adaptable powers, is uniquely the province of the states.”\textsuperscript{162} In 1977, however, the Treasury sought but did not receive authority for the IRS to seek remedial decrees in equity in federal district courts to correct violations uncovered while enforcing its authority to assess excise taxes on private foundations.\textsuperscript{163}

The Senate Finance Committee’s White Paper proposed expanding the powers of the U.S. Tax Court to enable it to enforce the fiduciary duties of boards and take action against both the charitable organizations themselves and individual board members as well as to permit individual directors and members of the public to sue charitable organizations and their directors in Tax Court for alleged violations of fiduciary obligations.\textsuperscript{164} The Panel on the Nonprofit Sector addressed “Federal Court Equity Powers and Standing to Sue” in the supplemental report to its final report.\textsuperscript{165} The panel wrote, “Congress should \textit{not} expand the equity powers or jurisdiction of the Tax Court over charitable fiduciaries.”\textsuperscript{166} The supplemental report explained,

Current state law and common law principles provide sufficient remedies for breaches of fiduciary duties. Redress for such breaches should remain the province of the state courts, since state judges and attorneys general have the greatest expertise in disputes involving corporate and trust governance and fiduciary responsibilities. The Tax Court and the IRS, whose expertise lies in the application of the tax law, are not as well-suited to take on these cases.\textsuperscript{167}

\textsuperscript{164} See White Paper, \textit{supra} note 45, at 16.
\textsuperscript{166} \textit{Id.}
\textsuperscript{167} \textit{Id.} at 29. The supplemental report further provides,

Given the unfettered standing of state attorneys general to pursue suits for breach of fiduciary duty, the limited groups of others with standing to sue, and the right of
The Tax Court has been granted equity jurisdiction in recent years in cases involving innocent spouses and collection due process.\textsuperscript{168} Consistent with the observations of the supplemental report, the Tax Court’s exercise of this equity jurisdiction has raised serious questions, not only as to its efficacy but even as to its constitutionality.\textsuperscript{169}

On the other hand, review of excise taxes has long been part of the workload of the Tax Court. To the extent that the Tax Court considers self-dealing under the private foundation rules or excess benefits under the intermediate sanctions rules, it already is addressing issues of fiduciary duty, albeit indirectly, since these rules implicate the duties of care, loyalty, and obedience.\textsuperscript{170} The discussion of the possible relation between the private benefit doctrine and the prudent management of charities, discussed above in the context of \textit{United Cancer Council}, shows how the Tax Court already must grapple with such issues.

Moreover, the argument in favor of state court adjudication of nonprofit governance disputes is not as unalloyed as the Panel’s supplemental report would have it.\textsuperscript{171} While state attorneys general have the authority to sue to enforce fiduciary duties, the authority in many states is seldom exercised. As Professor Harvey P. Dale has quipped in his inimitable way, “In most states, the Charity Bureau of the Attorney General’s Office is inactive, ineffective, understaffed, overwhelmed, or some combination of these.”\textsuperscript{172} Professor Norman Silber quotes the president of the National Association of Charities Officials as lamenting, “Of our fifty states . . . most do not have personnel dedicated to the exclusive regulation of charities.”\textsuperscript{173} Since, as discussed below, individuals seldom have standing to enforce violations of nonprofit governance laws, without enforcement of such disputes by attorneys general, state courts do not gain experience in questions of nonprofit governance, questions, as also discussed below, that are quite different from those involving for-profit corporations.

Professor Marion Fremont-Smith points to New York, California, Illinois, Massachusetts, Michigan, and Ohio as states with well-staffed and active charity bureaus.\textsuperscript{174} Professor Silber adds Pennsylvania and Missouri as states with large populations and active charity enforcement in which any person to bring a complaint to the IRS or state charity official, no constructive purpose would be served by expanding the number of persons with standing to sue charities in the federal Tax Court.

\textit{Id.}


\textsuperscript{170} I.R.C. §§ 4941, 4958 (2000).

\textsuperscript{171} See Supplemental Report, \textit{supra} note 165.

\textsuperscript{172} Fremont-Smith, \textit{supra} note 15, at 443 (internal quotation marks omitted).

\textsuperscript{173} Silber, \textit{supra} note 29, at 622 (citation omitted).

