State Attorneys General Powers and Responsibilities

Edited by
Emily Myers
National Association of Attorneys General

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This book is dedicated to Attorneys General and the men and women who work for them in the 56 jurisdictions. They continue to make an important contribution to state govenment and the American legal system. Without them, there would be no book to write.

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This book builds on previous editions, which were edited by Lynne Ross. We gratefully acknowledge her hard work and dedication to this project in its early years.

This book is a collaborative effort, in which different authors with expertise in each substantive area contribute their time and talent. The principal authors are noted on each chapter, but we would like to thank them again here for their hard work and dedication. Many thanks to the following authors:

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Chapter 12

Protection and Regulation of Nonprofits and Charitable Assets

By Robert Carlson, Assistant Attorney General, Missouri
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Attorneys general are charged with the unique and important duty of defending the public's interest in charitable assets and protecting the hundreds of billions donated to charity every year. Charitable entities hold assets for the benefit of the public and in most states only the attorney general has the power and standing to intervene and investigate misappropriation of charitable funds, breaches of fiduciary duty and self-dealing by directors, and fraud in charitable solicitations. For instance, only the attorney general can pursue a charitable trustee who takes funds held in trust for scholarships for under-privileged children, only the attorney general can pursue someone who takes money donated for cancer research but used instead for private gain, and only the attorney general can assure the hundreds of millions of dollars from a nonprofit hospital sale continue to serve the community. Such regulatory responsibility extends to all charitable assets, including those held by unincorporated associations, pure trust entities, and even funds solicited from the public for a charitable cause held as general funds. The attorney general's legal authority is exercised primarily in five areas of law: 1) nonprofit corporations 2) charitable trusts, 3) charitable solicitations, 4) registration, and 5) healthcare conversions.

Attorney General Role, Duty, and Authority

Although laws vary by state, they are consistent in giving the attorney general the authority to protect assets dedicated to charitable purposes. The attorney general's supervisory authority over charitable trusts and corporations originates in English common law. English courts of chancery began to enforce charitable trust for the benefit of the poor and support of churches in the fifteenth century. The attorney general occasionally brought enforcement actions, and gradually became the primary guardian of charitable assets.

During the post-revolutionary war period, American courts refused to recognize a common law authority to enforce charitable trusts. However, in *Vidal v. Girard's Executors*,[1] the Supreme Court held that charitable trusts were enforceable under common law despite the absence of a state statute. In many states, as in England, the common law authority to enforce the proper administration of charitable trusts fell upon state attorneys general.

Because the routine investigatory and information-gathering authority necessary to monitor the performance of charities was not included in the common law, states, starting with New Hampshire, in 1943, began to enact charitable trust registration and reporting statutes. Some states have enacted statutes based on the Uniform Supervision of Trustees for Charitable Purposes Act.[2]

The recent growth of the charitable sector, both in terms of the number of organizations and the charitable assets they control, presents new and important challenges for attorneys general. The public and the investigative press are increasingly focused on the nonprofit sector as a result of high-profile accounts of waste, mismanagement, and abuse. The attorney general's involvement may range from an informal meeting designed to educate and encourage corrective action to a full-blown investigation culminating in negotiation, mediation, or trial to judgment. Ultimately, attorneys general hold the power and the commensurate responsibility to determine the course of action best suited to the protection of the public's interest in charity.

Interjurisdictional Collaboration

Bound by a common mission of protecting charitable assets in each of their states, attorneys general are able to increase their effectiveness in the charitable sector through collaboration with the IRS, other Attorneys General, and international agencies. These collaborative efforts to understand and better regulate the sector are made possible through NAAG and the National Association of State Charities Officials (NASCO).

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1 43 U.S. (2 How.) 127 (1844).

2 *See, e.g.*, Cal. Gov't Code § 12580 - 12599.8; 760 Ill. Comp. Stat. § 5/1 – 5/21.

