Nonprofit Compensation and the Market

Peter Frumkin*
Alice Andre-Clark**

INTRODUCTION

One of the most recent and vivid illustrations of the continuing need for scrutiny of nonprofit compensation is the Kamehameha Schools Bishop Estate ("KSBE" or the "Estate") scandal, which culminated in the removal of all of the trustees of a multi-billion dollar charity charged with the operation of Hawai'i's renowned Kamehameha Schools and other educational programs targeted at native Hawaiian children.[1] The Estate's highly generous compensation practices—forty million dollars in trustee fees over ten years, and an average of $900,000 in annual compensation per trustee between 1994 and 1997—proved a lightning rod for critics.[2] Concern over the Estate's management led the Internal Revenue Service ("IRS") to threaten to revoke KSBE's tax exemption unless the trustees were removed.[3] The trustees, in turn, lobbied unsuccessfully against the 1996 passage of "intermediate sanctions" reforms that permit the IRS to impose excise taxes on individuals who collect excessive salaries or other benefits from public charities.[4] The KSBE case both highlights the limited power of donors and customers to shape charities' compensation practices, and suggests some of the difficulties regulators will face, even after the passage of intermediate sanctions, in defining what level of compensation is legally reasonable.

Critics of KSBE's governance argued for the necessity of government intervention in part because the trustees were largely insulated from the institutional pressures that dissatisfied donors or other skeptical stakeholders might have created.[5] With a trust amounting to five to ten billion dollars, KSBE trustees did not need to court potential donors by demonstrating wise

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* Assistant Professor of Public Policy, John F. Kennedy School of Government, Harvard University.
** Doctoral Candidate in Public Policy, John F. Kennedy School of Government, Harvard University.

[1] *See* Rick Daysog, *Then There Were None*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-1.

[2] *See, e.g.*, Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue of the *University of Hawai'i Law Review*.

[3] *See* Rick Daysog, *IRS Wants Bishop Trustees Out*, HONOLULU STAR-BULLETIN, Apr. 28, 1999, at A-1.

[4] *See Broken Trust*, *supra* note 2; 26 U.S.C. § 4958 (Supp. III 1997).

[5] *See, e.g.*, *Broken Trust*, *supra* note 2.

management.[6] While trustees were required to submit to a court-appointed master's annual review, observers charged that the master's power to enforce recommendations was limited, and that many of the large Estate's transactions were too complex for an outside reviewer to grasp readily.[7] In addition, many warned that the trustee selection process—trustees were chosen by the justices of the Hawai'i Supreme Court—significantly weakened accountability.[8] Because justices were potentially personally liable for negligent trustee selection, they faced a disincentive to review trustees' actions rigorously during court proceedings.[9] Moreover, critics argued that the justices, themselves appointed through a politicized process, were motivated to select trustees with good political connections but little or no estate management experience.[10] While some of these difficulties are unique to KSBE, management incentive problems, including permanent endowment, poorly informed donors, and inattentive directors, appear by no means uncommon in public charities.[11]

If the governance and compensation practices of KSBE suggest a lingering need for careful government regulation of compensation, the case also hints at the complexity of the task of developing a standard of reasonableness. At first glance, the extent to which the KSBE trustees earned their pay appears relatively easy to evaluate. The five community leaders who initially called for investigation of the trustees in the 1997 "Broken Trust" article declared that, while "the people made responsible" for protecting billions of dollars of wealth and carrying out a unique educational mission "arguably ought to be highly paid," KSBE clearly was not getting its money's worth from its current group of trustees.[12] They drew this conclusion not only from the trustees' generally weak estate management credentials, but from a variety of bizarre management decisions.[13] These included a series of high-risk investments that generated $264 million in losses in one year, a continuing refusal to hire a professional CEO to manage the Estate, the abandonment of an acclaimed set of early education and outreach programs, and a set of abrupt firings and other incidents that had led to a rapidly deteriorating relationship with the faculty of Kamehameha Schools.[14] By the time a judge temporarily removed the remaining trustees in May 1999, as two trustees faced criminal charges, one

[6] *See id.*
[7] *See id.*
[8] *See id.*
[9] *See id.*
[10] *See id.*
[11] *See infra* notes 187-203 and accompanying text.
[12] *See, e.g., Broken Trust, supra* note 2.
[13] *See id.*
[14] *See id.*

for a kickback scheme involving Estate land,[15] few disagreed with the community leaders' early assessment. A poll taken shortly after the removal revealed that nine out of ten registered Hawai'i voters favored the move.[16]

Though the community was largely united in its perception of most of the trustees, the treatment of trustee Oswald Stender suggests that whether a job performance merits high pay may often be in the eye of the beholder. Although Stender accepted the same compensation the other trustees did, he had substantial estate management experience, and he broke publicly with other trustees, opposing the offer of a CEO position to a candidate who had not been selected through a formal hiring process, and ultimately suing to remove a trustee whom he alleged had mismanaged the Kamehameha Schools.[17] The "Broken Trust" writers, while not arguing that the amount of his salary was justified, singled him out as the only trustee who measured up to his job.[18] When Stender resigned as the others were removed, one of the writers observed, "[t]he only thing that I'm not happy about is that Oz Stender ended up being dragged down with the rest of them."[19] However, the Attorney General sought removal of all of the trustees, including Stender, for excess compensation, and also for such omissions as the failure to meet financial reporting requirements or to review investments with due diligence, and she characterized Stender's efforts to remove the other trustee as a late response to overwhelming public criticism.[20] These disparate views of Stender's actions suggest that it would not be easy for a regulator to determine how much compensation his skills and services should reasonably have earned him.

The KSBE case also illustrates the increasing centrality of salary comparisons in the determination of what compensation is reasonable. In her removal petition, the Attorney General observed that virtually all school and college trustees receive no compensation, that the average annual compensation of trustees of foundations with assets in excess of one billion is $14,730, and that even the CEOs of this group of foundations received an

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15 *See* Rick Daysog, *9 of 10 Residents Back Bishop Board's Removal*, HONOLULU STAR-BULLETIN, May 24, 1999, at A-1.

16 *See id.*

17 *See* Rick Daysog, *Oswald Stender: Ousted Trustee Says He Was Willing to Step Down to Help Preserve the Bishop Estate's Tax-Exempt Status*, HONOLULU STAR-BULLETIN, May 8, 1999, at A-2.

18 *See Broken Trust*, *supra* note 2.

19 *See* Daysog, *supra* note 17.

20 *See* Petition of the Attorney General on Behalf of the Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048, (Haw. Prob. Ct. Sept. 14, 1998), *available at* <http://starbulletin.com/98/09/11/news/removal.html> [hereinafter Petition for Removal and Surcharge].

average salary of just $323,600.[21] The Attorney General's comparisons raise several normative questions: How should compensation comparisons be made? Should for-profit, as well as nonprofit, organizations be considered appropriate sources of comparison? If organizations hire officers with especially strong or weak credentials, how far outside the comparison range should we expect them to deviate? If customers, clients or contributors are able to impose substantial market pressures on an organization, should their approval of a high salary satisfy a government regulator that the salary is appropriate?

This Article explores the development of compensation regulation in public charities and examines the philanthropic "market" forces that constrain or fail to constrain compensation to reasonable levels. Compensation regulation has traditionally taken, and is likely to take in the future, a process-based approach. Though the intermediate sanctions legislation imposes new specific salary comparison requirements, we argue that this approach is at best a stopgap measure to address extreme cases such as that of KSBE, and that it will do little to discourage nonprofit executives from allowing salaries to creep steadily upward. Rather, we suggest that government and the nonprofit sector should turn their attention to measures that increase the supply of low-cost information to donors, and that educate donors and board members to demand reliable and detailed information to guide their decision making with respect to the nonprofit sector.

Part I of this Article reviews the pre-intermediate sanctions law regarding compensation regulation, and describes why process requirements have had little effect in the past on firms' or charities' discretion to set high salaries. Part II shows how the new intermediate sanctions legislation attempts to bring more rigor to process analysis in compensation regulation, and draws from its legislative history a set of criteria for effective compensation regulation. Finally, in Part III, we argue that the intermediate sanctions' new focus on comparisons will not greatly improve the rationality of compensation decisions because cross-sector comparisons are often not meaningful, and because an emphasis on comparisons may simply create pressure to raise salaries to an ever-increasing mean. As an alternative, we explain how steps to increase the availability of information, and donors' and boards' interest in acquiring it, can make the nonprofit sector a more effectively functioning market economy.

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21 *See id.*

I. GOVERNMENT REGULATION OF COMPENSATION: A CROSS-SECTOR COMPARISON OF PRE-INTERMEDIATE SANCTIONS LAW

Before the 1996 passage of intermediate sanctions,[22] compensation within public charities was regulated primarily by the federal tax law doctrines of private inurement and private benefit, and, indirectly, by fiduciary duties found in state corporation law. Most government efforts to regulate compensation in both the private and nonprofit sectors have centered on preventing organization insiders from leveraging their positions of power to secure excessive compensation for themselves. For nonprofits, the courts and the IRS have on occasion recognized a second purpose for regulating compensation: that of ensuring that tax-exempt dollars serve one of the Internal Revenue Code's enumerated exempt purposes.

Efforts to address compensation to insiders have been characterized by a strongly procedural, rather than an outcome-based, approach. Enforcement has generally been lax, and has been limited largely to efforts to prevent outright fraud or embezzlement rather than the more difficult question of the reasonableness of compensation. Before the advent of the new intermediate sanctions, the IRS's sole remedy was the severe revocation of tax exemption penalty, which IRS officials were likely reluctant to use. Litigation efforts have been infrequent, and have concentrated not on highly compensated officials of major institutions such as universities and hospitals, but on tiny charities with very weak governance structures. Churches, which are required neither to demonstrate substantial public support nor to file annual disclosure documents, appear to have been a particular focal point for compensation regulation. In this context, enforcement has focused not on whether compensation is excessive, but on whether it amounts to bilking. In the case of large, sophisticated institutions, the differential standards under private inurement case law are weak enough so that clever overcompensators can probably meet them without modifying the substance of their compensation decisions.

In addition to the IRS's enforcement efforts, corporations, whether business or charitable, are subject to state fiduciary duty standards that may affect compensation. Self-dealing transactions—when directors or officers vote on their own pay—must meet a strict fairness standard under the fiduciary duty of loyalty.[23] However, corporations can largely avoid duty-of-loyalty scrutiny simply by setting up processes that are formally independent of the interested director or officer. The work of independent compensation committees might be subject to closer court scrutiny if they displayed a lack of due care, but the courts' process-oriented view of due care (combined with a traditional

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[22] *See* 26 U.S.C. § 4958 (Supp. III 1997).
[23] *See infra* notes 100-31 and accompanying text.

reluctance to intervene in compensation matters) indicates that due care scrutiny is unlikely to restrain compensation committees substantially. Empirical and anecdotal evidence about these committees suggest that compensated executives are able to maintain significant control, and to exert strong pressure to raise wages, even in theoretically independent processes. For charitable corporations, the impact of fiduciary duty law is particularly weak because of resource and other constraints faced by state attorneys general, who generally have exclusive standing to enforce this law against charities.[24]

A. Private Inurement in Public Charities

In order to qualify for tax-exempt status, organizations must ensure that "no part of [their] net earnings . . . inures to the benefit of any private shareholder or individual."[25] Because the absence of private inurement is a condition for exemption, the only penalty for inurement prior to intermediate sanctions was revocation of the organization's tax exemption status.[26] In practice, the IRS often sidesteps more severe penalties by negotiating "closing agreements," which provide that further action will not be taken if an individual or organization corrects wrongdoing in specified ways.[27] However, when inurement is litigated, courts have generally held that even a minimal amount is enough to justify revocation.[28] There are two basic elements to the inurement cause of action: (1) that the compensated person is a "private shareholder or individual";[29] and (2) that the level of compensation is "unreasonable" for the services provided.[30]

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[24] *See infra* notes 128-29 and accompanying text.

[25] 26 U.S.C. § 501(c)(3) (1994).

[26] *See Full Text: IRS Commissioner's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 127-40 (June 16, 1993)(statement of IRS Commissioner Margaret Milner Richardson before the Ways and Means Subcommittee on Oversight on June 15, 1993) [hereinafter *Commissioner's Testimony*].

[27] *See id.*

[28] *See* Rink v. Commissioner, 47 F.3d 168, 169-71 (6th Cir. 1995)(describing negotiations over a closing agreement resolving the extent of taxpayers' liability); Church of Scientology v. Commissioner, 823 F.2d 1310, 1316 (9th Cir. 1987)("The term 'no part' is absolute. The organization loses tax exemption if even a small percentage of income inures to a private individual."). *But see* Carter v. United States, 973 F.2d 1479, 1487 n.5 (9th Cir. 1992)("We have grave doubts that the de minimis doctrine, which is so generally applicable, would not apply in this situation.").

[29] *See, e.g.*, Variety Club Tent No. 6 Charities v. Commissioner, 74 T.C.M. (CCH) 1485 (1997).

[30] *See, e.g.*, World Family Corp. v. Commissioner, 81 T.C. 958, 968 (1983).

1. The insider

Federal regulations define the "private shareholder or individual"—or "insider"—as anyone "having a personal and private interest in the organization."[31] Until recently, the IRS took the position that anyone employed by a charity could be an insider. Through the 1980's, a series of IRS documents indicated the agency's broad conception of the insider. An outside investment advisor to a real estate company, physicians subsidized by a hospital to perform emergency room and training duties, and university athletic coaches all were termed insiders,[32] and a 1987 General Counsel Memorandum even declared that "all persons performing services for an organization" were insiders.[33] However, the Tax Court had made "substantial and formal practical control" of the organization's finances or governance processes the test of an insider.[34] Thus, a former president and current board member of a charitable bingo game was an insider given his control over the games' procedures and disposition of the proceeds, but a former bingo operator and current twenty percent stockholder in the corporation that rented the game its bingo hall was not, because he "did not have any formal voice" in, or practical control over, the entity's activities.[35]

The Seventh Circuit in its 1999 *United Cancer Council v. Commissioner*[36] ("*UCC*") decision definitively limited the definition of insider. Judge Posner's opinion stated that the purpose of private inurement is to stay the hands of those who are in a position to siphon off charitable funds for their own benefit, and not to stop arm's length transactions by disinterested but unwise managers and directors.[37] In 1984, UCC, a cancer charity verging on bankruptcy, entered into a five-year contract with direct-mail fundraiser Watson & Hughey ("W&H").[38] W&H fronted the expenses for a fundraising campaign in return for exclusive access to UCC's "housefile," or donor list, and the right to be UCC's exclusive fundraiser.[39] W&H sent out eighty million letters and raised $28.8 million for UCC, but collected $26.5 million to defray costs.[40] The Tax Court upheld the IRS' revocation of UCC's exemption, finding that, while the contract was negotiated at arm's length,

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[31] 26 C.F.R. § 1.501(a)-(1)(c) (1998).

[32] *See* Gen. Couns. Mem. 38,905 (June 11, 1982); Gen. Couns. Mem. 39,498 (Apr. 24, 1986); Gen. Couns. Mem. 39,670 (Oct. 19, 1987).

[33] Gen. Couns. Mem. 39,670 (Oct. 19, 1987).

[34] *See Variety Club*, 74 T.C.M. (CCH) 1485.

[35] *See id.*

[36] 165 F.3d 1173 (7th Cir. 1999).

[37] *See id.* at 1176.

[38] *See id.* at 1175.

[39] *See id.*

[40] *See id.*

W&H became an insider with respect to later contract-related transactions.[41] It likened W&H's fronting the fundraising costs to the act of a founder, and, pointing to the contract's exclusivity, argued that W&H had substantial control because UCC would have been powerless to engage another fundraiser if it stopped its efforts.[42]

In reversing the Tax Court's finding, the Seventh Circuit described the private inurement test as follows:

> A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager. The test is functional. It looks to the reality of control rather than to the insider's place in a formal organizational table.[43]

While admitting that the terms of the contract were quite favorable to W&H, the court recognized it was an arm's length transaction with a disinterested though imprudent board.[44] The court maintained that the IRS had simply misunderstood the market incentives for allocation of risk that had likely shaped the contract,[45] interpreting the exclusivity as an inducement for W&H to front expenses for a risky endeavor.[46] Furthermore, because contract law implies a best effort clause, UCC would not have been powerless if W&H had stopped soliciting.[47] Ultimately, the court rested its decision on the bargaining process. The court determined that all of the contract's advantageous provisions had been agreed upon during the arm's length negotiations that took place before W&H became an insider.[48] The market analysis served to demonstrate that UCC could plausibly enter into such a contract even without the illegitimate influence of an insider.[49]

Three critical points emerge from the *UCC* decision. First, the *UCC* court makes clear that the IRS may not use the private inurement test to attack every bad compensation decision that results simply from a passive board's inattention.[50] Rather, the compensated person must have had some direct voice in the wage-setting process. Second, the compensated person probably

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41 *See id.* at 1176.
42 *See id.*
43 *Id.*
44 *See id.*
45 *See id.* at 1176-77.
46 *See id.*
47 *See id.* at 1177.
48 *See id.* at 1178-79.
49 *See id.*
50 However, the court found that the private benefit test may have some application to excess compensation when the effect is to take substantial sums of money away from the organization's charitable purpose. *See id.* at 1179-80. *See also infra* notes 75-98 and accompanying text.

cannot escape insider status by formally distancing herself from the wage-setting process. The *UCC* court makes clear that the test of insider status is functional, suggesting that setting up an independent compensation committee will not protect an influential insider from an inurement finding. Third, though the *UCC* decision offered a functional definition of "control," there are few cases applying the definition to specific factual examples. Founders, directors, officers, and their family members almost certainly are insiders,[51] and independent contractors almost certainly are not,[52] but much territory lies between these extremes.