\textsuperscript{174} Fremont-Smith, \textit{supra} note 15, at 445.
attorneys general at least have the legal authority to bring a large variety of legal actions for nonprofit misconduct.\textsuperscript{175} He continues, “These are areas where national nonprofit organizations—and those intending to become national—need to operate. By so doing, they open themselves to effective monitoring by multiple state jurisdictions.”\textsuperscript{176}

Professor Silber’s argument requires consideration of the extent to which a state can regulate the internal corporate governance of a nonprofit operating in its state but incorporated in another. That question is the subject of other papers in this conference and beyond the scope of this essay.\textsuperscript{177} But it also involves the issue of state competition so dear to the hearts of many of the critics of SOX. Professor Romano has written that states “operate in a competitive environment: Corporations choose in which state to incorporate and can change their domicile if they are dissatisfied with a legal regime . . . .”\textsuperscript{178}

Although I do not know of any studies addressing the question, it is my impression that such state competition has not operated strongly, if at all, in the nonprofit sector, although practitioner friends have reported that this may be changing. Even if that is the case, far more important than state competition for nonprofits is the competition between the corporate form and the trust form and the extent to which choosing the trust form can avoid certain nonprofit corporation requirements.\textsuperscript{179} Nonetheless, I do not believe that any single state dominates the incorporation of nonprofit corporations in the way that Delaware dominates incorporation of public companies.\textsuperscript{180} If such competition existed, we would expect nonprofit corporations to choose states with little statutory constraints and little state enforcement.

Again, that does not seem to be the case. My own home state of California has some famously onerous requirements, most notably a requirement that no more than 49% of the board of nonprofit public benefit corporations, including family foundations and the smallest of public charities, can be interested parties,\textsuperscript{181} and a very stringent application of the

\textsuperscript{175} See Silber, supra note 29, at 622.
\textsuperscript{176} Id.
\textsuperscript{177} I note, however, that FAQ 1 regarding the California Nonprofit Integrity Act states, “The law applies to all foreign charitable corporations (corporations formed under the laws of other states) doing business or holding property in California for charitable purposes.” Office of the Cal. Att’y Gen., supra note 48 (follow “FAQ 1: To whom does the Nonprofit Integrity Act of 2004 apply?” hyperlink).
\textsuperscript{178} Romano, supra note 25, at 1598. See generally Romano, supra note 41.
\textsuperscript{179} See generally Evelyn Brody, Charity Governance: What’s Trust Law Got to Do With It?, 80 Chi.-Kent L. Rev. 641 (2005).
\textsuperscript{180} Clark, supra note 25, at 257 (stating that half of all public companies are Delaware corporations).
\textsuperscript{181} Cal. Corp. Code § 5227 (West 1990). “Interested” is defined as having received compensation for services rendered within the previous twelve months, including as an independent contractor or otherwise (except to a director as director) and certain family members of such persons. Id. California practitioners often form charities as trusts rather than corporations in part for this reason. Many prominent California nonprofits, including the J. Paul Getty Trust and Stanford University, are trusts.
charitable trust doctrine. Nonetheless, according to 2000 Core File of the National Center for Charitable Statistics, California had 87,775 active section 501(c)(3) organizations organized in the state circa 1999, while New York had 57,574, and Delaware, the darling of the public corporation, had only 2502.

My impression is that nonprofit corporations are far more likely to incorporate in the state of their initial or primary operations. Thus, to the extent the critique of SOX for federalization of corporate governance, including the critique of federal judicial enforcement, turns on a competitive market regarding a corporation’s choice of governance regime to which it will subject itself, the argument does not apply to federal regulation of nonprofits.

Nonetheless, the appropriate locus of judicial enforcement for questions of nonprofit corporate governance is far from certain. On the one hand, expanding the equity jurisdiction of federal courts is problematic. On the other hand, the argument for state court enforcement is not strong. While state statutory laws may adequately address the issue, lack of enforcement of the provisions in many states means that courts have little experience in such matters. Thus, there is the risk that they would rely on experience with for-profit corporations, even though “the corporate law that has been developed for business corporations, and particularly that which concerns the fiduciary obligations of corporate management, often provides a poor model for nonprofit corporation law.”