In a number of states, attorneys general are not the only state entity charged with protecting the nonprofit sector and its donors. In 23 states, the authority to regulate fundraising by and on behalf of charities is shared by the attorney general and another state-level office or department – usually the Secretary of State.[3] Nonprofit regulators from throughout state government have formed NASCO as an affiliate of NAAG. NASCO's purpose is to provide a forum for the exchange of views and experiences of its members, provide continuing education to its members, foster interstate cooperation on legal and law enforcement issues, and foster communication and coordination with the public.[4]

NASCO provides educational resources to its members, including the annual NAAG-NASCO conference, which features public and private sessions. Another significant NASCO initiative has been the development of a single portal multistate registration system, which will centralize registration and financial reporting for charities and allow charity regulators to draw filings from a single central repository.

State charities regulators also work closely with the Internal Revenue Service (IRS). The IRS performs two key functions in the nonprofit sector: it grants recognition of tax exemption to entities who apply; and it administers the Form 990, which is the informational tax return for entities recognized as tax-exempt. Smaller charities may apply for tax exemption through IRS Form 1023EZ, which essentially provides for self-certification of an organization's tax exempt status. Federal funding of the IRS' Exempt Organizations Division has not kept pace with the growth in exempt organizations,[5] and the number of exempt organizations being examined has steadily decreased.[6] Although the IRS remains a key

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3 *See* "State Regulation and Enforcement in the Charitable Sector" Appendix B, Urban Institute (Cindy M. Lott, et al.) (September 2016) (the attorneys general in fifteen states share charitable regulatory authority with the Secretary of State, with the Department of Agriculture and Consumer Services in two states, with the Division of Consumer Affairs or Protection in two states, with the Department of Consumer and Regulatory Affairs in one state, with the Department of Business Regulation in one state, the Department of Professional and Financial Regulation in one state, and with the Department of Financial Institutes in one state.)

4 *See* Art. I, Constitution of the National Association of State Charities Officials, *Amended and Restated reflecting amendments approved at the September 16, 2003, October 7, 2008 and October 18, 2016 annual meetings*.

5 "IRS Oversight of Charities and Foundations." *IRS Oversight of Charities and Foundations*. Independent Sector, 22 Dec., 2016.

6 *Tax-Exempt Organizations: Better Compliance Indicators and Data, and More Collaboration with State Regulators Would Strengthen Oversight of Charitable Organizations (GAO-15-164)* .

partner for state Attorneys General, reduced funding for and enforcement by the IRS makes state enforcement even more important.[7]

Nonprofit Corporations

Attorneys general are the primary protectors and regulators of nonprofit corporations in their states. Nonprofit corporations differ from for-profit corporations in that they are prohibited from issuing stock, paying dividends to investors, or distributing profits to persons in control of the organization (these limits are referred to as the "nondistribution constraint"). Instead, revenues and assets must be used to further nonprofit corporations' charitable purposes, although nonprofit corporations may pay reasonable compensation to officers and directors without violating the nondistribution constraint.

All states have laws allowing for the formation and operation of nonprofit corporations, although their specific provisions vary. A majority of states have adopted a version of the Revised Model Nonprofit Corporation Act (Model Act). These statutes give attorneys general the power to stop *ultra vires* acts, remove directors, address conflicts of interest, appoint receivers, and even seek to judicially dissolve nonprofit corporations. Other provisions include requirements of advance notification to the attorney general of anticipated events such as a voluntary dissolution, merger, or sale of significant assets. These requirements enable attorneys general to monitor the transactions to ensure that charitable assets are used or transferred appropriately. In many states, the attorney general's duty to protect charitable assets in charitable corporations is founded in common law duty to protect charitable assets in charitable trusts.