2. Unreasonable compensation

A central idea in private inurement cases pertaining to compensation is that the "law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."[53] The Tax Court asserts that it applies to charities essentially the same test—I.R.C. § 162, which requires that the salary be reasonable, or an "ordinary and necessary" business expense—as the IRS uses to determine the deductibility of private firm salaries.[54] Although courts vary slightly in the factors they consider, one widely cited test comes from the Ninth Circuit's decision in *Elliotts, Inc. v. Commissioner*.[55] The *Elliotts* court considered five categories of factors: (1) the employee's role in the organization—position, hours worked, duties performed, and general importance to the organization's success; (2) comparisons of the employee's salary to salaries of those who perform similar services for similar organizations; (3) the "character and condition" of the organization—its size, complexity, and economic condition; (4) the extent of the employee's ownership interest (we might read "insider status" in the charity context); and (5) whether owner-employees (again, we might read insider-employees) are paid similarly to non-owner-employees.[56] Rather than state all the factors, the Tax Court tends to describe a rule-of-thumb version, asking simply whether the employee's services "would cost as much if obtained from an outside source in an arm's length transaction."[57]

While the Tax Court theoretically applies the same multi-factor test used to determine reasonableness for private firm salaries, courts seldom explicitly

[51] *See United Cancer Council*, 165 F.3d at 1176.

[52] *See id.*; *see also* National Found., Inc. v. United States, 13 Cl. Ct. 486 (1987).

[53] World Family Corp. v. Commissioner, 81 T.C. 958, 969 (1983).

[54] *See* Truth Tabernacle v. Commissioner, 57 T.C.M. (CCH) 1386 (1989).

[55] 716 F.2d 1241 (9th Cir. 1982).

[56] *See id.* at 1245-48.

[57] *World Family Corp.*, 81 T.C. at 969 (1983)(quoting B.H.W. Anesthesia Found. Inc. v. Commissioner, 72 T.C. 681, 686 (1979)).

state their test, make salary comparisons, or draw conclusions about the individual's special skills or the job's level of difficulty beyond the number of hours the individual worked.[58] Rather, the reasonableness determination has focused on process—on the degree of the compensated person's insider status, on the justifications offered for salary fluctuations, and on the appropriateness of these justifications to the compensated person's job description. Several patterns emerge from the inurement cases.

First, following the fourth factor in the *Elliotts* test, courts have given especially close scrutiny in instances in which the compensated person is what we might call a "super insider." In both *Church of Modern Enlightenment v. Commissioner*[59] and *Church of Eternal Life & Liberty, Inc. v. Commissioner*,[60] a close-knit three-member board of trustees led the Tax Court to observe that, when one individual or a "small self-perpetuating group" controls all of an organization's funds and activities, a strong inference of inurement is created.[61]

A second factor at work in the compensation cases is that, if compensation fluctuates, the organization should be able to attribute the fluctuation's relationship to the employee's performance. For example, contracts contingent on an organization's revenues might be reasonable for some types of employees, but courts have rejected contingent compensation for a gemology instructor[62] and a minister, with one court observing that "[w]hatever [the minister's] services are worth, they are not directly related to petitioner's gross receipts. The value of solace and spiritual leadership cannot be measured by the collection box."[63] In another case, when a minister's parsonage allowances varied from $13,600 to $33,650 and back to $12,000 without any evidence of a change in duties to justify the modification, the fluctuation was construed to support a finding of excess compensation.[64]

Third, the contingent contract mechanism generally has troubled the IRS. As seen above, one reason for this skepticism is the belief that, in many jobs, receipts are a poor measure of one's skill and effort. However, organizations have overcome this perception where skill and effort clearly are reflected in receipts, such as in the case of the president of an organization that raised

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[58] See cases cited *infra* note 71.

[59] 55 T.C.M. (CCH) 1304 (1988).

[60] 86 T.C. 916 (1986).

[61] *See id.*

[62] *See* Gemological Inst. of Am. v. Commissioner, 17 T.C. 1604 (1952), *aff'd* 212 F.2d 205 (9th Cir. 1954).

[63] People of God Community v. Commissioner, 75 T.C. 127 (1980).

[64] *See* Unitary Mission Church v. Commissioner, 74 T.C. 507, 514, 516 (1980), *aff'd* 647 F.2d 163 (2d Cir. 1981).

funds for missionary work.[65] Another reason for courts' concern over contingent contracts is the fact that the private inurement clause specifically forbids organizations from allowing *net earnings* to inure to insiders.[66] When compensation is based directly on earnings, it might create an inference that inurement of earnings is precisely what is occurring.[67] While the concept of reasonable compensation would seem to suggest that the amount of compensation is what matters, courts have in practice often noted the percentage of earnings received. Even though the Tax Court rejected a minister's compensation scheme (which provided him more than two-thirds of the church's receipts) in part because it had no upper limit,[68] the same court later permitted contingent fees of up to twenty percent, with no upper limit, for fundraisers.[69] Courts appear unlikely to approve contingent compensation when it constitutes half or more of receipts, and the compensated person has a very high level of control over the wage setting process.

What is striking about the pattern of reasonableness assessment is that it has concerned the process more than the outcome of wage setting, and that it has required a very low level of process rigor. Organizations likely to face revocation for private inurement were those that allowed the compensated person to dominate all of its governance processes, that raised and lowered salaries without explanation, and that turned vast percentages of receipts over to employees without thought as to whether percentage of receipts appropriately measures performance. As we will see in Part II, part of the intent of intermediate sanctions is to make the IRS less reluctant to pursue excess compensation in sophisticated organizations such as universities and hospitals. While such major institutions do occasionally fail to follow minimal formal wage setting processes,[70] requiring no more than these

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[65] *See* World Family Corp. v. Commissioner, 81 T.C. 958 (1983).

[66] *See* 26 U.S.C. § 501(c)(3) (1994).

[67] *See, e.g., Gemological Inst.*, 17 T.C. 1604. The Tax Court rejected as inurement a salary of 50% of net earnings:

> However, when petitioner further says that Shipley's compensation was not part of its earnings but only measured by the amount of its net earnings, we can not accept this argument. . . . Regardless of what these amounts are called, salary or compensation based on earnings, it is obvious that half of net earnings of petitioner inured to the benefit of an individual. . . . Such a distribution of net earnings is unequivocally prohibited by the statute.").

Id. at 1609-10.

[68] *See People of God Community*, 75 T.C. at 132.

[69] *See generally World Family Corp.*, 81 T.C. 958. This was a rare case in which a court made comparisons of a sort, noting that the percentage of receipts retained by the fundraiser fell well within the limits prescribed by state charitable solicitation statutes. *See id.* at 969 (citing FLA. STAT. ANN. § 496.11 (West 1976)).

[70] One notable example of a major institution's failure to meet even these minimal standards is Adelphi University trustees' grant of repeated raises to President Peter Diamandopoulos

processes may not be a significant check on these institutions' compensation levels. For example, given the many subjective factors that enter into a performance evaluation, it is probably not difficult for a board to record a few ex-post positive factors to justify a raise, and certainly few hospitals and universities are likely to be dominated by super insiders to the degree the churches described above were. Thus, the case law of private inurement suggests that any regulatory regime that focused on outcomes and salary comparisons would be operating on largely new territory. However, if the regime continues the private inurement's process focus, a higher process bar would certainly be necessary to change major institutions' decision making processes about compensation.

In the end, the IRS' reluctance to litigate the drastic penalty of revocation is apparent both in the scarcity of private inurement compensation cases—we found 33 reported Tax Court decisions over the past 20 years[71]—and in the

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without a vote and without any formal evaluation of Diamandopoulos' performance, in violation of their own by-laws. *See* Bruce Lambert, *New York Regents Oust 18 Trustees from Adelphi U.*, N.Y. TIMES, Feb. 11, 1997, at A1.

[71] We considered Tax Court, Court of Claims, District Court, and Courts of Appeals cases in which a private inurement issue involving compensation was a significant issue. These are not, of course, necessarily a representative sample of the cases in which the IRS alleged inurement, and it does not take into account actions that were not appealed or disputes that were resolved in a negotiated settlement. The cases we found include: United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999); Airlie Found. v. United States, No. 93-5254, 1995 WL 310025 (D.C. Cir. Apr. 24, 1995); Church of Scientology v. Commissioner, 823 F.2d 1310 (9th Cir. 1987); Presbyterian & Reformed Publ'g Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984); Bubbling Well Church of Universal Love v. Commissioner, 670 F.2d 104 (9th Cir. 1981); Brian Ruud Int'l v. Commissioner, 733 F. Supp. 396 (D.D.C. 1989); Freedom Church of Revelation v. United States, 588 F. Supp. 693 (D.D.C. 1984); Church of Gospel Ministry v. Commissioner, 640 F. Supp. 96 (D.D.C. 1986), *aff'd*, 830 F.2d 1188 (D.C. Cir. 1987); Incorporated Trustees of the Gospel Worker Soc'y v. United States, 510 F. Supp. 374 (D.D.C.), *aff'd mem.*, 672 F.2d 894 (D.C. Cir. 1981); Basic Unit Ministry of Alma Karl Schurig v. United States, 511 F. Supp. 166 (D.D.C. 1981); Bob Jones Univ. Museum & Gallery v. Commissioner, 71 T.C.M. (CCH) 3120 (1996); Church of the Living Tree v. Commissioner, 71 T.C.M. (CCH) 3210 (1996); Tony & Susan Alamo Found. v. Commissioner, 63 T.C.M. (CCH) 2422 (1992); Bill Wildt's Motorsport Advancement Crusade v. Commissioner, 56 T.C.M. (CCH) 1401 (1989); Truth Tabernacle Church v. Commissioner, 57 T.C.M. (CCH) 1386 (1989); Good Friendship Temple v. Commissioner, 55 T.C.M. (CCH) 1310 (1988); Church of Modern Enlightenment v. Commissioner, 55 T.C.M. (CCH) 1304 (1988); Universal Church of Jesus Christ v. Commissioner, 55 T.C.M. (CCH) 144 (1988); National Found., Inc. v. United States, 13 Cl. Ct. 486 (1987); Easter House v. United States, 12 Cl. Ct. 476 (1987), *aff'd*, No. 87-1519, 1988 WL 25416 (Fed. Cir. Mar. 28, 1988); Church of Eternal Life v. Commissioner, 86 T.C. 916 (1986); Triune of Life Church v. Commissioner, 85 T.C. 45 (1985), *aff'd mem.*, 791 F.2d 922 (3d Cir. 1986); New Concordia Bible Church v. Commissioner, 49 T.C.M. (CCH) 176 (1984); Church by Mail v. Commissioner, 48 T.C.M. (CCH) 471 (1984); Self-Realization Bhd. v. Commissioner, 48 T.C.M. (CCH) 344 (1984); Alive Fellowship of Harmonious Living, 47 T.C.M. (CCH) 1134 (1984); Truth Tabernacle, 41 T.C.M. (CCH) 1405 (1981); New Life

choice of organizations against which revocation was pursued. Over three quarters of the focal organizations were churches. The religious exemption category is particularly vulnerable to abuse, and indeed, many of the churches in question had spent no money on religious articles and had few members or infrequent services.[72] This vulnerability exists because of the low capital costs of starting a church, because churches (along with certain schools and medical organizations) can qualify as public charities without meeting a test of public support,[73] and because churches (unlike these other organizations) need not file the IRS's disclosure Form 990.[74] Thus, the IRS's choice of revocation targets likely reflects both suspicion that many did not serve a charitable purpose at all, and concern that low accountability and visibility to donors might lead to lax wage setting processes.

B. Private Benefit in Public Charities' Compensation Processes

Recent developments in case law suggest that the private benefit doctrine may support compensation regulation even when the compensated person is not an insider. The private benefit doctrine stems from the requirement that an exempt organization be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational

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Tabernacle v. Commissioner, 44 T.C.M. (CCH) 309 (1982); John Marshall Law Sch. v. United States, Nos. 27-78 & 28-78, 1981 WL 11168 (Cl. Ct. June 24, 1981); World Family Corp. v. Commissioner, 81 T.C. 958 (1983); People of God Community v. Commissioner, 75 T.C. 127 (1980); Southern Church of Universal Bhd. Assembled, Inc. v. Commissioner, 74 T.C. 1223 (1980); Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[72] *See, e.g., Bubbling Well Church*, 670 F.2d 104 (affirming denial of tax-exempt status to church that had no members other than the founding family, and that held services only at Christmas and Easter); *Southern Church of Bhd.*, 74 T.C. 1223 (denying tax-exempt status to church that had only five members, all of whom served as trustees); *Church of Modern Enlightenment*, 55 T.C.M. (CCH) 1304 (denying tax-exempt status to church where no church funds were spent on religious services, articles, or supplies).

[73] Certain schools and medical organizations can also avoid the requirement of public support and still qualify as public charities. Other public charities must demonstrate that they receive more than one-third of their support from gifts, grants, membership, and related business. Generally, no more than two percent of total receipts from a single person is countable, and contributions from donors providing over $5,000 are also excluded, so the organization must demonstrate that it receives support from multiple sources. *See* 26 U.S.C. §§ 170(b) & 509(a)(1)-(2) (1994).

[74] *See* 26 U.S.C. § 6033(a)(2) (1994). Form 990 requires disclosure of information about the organization's revenues, expenses, purposes accomplishments, and compensation levels for its officers, directors, trustees, and five highest paid other employees. *See IRS Form 990.*

purposes."[75] From this, courts have determined that expenditures that benefit a private interest more than incidentally justify exemption revocation.[76]

The private benefit test was stated most clearly in *American Campaign Academy v. Commissioner*,[77] in which the IRS revoked the exemption for a school for political campaigners.[78] It alleged no inurement to insiders, but noted that the Academy was funded by Republican interests, and that it could not report ever having graduated anyone who worked for candidates from any party other than the GOP.[79] The Tax Court agreed with the IRS's determination that the Academy provided substantial private benefit to the Republican Party.[80] The court acknowledged that the primary beneficiaries, the students, received educational benefits, and so they constituted a charitable class.[81] It added that all effective educational programs incidentally benefit some employer or other third party.[82] However, the secondary benefits in this case were targeted at "a select group of members earmarked to receive benefits."[83] Because the Republican Party is not a charitable entity—helping it does not fit any of the purposes listed in § 501(c)(3)—the substantial private benefit it received was enough to justify revoking the exemption.[84]

The IRS has most frequently applied the private benefit test to compensation in the context of hospitals' recruitment incentives for physicians.[85] Because hospitals receive their exemption under the nebulous "community benefit" standard, the IRS appears to scrutinize hospitals—and the recruitment incentives that hospitals offer to induce physicians to affiliate with them—more heavily than other types of organizations.[86] Even though the

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75 26 U.S.C. § 501(c)(3) (1994).

76 *See, e.g.*, American Campaign Academy v. Commissioner, 92 T.C. 1053, 1069-79 (1989). A private interest is one that is not listed in the statute.

77 92 T.C. 1053 (1989).

78 *See id.* at 1079.

79 *See id.* at 1071-79.

80 *See id.* at 1069-79.

81 *See id.* at 1073.

82 *See id.* at 1074.

83 *Id.* at 1076.

84 *See id.* at 1069-79.

85 *See, e.g.*, Harding Hosp. v. United States, 505 F.2d 1068 (6th Cir. 1974); Rev. Rul. 97-21, 1997-18 I.R.B. 8; Gen. Couns. Mem. 39,862 (Nov. 22, 1991); Gen. Couns. Mem. 39,498 (Apr. 24, 1986); Announcement 95-25, 1995-14 I.R.B. 11; Todd Greenwalt, *Full Text: Hermann Hospital Closing Agreement Released* (Oct. 13, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 203-59 (Oct. 17, 1994).