To some extent, the question is an empirical one. If Professor Silber is correct and the vast majority of charitable dollars and organizations are subject to the regulations of states that have both active enforcement and jurisdiction over fiduciary duties of public charities, the argument for

186. As noted above, this tendency may be changing. Material is now available that allows lawyers to compare the applicable law of various jurisdictions to decide where to incorporate. For example, CCH, a provider of tax software, has an interactive Smart Chart available on its Tax Research Network in which the position of various jurisdictions on selected topics can be compared. See CCH, Salestax.com from CCH Is New Destination Site for Sales, Use Tax Professionals, http://www.cch.com/press/news/2005/20050125t.asp (last visited Oct. 12, 2007).
188. See Silber, supra note 29, at 636.
some kind of federal regulation may weaken. The holes in state enforcement, however, suggest to me that the argument for federal regulation and enforcement is stronger for nonprofit corporations than for for-profit ones. It may be preferable, however, as Professor Evelyn Brody has suggested, to follow the 1977 proposals and give federal equity jurisdiction to the federal district courts rather than the Tax Court with its specialized docket and the experience of its judges.  

3. Alternatives to Federal Regulation

Critics of SOX argue that its mandatory federal regulation was unnecessary because other options would have better corrected the ills it addressed. If Congress had not acted, the argument goes, others would have. One alternative, of course, is state corporate law, as discussed above. State law gives shareholders various rights to sue their corporations through derivative actions. Such shareholders have standing to do so. Either large, highly visible institutional investors (themselves often nonprofits, such as retirement funds) or smaller shareholders in class actions will have sufficient financial motivation to bring such suits. Institutional investors often have large enough stakes to influence management directly. Critics of SOX point as well to the fact that stock exchanges subject their listed companies to governance provisions. Professor Romano observes that stock exchange audit committees that were in place pre-SOX required financial literacy of all audit members and accounting or finance expertise of one. She notes, “A stock exchange is a more appropriate locus of authority for such requirements as it is capable of moving far more rapidly than Congress, should the business environment change and necessitate adjustment in the expertise requirement.” Professors Butler and Ribstein observe that the New York Stock Exchange has adopted listing standards requiring the majority of the board to be independent.

Perhaps most importantly in the mind of these critics is that securities analysts and investment managers can take advantage of the long-standing mandatory disclosure system to monitor public corporations. “The question for federal regulators and Congress should have been whether this system ought to have been tweaked to give the market the information it needs” because “[t]he only effective antidotes to fraud are active and vigilant

190. Butler & Ribstein, supra note 2, at 94–99.
191. See supra notes 172–75 and accompanying text.
192. See Romano, supra note 41, at 40 n.82.
193. Id. at 40 n.82.
194. Butler & Ribstein, supra note 2, at 36. Included among the requirements are that a majority of the board cannot have a material relationship with the firm; directors must meet without management; and both the nominating and compensation committee must be wholly independent. Id. at 111 n.29.
195. Id. at 29.
markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.”

As many others have suggested, none of these methods is available for nonprofits. Professor Brakman Reiser writes, “[T]he nonprofit sector lacks comparable private groups motivated and authorized to act on disclosed information.” Professor Fremont-Smith explains that nonprofit corporations are not subject either to “‘watchdog’ shareholders with an equity incentive to police the action of board members” or to “an active plaintiff’s bar that would profit from bringing derivative suits.” While large grant makers and large donors can exercise some control over organizations to which they make grants, should some donor or would-be beneficiary of a nonprofit corporation wish to bring suit in state court to enforce duties related to corporate governance, they will generally lack standing. Proposals to expand such standing at the state level are among the most controversial of possible nonprofit reforms.

Private groups, such as the Better Business Bureau’s Wise Giving Alliance program, do attempt to function as watchdogs of the nonprofit sector. The requirement that exempt organizations make the Form 990s widely available and the easy access to such forms on Guidestar, which posts information on all tax-exempt organizations, have increased disclosure. But without a group of sophisticated analysts with the motive to examine the data available, the disclosure model that underlies our securities laws can have only limited relevance to the nonprofit sector. Overall, the response of the nonprofit sector to SOX can be viewed either as a vindication or a repudiation of SOX’s critics. The issues of corporate governance that the federal mandate of SOX attempted to address clearly struck a chord within the nonprofit sector and its regulators. The response, however, was exactly the kind that SOX’s critics cheer—advice from advisors, professional groups, and trade organizations urging voluntary adoption of SOX principles and legislative proposals largely from the states, with only California actually adopting additional regulation. Until very recently, Congress did not act, and the action it took was limited. For the most part, the action was by private parties on a voluntary basis. What more could free marketers desire?