There is a common misperception that merely incorporating as a nonprofit is sufficient to create a tax-exempt charity. In fact, all organizations must apply to the IRS to obtain federal tax-exempt status. There are several different kinds of IRS tax-exempt designations. Most public benefit or charitable corporations

7 Since 2014, representatives of state attorneys general offices have participated in a bi-annual International Charities Regulators' Teleconference with eight other countries that also have registration and regulatory requirements for charitable organizations: Australia, New Zealand, Singapore, England, Scotland, Northern Ireland, Ireland, and Canada. The group serves as an important resource for information about regulatory and enforcement laws and procedures, methods of identifying potential fraud, current cases and trends, and information about new forms of scams.

apply for and hold IRS 501(c)(3) status, which qualifies the organization to be both tax exempt and to receive tax-deductible donations. Whether a corporation is considered to be a charity under state law does not necessarily depend upon its federal tax status. State law varies as to how to obtain or qualify for state or local tax exemption. If a nonprofit corporation has obtained 501(c)(3) status, failing to abide by the restrictions associated with that status can constitute a breach of fiduciary duty under state law and there are other areas in which state charitable regulation may be closely linked to IRS rulings and requirements.

Attorneys general are responsible for ensuring that charitable corporations comply with legal requirements, that their assets are properly managed and spent, and that directors and officers fulfill their fiduciary obligations. The officers and directors of charitable corporations generally are subject to the business judgment rule. The law does not require that nonprofit directors always be right in their decisions, but they must act with ordinary prudence and reasonably believe their actions are in the best interest of the corporation.

Attorneys general can pursue relief against directors who violate their fiduciary duties. Those duties are often broken down into three categories: 1) the duty of due care, which requires directors to make informed decisions and to conduct appropriate inquiries; 2) the duty of loyalty, which requires that directors place the interests of the nonprofit corporation ahead of their own personal or financial interests; and 3) the duty of obedience, which obligates directors to follow the law and abide by the organization's mission and governing documents. Under the Model Act, directors may engage in transactions in which they have a personal financial interest so long as they provide full disclosure of their interest to the rest of the board, the transaction is fair to the corporation, and it is approved by a majority of disinterested directors. The Model Act also allows attorneys general to approve those conflict of interest transactions.

Reports of mismanagement of charitable corporations can come to the attention of attorneys general in a variety of ways, including through the media, donors, "whistleblowers" within the organization, or former officers, directors, and employees. Many corporate governance problems stem from board directors' lack of engagement or involvement. For example, when embezzlement within nonprofits occurs, it can go undetected for long periods of time if board directors fail to provide effective oversight, which may include reviewing bank statements, instituting and monitoring spending policies for senior management, or being sufficiently engaged with the organization's auditors. Many attorneys general provide handbooks or other guidance for board members on their fiduciary responsibilities.

Another nonprofit corporate governance issue that attracts media and public attention is executive compensation. While charitable corporations are prohibited from distributing profits to those in control of the organizations, they are allowed to pay reasonable compensation to their employees and others in exchange for their services. Attorneys general may bring actions for breach of fiduciary duty or other causes if excess compensation can be shown. However, determining when executive compensation is unreasonable or a disguised unlawful distribution may be difficult because there are no bright lines in this area of the law. The Model Act also includes provisions allowing attorneys general to bring, or intervene in, certain types of litigation involving religious corporations.

Actions involving religious corporations may raise constitutional issues, but courts have upheld the role of Attorneys' General in protecting the assets of such entities, so long as the dispute is one that involves the application of neutral principles of law and does not require the resolution of matters of religious doctrine.[8] This concept is called ecclesiastical abstention. Although many religious corporations are exempt from state registration and reporting requirements, the assets and operations of such organizations may still be subject to attorney general oversight and jurisdiction through states' nonprofit corporation acts or other applicable laws.

Emerging issues

Hybrid entities

With the rise of corporate conscience and social enterprise in recent years, the bright line between for-profit business entities and nonprofits has begun to fade and a wide array of "hybrid" business models have begun to emerge. These hybrid entities strive to combine the best aspects of for-profit and nonprofit organizations. These corporate forms have given rise to fears in the nonprofit sector that they could divert funds from existing projects. Moreover, the IRS has not recognized hybrids as exempt from taxation, thus limiting their usefulness.