86 Until 1969, the IRS took the position that hospitals were required, to the extent of their financial ability, to provide services to indigents. *See* Rev. Rul. 56-185, 1956-1 C.B. 202; *cf.* Rev. Rul. 69-545, 1969-2 C.B. 117. However, as health benefits and insurance became more widely available, the IRS determined that a hospital could qualify for exemption if it met the community benefit standard—i.e., if it promoted the health of a class sufficiently broad to

IRS now acknowledges that many staff physicians are not insiders, recruitment incentives have been controversial in part because they can be a way for hospitals to win physician loyalty and limit competition from outpatient facilities.[87] In the most recent of several rulings and memoranda on the subject, the IRS strongly indicated that, whether or not a physician is an insider, hospitals providing recruitment incentives must demonstrate through a community needs assessment that the recruited physician will ease a shortage of physicians who specialize in a certain area of medicine, or who are willing to accept indigent patients.[88] While many different types of incentives (e.g., below-market rent on office space, liability reinsurance reimbursement, even a mortgage guarantee on a personal residence) are acceptable, the compensation provided should fall within the range reflected in national or regional surveys for the doctor's specialty.[89] Ignoring requests for clarification, the IRS declined to say whether it would permit hospitals to offer retention incentives.[90] This standard's attention to community needs strongly

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benefit its community. See Rev. Rul. 69-545, 1969-2 C.B. 117, which states:

> The promotion of health, like the relief of poverty and the advancement of education and religion, is one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members of the community, provided that the class is not so small that its relief is not of benefit to the community.

However, as for-profit hospitals have proved to be stronger and stronger players in health care, many commentators have suggested that we should demand more charity care and community commitment from nonprofits if we are to justify exempting them. *See, e.g.*, Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures, a Regeneration of Tax Exemption Standards*, 37 B.C. L. REV. 1, 103-10 (1995); David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J.L. & MED. 327, 375-80 (1990). To see if a broad enough class benefits, the IRS considers whether the hospital operates a free emergency room, whether it makes staff privileges and office space available to all qualified physicians, whether it draws its board from the community, and whether it treats patients insured through Medicaid and Medicare. *See* Rev. Rul. 83-157, 1983-2 C.B. 94; *see also* Sonora Community Hosp. v. Commissioner, 397 F.2d 814 (9th Cir. 1968)(denying exemption to a hospital that limits staff privileges to a few doctors and instructs ambulance drivers to take emergency patients elsewhere); Rev. Rul. 69-545, 1969-2 C.B. 117 (identifying free emergency care as a strong indicator of community benefit).

[87] *See* Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax Exempt Organizations: Reasonableness, Comparability and Disclosure*, 71 TUL. L. REV 819, 838-42, 846 (1997)(reviewing recent developments in intermediate sanctions law).

[88] *See* Rev. Rul. 97-21, 1997-18 I.R.B. 8.

[89] *See id.*

[90] *See id.*; *see also* Marlis L. Carson, *Health Care Practitioners Suggest Improvements to Proposed Physician Recruitment Revenue Ruling* (July 21, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 142-3 (July 21, 1995)(requesting that IRS guidance also encompass retention incentives). The IRS's widely publicized closing agreement with Hermann Hospital prohibited all retention incentives. *See* Greenwalt, *supra* note 85.

suggests that the IRS views physician compensation practices as an indicator of whether the hospital adheres to the difficult-to-measure standard of community benefit.

While most of the IRS's examination of compensation to non-insiders has taken place around hospitals, the *UCC* decision suggests that private benefit may apply to compensation in other kinds of organizations. Judge Posner's opinion argues both that incentives for donors and directors to monitor charities can be very weak, and that private benefit revocation may be in order when less-than-diligent management allows exempt dollars to drift too far from their public purpose.[91] While the court ruled that no inurement occurred, it pointed to state court decisions finding that charities' directors owe a duty of care,[92] and lamented:

> Charitable organizations are plagued by incentive problems. Nobody owns the right to the profits and therefore no one has the spur to efficient performance that the lure of profits creates. Donors are like corporate shareholders in the sense of being the principal source of the charity's funds, but they do not have a profit incentive to monitor the care with which the charity's funds are used. Maybe the lack of profit made UCC's board too lax. Maybe the board did not negotiate as favorable a contract with W&H as the board of a profitmaking firm would have done.[93]

The court remanded the case for a determination as to whether the UCC board's lack of due care resulted in substantial private benefit to W&H.[94] It argued that perhaps by means of the disastrous contract, UCC did operate for W&H's benefit, "though not because it was the latter's creature."[95]

The private benefit cases suggest a purpose for compensation regulation that is present in charities but not in the private sector: keeping charitable dollars within the confines of authorized exempt purposes. This function may be especially important where authorized purpose is ambiguously defined, as is the community benefit standard. The *UCC* decision adds broader significance to the private benefit doctrine. It argues that protecting donors and taxpayers from insiders' greed is only part of the incentive problem that charities face—that regulating only inurement fails to address the carelessness that may result from the absence of profit incentives. While the implications of aggressively pursuing private benefit in compensation cases would be

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[91] *See* United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173, 1179-80 (7th Cir. 1999).

[92] *See id.* at 1180 (citing Riss v. Angel, 934 P.2d 669, 680-81 & n.5 (Wash. 1997); Fairhope Single Tax Corp. v. Rezner, 527 So.2d 1232, 1236 (Ala. 1987); Frances T. v. Village Green Owners Ass'n, 723 P.2d 573, 582 n.13 (Cal. 1986)).

[93] *Id.* at 1179.

[94] *See id.* at 1179-80.

[95] *See id.* at 1179.

significant, the cases' likely impact on charities' behavior should not be overstated. One IRS official estimated recently that the agency had actually revoked a hospital's exemption only twice since the current auditing program began in the early 1990s.[96] Moreover, because the less severe remedy of intermediate sanctions is available only in cases involving insiders, private benefit revocations are not likely to become more common in the near future.[97] Finally, the scope of private benefit regulation in cases not involving hospitals remains undefined. The *UCC* court stated only that private benefit had possible application in a case in which tens of millions of dollars and over ninety percent of a charity's funds moved directly into its fundraiser's pocket.[98] If an outsider must receive compensation as substantial as W&H's in order for private benefit revocation to be invoked, the private benefit test is likely to be a very infrequent source of compensation regulation.

C. Duty of Loyalty and Duty of Care for Private and Nonprofit Corporation Directors

The Internal Revenue Code is not the only source of compensation regulation for nonprofits. Common law or statute in every state imposes at least some fiduciary obligations on the directors of both charitable and for-profit corporations, most notably the duty of loyalty and the duty of care. Like courts enforcing § 501(c)(3), those interpreting fiduciary duties have focused most of their attention on conflict-of-interest transactions, but have inferred conflict in a narrower range of situations than under private inurement. Absent such a conflict, courts give very broad discretion. To the extent courts have intervened when no conflict was present, they have focused largely on procedural shortcomings rather than outcomes. The threat of duty-of-care sanctions likely has a very small impact on compensation, both because corporations have proved adept at displaying procedural formalities without modifying the substance of decision making, and because courts have shown a particular reluctance to overturn compensation decisions. Fiduciary duties are perhaps an even weaker check on charities because the state attorneys general who are tasked with enforcement are often constrained from acting by resource shortages or by reluctance to deter charitable efforts.[99]

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[96] *See* Carolyn D. Wright & Fred Stokeld, *Revocation Threat Against Hospital System Chastens Exempts* (Dec. 19, 1997), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 97 TNT 244-3 (Dec. 19, 1997).

[97] *See* 26 U.S.C. § 4958 (Supp. III 1997).

[98] *See United Cancer Council*, 165 F.3d at 1176.

[99] *See* Robert Franklin, *Critics Say Charity Watchdogs are Nearly Toothless; Many State Agencies Have Inadequate Staff, Resources*, MINNEAPOLIS STAR TRIB., Sept. 28, 1992, at A1; Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1410-13 (1998).

The duty of loyalty is a duty to refrain from self-dealing at the corporation's expense.[100] A director or officer who violates this duty can be required to compensate the corporation and rescind the transaction or pay rescissory damages.[101] While conflict-of-interest transactions were voidable at common law regardless of fairness, most states now permit the transaction to stand if it was fair to the corporation, and it was approved by disinterested directors or shareholders who were aware of the relevant conflicts of interest.[102] Fiduciary duty case law also strongly suggests that the duty is implicated only when a director or officer who stands to benefit from a decision actually votes in the decision making process.[103] Thus, a corporation can usually secure a safe harbor for its compensation decisions simply by setting up an independent compensation committee of outside directors.

Apart from their obligation not to self-deal, directors have a duty to oversee the organization's operations with due care. Specifically, they have an obligation to evaluate whether the business is being properly managed, review its major plans and actions, and, most relevantly to compensation regulation, select principal executives, evaluate them regularly, and set their compensation.[104] One commonly invoked standard of due care is that the director should act as the "ordinarily prudent person" would behave in the conduct of her own affairs.[105] However, a key limitation on directors' due care liability is the business judgment rule. The business judgment rule provides a safe harbor for directors who make their decisions under certain conditions, generally that: (1) the decision is made without a conflict of interest; (2) directors were informed—i.e., they availed themselves of relevant information reasonably available at the time of the transaction; and (3) they acted with a rational belief that their judgment was in the corporation's best interests.[106] If these requirements are met, courts generally reexamine the

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[100] *See* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 IOWA J. CORP. L. 631, 646; *see also* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 199-382 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

[101] *See* Cinerama, Inc. v. Technicolor, Civ. Action No. 8358, 1991 Del. Ch. LEXIS 105, at *30 (Del. Ch. June 21, 1991).

[102] *See* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 6 (1993).

[103] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, a cash-out merger was heavily promoted by the CEO, who owned 75,000 shares of stock, which would be purchased in the merger. If private inurement law applied, a CEO who had a large financial interest in a transaction would clearly be an insider, but because a disinterested board of directors approved the transaction, breach of the duty of loyalty was not an issue. *See id.* at 865-70.

[104] *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, at 86.

[105] *See id.* at 144-61.

[106] *See id.* at 172-88.

merits of the decision only if gross negligence is present.[107] If they are not met, directors have the burden of showing that the terms of the transaction to the corporation are "entirely fair" to the corporation.[108] Among the rationales offered for this deference to business judgment are the desire to encourage directors' rational risk taking and innovation, the effort to avoid deterring quality directors from service, and the courts' reluctance to second-guess directors who are better positioned to understand their corporation's needs.[109]

In the context of challenges to compensation, courts generally have characterized their deference as "particularly broad."[110] If a compensation decision has received shareholder ratification, courts normally require a showing of waste of corporate assets in order to find breach of a duty of care, meaning that "'no person of ordinary sound business judgment would say that the consideration received . . . was a fair exchange for the options granted.'"[111] Explaining this position, one court acknowledged that "compensation payments may grow so large that they are unconscionable," but observed that a "court is confronted with inherent difficulties in determining whether payments for services are 'reasonable' or 'excessive'. The value of services is obviously a matter of judgment on the part of the person who must pay for them."[112] In a recent case, a court also passed up the opportunity to toughen the "informed" prong of the business judgment rule in the compensation context.[113] It did so by refusing to allow a shareholder derivative suit to go forward over the $140 million severance package that Michael Ovitz had received from Disney.[114] In this case, compensation expert Graef Crystal, who had advised the board on the Ovitz employment agreement, acknowledged in hindsight that "nobody quantified [the total cost of the severance package] and

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[107] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n.31 (Del. 1994).

[108] *See* Cinerama v. Technicolor, 1991 Del. Ch. LEXIS 105 at *30 (1991).

[109] *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, at 135.

[110] *See, e.g., In re* Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998). Delaware courts are clearly not alone in reducing scrutiny for executive compensation decisions. *See* PAT K. CHEW, DIRECTORS' AND OFFICERS' LIABILITY (1998)(citing Cohen v. Ayers, 596 F.2d 733, 739-40 (7th Cir. 1979)("[A] plaintiff attacking a corporate payment has the heavy burden of demonstrating that no reasonable businessman could find that adequate consideration had been supplied for the payment.")); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 100, § 5.03 cmt. c (arguing that a lower level of scrutiny is appropriate for compensation decisions than for other self-interested transactions, because of the deterrent value of the publicity they receive, and the institutionalization of disinterested compensation decision-making processes).

[111] Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979); *see also* Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997).

[112] Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962).

[113] *See Walt Disney*, 731 A.2d 342.

[114] *See id.*

I wish we had."[115] The court maintained that it was sufficient that the board knew how the payment was calculated, and relying on an expert who did not actually make the calculation lacked the "egregiousness" necessary to take the case outside of the business judgment rule.[116]

Finally, the procedural requirements contained in fiduciary duty cases are easily met. The strictures of fiduciary duty cases are not difficult for firms to follow without changing the substance of their decision making practices.[117] While corporations have not had to fear regulation of fiduciary duty, some manipulation of process is apparent in their use of independent compensation committees to avoid scrutiny. Since the 1980s, corporations have increasingly turned to independent compensation committees and compensation consultants to set executives' wages.[118] Graef Crystal describes a process with little real independence from the compensated person. He observes that often the outside directors on the committee are personal friends of the compensated CEO, and that the CEO may in turn set their fees.[119] Moreover, Crystal argues that the independent compensation consultants, recognizing that they must please the CEO in order to get future consulting opportunities, serve as strong advocates for pay increases.[120] If surveys performed by consultants show the CEO's salary to be below average, a compensation committee already positively inclined towards that CEO will likely have difficulty justifying that it remain that way.[121] Even for executives of poorly performing firms, consultants are often able to justify pay increases in the form of stock options and restricted stock as a motivator for improved performance.[122] As a reviewer of Crystal's work observes, if every CEO believes he should be paid at the 75th percentile, and there are few voices to raise countervailing concerns, upward pressure on salaries is probably inevitable.[123] These observations suggest that it may be difficult for a government regulator to craft process guidelines that move wage setting closer to a genuine arm's-length bargain.

Most of the case law defining the duty of care has come from the for-profit rather than the nonprofit sector. Do courts and legislatures treat the two types

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[115] *Id.* at 361 (internal quotation marks omitted).

[116] *See id.* at 362.

[117] *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 681-88 (1995).

[118] *See* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1878 (1992)(book review).

[119] *See id.* at 1877 & n.27. Yablon refers to GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 42-50 (1991).

[120] *See id.* at 1878-81 (citing CRYSTAL, *supra* note 119, at 23-65).

[121] *See id.*

[122] *See id.*

[123] *See id.* at 1878.

of corporations differently? Some commentators have suggested that the for-profit treatment of self-dealing is inappropriate to nonprofits, pointing out that allowing disinterested directors to ratify interested transactions is problematic in the nonprofit form because directors do not represent any owner group that can consent to self-dealing of their property.[124] However, Delaware case law explicitly rejects a common law tradition of treating directors of charitable corporations as trustees (who are forbidden to self-deal under virtually any circumstances).[125] Though case law on the subject is limited, courts in several states have indicated that the business judgment rule is appropriate for nonprofit corporations.[126] Dicta in the Delaware case *Oberly v. Kirby* suggested that something like the private benefit test may limit business judgment protection. The court noted that a board's approval of an "action that poses a palpable and identifiable threat" to the organization's charitable purposes would not be binding, but it declined to specify how it would review such actions, and the private benefit analogue does not seem to have developed further since then.[127]

A significant reason for the absence of case law developing charity directors' fiduciary duties is the limitation of standing to sue to the state's attorney general.[128] Attorneys general often report that they are hampered by the lack of resources. Illinois' chief charity prosecutor once lamented, "We should tell our citizens that nobody in Illinois is looking at this stuff," while others express the belief that they are failing to call to account a large number of tiny charities that appear to self-deal extensively.[129] Some suggest that in cases involving negligence but no self-dealing, it is politically almost impossible to win cases against respected community leaders for misjudgments in their charitable efforts.[130] Moreover, the actions of both attorneys general and courts hint at apprehension that potential directors will be deterred from serving if they face significant risk of liability.[131] In addition

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[124] *See, e.g.*, Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 140-44 (1993)(describing the common law tradition and its rejection).

[125] *See* Oberly v. Kirby, 592 A.2d 445, 466-67 (Del. 1991).

[126] See Goldschmid, *supra* note 100, at 644 & n.76 for citations of cases applying the business judgment rule to charities.

[127] *See Oberly*, 592 A.2d at 462, 469.

[128] Directors, voting members, and the corporation itself may sue a director for breach of fiduciary duty, but service recipients and donors generally may not. *See* CHEW, *supra* note 110, at 208-10.

[129] *See* Franklin, *supra* note 99.

[130] *See* Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations — The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 771-72 (1988).

[131] See Brody, *supra* note 99, at 1410-13 (citing George Pepperdine Found. v. Pepperdine, 271 P.2d 600, 604 (Cal. Dist. Ct. App. 1954), in which a foundation founder was held not liable

to the negative incentives attorneys general face, they of course lack the shareholder's positive incentive to recover or prevent lost profits due to breach of fiduciary duty.

As the foregoing discussion makes clear, state efforts at enforcement of the fiduciary duties of directors do not appear to have had a substantial impact on compensation practices in general, and on charities' compensation practices in particular. While courts have occasionally deviated from the business judgment rule, they have expressed particular reluctance to attempt to acquire the knowledge of executive talents and organizational needs necessary to scrutinize compensation decisions carefully. To the extent that the fiduciary duty has modified the behavior of corporations, it appears to have done so by causing careful documentation of procedures. While such documentation might lead to more thoughtful decisions, it is unclear that this documentation translates into rigorous and tough compensation negotiation.