196. Ribstein, supra note 120, at 3.
198. Fremont-Smith, supra note 15, at 233–34; see also Brakman Reiser, supra note 16, at 602.
200. Id. at 336–38.
202. See Brakman Reiser, supra note 16, at 612; Brakman Reiser, supra note 6, at 243–45.
203. See supra notes 16–20 and accompanying text.
Yet the nonprofit sector responded to the federal legislation of SOX as well as to the threat of far-reaching legislation as described in the Senate White Paper. Without such federal impetus, it is not clear what would have happened regarding improved nonprofit governance. Moreover, the sector itself is open to federal legislation beyond that enacted in the Pension Protection Act. For example, the final report of the Panel on the Nonprofit Sector, which involved and has been endorsed by many kinds of nonprofit organizations throughout the country, urges Congress to direct the IRS “to require that the Form 990 series returns be signed, under penalties of perjury, by the chief executive officer, the chief financial officer, or the highest ranking officer of the organization” and to require charities with at least $1 million in total annual revenues to conduct an audit.204

That the nonprofit sector itself welcomes at least some federal regulation does not of itself undermine the arguments made by the critics of SOX; nonetheless, the arguments they make to question federal regulation of public companies apply with far less force to nonprofit corporations. I turn to the implications of this conclusion next.

II. IMPLICATIONS FOR THE NONPROFIT SECTOR

As Professor Fremont-Smith has said, “A distinguishing feature of charity regulation is that it is a dual system, with state and federal rules and enforcement programs that parallel each other to a large degree.”205 The challenge is how best to harmonize and make use of this dual system.

One school of thought fears that, in the nonprofit sector as elsewhere, “inadequate attention to poor performance results from coextensive supervision and enforcement responsibility” because “the more complex, multilayered, or fragmented the legal and political setting,” the more likely it is that the result will be unsatisfactory regulation, the tragedy of the “regulatory commons.”206 Professor Silber suggests making “more formal assignments of primary enforcement responsibilities in the nonprofit legal regime” in order to “increase the predictability of enforcement.”207

Another school welcomes “jurisdictional redundancy” and duplication, particularly in judicial review. Thus, Professor Robert Ahdieh defends SOX against its critics by suggesting that mixed governance fosters “efficient innovation in corporate law.”208 The Pension Protection Act of 2006 appears to endorse such a point of view. It permits the IRS to disclose to state officials charged with overseeing tax exempt organizations information about investigations related to refusal to recognize an organization as tax exempt or revocation of tax exemption.209 Such a
change to the law, proponents have argued, will enable states to identify “organizations that have violated state law.”

For the nonprofit sector, much of the concern about this dual system is aimed at spotty state regulation. Thus, the final report of the Nonprofit Panel recommends that Congress “authorize funding to be provided to all states to establish or increase oversight and education of charitable organizations,” as well as additional matching dollars for further improvements.

To me, the reasoning underlying the critiques of SOX set out above justifies both regulation of nonprofits and a greater federal role in nonprofit governance. Given the lack of private parties monitoring the sector and the limited state enforcement, we need to develop ways to achieve a more direct federal presence regarding matters of governance.

First, I suggest federalization of incentives for education. Everyone who has looked at the issue of nonprofit governance has stressed the importance of educating nonprofit boards. The work of Professor Romano, one of the foremost critics of SOX, confirms the importance of financial expertise for audit committee members. The current incentives for such financial and general board education in the nonprofit sector, however, have simply not been adequate. We need to come up with ways in which the IRS can encourage nonprofit corporations to educate their boards.

One possibility is allowing the completion of educational programs developed by the IRS or the demonstration of expertise on the board to expedite or reduce fees for processing exemption applications. Another possibility would be demonstration of some kind of educational programs or the presence of expert board members as one of the conditions for the rebuttable presumptions under section 4958. Financial issues go well beyond insider compensation, of course, but since compensation represents so large a percentage of so many nonprofit organizations’ costs, the connection is at least plausible. A showing of educational programs might go to rebate or correction of various excise taxes. As with the initial application, educational programs developed by the IRS might be offered as part of any periodic required renewal of tax exempt status, with different programs for organizations of different sizes, complexity, and sophistication. As with the initial application, completion of the programs or demonstration of board expertise could make the organization eligible for a reduced fee for such renewal.