One such hybrid organization is known as a Social Purpose Corporations (SPC). SPCs are for-profit entities that are permitted to sacrifice profit-maximizing

8 In *Employment Division v. Smith*, the Supreme Court held that "the right of free exercise does not relieve an individual of the obligation to comply with a 'valid and neutral law of general applicability on the ground that the law proscribes (or prescribes) conduct that his religion prescribes (or proscribes).'" 494 U.S. 872, 879 (1990).

goals in favor of social and environmental issues. SPCs, which are still fairly new, are recognized in Florida,[9] Washington,[10] and California.[11] A more widely recognized type of hybrid organization is the Benefit Corporation or Public Benefit Corporation. A Benefit Corporation is a for-profit structure that must serve a general public benefit and the performance of the Benefit Corporation is evaluated based on the company's social, environmental, and financial performance. In addition, there may be annual public reporting requirements. As of 2016, 31 states had passed Benefit Corporation legislation.[12]

A new form of limited liability company has also emerged to address the business needs of this sector: The L3C, low-profit limited liability company, shares characteristics of a for-profit and a nonprofit business entity. An L3C can only be formed in furtherance of some charitable or educational purpose, but it may have equity owners who have the right to distributions of profits and appreciation of their ownership value. A total of nine states have adopted the L3C form since 2008.[13]

Model Protection of Charitable Assets Act (MPOCAA)

In 2011, the National Conference of Commissioners on Uniform State Laws adopted the Model Protection of Charitable Assets Act ("MPOCAA"). The goal of the model law was to codify state attorney general authority over charitable entities and assets. If adopted by a state, it gives the attorney general oversight authority over charitable assets regardless of the form in which they are held. MPOCAA also requires charitable organizations to register with the attorney general and provides investigatory powers to Attorneys General. The key statement of the new MPOCAA model law is Section 3, which states:

> The Attorney General shall represent the public interest in the protection of charitable assets and may: (1) enforce the application of a charitable asset in accordance with: (A) the law and terms governing the use, management, investment, distribution, and expenditure of the charitable asset; and (B) the charitable purpose of the person

9 Fla. Stat. Ann. §§ 607.501-607.513.

10 Wash. Rev. Code § 23B.25.005 *et seq*.

11 Cal. Corp. Code § 2500 *et seq*.

12 For a complete review of states with Benefit Corporation statutes, see http://www.benefitcorp.net/policymakers/state-by-state-status.

13 North Carolina was among these nine states, but has since repealed their L3C law effective January 1, 2014.

> holding the asset; (2) act to prevent or remedy: (A) the misapplication, diversion, or waste of a charitable asset; or (B) a breach of fiduciary or other legal duty in the administration of a charitable asset; and (3) commence or intervene in an action to: (A) prevent, remedy, or obtain damages for the misapplication, diversion, or waste of a charitable asset or for a breach of fiduciary or other legal duty in the governance, management, or administration of a charitable asset. . . .

Maryland was the first state to adopt the MPOCAA in 2014.[14] Hawaii enacted only Section 3 of the MPOCAA, which relates to the attorney general's authority to protect charitable assets.[15] Hawaii's adoption of MPOCAA was limited in scope because Hawaii's existing statutes already encompassed most of the act's provisions. Likewise, MPOCAA act is substantially similar to laws already in effect in many states including California, New York, Illinois, Michigan, and Ohio.