D. Pre-Reform Compensation Regulation as an Approximation of Comparative Advantage

One way to conceptualize compensation regulation is as an assessment of comparative advantage—the idea that two parties in a trade maximize their gain when each specializes in providing the good it is best at producing.[132] Government, directors and officers, and donors all have significant potential to influence how executives are compensated, and have different abilities and opportunities to gather information about what constitutes reasonable compensation for a particular executive. In developing its systems for regulating compensation, government has implicitly defined two concepts as particularly important in determining comparative advantage, namely self-interest and the distinction between substance and process. In doing so, it has left largely unresolved the question of who should evaluate whether compensation furthers a charitable purpose, and it has only in the broadest terms explored oversight abilities and opportunities.

Directors and officers start with some obvious advantages over government in their opportunities to gather information about how much an executive should be compensated. They have more chances for personal interactions that allow them to observe subtleties of an executive's abilities, and a window into the day-to-day operations of the organization that might help them to

for losing $300 million in bad investments because, in the court's opinion, it would be "crazy and cruel as to assert a claim against him for his carelessness in not holding intact the fortune which he intended to bestow on others.").

[132] *See* Randall Stokes & David Jaffee, *Another Look at the Export of Raw Materials and Economic Growth*, 47 AM. SOC. REV. 402, 402 (June 1982).

determine the special skills required to manage it. To the extent that for-profit board members are also executives, they may bring a wealth of general business expertise to guide them in predicting the company's future problems and in estimating the value of someone who can solve them. Similarly, a nonprofit board member with strong community contacts may have a similar grasp of community problems and how urgently they require a particular executive who commands a high salary. The core of the business judgment rule is the recognition that those with firsthand knowledge and special expertise should be free to operate without fear that they will incur substantial liability for taking a risk.[133] Counterbalancing this deference to business judgment is a widespread perception that boards do not always work very hard at exercising their best business judgment.[134]

When does business judgment fail to give directors the advantage in determining appropriate compensation? In both the private sector and nonprofits, government has recognized that its disinterested perspective may give it the advantage when someone who will receive the compensation has enough influence over the compensation decision. Courts have often carved out a sphere of protection for board judgment by making their decisions about process, rather than about substantive outcomes.[135] Private inurement decisions have focused almost entirely on such factors as the extent of the compensated person's influence and the organization's ability to explain the reasoning behind its wage structure, and not on the compensated person's skills or the particular demands of the job. Courts interpreting due care have

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[133] *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989)(noting that the business judgment rule is an extension of the fundamental principle the board manages and directs the affairs of a corporation); Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981)(observing that the business judgment rule gives recognition and deference to directors' business expertise when exercising their managerial power).

[134] Literature criticizing the passive and management-captured board includes, e.g., James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 397 (1987)("Because nonprofits tend to have many directors who are on the board for 'window dressing' only, a common phenomenon of nonprofit boards is directors who do not direct."); Goldschmid, *supra* note 100, at 633-34 (detailing the inaction and other negligence of the United Way board in the face of CEO William Aramony's criminal conduct); Alison Leigh Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at D1 (suggesting the reciprocity inherent in board relationships—a computer analysis by consulting firm Directorship revealed that 39 of the 788 largest public companies had cross-directorships with another company).

[135] *See* Unitary Mission Church v. Commissioner, 74 T.C. 507, 514, 516 (1980), *aff'd* 647 F.2d 163 (2d Cir. 1981)(decrying unexplained fluctuations in compensated person's salary); Church of Modern Enlightenment v. Commissioner, 55 T.C.M. (CCH) 1304 (1988)(focusing on the salaried person's near-total control of the wage-setting process).

expressed reluctance to evaluate compensation decisions at all given the subjectivity of valuing services.[136]

There are likely two reasons for the process focus. First, evaluating the best process for making a compensation decision might require some general knowledge of best practices, but it requires far less organization-specific knowledge and community or business expertise than determining the actual salary. Second, a weak process provides evidence that directors were not actually exercising their business judgment. A court could reasonably decide that its careful weighing of factors justifying compensation is a better decision making process than an expert's intuitive judgment that is unsupported by performance analysis or salary comparisons.

While courts are probably right to recognize that boards have a greater advantage in choosing outcomes than in analyzing processes, it is not clear that one can develop a process analysis of any rigor without challenging directors' substantive expertise. The IRS has expressed the hope that intermediate sanctions will allow it to address overcompensation in major institutions that are otherwise sound.[137] These institutions, however, will be significantly more sophisticated at reshaping processes to justify their pre-existing compensation decisions than the tiny churches that private inurement typically targeted. The change in targets suggests that courts and the IRS might have to step outside the confines of process regulation if they are to be the agents of meaningful reform.

Part II of this Article examines the legislative history of intermediate sanctions in order to develop criteria for effective government monitoring of nonprofits, and explains how intermediate sanctions law has been structured to further these criteria and to build on existing regulation. Part III draws on the criteria developed in Part II to suggest that government may be ineffective if it relies only on process rules in compensation regulation. We conclude by exploring some of the mechanisms that government and the nonprofit sector itself might develop to permit donors and clients to take a more active and effective role in fostering efficient compensation decisions.

II. INTERMEDIATE SANCTIONS: THE MOST RECENT EFFORT TO REGULATE COMPENSATION IN PUBLIC CHARITIES

The passage of intermediate sanctions legislation in 1996 was preceded by a significant amount of discussion on why government is needed in regulating nonprofit salaries, and why the private inurement and private benefit doctrines

[136] *See* Michelson v. Duncan, 407 A.2d 211 (Del. 1979); Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997).

[137] *See Commissioner's Testimony, supra* note 26.

are inadequate remedies. We begin this Part with a brief description of the legislative history of intermediate sanctions. Drawing on this history and commentary related to it, we develop two categories of criteria for government's regulatory role. The negative criteria are constraints that government should place on its power to regulate. The positive criteria are the "value added" by regulation, the flaws in the philanthropic market that government can address, and the public purposes it can achieve. Finally, we outline key provisions of the 1996 intermediate sanctions legislation and its regulations, identifying how they support the criteria outlined in the legislative history, and how they supplement existing law.

Legislative history suggests five constraints that should shape a regulatory remedy for compensation. First, a regulatory remedy should minimize harm to stakeholders who did not participate in the excess compensation. Second, equality demands that government as regulator treat like cases equally. Third, organizations are entitled to fair notice of their obligations under the law. Fourth, the costs of disclosure and documentation should be minimized, and should be to some degree proportional to the amount of exempt money at stake. Fifth, compensation regulation should show some deference to charities' business judgment. Legislative history and commentary also suggest four answers to the question of why government adds value as a regulator: (1) because existing disclosure mechanisms remain flawed; (2) because the nondistribution constraint and the structure of nonprofits weaken both donors' and boards' incentives to monitor; (3) because several categories of nonprofits are substantially insulated from a market of donors or customers; and (4) because, even if stakeholders monitor diligently, compensation regulation may be necessary to ensure that charitable dollars stay within the confines of exempt purposes.

The intermediate sanctions law and its proposed regulations build on the law's existing emphasis on regulating process and insiders, and they also furthers the criteria described above in several important ways. The IRS has attempted to provide better notice to organizations by clarifying both the definition of the insider (now called "disqualified person") and by describing in some detail a process of compensation comparison and evaluation to which it will grant some deference to business judgment. In specifying the compensation decision making process, it relaxed its rules to some degree for small organizations. New disclosure requirements have addressed concerns about informing donors. Most significantly, the intermediate sanctions penalty, a targeted excise tax modeled on the self-dealing rules for private foundations, is designed not only to focus more narrowly on wrongdoers, but to improve notice and equal treatment by giving the IRS a moderate penalty that will reduce its reliance on the draconian remedy of exemption revocation or closing agreements.

A. A (Very) Brief History of Intermediate Sanctions Legislation

Significant efforts to pass intermediate sanctions began in 1991, when the House Ways and Means Committee and its subcommittees held hearings on several issues related to the tax-exempt status of medical organizations. Witnesses at one set of hearings lamented the fact that many hospitals were providing charity care in dollar amounts far lower than the value of their exemption.[138] At another, Representative Fortney "Pete" Stark called attention to the conversion of HMOs to for-profit status, expressing the fear that HMO insiders would receive private inurement from the conversion.[139] In response to questions by committee members, one IRS official observed that the capacity of agents to address the problem was limited because agents were "reluctant to propose revocation" in many inurement cases.[140] Following this testimony, Stark introduced legislation to impose excise taxes on certain medical organizations.[141]

While the legislation did not pass, the issue surfaced again during 1993 and 1994 hearings of the Committee's Oversight Subcommittee.[142] Opening the hearings, Representative J.J. Pickle voiced his concern over media reports of public charity executives' using tax-exempt dollars to pay for cars, servants, and country-club memberships.[143] He observed that the Subcommittee had found that fifteen percent of the top 2000 executives of the 250 largest charities were earning more than $200,000 per year, and thirty-eight individuals were receiving more than $400,000.[144] As the hearings unfolded, several witnesses expressed frustration at the difficulty that donors faced in

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[138] *See, e.g.*, Michele Melden, *Health Care Advocate Testifies on Tax-exempt Status of Hospitals* (July 10, 1991), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 91 TNT 146-43 (July 11, 1991)(testifying in support of H.R. 1374 and 790, proposed legislation to require more indigent care from tax-exempt hospitals).

[139] *See* Bernadette M. Broccolo et al., *Rules to Live By: IRS Releases Intermediate Sanctions Regulations* (Sept. 8, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 173-77 (Sept. 8, 1998)(citing *Tax-Exempt Status of Hospitals, and Establishment of Charity Care Standards: Hearing Before the House Ways and Means Comm.*, 102d Cong. 112 (1991)(statement of John E. Burke, IRS Assistant Commissioner)); H.R. 4042, 102d Cong. (1991).

[140] *See* Broccolo et al., *supra* note 139.

[141] *See id.* (citing H.R. 4042, 102d Cong. (1991)).

[142] Rep. J.J. Pickle, *Full Text: Rep. Pickle's Statement at W&M Oversight Hearing on Public Charities* (Aug. 2, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 161-43 (Aug. 3, 1993).

[143] *See id.*

[144] *See* Subcommittee on Oversight of the House Committee on Ways and Means, *Full Text: Unofficial Transcript of Oversight Hearing on Nonprofit Abuses* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 131-19 (June 21, 1993).

getting enough information to make informed decisions, while IRS Commissioner Margaret Milner Richardson reiterated the agency's dissatisfaction with having no penalty options other than revocation.[145] Following this round of hearings, the Treasury Department sent an excise tax proposal to Congress.[146] Intermediate sanctions were finally enacted, as part of the Taxpayer Bill of Rights in July 1996.[147] In August 1998, the IRS released proposed intermediate sanctions regulations and it is currently revising those regulations based on public comments.[148]

B. *The Intermediate Sanctions Law and Proposed Regulations*

The 1996 intermediate sanctions law[149] and the IRS's 1998 proposed regulations implementing it continue compensation regulation's traditional focus on the self-interested insider. However, the proposed regulations significantly clarify who constitutes an insider (or "disqualified person," in the legislation's terminology), and what decision making processes are likely to demonstrate that any given decision was made with due care. A particularly important component of the legislation is the excise tax scheme it provides, which reduces harm to non-culpable beneficiaries of the charity, and targets incentives for due care towards those who are in a position to influence compensation decisions directly. Below we outline some of the most significant features of the legislation and proposed regulations.

1. *"Disqualified person" defined*

Consistent with the idea that the ability to set one's own salary puts one at special risk of placing self-interest ahead of the organization's interest, the intermediate sanctions law limits its penalties to "disqualified persons," who include "any person who was, at any time during the 5-year period [prior to the transaction], in a position to exercise substantial influence over the affairs of the organization," a family member of someone with substantial influence, or an entity of which a disqualified person has more than thirty-five percent

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145 *See id.*

146 *See* Leslie B. Samuels, *Samuels Submits White House Intermediate Sanctions Proposal* (Aug. 8, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 155-23 (Aug. 9, 1995).

147 *See* 26 U.S.C. § 4958 (Supp. III 1997).

148 *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495-505 (1998)(to be codified at 26 C.F.R. § 53.4958-53.4958-6)(proposed Aug. 4, 1998); Jon Almeras, *IRS, Treasury Mulling Comments on Intermediate Sanctions Regs* (May 7, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 89-5 (May 10, 1999).

149 *See generally*, Kertz, *supra* note 87.

control.[150] The intermediate sanctions statute states that presidents, CEOs, CFOs, and those with a material interest in a provider-sponsored organization are by definition disqualified persons.[151] Beyond these categories, "substantial influence" is a matter of facts and circumstances,[152] but the IRS lists several categories of persons who would be likely to have substantial influence:

- founders;
- substantial contributors (those who donate more than $5,000 or two percent of total contributions);
- those whose compensation is contingent on revenues from activities of the organization that they control;
- those with authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or employee compensation;
- those who have managerial authority, or who serve as key advisors to someone with managerial authority;
- those with controlling interests in a disqualified entity.[153]

Facts and circumstances tending to show the absence of substantial influence include the focal person's bona fide vow of poverty or her status as an independent contractor who does not benefit (other than receiving professional fees) from the transaction on which she advises.[154] The regulations indicate that managerial control over a discrete segment of the organization can in some circumstances constitute substantial influence. For example, the dean of a law school which contributes substantially to a university's reputation and revenues and the head of a hospital cardiology department which is a major source of patients may both be disqualified persons if they have sufficient authority over their units.[155] The IRS is currently revising the disqualified person standard, based on comments and on the *UCC* decision.[156] Commentators have noted that the standard does not make clear whether a CEO, for example, is a disqualified person for purposes of the contract that

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[150] 26 U.S.C. § 4958(f) (Supp. III 1997).

[151] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,490 (1998)(to be codified at 26 C.F.R. § 53.4958-3(c))(proposed Aug. 4, 1998).

[152] *See id.* at 41,490 (to be codified at 26 C.F.R. § 53.4958-3(e)(1)).

[153] *See id.* (to be codified at 26 C.F.R. § 53.4958-3(e)(2)).

[154] *See id.* at 41,490-91 (to be codified at 26 C.F.R. § 53.4958-3(e)(3)).

[155] *See id.* at 41,499 (to be codified at 26 C.F.R. § 53.4958-3(f)).

[156] *See* Almeras, *supra* note 148.

made her a CEO, or whether someone with shared or secondary managerial authority is disqualified.[157]

2. Unreasonable compensation

The intermediate sanctions statute defines excess benefit transactions as those in which an economic benefit provided by a tax-exempt organization to a disqualified person "exceeds the value of the consideration (including the performance of services) received for providing such benefit."[158] Proposed regulations state that compensation is an excess benefit if it "exceed[s] what is reasonable under all the circumstances," and that compensation is reasonable "if it is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[159]

3. The rebuttable presumption

Given the dearth of case law defining what is reasonable, the reasonable compensation definition by itself would leave organizations with little notice as to what was required of them, and offer little protection of their expert judgment. In order to allow charities to exercise this judgment with greater certainty, Congress placed a rebuttable presumption in the legislative history, and the IRS adopted it in the proposed regulations.[160] Charities may rely on a rebuttable presumption that their compensation decision was reasonable if it was approved by a board that: (1) is made up entirely of individuals unrelated to, and not subject to, the control of the disqualified person; (2) obtains and relies on appropriate comparability of compensation data; and (3) adequately documents the basis for its salary decision.[161]

Relevant data for demonstrating reasonableness include:

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[157] *See, e.g.*, Carolyn D. Wright, *Intermediate Sanctions Witnesses Wrap Up Testimony* (Mar. 17, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 52-2 (Mar. 18, 1999)(describing testimony in which Phil Royalty of Ernst & Young urges that an individual should not become a disqualified person by virtue of a first transaction with the organization—the "first-bite rule").

[158] Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(b)(3))(proposed Aug. 4, 1998).

[159] *Id.*

[160] *See* H.R. REP. NO. 104-506, pt. 2, at 56-57 (1996); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495 (1998)(to be codified at 26 C.F.R. § 53.4958-6(a))(proposed Aug. 4, 1998).

[161] *See* Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,495 (1998)(to be codified at 26 C.F.R. § 53.4958-6(a))(proposed Aug. 4, 1998).