Second, and more fundamentally, I urge consideration of legislation establishing some federal minimum standards of nonprofit governance for the IRS to enforce, with the IRS to withdraw if state regulation is shown to

---

212. See id. at 24–27; Brakman Reiser, supra note 16, at 612.
be sufficient. The arrangement I envision would, to some extent, parallel current federal-state enforcement of environmental laws. As one environmental textbook explains,

The environmental laws authorize EPA to delegate to states responsibility for administering and enforcing the federal clean water, clear air, and hazardous waste programs. To qualify for program delegation, states must satisfy EPA that they can operate the programs in a manner that meets all federal requirements. . . . If states operating delegated federal programs fail to meet minimum federal standards, EPA has the authority to withdraw the delegation, but this authority is virtually never exercised because the Agency is loathe to take over operation of state programs without receiving additional resources. The EPA also has generally had the authority to take enforcement action on its own when it does not believe that states have adequately addressed certain violations.

This relationship, known in the environmental context as well as others as cooperative federalism, seems to me to offer a model. I imagine an approach for the nonprofit sector that would explicitly allow states to establish requirements more rigorous than the minimal federal ones. Such is the case for environmental law, where “cooperative federalism involves programs where federal monies are made available to each state contingent on its creation of a regulatory scheme that is at least as stringent as the federal floor.”

Such a proposal, of course, needs more detail as to what such minimum standards and sufficient state enforcement would be. Building substantive requirements related to the governance disclosures required by the new draft Form 990 is one possibility. Such a proposal is not without dangers, some of which, such as federal judicial enforcement, I have sketched out above. It would complicate the role of the IRS and divert it from its tax functions in some states and not others. Sufficient funding, as always, would be an issue. However, I agree with Professor Fremont-Smith that the intermediate sanction regime has already established “a major expansion of

213. Cf. Marion R. Fremont-Smith, Foundations and Governments: State and Federal Law and Supervision 438–40 (1965) (“It is, however, worthwhile to consider whether state programs of supervision can be utilized to complement federal programs . . . . Furthermore, the Commissioner should be granted discretion to withhold action if the state has taken jurisdiction and is effecting a correction.”); Fremont-Smith, supra note 15, at 461; John G. Simon, Private Foundations as a Federally Regulated Industry: Time for a Fresh Look? (1999) (unpublished manuscript, on file with N.Y. Univ. Sch. of Law, Nat’l Ctr. on Philanthropy and the Law), available at http://www.law.nyu.edu/ncpl/library/publications/Conf1999_Simon_Final.pdf (suggesting that the federal government take steps to help state attorneys general do their jobs more efficiently through revenue sharing to deliver needed resources to state regulators, with the primary role to be given to the states).


the power of the Service to regulate the behavior of charitable fiduciaries" and that “it is naïve to think that Congress would remove regulation of charities or other exempt entities from the Service.”

This approach of imposing minimal federal standards that a state could displace avoids some of the objections that have been made to federalization in this area. Unlike full-fledged federalization, it would avoid a general need for a nonprofit to satisfy conflicting federal and state duties. It would answer Professor Brody’s concern regarding the proposal in the White Paper to impose federal standards “that are more stringent than allowed under State law.” It would allow those states that have active charities bureaus to continue their work and supply needed enforcement in those states that do not.

CONCLUSION

Nonprofit corporations, of course, are not alone in having to satisfy both federal and state regulators. The history of regulation in this sector, combining state corporate law with federal tax law, has produced some particular complications. How best to resolve those complications is a continuing challenge, but one that cannot be avoided.

The response to SOX and the relationship between the SEC and for-profit corporate governance offer some guidance and insight. The critique of SOX suggests revisions to current laws or proposed laws regarding nonprofits. In particular, it suggests reliance on expertise instead of complete independence for audit committees. It also, however, demonstrates that the nonprofit sector differs from the for-profit sector in ways that favor further federal regulation of the nonprofit sector.

216. Fremont-Smith, supra note 15, at 263.
217. Id. at 465.
218. Brody, supra note 189.