1. compensation levels paid by similarly situated tax-exempt and taxable organizations for positions that are functionally comparable;
2. the price of similar services in the organization's geographic area;
3. independent compensation surveys conducted by independent firms;
4. actual written offers from similar organizations competing for the compensated person's services.[162]

The proposed regulations offer a rather daunting illustration of appropriate comparability data, describing as appropriate a customized compensation survey commissioned by a hospital, covering executives with similar responsibilities, sorting survey data by hospital size, nature of services, level of experience and specific responsibilities of executives, and the composition of the compensation packages.[163] In the example, board members also received a detailed written analysis of the survey data, and had opportunities to question a member of the survey firm. While the proposed regulations do not provide examples of a less exacting comparability data standard that would suffice, they do recognize that documentation costs for small organizations are large relative to program budgets. Charities with annual gross receipts of less than one million dollars may rely on the compensation paid by five comparable organizations in the same community, or similar communities, for similar services.[164]

The third requirement, under which a board must follow several documentation procedures, seems designed to address the weak incentives for diligence among charity board members. The IRS specifies that in all cases, adequate documentation must include:

1. the terms of the compensation transaction, the date of its approval and who participated in debate or voted on the transaction;
2. a description of the comparability data and how it was obtained;

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[162] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41486, 41,504 (1998)(to be codified at 26 C.F.R. § 53.4958-6(d)(2))(proposed Aug. 4, 1998).

[163] *See id.* In another example, a university's use of a national compensation survey for university presidents, which is not divided by size of university or any other criteria, and which is used by a board with general business experience but without significant experience in higher education compensation, is deemed not appropriate data. *See id.*

[164] The proposed regulations offer an example in which a small repertory theater had appropriate data for setting its artistic director's salary when it conducted a telephone survey of six theaters of similar size, summarized findings in a written report, and had the board evaluate the director's prior salary and performance. *See id.* at 41,505.

3. actions taken on the compensation decision by anyone who was a board member but who had a conflict of interest.[165]

In addition, where compensation is higher or lower than the range of comparable data, the board must document by the time of its next meeting after approving the transaction (with reasonable time to review and approve the documentation) its basis for determining that compensation outside the comparability range was appropriate.[166] On rebutting the presumption, the proposed regulations say simply that the IRS can rebut it with "additional information showing that the compensation was not reasonable . . . ."[167]

4. The intermediate sanctions penalty

A critical tool for strengthening incentives for manager diligence and minimizing the effect of penalties on innocent parties—and therefore making the IRS less reliant on the case-by-case closing agreement procedure—is the structure of the intermediate sanctions penalty. Based on a similar excise tax scheme the IRS applies to self-dealing in private foundations,[168] the intermediate sanctions penalty is a two-tiered tax. Once the IRS determines that a charity has paid excess compensation, it imposes an initial twenty-five percent tax on the excess on the disqualified person who received the excess amount.[169] This individual must not only pay the tax, but repay the amount of the excess compensation to the organization.[170] If she does not repay the excess by the time the IRS mails a notice of deficiency or assesses the twenty-five percent tax, she is then liable for a 200% tax on the excess.[171]

Intermediate sanctions penalties also target managers who willfully fail to prevent the excess compensation. Any manager who participates willfully and without reasonable cause in the compensation transaction is liable for a ten percent tax on the excess amount.[172] Participation is willful if the manager actually knows of facts indicating that the compensation is excessive, or

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165 *See id.* at 41,505 (to be codified at 26 C.F.R. § 53.4958-6(d)(3)).

166 *See id.*

167 *Id.* at 41,504 (to be codified at 26 C.F.R. § 53.4958-6(c)).

168 *See* 26 U.S.C. §§ 4940-4948 (1994).

169 *See* 26 U.S.C. § 4958(a)(1) (Supp. III 1997).

170 *See* 26 U.S.C. § 4958(f)(6).

171 *See* 26 U.S.C.§ 4958 (a)(1) & (b).

172 *See* 26 U.S.C. § 4958(a)(2); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,496-97 (to be codified at 26 C.F.R. § 53.4958-1(d)(3))(proposed Aug. 4, 1998). Participation includes silence where the manager had a duty to speak, but does not include unsuccessful attempts to prevent the transaction.

negligently fails to ascertain whether it is excessive.[173] The manager has reasonable cause for participation (and so is not liable for the tax) if she has acted "with ordinary business care and prudence."[174] One who acts under the guidance of a reasoned, written legal opinion will normally be found to have reasonable cause.[175]

Thus, the intermediate sanctions legislation enables the IRS to pursue excess compensation more aggressively by permitting it to target penalties narrowly at those who received or could have prevented excess compensation. The application of more formal penalties will likely reduce reliance on inconsistent and unequal closing agreements. The legislation recognizes the special danger that self-interested insiders pose when incentives for rigorous oversight are weak, as well as the need to discourage charity managers from negligent decision making. At the same time, it provides some insulation for business judgment by specifying processes that invoke the rebuttable presumption and shielding ordinarily prudent managers. Donors and government can also look to significant reforms in Form 990's requirements to make information gathering about compensation decisions easier.

C. *Criteria for Evaluating Compensation Regulation in Public Charities*

As representatives of government, watchdog organizations, charities, and charities' legal organizations commented on intermediate sanctions legislation and the proposed regulations, they implicitly or explicitly advanced two sets of policy criteria against which government should evaluate its efforts. The first concern was what government should not do, namely the instances in which fairness or efficiency mandated that government refrain from regulating compensation. The second concern was to figure out when government had comparative advantage in regulating compensation.

1. *Policy constraints on government as charitable compensation regulator*

Perhaps the core concern over the inadequacy of the revocation penalty for intermediate sanctions was expressed by IRS Commissioner Margaret Milner Richardson at the 1993 intermediate sanctions hearings:

> Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue. For example, assume that an

[173] *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,497 (1998)(to be codified at 26 C.F.R. § 53.4958-1(d)(4))(proposed Aug. 4, 1998).

[174] *See id.* at 41,497 (to be codified at 26 C.F.R. § 53.4958-1(d)(6)).

[175] *Id.* at 41,488 (to be codified at 26 C.F.R. §53.4958-1(d)(7)).

> examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to that paid to presidents of comparable universities [or provided a large interest-free loan or luxuries for the official residence]. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community—employees, students, and area residents.[176]

Tiny, weak-governance churches have likely been popular targets for inurement revocation because revoking their exemption often harms no one other than the few board members who made up most or all of the congregation, and who also allowed the excess compensation. However, even a school, hospital, or museum that grossly overcompensates is likely to create some significant value for employees and customers who have little or no power to stop the overcompensation. Thus, a *first* principle of compensation regulation is that the penalty should minimize harm to those who did no wrong, and, instead, it should target narrowly those who were in a position to reduce the excess compensation.

Two more principles are reflected in the IRS practice of using closing agreements to address overcompensation in organizations for which revocation would have been inappropriate. Richardson observed that closing agreements have been useful in curbing some excess benefit transactions, but that the agreements were "not an ideal tool."[177] "In particular, because each agreement results from separate negotiations with a particular organization, it is difficult to ensure that similar organizations are treated consistently."[178] When government relies heavily on a negotiated remedy, the result is to make arbitrary distinctions in its treatment of citizens, with the sharper negotiators regulated less strictly. Moreover, closing agreements are problematic both because they do not create incentives for other organizations to emulate a clear standard of behavior, and because other organizations risk facing an inurement penalty without having received fair notice of what conduct was expected. When the IRS concluded a protracted battle with Hermann Hospital with strict negotiated limits on the physician recruitment incentives the hospital could use, representatives of other hospitals expressed confusion as to whether the limits constituted precedent even after IRS officials issued public statements saying that they did not.[179] Thus, the closing agreement experience suggests

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176 *Commissioner's Testimony*, *supra* note 26.

177 *See id.*

178 *Id.*

179 *See* Paul Streckfus, *Significance of Hermann Hospital Closing Agreement Downplayed by IRS at Tax Conference* (Oct. 28, 1994), *available in* LEXIS, Fedtax Library, State Tax Notes File, *as* 95 STN 3-62 (Jan. 5, 1995); R. Todd Greenwalt & Timothy J. Deveski, *IRS Rules on*

second and *third* criteria: government should provide reasonable notice of required conduct before imposing a regulatory penalty; and regulators should offer equal treatment to like organizations.

A fourth issue that emerged briefly during the 1993 hearings and repeatedly in comments and hearings on the proposed regulation was the cost of disclosure. In his 1993 testimony, Thomas E. McCabe, chairman of the accrediting organization Evangelical Council for Financial Accountability ("ECFA"), recognized the importance of disclosure and documentation for accountability, but revealed that his organization did not accredit very small organizations lest its disclosure requirements "unduly burden" them.[180] He warned that charities were bearing "greater responsibilities in addressing social, spiritual, physical and economic needs of society (with ever dwindling government funding)" and urged that the IRS do more to offer overburdened nonprofits adequate resources and instruction to allow them to meet disclosure requirements.[181]

Hearings and comments on the proposed regulations again brought out the general cost concern and in particular the solicitude of small organizations. One former IRS attorney said of the process of making salary comparisons: "YOU [the IRS] may get the information when YOU call, but that is not what happens to non-IRS people. We will have to go in person to each office to inspect their annual reports, which may take perhaps 30 to 50 hours over several months."[182] Others warned that small organizations would have difficulty finding salary comparability data, and that the costs of disclosure could consume a significant portion of their budgets relative to those of larger organizations.[183] These statements suggest a *fourth* criterion, that the costs of documentation and disclosure should not be disproportionate to the amount of exempt money at stake, and should not detract substantially from program budgets.

Finally, a critical consideration that we covered extensively in Part I is the business judgment concept, that diligent charity officers and directors have

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Cross-Town Recruiting of Physicians (July 15, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 140-83 (July 22, 1999).

[180] *See* Thomas E. McCabe, *Full Text: Evangelical Group's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 93-6776 (June 16, 1993).

[181] *Id.*

[182] Walter A. Ludewig, *Recordkeeping Requirements Must be Reasonable, Says Former IRS Attorney* (Mar. 8, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 58-27 (Mar. 26, 1999).

[183] *See* Internal Revenue Service, *Unofficial Transcript of IRS Hearing on Intermediate Sanctions* (Mar. 16, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 63-23 (Apr. 2, 1999)(testimony of law professor Ellen Aprill and Bar Association of the City of New York representative Pamela Mann).

expert, firsthand knowledge of the needs of their communities, and of the subtle personal qualities and special skills that the compensated person brings to the job.[184] An IRS agent or a court reviewing credentials and salary statistics simply cannot replicate this level of knowledge. Several statements in the legislative history of intermediate sanctions address the business judgment concern. In his letter accompanying the Treasury Department's intermediate sanctions proposal, Assistant Secretary Leslie B. Samuels emphasized the importance of "prevent[ing] intermediate sanctions from unduly interfering with the operation of organizations that are complying with the law."[185] Several comments on the IRS's proposed intermediate sanctions regulations touched on the desirability of this deference. Los Angeles attorney J. Patrick Whaley urged the IRS to clarify its intention not to "manage the affairs of an exempt organization by second-guessing those who are responsible for administering the organization's affairs[,]" and he warned against a "cookie-cutter approach to compensation."[186] While observers of nonprofits might differ on how much deference is owed to directors' and officers' business judgment, a *fifth* criterion is that regulators should take into account charities' generally superior opportunities for fact finding about their employees and their community before restricting compensation flexibility.

B. Policy Objectives of Government as Compensation Regulator

The legislative history of intermediate sanctions and other commentary on nonprofits have offered reasons to believe that government may have comparative advantage in regulating compensation, and that it can fulfill several important policy objectives by reviewing compensation decisions carefully, at least under some circumstances. The first three policy objectives we describe—correcting poor disclosure, bolstering weak board and donor monitoring incentives, and addressing organizations whose funding sources limit their need to be responsive—center on failures in a philanthropic "market" in which the donor's intent fails to get effectuated and government intervention becomes necessary. The fourth objective—protecting charitable purpose—holds that government may need to protect the public interest in charitable function even if donors are satisfied with compensation decisions.

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184 *See supra* notes 133-36 and accompanying text.

185 Leslie B. Samuels, *Samuels Submits White House Intermediate Sanctions Proposal* (Aug. 8, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 155-23 (Aug. 9, 1995).

186 Patrick J. Whaley, *Attorney Suggests Changes to Proposed Intermediate Sanctions Regs* (Mar. 16, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 67-33 (Apr. 8, 1999).

1. Correcting poor disclosure

First, explicitly featured in the history of intermediate sanctions is the idea that donors, even if they strive to be well informed and thoughtful in their donations, cannot access enough information to make optimal decisions. Given that firsthand observation of charitable programs and conducting detailed studies on outcomes cost dearly in terms of time and money, donors must generally rely on existing documentation describing the charity's purposes, programs, expenditures, and outcomes in order to determine whether it is a worthy donee. Neutral accrediting or monitoring agencies might provide this information, but the organizations themselves are expected to make it available via IRS Form 990.

Form 990 is an annual reporting form filed by all public charities except for churches and certain other religious organizations, religious schools below the college level, government entities, and organizations whose annual receipts are $25,000 or less.[187] Form 990 requires organizations to report the amounts of their revenues, expenses and assets and liabilities, with the expense category broken down by program, management, and fundraising.[188] They must report their major purpose and describe program service accomplishments.[189] Most relevant to reasonable compensation, they must disclose compensation for officers, trustees, and directors, as well as for their five highest paid employees other than officers, trustees, and directors, and for their five highest paid independent contractors.[190] They must also disclose certain taxes and fines paid during the previous year, now including intermediate sanctions penalties.[191]

Although the law has long required charities to make their Form 990s available upon request, participants in the intermediate sanctions hearings reported difficulties in gaining access to them. In addition, participants complained that some organizations neglected to report fringe benefits, spread compensation reporting among several affiliated organizations so that it appeared smaller, or simply reported incorrect numbers.[192] Responding to these concerns, Congress passed legislation toughening the Form 990

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[187] *See* IRS Form 990.

[188] *See id.*

[189] *See id.*

[190] *See id.*

[191] *See id.*

[192] *See* Consuelo Lauda Kertz, *New Sanctions Aimed at Noncompliant Tax-Exempt Groups*, 25 TAX'N FOR LAWYERS 219, 225-226 (1997); *Commissioner's Testimony*, *supra* note 26.

disclosure requirements, and the IRS finalized regulations in April 1999.[193] Congress and the IRS aimed at improving access by requiring not merely that organizations make Form 990s available, but that they photocopy and mail them upon request.[194] Alternatively or in addition to this requirement, the organization may make its Form 990 available over the Internet.[195] To increase incentives for disclosure, the statute provides for a twenty dollars per day penalty (up to a maximum of $10,000) for failing to make the Form 990 available—up from the ten dollars per day and $10,000 maximum penalty previously in force.[196] A finding of willful failure to make the return available leads to a penalty of $5,000 per return (up from $1,000).[197] In addition, the intermediate sanctions legislation contains some provisions to try to resolve some of the difficulties in reporting compensation. Organizations must now count all direct or indirect payments received by employees as compensation, so that fringe benefits must not be concealed, and reported compensation must not be split among several affiliated organizations.[198]

2. Bolstering monitoring incentives

A likely second set of concerns motivating intermediate sanctions is the absence of strong monitoring incentives for either board members or donors. To the extent they have input into the makeup of their board of directors, charity managers have little incentive to encourage selection of board members who will observe carefully and ask tough questions. When an insider has a strong self-interest in securing a large salary, a half-attentive board is likely to be a particularly weak check. Donors do not have a good mechanism for assessing whether a board member is diligent as a board member, and they have no direct control over board selection because they do not have the voting power of shareholders.

Furthermore, funders of charitable organizations differ from shareholders in their incentives to monitor. As Judge Posner pointed out in *UCC*, donors do not have the profit incentive to monitor.[199] They also may face a more

[193] *See* T.J. Sullivan, *Regs Make Nonprofits' Information Widely Available*, 1999 TAX NOTES TODAY 104-82, June 1, 1999, *available in* LEXIS, Fedtax Library, TNT File (citing 26 U.S.C. § 6104).

[194] *See* 26 U.S.C.A. § 6104(d)(1)(B) (West Supp. 1999).

[195] *See* 26 C.F.R. § 301.6104(d)-2(b)(2) (1999).

[196] *See* 26 U.S.C.A. § 6652(c)(1)(A)(ii) (West Supp. 1999).

[197] *See* 26 U.S.C.A. § 6685 (West Supp. 1999).

[198] *See* 26 U.S.C. § 4958(c)(1)(A) (Supp. III 1997); Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Requirements, 63 Fed. Reg. 41,486, 41,501 (1998)(to be codified at 26 C.F.R. § 53.4958-4(b)(3))(proposed Aug. 4, 1998).

[199] *See United Cancer Council v. Commissioner*, 165 F.3d 1173, 1179 (7th Cir. 1999).

complex information gathering challenge than shareholders because nonprofit goals may be more complex and long-term than those of an owner. For example, a private firm owner can rely on a financial statement for fairly clear objective measures of the firm's profitability in the recent past. In contrast, if a donor is interested in whether an after-school program reduces dropout rates, she must hope that the charity has commissioned a scientifically sound study, or attempt to guess at children's future behavior from anecdotal evidence of their program experiences. Donors' incentives may also be weaker than those of a charity or a private firm's customers. Customers have some advantages over donors as effective monitors in that: (1) the customer learns information about the charity by firsthand experience of its services; and (2) in deciding whether to give repeat business, the customer need only make a judgment about the program's impact on her own utility, and not on someone else's. Thus, we might expect monitoring to be more problematic for charities in which most funds come from donors who do not use services, as opposed to customers. Generally, the second set of concerns motivating government role in compensation regulation are that funders and board often have weak incentives to pay careful attention to the compensation decisions of charities.

3. Addressing organizations that do not respond to a market

A third category of concerns driving intermediate sanctions is the desire to find a solution to the problem of creating oversight of organizations for which funders are unable to offer strong incentives for establishing reasonable compensation. Most public charities must meet a support test—i.e., they must demonstrate that they receive at least one-third of their annual support from contributions, grants, or fees (with no more than two percent of the total counted from any one source under one test and no contributions counted at all for donors of over $5,000 under another).[200] The support test provides some indicator that multiple funders have found the outcomes of compensation and other program decisions sound. Because churches, schools, hospitals, and medical research organizations need not meet the support test,[201] they may choose to rely primarily on endowments or (particularly in the case of small churches) a single donor or a handful of donors. Endowments would seem to weaken the incentives to compensate reasonably because they liberate organizations from having to satisfy donors or customers once the initial funding decision is made. As the church cases

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[200] *See* 26 U.S.C. §§ 170(b)(1)(A)(vi) & 509(a)(1)-(2) (1994); 26 C.F.R. § 1.170A-9(e)(ii) (1999).

[201] *See* 26 U.S.C. §§ 170(b)(1)(A)(vi) & 509(a)(1)-(2); 26 C.F.R. § 1.170A-9(e)(ii).

on private inurement illustrate,[202] reliance on a small number of donors may provide especially weak incentives when the handful of donors all do business or receive compensation from the charity, or are related to those who do. Furthermore, because churches are not required to meet Form 990 disclosure requirements,[203] funders may be unable to find enough information to take into account compensation decisions when deciding whether to donate. From the IRS's concentration on churches in private inurement cases and its attention on the compensation practices of hospitals, we might infer that compensation regulation is particularly needed in categories of organizations which are not required to disclose to, or draw support from, a broad range of donors.

4. Preventing private benefit

Suppose that funders and the board have diligently reviewed and approved a particular compensation decision. Absent disclosure and incentive problems, is there any role for compensation regulation in protecting charitable purpose? If hospital exemptions are to be permitted only under the community benefit standard,[204] the standard clearly suggests an additional role. It is easy to see that a hospital board and its major donors and patients might agree on a strategy of paying top dollar to lure the nation's foremost specialists, rather than looking for doctors who would be willing to care for the poor at more modest salaries. Further, the *UCC* decision[205] indicates that, even within other types of organizations, overcompensation by a careless board may violate a duty to taxpayers by taking the organization's dollars outside of its exempt purpose. However, the *UCC* court's emphasis on due care suggests that, outside the context of the ambiguous community benefit standard, the government's duty to protect charitable purpose is principally a matter of getting the board's incentives right. It remains unclear whether there are instances in which a diligent and well-informed board could pay a university president or a museum curator so much that the excess compensation would constitute an illegitimate private benefit. However, *UCC* and the physician recruitment cases suggest a fourth purpose for compensation regulation: to prevent excessive salaries from diverting charitable dollars from furthering a charitable purpose. As we saw in section II.B., intermediate sanctions legislation would appear to satisfy many of the constraints identified by witnesses, and address several of the compensation regulation purposes that commentators have identified. However, at least some aspects of the new

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[202] *See supra* notes 59-69 and accompanying text.
[203] *See* 26 U.S.C. § 6033(a)(2) (1994).
[204] *See supra* notes 59-69 and accompanying text.
[205] *See supra* notes 37-47 and accompanying text.

regulations raise questions about how successful any attempt by government to regulate nonprofit compensation is ultimately likely to be. The potential problems left unaddressed by the new legislation are explored in Part III.

III. NONPROFIT ACCOUNTABILITY: CREATING A SUPPLY OF AND A DEMAND FOR INFORMATION

The compensation given to the trustees of KSBE bring to mind two questions related to trusteeship.[206] The first is related to fairness: were the trustees entitled to be compensated at the rate of nearly $900,000 a year for their stewardship of the massive endowment and the educational mission it funded?[207] This question amounted to a challenge to the qualifications of the Estate trustees and the nature and quality of the work they performed on behalf of the charity. This was a question that could be answered, in principle, by looking at the tasks performed by the trustees, the work that other trustees performed on behalf of other organizations, and the performance of the organization under this particular group of leaders.

The second question is a more philosophical one. Should trustees ever be compensated at the rate of those of KSBE? To answer this second question, no study is needed to compare work responsibilities and no outside consultants are required to conduct a survey of practices at other like organizations. The question simply raises an ethical question about whether any trustee who works for any charity should ever accept large amounts of compensation for their work, no matter its nature and no matter the success with which their duties are fulfilled.

The new system for regulating nonprofit compensation allows one to sketch an answer to the first question, but not the second question. As we have seen, the standards rest in large measure on the idea of "reasonableness" that can be met through a rebuttable presumption. This approach emphasizes a good faith effort to find information on what other similar organizations pay their executives. By looking at and documenting the decisions reached by others, nonprofit boards can justify their compensation decisions and inoculate themselves from intermediate sanctions. There are at least two criticisms that can be leveled against this standard and each are discussed in this section. The first is that the universe of organizations to which nonprofits can compare their salaries *includes taxable organizations*, especially if the candidate has offers to work for a business corporation. Given the fact that many for-profit

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[206] For a broad analysis of the duties of trustees, see DAVID H. SMITH, ENTRUSTED: THE MORAL RESPONSIBILITIES OF TRUSTEESHIP (1995).

[207] *See* Mike Yuen, *Allegations of Conflict of Interest Prompt Cayetano to Order an Inquiry*, HONOLULU STAR-BULLETIN, Aug. 13, 1997, at A-12 (noting that the annual compensation for KSBE trustees is approximately $843,000).

salary packages include stock options and incentives keyed to profits, it is not clear how nonprofits can engage in this kind of cross-sector inquiry into comparative worth while continuing to breathe life into the non-distribution constraint that many believe defines the nonprofit sector. Second, the idea of regulating nonprofit compensation in public charities through the enforcement of penalties is an inferior approach to the creation of a broader more active market for information that turns clients and donors into regulators, not just of an organization's compensation, but of the more critical question of the organization's performance. We argue that the idea of creating a rebuttable presumption and new sanctions is not optimal for those nonprofits that depend on donors and clients for their funds, and that there is ultimately no substitute for both a reliable *supply* of information about nonprofits, along with stakeholders that *demand* this information and act on it. We conclude by explaining that the cultural consequences of setting up a system that both creates a supply and demand for information are likely to be significant and could even change part of the identity of the nonprofit sector.

A. Nondistribution and Cross-Sector Comparisons

At the core of the new regulatory regime is the idea that nonprofit compensation can be alternatively judged excessive or allowable through a process of comparing what one nonprofit worker earns to the salary of a group of persons performing similar tasks in similar circumstances. A key part of this comparative process involves looking not just to other nonprofit salaries, but to those paid in the business sector. Given the nondistribution constraint under which nonprofits operate, this cross sector comparison may turn out to be unworkable because many corporate compensation packages include stock options that translate into huge bonuses based on the company's performance as measured by the company's stock. In short, for-profit compensation is inextricably bound with the distribution of profits and therefore may never be the basis of a workable starting point for judging nonprofit compensation.

Why do nonprofits operate under a non-distribution constraint that prohibits those who control nonprofits from benefiting from or distributing earnings? Bound by their promise to use their resources to advance their missions rather than benefit private parties, nonprofit organizations emerge as a solution to what Hansmann called "contract failure."[208] People seek out nonprofits in areas where they cannot penetrate and police services using ordinary contractual devices, in situations where trust and information are scarce, and assessing the value of the services they receive for their money is difficult.

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[208] *See generally*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980)(arguing that the idea of contract failure is central to the theory of nonprofit provision).

The legally binding non-distribution constraint of nonprofit organizations provides a powerful contractual assurance that the consumer will not be taken advantage of or betrayed by producers for personal gains. The fact that profits are not allowed to be distributed to shareholders or owners gives the consumer of services a certain confidence that the transaction will result in a fair exchange.

The nonprofit sector's ability to respond to contract failure is not without its complications. Hansmann pointed to the loss of efficiency due to the elimination of financial incentives created by the non-distribution constraint and the possibility that the spirit of the non-distribution constraint will be violated through high levels of staff compensation.[209] Still, in cases where the consumer has little information and where the need to trust producers is important, the attraction of nonprofit sector provision can be powerful.

Contract failure occurs in a wide variety of contexts and takes on a broad array of forms. The purchaser and the recipient of the service may be distanced from one another. With some charities, donors are unable to see the actual recipients of their money because the recipients may be far away or because it would be inappropriate to reveal the names of service recipients. With overseas famine relief programs like CARE and Oxfam, for example, the donors that respond to appeals for contributions do so in part because they trust the charities to use their funds responsibly. It is unlikely that small donors living in the United States will be able to monitor closely the activities of a relief agency operating in Bangladesh and make judgments about of how well or efficiently their funds were used. To be sure, some relief organizations have attempted to provide detailed information to donors about the people or children that are served, but, for the most part, many emergency assistance efforts are done with minimal client tracking. For donors, the fact that recipient organizations may be separated by great distances is not an insurmountable problem because the charity operates under the nondistribution constraint. Unlike in a for-profit business, the staff of relief organizations have no obvious incentive to maximizing anything except the assistance they deliver to needy people.

According to Hansmann, contract failure may also be a factor with certain public goods, which are defined by their equal cost of provision to one person or to many, and by the impossibility of preventing others from consuming the good once it has been consumed by one person.[210] Examples of such nonexcludable public goods include air pollution control and public radio. Unlike relief organizations that serve clients, the contributor to public radio is also the consumer of the good. Thus, the problem of generating

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[209] *See id.* at 873-76.
[210] *See id.* at 848-51.

contributions does not stem from an inability to see if the services are ultimately delivered, but instead, from the indivisible nature of the broadcast service involved, which makes it a public good and creates a free rider problem.

For organizations that depend significantly on fees for the services they render, the problem of contract failure is somewhat different. Consumers will actively seek out nonprofit organizations because they want to be able to trust producers and grant them a great deal of discretion. It is therefore hardly surprising that nonprofit day care centers enjoy broad popularity. By offering parents critical services that they will consume while removing the profit motive, a complex service can be delivered in a way that inspires confidence in the consumer.

Hansmann's central argument is consistent. We can understand the emergence of the nonprofit sector by looking at the unsatisfied demand for certain kinds of goods. Contract failure opens a door through which the nonprofit sector can move and capitalize on some of the shortcomings of for-profit firms. For Hansmann, the appearance and continued survival of nonprofit activity in a broad array of fields ultimately comes down to the ability of these organizations to satisfy an unmet demand by inspiring trust.[211] Rising nonprofit salaries clearly have the potential to undermine the trust that lies at the heart of at least one powerful rationale for the existence of nonprofit organizations. If staff salaries and directors' fees become too high, they can siphon off organizational resources for private advantage, which, for all intents and purposes, is equivalent to a "distribution" of "excess revenue."

This kind of distribution through salaries and fees rather than through the payment of dividends is problematic for three reasons, each of which corresponds to a critical constituency for nonprofits. First, it weakens a *community*'s confidence in the motives of nonprofit workers and weakens support for the tax exemption that charitable nonprofits enjoy. Second, it shakes the confidence of *clients* in the services that are being rendered because the motives of the providers are different when the constraint of profiteering is lifted. Third, it undermines the ability of *donors* to assume a link between the size of their gift and the amount of charitable services delivered. Clients of nonprofits, their donors, and the community in which they operate are thus all affected by a violation of the nondistribution constraint. For all these reasons, some limits on the ability of nonprofits to pass increased revenues on in the form of increased salaries are needed if the ability of nonprofit to respond to contract failure is to continue.

Our concern is that the new process requirements embodied in intermediate sanctions are unlikely to prevent violations of the non-distribution constraint,

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[211] *See id.* at 844.

particularly in large nonprofit organizations. The nonprofit sector has grown over the years to the point where many very large nonprofits, including the Salvation Army, the YMCA, the American Red Cross, and many hospitals and universities have billion dollar budgets and employ tens of thousands of people.[212] Since the pool of very large nonprofits is still relatively small, the question becomes what the salaries of these most visible nonprofit leaders should be.

Under the new regulations, an organization like the American Red Cross could argue that in making compensation decisions it is appropriate for it to compare its executive salaries with those of a diversified service corporation with annual revenues of two billion dollars, rather than look only to the small pool of other large nonprofit organizations. If the executive of the Red Cross were recruited directly from business, as many of the senior managers in the blood services division have been, this would appear to be not only a permissible action, but a responsible one. In building a rebuttable presumption, the Red Cross might begin its search process by assembling a list of what business managers in large bio-tech and health corporations earn, which might then be a first step toward justifying extraordinarily generous compensation packages.

Part of the difficulty involved in basing a system of regulation on cross sector equivalencies lies in the subjectivity with which many comparisons are made and the consequences of such comparisons. In the case of the Red Cross, the "comparable list" would have to take into account both the salary paid to senior business managers and the stock options that are part of many compensation packages. In many corporations the stock options given to a senior executive can often amount to millions of dollars of deferred compensation.[213] In many small and mid-sized companies, stock options, though smaller in dollar terms, remain a critical tool for motivating and retaining senior managers. The question that naturally arises is the following: how can nonprofit make the kind of comparisons envisaged in the new regulations, particularly if cross-sector comparisons involve non-distributing nonprofit organizations and corporations that distribute profits generously?

Cross-sector comparisons are also problematic in that it is common for a business executive to be paid well for performance that was perceived as poor. For example, many objected to Disney's Michael Ovitz's earning a multimillion-dollar golden parachute after a fourteen-month tenure that was

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212 *See* Thomas J. Billitteri & Debra E. Blum, *Salaries Rise Moderately at Charities*, CHRON. PHILANTHROPY, Sept. 24, 1988, at 1.

213 When the chief of one of Lucent's biggest divisions recently left to become the CEO of Hewlett Packard, she left behind stock options worth over $50 million only to be granted new ones worth potentially $90 million. *See* Steve Lohr, *Setting Her Own Precedents*, N.Y. TIMES, July 23, 1999, at C1.

widely viewed as quite unsuccessful.[214] Observers have also criticized boards that remain passive in the face of poor performance, as when IBM directors allowed the firm to lose market share over several years before choosing a new CEO.[215] Analysts of the broader trends in executive compensation point out both that for-profit executive salaries are growing, and that they are very weakly related to firm performance.[216] The ambiguity of performance standards in nonprofits make establishing a strong performance-pay link even more problematic. Moreover, analysts of nonprofits and for-profits have raised remarkably similar concerns about the quality of governance. As the

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[214] *See* Charles Pretzlik, *Where Getting Fired Can Make You a Fortune: Hooray For Hollywood and Its Multi-Million Payoffs*, DAILY TELEGRAPH, Jan. 7, 1997, at 8; Claudia Eller & James Bates, *Company Town; Rank and File Are Smarting Over Ovitz's Severance Deal*, L.A. TIMES, Dec. 20, 1996, at D1.

[215] *Cf.* Elson, *supra* note 117, at 657 n.15.

[216] One study indicated that the median annual pay package for major industrial company CEOs rose by more than 70% in real terms between 1983 and 1993. *See* Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 81 n.2 (citing MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 9 (1995)). Evidence of an often-weak link between performance and pay includes a 1991 study by compensation expert Graef Crystal, which revealed that a 20% decline in company profits was associated with a 7.6% increase in pay, and a 30% decline in profits with a 6.1% pay increase. *See* Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205, 1214 (1999)(citing Graef S. Crystal, *How Much CEOs Really Make*, FORTUNE, June 17, 1991, at 72, 76). Other analyses have generally indicated that the relationship between firm performance and CEO pay is positive, but very weakly significant. *See, e.g.*, Maura A. Belliveau et al., *Social Capital at the Top: Effects of Social Similarity and Status on CEO Compensation*, 39 ACAD. MGMT J. 1568, 1569 (1996)(citing GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991)); G. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 18 J. FIN. 593, 611, 615 (1988)). Another study revealed that "'each $1,000 change in shareholder wealth corresponds to an increase in this year's and next year's salary of only two cents.'" Baker et al., *supra*, at 611. The increasing popularity of stock options and pay for performance suggests that this relationship might improve, however. A 1998 study of CEO panel data set suggests that the relationship between performance and pay has increased dramatically over the past fifteen years—the elasticity of CEO compensation to firm market value more than tripled between 1980 and 1994—and that previous researchers have neglected the impact of stock holdings and stock options. *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* CXIII Q.J. ECON. 653, 653-56, 686 (1998). Still, if performance incentives are poorly structured they can reward weak performance. Charles Yablon (in reviewing a Graef Crystal book on compensation) cites several examples of circumstances in which stock options can result in large gains for mediocre performance, including when a rise in stock price merely matches the market, or when the grant consists of so many shares that even a tiny gain in value leads to a multi-million dollar payoff. *See* Yablon, *supra* note 118, at 1879-80 & nn.32-34. Of course, performance incentives are less readily available to improve compensation decisions in nonprofits, simply because performance, outside of fund raising, generally cannot be easily summarized in a bottom line.

public learns of individual cases involving months or even years of self-dealing or incompetence, the question almost invariably asked is simply: where was the board?[217]

The problem of making cross sector comparisons is not limited to compensation decisions in large public charities like the American Red Cross or the YMCA. While many small nonprofits do not appear to have corporate equivalents, some nonprofit executive directors could well argue that their organizations are roughly analogous to small businesses. In both sectors, the work is entrepreneurial, involves the mobilization of resources, and often demands supervising a small group of workers. The rise of a new cadre of more bottom-line oriented managers in start-up nonprofits only makes this connection more realistic. Again, however, the question will arise as to how to translate the profits paid to small business owners into terms that are meaningful in the nonprofit sector.

New cross-sector comparisons may also open up excuses where none previously existed. In the case of KSBE, the ability to compare compensation across sectors would appear to be the only possible defense for what many viewed as excessively high levels of pay. Within the nonprofit sector, payments or fees to trustees are not uncommon. Most often they tend to range from a hundred to a few thousand dollars. Although the national trade association representing the sector generally frowns on such payments, it allows that they can be justified in some cases. In the case of KSBE, where one of many criticisms centered on the trustees' compensation of $900,000 a year,[218] it would be very hard to find many other nonprofit organizations that pay fees anywhere near this amount.[219] However, under a system where payments could be justified with reference to compensation in the business sector, a whole new set of justifications and arguments appears to be open to the trustees of the Estate.

Instead of being limited by the fact that nonprofit directors do not generally receive generous compensation, the KSBE trustees, who manage assets worth by some estimates up to ten billion dollars,[220] might conceivably argue the appropriate comparison is actually with private sector investment fund

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[217] Charles Elson, reflecting on IBM retaining its CEO despite several years of poor performance, and SEC General Counsel Harvey J. Goldschmid, noting the United Way board's inaction in the face of William Aramony's excesses, both ask precisely this question. *See* Elson, *supra* note 117, at 660; Goldschmid, *supra* note 100, at 633-34.

[218] *See* Yuen, *supra* note 207.

[219] For a review of compensation practices within the more specialized field of private foundations, see COUNCIL ON FOUNDATIONS, FOUNDATION MANAGEMENT REPORT (1998) [hereinafter FOUNDATION MANAGEMENT REPORT].

[220] *See* Pete Pichaske, *IRS Audit Can Be 'Ruinous' to Tax-Exempt Organizations*, HONOLULU STAR-BULLETIN, Nov. 4, 1997, at A-1.

managers. Large mutual fund companies often pay their fund managers huge salaries, sometimes reaching tens of millions of dollars—based both on performance and on the amount of assets under management. For-profit firms that manage large university and foundation endowments also receive generous compensation. For example, the private firm that manages Harvard University's fourteen billion endowment recently reported that one of its key portfolio managers earned over seven million dollars in 1997.[221] This level of compensation was explained by the fact that Harvard's endowment registered returns in recent years that outpaced the performance of other elite university endowments.[222]

Whether the KSBE trustees managed the Estate astutely or not is a subject of some controversy. There is some evidence that mistakes were made.[223] However, whatever one's judgment of their performance might be, it remains likely some will be tempted to create a rebuttable presumption by pointing to what financial managers in the business world routinely earn. Although few if any of the KSBE trustees had the formal training that large fund managers typically possess, the management of the Estate does in fact involve the oversight of a huge and complex portfolio of assets. Thus, the problem with opening the door to cross-sector comparisons of compensation is that it makes possible—and to some extent legitimizes—a whole new set of arguments about what is reasonable compensation in the nonprofit sector.

While the IRS has reserved for itself the right to challenge and reject any wrongheaded comparisons, the problem of creating a sense of entitlement to cross-sector pay equity may cause confusion and problems for years to come. In the end, a system of regulating nonprofit compensation that explicitly allows for cross-sector comparisons is problematic because it threatens to undermine the fragile identity of public charities as service and mission-driven organizations where motives and rewards cannot be measured in terms of dollars and cents. If every major hiring decision takes place in a regulatory environment that encourages scrutiny of comparable hires in other nonprofits and businesses, it is unlikely that the Salvation Army and the American Red Cross would be able to recruit and retain their presidents while paying only

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[221] *See* Steve Bailey & Steven Syre, *Top Gun Quits Harvard Management to Start Hedge Fund: University to Invest $500M in Jacobson's Firm*, BOSTON GLOBE, Apr. 7, 1998, at C-1.

[222] *See id.*

[223] *See* Stephen G. Greene, *Bishop Estate to Pay IRS $9-Million but Retain Its Tax-Exempt Status*, CHRON. PHILANTHROPY, Dec. 12, 1999, at 32 (reporting that KSBE has entered into a settlement that permanently removes five trustees and requires major changes in management and governance). Daniel Kurtz, an expert on trustee liability, is quoted in the article: "There was so much venal behavior and so much abuse of power, where people running [the charity] thought they could laugh at the law." *Id.*

$78,646 and $90,000 respectively in 1997.[224] While the Salvation Army has long had a reputation for frugality, the levels of compensation it pays most senior managers can only be described as meager.[225] For some nonprofits, however, low wages are part of the identity of the organization and a critical reason why clients trust and believe in it. Clients and donors are attracted to organizations that spend money on programs that advance a charitable mission rather than on compensation and perks for those who are doing the work.[226]

Yet, the newly enacted regulations, although far from eliminating or discouraging financial abuses, may create new pressure to pay "comparable worth" in the nonprofit sector, leading to the unintended outcome of rising salaries in some charities. As boards begin to consult studies of what other organizations pay and what businesses offer to their executives, a slow but steady "regression to the mean" is possible. Concerned with not paying too much, nonprofits may collect data on what others are doing and gravitate toward what they believe is the mean salary for the kind of position they are seeking to fill. This regression to the mean has already occurred in some fields where professionals and experts play a prominent role. In the field of private foundation philanthropy, for example, annual "management reports" document in detail the educational backgrounds and salaries of foundation staff.[227] These reports are the starting points for many compensation decisions within foundations.[228] While there is nothing inherently wrong with paying the mean salary, it may well be that a charity could well find someone who would work for less money. Of course, it would be an ironic turn of events if the creation of a system designed to limit nonprofit compensation based on comparisons actually ended driving up some salaries. The history of public policy implementation is absolutely full of stories of surprising and unintended consequences.[229]

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[224] *See* Billitteri & Blum, *supra* note 212, at 1.

[225] *See* Julie Connelly, *Marching Smartly to Their Own Drummer*, N.Y. TIMES, Nov. 17, 1999, at H1.

[226] *See* DWIGHT F. BURLINGAME, CRITICAL ISSUES IN FUNDRAISING (1997).

[227] *See* FOUNDATION MANAGEMENT REPORT, *supra* note 219.

[228] For a discussion of professionalization in philanthropy, see generally Peter Frumkin, *The Long Recoil from Regulation: Private Philanthropic Foundations and the Tax Reform Act of 1969*, 28 AM. REV. PUB. ADMIN. 266 (1999); and Peter Frumkin, *Private Foundations as Public Institutions*, *in* PHILANTHROPIC FOUNDATIONS: NEW SCHOLARSHIP, NEW POSSIBILITIES 69-98 (Ellen Condliffe Lagemann ed. 1999).

[229] *See* JEFFREY L. PRESSMAN & AARON WILDAVSKY, IMPLEMENTATION 35-69 (3d ed. 1980)(describing how complex details of implementing an economic development project ultimately led to its slow completion and very modest results).

B. Accountability in the Nonprofit Sector

If the process regulations detailed in the new regulations are problematic, how then should abuses in charities be detected and how should punishment be delivered? In this final section, we examine the idea of "information as regulation" and suggest that creating both a supply of reliable information and a strong demand for usable information would be one possible alternative. However, to move fully away from a regime built on rebuttable presumptions and government imposed fines, the nonprofit sector would have to change dramatically both its management and its culture. To understand the complexity of alternatives to intermediate sanctions, it is important to start with the fact that nonprofits have no owners and how this fact shapes both the supply of, and demand for, information about these organizations.

1. No owners equals little accountability

Beyond the fact that they operate under a non-distribution constraint, a second defining feature of nonprofit organizations is that they have no clear owners. This trait separates these entities from both business and government. Businesses must meet the expectations of shareholders or they risk financial ruin. The ownership question in the business sector is clear and unambiguous, with shareholders owning larger or smaller pieces of the company depending on the number of shares of stock they own. Similarly, government is tethered to a well-identified group of individuals, namely voters. Executive and legislative bodies—and the public agencies they supervise—must heed the will of the electorate if they are to be able to pursue public purposes and retain the support and legitimacy needed to govern. There is also a long tradition in the United States of conceiving government as "belonging" to citizens, though the ways in which this ownership claim can be exercised are severely limited. In the nonprofit sector, lack of clear lines of ownership complicates the accountability question substantially.

Nonprofit organizations have many masters that they must serve, including donors, clients and local communities, none of which is ultimately able to exert complete control over these organizations nor make an ownership claim. The relative strength of any claim made by these groups ultimately depends on how an organization is funded. Nonprofit organizations that depend heavily on charitable contributions are often held closely accountable by their donors, some of whom believe that as social investors, they have a strong stake in their donees. Nonprofits that are largely driven by the service fees charged to clients are in a completely different position. While these more commercial organizations do not have donors asserting claims over them, they must respond to the needs and demands of clients or risk financial trouble.

Often, however, the lines of ownership and accountability are rendered more complex by the fact that many nonprofit organizations combine grants from multiple sources—foundations, corporations, government, and individuals—with earned income, making it hard to point to any particular party as the key stakeholder to whom these special institutions must answer. One might be tempted to point to the fact that nonprofit organizations are almost always governed by boards as a solution to the ownership and accountability issue. Unfortunately, board members are not owners but rather stewards that are held responsible for the actions of the organization. In the end, nonprofit organizations are authorized to act in the public interest by the communities in which they operate, though the lines of accountability are weaker than those in the public sector and the lines of ownership are far more obscure than in the business sector.

One of the most obvious problems raised by unclear lines of accountability and the ownerless character of nonprofit organizations is that the potential for fraud and abuse is significant. Financial scandals are cause for concern and draw attention to the fact that determined thieves will find a way of siphoning off charitable funds for private benefit. In organizations that do not have owners watching vigilantly over the register, it is not only possible, but likely, that some will attempt to take advantage and steal.

Even if charities follow the new process regulations and make difficult comparative judgments about compensation, it is not clear how this kind of action will solve some of the deep-seated legal and ethical problems in these distinctive ownerless organizations that operate with weak accountability systems. Instituting a set of detailed process regulations that spell out steps that nonprofits must take to create a rebuttable presumption for their compensation decisions will not eliminate graft outside the formal decision making processes. In fact, the very nature of the embezzlement and fraud are that they are done secretly and without the knowledge of others. Thus, while process rules may tighten up the way honest nonprofits go about making their compensation decisions, these rules will be of little concern to those committed to crime. Only greater enforcement of existing criminal laws will deter someone bent on stealing from a charity. Unfortunately, the IRS is ill-equipped at present to mount a major law enforcement effort in the nonprofit arena. In fact, some reports suggest that the IRS has reached an all time low in terms of its ability to audit and investigate suspect tax-exempt organizations.[230]

[230] *See* Elizabeth Greene & Grant Williams, *Asleep on the Watch?*, CHRON. PHILANTHROPY, July 27, 1995, at 1; Jennifer Moore & Grant Williams, *Taxing Times for the Tax Agency*, CHRON. PHILANTHROPY, Oct. 17, 1996, at 1.

The fact that nonprofits do not have owners and clear lines of accountability raises the question of how to eradicate both inappropriate compensation decisions and other financial abuses, while at the same protecting the independence of charities and allowing them to operate freely. For some charities, one answer may lie in the creation of a supply of reliable information about the financial management of charities and in a vibrant demand for this information within the many stakeholders that surround charities, including the donors, the clients, and the general tax paying public. The idea of "information as regulation" is appealing because it offers a way of bringing behavior in the nonprofit sector under control without resorting to process regulations that are difficult to apply. We believe that by opening up nonprofits to the "marketplace" of competition and empowering the multiple stakeholders in these organizations with information that can inform and guide their contributions and use of services, it may be possible to begin to overcome the problems that grow out of the lack of clear ownership and accountability. A first step in moving in the direction of a market alternative to more regulation involves creating a better and more reliable *supply* of data and information on nonprofit organizations.

2. The supply of information

As part of the IRS' move to implement intermediate sanctions, new disclosure requirements were put in place. Charities must now send their Form 990, which available to any interested party, or post it on the Internet.[231] This marked a major change from the previous disclosure law, which only required that the forms be shown upon request in a charity's office.[232] Few contributors ever made pilgrimages to see the forms. The supply of information on the management of public charities was therefore largely determined by what organizations chose to disclose in their annual reports.

Despite the recent reform, there is reason to believe that improvement in the quantity and quality of information supplied to donors will not be instantaneous. A study of Form 990 returns from exempt organizations in twelve states, begun after the new disclosure regulations took effect in June 1999, revealed that just thirty-seven percent immediately fulfilled Form 990 requests, and thirty-one percent responded in ways coded as obfuscation— they referred survey takers to another office, or required them to leave

[231] *See* 26 U.S.C.A. § 6104(d)(1)(B) (West Supp. 1999); 26 C.F.R. § 301.6104(d)-2(b)(2) (1999).
[232] *See* 26 U.S.C. § 6104(d) & (e) (1994)(repealed 1999).

voicemail messages that were not returned.[233] The study organizer suggested that many organizations appeared either to be following a long-established process, or to have no process at all, for responding to information requests.[234] Whether Form 990s will become substantially more accessible in the future depends on several unknowns, including how quickly organizations communicate rules changes through their networks, and how aggressively the IRS is perceived to be monitoring compliance. Still, we believe that government could do more to both inform nonprofits of the rule change and enforce disclosure requirements. This would require that the government take an active role in simplifying Form 990, communicating more directly with nonprofit organizations, and building a credible enforcement staff capable of letting nonprofits know that disclosure is a critical responsibility.

Making Form 990s easier to access is a first step in improving the supply of information, but it is not the only alternative. Some critics of nonprofits have long argued that the weak supply of information will only be solved by creating independent accrediting and watchdog organizations that will not only collect data, but analyze it and explain it to the public. Independent accrediting and oversight agencies have in fact been established in many fields, though the results have been mixed. The Better Business Bureau, for example, reviews charities' compliance with standards regarding, among other things, using a high percentage of funds for program activities, having active governance, and providing complete and accurate solicitations and informational materials to donors.[235] It also catalogues government action against national charities.[236] The National Charities Information Bureau ("NCIB") acts as a kind of accreditor for charities by collecting information on nonprofits and reporting which organizations have complied with requests for information and which have not.[237] These broad voluntary systems rely on the good will of charities to both send in information and to report data accurately. The main problem with these approaches is that they are unable to monitor the organizations that ignore requests for information, which are of course the organizations in which problems are most likely to occur. While NCIB has in the past attempted to attach a stigma to not complying with requests for information by publishing and disseminating lists of those who

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[233] *See* Fred Stokeld, *Study of EO Compliance with Disclosure Rules Has Mixed Results* (July 9, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 132-5, (July 12, 1999).

[234] *See id.*

[235] *See* Bennett M. Weiner, *Full Text: Better Business Bureau's Testimony at W&M Hearing on Tax Laws Applicable to Tax-Exempt Organizations* (June 15, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 93 TNT 127-42 (June 16, 1993).

[236] *See id.*

[237] NCIB's statement of purpose can be found at <http://www.give.org>.

ignore their requests, it is not clear that such publicity is likely to pose much of a threat to nonprofits. The audience for these reports is still relatively limited.

Within narrower sub-fields of the nonprofit sector, focused accrediting systems have been set up, aimed at ensuring that member organizations act responsibly. However, there are at least two major limitations to these kind of accrediting agencies. First, like IRS enforcement, they tend to be audit lotteries, processes that select few enough cases for review so that quiet noncompliance becomes an attractive gamble. The Evangelical Council for Financial Accountability, for example, reviews documents for all accredited agencies, but only performs field tests of accuracy on about six percent of its members each year.[238] Second, while accreditors can record objective salary data and organizations' descriptions of their activities and successes, they are not as well-positioned to aid donors in determining whether an organization's accomplishments or an individual's talents are enough to justify a particular salary. The subjectivity of the salary determination and the high costs of gathering enough data to reevaluate organizations' decisions are problematic for any neutral agency that must monitor a large case load.

There is at least one major development on the horizon that may help answer the supply side of the information equation. A new nonprofit organization has been formed to disseminate financial information on nonprofits over the Internet. The project, known as Guidestar, is still in its early stages, but it promises to overcome at least part of the information problem. The Guidestar web-site will allow any person to access the essential financial data for a large number of nonprofit organizations.[239] Information about operating expenses, administrative overhead, and fund-raising costs will all be available to potential contributors and volunteers.[240] The goal of the project is to make research on nonprofits easier for the average donor by putting this data where it is easiest to access.

There are at least two challenges facing this effort and a range of other state-level efforts to put information about charities on line, problems that have plagued other efforts to improve reporting undertaken by accreditors. The first is that all the information that is made available is supplied voluntarily by the charities.[241] This means that organizations with either embarrassing data to report (such as very high administrative-to-program-expense ratios) will likely avoid the system entirely. The second is that there are major gaps in the generally accepted accounting principles for nonprofits

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[238] *See* McCabe, *supra* note 180.

[239] See Guidestar's web-site at <http://www.guidestar.org>.

[240] *See id.*

[241] *See id.* Nonprofit organizations are requested by GuideStar to provide data that is not on the Form 990. There is no penalty for non-compliance.

that make it hard to ensure the accuracy of reported information.[242] This is especially problematic given that Guidestar is also set up as an on-line giving program that allows contributors to look up information and then make a pledge on line. Since no hard and fast rules exist for separating out program and administrative costs, the temptation for many charities will be to put their best foot forward and to engage in a kind of strategic "gaming" aimed at making themselves look as efficient as possible. With contributors' dollars hanging in the balance, Guidestar may well end up fueling a race to the bottom as creative accounting techniques allow charities to control their image. None of these technical problems is insurmountable with a few modest reforms, including separating more clearly the reporting and fund-raising functions of the service and developing a workable auditing system. To date, however, it remains unclear how aggressively Guidestar will confront these pressures, while at the same time working to ensure the broadest possible participation among nonprofits.

The problems inherent in voluntary reporting, both through accrediting organizations and via on-line databases, are significant enough to lead Herzlinger to argue that the only real solution to the accountability problem in the nonprofit sector, and the narrower compensation question that has emerged most recently, may lie in the establishment of an SEC-type organization that could ensure openness and disclosure as way of regulating through information.[243] The principal role of a "nonprofit SEC" would be to be to bring uniform accounting techniques to public charities, disseminate information on the financial condition of organizations, and create channels through which donors, volunteers, clients, and community members could access and use this information. Of course, this would be a far more complex proposition in the nonprofit sector, where lines of ownership are overlapping and ill-defined, than in the business sector, where one group of owners, namely shareholders, have clear interests in solid information. For information to have a chance to work as regulation and for Herzlinger's provocative idea of a "nonprofit SEC" to have an opportunity to succeed, a major transformation is needed not just in the kind of information that is made available, but in the outlook of the many stakeholders of nonprofit organizations, including donors, clients and the general public.

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[242] *See* Regina Herzlinger, *Can Trust in Government and Nonprofits Be Restored?*, HARV. BUS. REV., Mar.-Apr. 1996, at 103.

[243] *See id.*

3. *The demand for information*

Information is ultimately only as good as the purpose to which it is applied. Information that is accurate, broadly available, and reliable performs little ultimate service unless it is used. Three questions thus impose themselves. Is there currently a demand for information? How can and should information be used by nonprofit stakeholders? What would the nonprofit sector look like if data and information on the finances—and perhaps even the performance—of nonprofits were in fact suddenly used to make critical decisions about which organization will receive contributions and which organizations will be patronized by clients?

Although public charities are ownerless organizations, they do have a number of important stakeholders, parties that are interested in and committed to the missions and organizations that make up the nonprofit sector. Each group has a different interest in the compensation issue and each is affected differently by charities that compensate excessively. Clients may be hurt by excess compensation because excess salaries drive up the cost of services and make the use of nonprofit organizations less attractive. Donors may be hurt by excess compensation, in that charitable resources are siphoned off for non-charitable purposes, which thwarts the donor's charitable intent and the organization's stated mission. Taxpayers and community members are also hurt because the tax expenditure that they make to support nonprofit organizations is not being used to produce outcomes that are most valuable to the community. Although each of these three stakeholders in public charities is potentially affected by excessive compensation within nonprofit organizations, each faces substantial obstacles to taking an active interest in the performance and management of the charities to which they are committed.

Clients. Over the past two decades, earned income—revenues derived from client fees or commercial ventures—has quietly become a critical engine driving many parts of the nonprofit sector. While there are still some parts of the sector that are entirely dependent on charitable gifts, the vast majority of nonprofit organizations depends in part or in great measure on revenue that is derived from fees and other commercial activities. The more a charity is dependent on fees and ventures, the more it is exposed to market pressures and the more it is dependent on the judgment of clients. At present, however, few clients of nonprofits act like aggressive consumers. Because many nonprofits engender trust and are often viewed as community resources, it is a rare occasion indeed that clients ask tough questions before using charitable services. The primary concern is with the quality and affordability of the services to be delivered. Rarely, however, do concerns over quality and price translate into inquisitiveness about the underlying factors that make a charity either able or unable to meet expectations.

Donors. Many charities are dependent to a greater or lesser extent on contributed income. These "donative" nonprofits gather funds from foundations, corporations, federated funders, and individuals in order to carry out their charitable missions. Institutional funders have long studied the financial statements of nonprofits during the grant review process. This oversight is limited in impact and scope, however, by the fact that the vast majority of giving is done by individuals, not by the more visible institutional givers.[244] Research indicates that individual contributors typically support organizations with which they have contact in the past or which are working in their local communities.[245] Contributions are thus often a way for individuals to enact their values and commitments, to help causes that are important to the donors. As a consequence, individual contributions rarely reflect the careful consideration of a charity's financial statements, including its compensation decisions.

Community. Within neighborhoods and communities, public charities are often viewed as critical resources, especially in areas where business investment is low and where public programs are lacking. Even in the most organized and politically-engaged communities, however, few residents watch over the local nonprofits with a sense of ownership. Some community members may become involved in an organization, sometimes by serving on an advisory board or volunteering. Nevertheless, it is rare for members of the general public to actively oversee the operations of nonprofit organizations operating in the community. Far more important to many residents are the programs that the charity offers. At times, local governments have taken action against nonprofits to protect community interests, in one case zoning social service agencies out of a city's downtown business district, in another case seeking to impose property taxes on affluent charities, and in a few cases attempting to block nonprofit to for-profit hospital conversions.[246] These episodes are rare, however, and do not usually reflect a consistent ongoing scrutiny of nonprofit administration and finance. Communities may want charities to act as good citizens, but rarely do they ask questions about compensation decisions or attempt to shape them by applying political or moral pressure.

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[244] *See* Elizabeth T. Boris, *The Nonprofit Sector in the 1990s*, *in* PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 1, 19 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999).

[245] *See* FRANCIE OSTROWER, WHY THE WEALTHY GIVE 86-99 (1995). Giving to colleges and cultural organizations is a clear example of this tendency.

[246] For an overview of the full range of public nonprofit interactions, see BURTON WEISBROD, TO PROFIT OR NOT TO PROFIT? (1998).

Patterns of client, donor and community involvement with nonprofit organizations raise two questions. First, how might a SEC-type organization for the nonprofit sector operate? Second, could such an organization operate as the hub of a new system for the dissemination and use of accurate financial information about charities? In the business world, the SEC regulates the securities exchanges through disclosure requirements, civil and criminal law enforcement, and auditing and oversight of corporate accounting.[247] By ensuring that the information about publicly-held corporations reaching investors is accurate and consistent, the SEC is able to create confidence in the markets. Demand for information on companies is intense because investors use this information to predict how well a company is likely to do in the future, which in turn informs their investment decisions. In recent years, both SEC disclosure[248] and proxy law regulating their interactions with shareholders has undergone review and reform designed to address a perceived overcompensation problem.[249] The results of reforms in SEC proxy rules are especially relevant for nonprofits, because they suggest that there

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[247] *See* 15 U.S.C. §§ 78a-78mm (1994 & Supp. IV 1999).

[248] In 1992, following complaints that corporations present compensation packages in an overly complex and even sometimes a deliberately misleading manner, the SEC adopted several new disclosure requirements designed to make compensation practices more comprehensible. *See* Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (1992)(to be codified at 17 C.F.R. pts. 228, 229, 240, 249). Corporations must now present the following information for their highest paid executives: a summary compensation table, putting in one place the major forms of compensation (i.e., not only salaries, but bonuses, payouts from long-term performance plans, and restricted stock value); a table describing stock option incentives in detail; a chart comparing the company's stock price over the past five years to that of a peer group of other companies; and a report from the firm's compensation committee explaining how it arrived at its compensation figures. *See id.*; *see also* Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 731-38 (1995); Michael E. Ragsdale, Comment, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 549-61 (1993).

[249] One critical way in which shareholders can dissent from governance they see as faulty is by introducing a shareholder proposal, which, provided certain threshold conditions are met, the corporation must include in its proxy materials. *See* 17 C.F.R. § 240.14a-8 (1999). The SEC has generally required that these proposals be phrased in advisory, non-binding language. *See* Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 418 n.232 (1994). The corporation is permitted to exclude the proposal if (among other reasons) the proposal relates to its "ordinary business operations." *See* 17 C.F.R. § 240.14a-8(i)(7). In 1992, the SEC reconsidered its longstanding policy of permitting corporations to exclude compensation-related proposals under this exception and began to require that these proposals be included, provided that they relate to senior executives' compensation. *See* Goforth, *supra*, at 418. With this reform, and with a recent increase in the holdings of sophisticated and knowledgeable institutional investors (i.e., banks managing trust funds, mutual funds, endowments, insurance companies, etc.), it appeared possible that shareholders would have a significant new influence on compensation matters. *See id.*

may be significant additional barriers to any activist's ability to deter overcompensation.

Many of the disincentives to activism for individual and institutional investors—such as the dispersion of voting power, the high costs of activism relative to its potential to increase profits, and the desire to maintain ongoing business relationships—appear to have analogues for nonprofit stakeholders who may wish to constrain compensation. Although it would be tempting to simply argue that the market will reward and encourage the development of programs that donors, clients, and communities value, the "Wall Street Rule"—a cornerstone in the business world that holds that dissatisfied investors can express themselves by moving funds from one investment to another—is not fully operative in the charitable world. After all, those who want to give to disaster relief in a particular region, support and go to the opera, or attend a local university may have few or no substitute organizations from which to choose. Some unique nonprofit services raise the possibility that nonprofit stakeholders will be left deeply dissatisfied with an organization's governance but unprepared to stop donating and patronizing a particular organization. The number of unique nonprofit services is, however, likely to diminish as competition between nonprofits for financial support intensifies in fields ranging from social services to education to the arts.

Reform of nonprofit compensation also seems potentially vulnerable to the collective action problems and institutional pressures that exist in the business world. Recent reforms in SEC law have made it easier for those who offer proposals to communicate with other shareholders,[250] but nonprofit stakeholders dissatisfied with a charity's compensation policy have no easy way to contact other concerned parties to let them know about the problem. Compared to shareholders, it will likely be more costly and time-consuming for nonprofit stakeholders to educate themselves about the issue of reasonable compensation and reach collective conclusions about appropriate levels in particular cases. Because a donor, a client, or a community member does not personally profit from the charity's efficient operations, the returns to improving efficiency through reduced compensation levels may simply outweigh the costs of action.

Still, some stakeholders have in fact taken an active role in improving charities. In some cases, action by stakeholders has turned out to be a far more potent tool for regulating nonprofit behavior than the modest penalties provided by intermediate sanctions.[251] The recent history of the United Way provides perhaps the best example of donors reshaping an organization

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[250] *See supra* note 249 and accompanying text.

[251] *See* Liz Spayd, *United Way Chapters Battling to Regain Public Confidence*, WASH. POST, Sept. 15, 1994, at A12.

through pressure and through the withholding of funds. Following the scandal that led to the jailing of its president, the United Way experienced a significant fall-off in the amount of funds it collected within many of its critical chapters.[252] Many faithful donors to the organization demanded change and greater accountability for the use of their charitable dollars.[253] Over the past few years, the United Way has responded to this pressure by giving contributors more options, including more say in the selection of beneficiaries, and by instituting a rigorous evaluation program for the grants that are made.[254] Today, the United Way actively solicits contributions on the basis of the efficiency and cost effectiveness of its recipient organizations.[255] Of course, these reforms occurred only after a national scandal brought enormous publicity to the organization.[256] However, it is clear that nonprofits can and do respond to pressures brought to bear on them by their stakeholders. What is needed is a system by which information can be circulated and used to inform decisions—before scandals or problems occur. Vesting primary responsibility for the oversight of nonprofit compensation in the IRS's new process regulations is a much weaker solution to the long-run problem of bringing greater accountability to donative and commercial nonprofits than the creation of a system of checks and balances anchored in a reliable and usable supply of information and active and engaged demand for this information.

Among public charities that are exposed to market pressures and that depend on earned income from client fees or contributions from donors, there is an opportunity to create a self-regulating system anchored in both a greater supply and demand for information. However, for information to work as a way of regulating nonprofit compensation, major changes would be needed in the way clients, donors, and communities view their relationship with the charities. Clients will need to realize that the way nonprofits are managed directly impacts the quality and cost of services that are rendered. They would also have to begin to view the nonprofits on whose services they rely less as vendors and more as community assets. Donors will have to stop thinking of their contributions as symbols of their good will and begin instead to view their gifts more strategically as financial investments, which need to be monitored in order to produce maximum outcomes. While many large donors are moving in this direction, smaller donors will have to at least ask tough questions before writing a check to an organization whose mission simply sounds appealing. At the same time, communities will need to take an active

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[252] *See id.*

[253] *See id.*

[254] *See* Tracy Thompson, *United Way Funding Shifts from Districts to Suburbs: Donors' Desire to Target Charities Limits Agency*, WASH. POST, Oct. 2, 1995, at A1.

[255] *See id.*

[256] *See id.*

interest in the governance and management of local charities. This may mean that the governance systems of nonprofits will need to be opened up not just to wealthy and influential citizens, but to a broader cross section of people interested and committed to an organization's cause and willing to devote significant time to it.

In the end, all stakeholders in public charities will need to become more involved in the oversight of these ownerless organizations if an alternative to more cumbersome and unworkable process rules is to be found. This will call for an adjustment to the dominant culture of the nonprofit sector, where performance and outcomes sometimes play second fiddle to commitment and mission. One of the best ways to help build a demand for usable and reliable information on nonprofit finances is to improve substantially the supply of information by lowering the barriers to quick access and by increasing the quality of the metrics that are used. Though still in need of improvement on several fronts, the independent web-based purveyors of data, including NCIB and Guidestar, will need to play an active role not just in the collection of data, but in the cultivation of higher levels of demand for their services. Such work may well find itself bolstered by new fund-raising practices that emphasize not just mission, but efficiency and effective use of contributions. At a time when competition for donations has become fierce, many nonprofits no longer position their organizations solely on the basis of mission; they now stress the organization's management, as well as the nature of its programs. To differentiate themselves from competitors, nonprofits are becoming more and more willing to share and explain data about their operations. Changes in fund-raising thus portend well for stimulating demand in the coming years for data on the financial performance of nonprofit organizations, as donors may well come to expect heightened levels of disclosure.

The problem of mobilizing nonprofit stakeholders to take interest in assuming a role in the oversight of charity compensation decisions does raise the important problem that changing the way donors, clients, and community approach their engagement with charities will ultimately require new norms in a sector that has long depended on good will and, in many cases, faith. This means making the argument that having a vital and effective nonprofit sector requires input from those who support and those who patronize nonprofits. Until the movement for greater accountability spreads more widely, perhaps due to competition for donations, it may be necessary to view the new IRS process regulation as an imperfect stopgap measure, not the final word on the question of controlling nonprofit compensation.

CONCLUSION

The problem of excess compensation is serious. It threatens to undermine the trust that is a critical part of charitable work, while also exposing the weaknesses that are inherent in the ownerless character of nonprofits. The new intermediate sanctions are clearly needed for those charities like KSBE that are shielded from market pressures by large endowments. In such organizations, clients, donors, and community members are in no position to act as overseers. However, for the vast majority of charities that are buffeted by the financial environment around them, an alternative to process regulation exists—one that has not been fully explored. Creating a system of regulation that has information at its core would change many of the dynamics of the nonprofit sector. Until more reliable, more consistent, and more meaningful financial data is made available and used, charities and their stakeholders will have little choice but to rely on the problematic new rules that encourage nonprofits to engage in cross-sector salary comparisons in an attempt to create rebuttable presumptions. At the same time, there can be little doubt that the nonprofit sector deserves, and must work to build, a far better system for managing accountability than this.