Charitable Trusts, Wills, and Endowments

Charitable trust law is the oldest area of law by which attorneys general regulate and protect the nonprofit sector. The attorney general's supervisory authority over charitable trusts and charitable corporations has its historical roots in the English common law. Today, the attorney general not only protects charitable trusts, but charitable assets wherever they are held in trust, including charitable interests in wills and in endowment funds. Charitable trusts are enforceable under common law despite the absence of a state statute.[16] In most states, as in England, the common law authority to enforce the proper administration of charitable trusts falls upon the Attorneys General. This authority has been described as follows:

> [It] implies the duty to oversee the activities of the fiduciary who is charged with the management of the funds, as well as the right to bring to the attention of the court any abuses which may need

14 Md. Code Ann. Bus. Reg. § 6.5-101 *et seq.*

15 Haw. Rev. Stat. § 28-5.2.

16 *Vidal v. Girard's Executors*, 43 U.S. (2 How.) 127 (1844).

> correction. Thus, a duty to enforce implies a duty to supervise (or oversee) in its broader sense. It does not, however, include a right to regulate, or a right to direct either the day-to-day affairs of the charity or the action of the court.[17]

Beginning with the codification of the common law in New Hampshire in 1943, states started to enact charitable trust registration and reporting statutes to facilitate oversight. These statutes authorize investigations into charitable trust activities and possible breaches of fiduciary duty. In addition, thirty-one states and the District of Columbia have enacted a version of the Uniform Trust Code ("UTC"), which codifies the attorney general's common law rights and responsibilities with respect to charitable trusts. Some states also require charitable trusts to register or file periodic financial reports with their attorney general. Lastly, attorneys general are necessary parties in actions seeking to modify or terminate charitable trusts.

Under common law and statutory authority, attorneys general also have a responsibility to enforce charitable trusts and protect them from breaches of fiduciary duties. In general, a charitable trust is created when there is manifestation of an intention to devote property to a charitable purpose.[18] The trustee or organization holding property dedicated to a charitable purpose bears fiduciary responsibility to manage the property solely for the purpose to which it is dedicated.[19] In a private trust, the property is devoted to specified persons as designated beneficiaries; in a charitable trust, the property is devoted to purposes that are beneficial to the community.[20] Attorneys general represent the community and the public interest in ensuring that gifts directed to charitable purposes are properly managed and used in accordance with the donor's intent.

The attorney general's standing to enforce a charitable trust is nearly universal under common law and has been codified in the majority of states. Although the attorney general's standing to enforce charitable trusts was historically exclusive, some courts have recognized that trustees of a charitable trust and those with a sufficiently significant interest in a charitable trust also have standing. This liberalization of standing is reflected in the most recent Restatement of

17 Marion Fremont-Smith, Foundations and Government 198 (Russell Sage Foundation 1965).

18 Restatement (3d) of Trusts § 2, 28.

19 Restatement (3d) of Trusts § 78(1); Uniform Trust Code § 802.

20 Restatement (3d) of Trusts § 28.

Trusts and Uniform Trust Code.[21] However, if an action to enforce a charitable trust is brought by another party, the attorney general must be made a party to the proceeding.[22] Furthermore, some states have enacted statutes or judicial rules requiring notice to the attorney general of probate proceedings involving charitable assets, such as administration of estates with bequests for charitable purposes and accountings for charitable trusts.

Attorneys general typically bear responsibility for bringing lawsuits against responsible fiduciaries and third parties, to halt and seek restitution for conduct that has harmed charitable trusts. Such cases include actions for self-dealing, fraud, embezzlement, waste, neglect resulting in unnecessary loss, governance failures, abuse of discretion in distributions, diversion, imprudent investment, excessive fiduciary fees or compensation, or any other conduct that harms a charitable trust or asset.[23] The attorney general also has authority to initiate various actions to prevent harm to charitable trusts, such as an action to request appointment of a trustee if a trust instrument does not provide for one, or when a trustee becomes incapable of carrying out the required fiduciary duties. The attorney general may also initiate an action to construe the meaning of a trust document that expresses a charitable intent, or an action to modify a charitable trust.

Thirteen states require charitable trust registration, which compels varying disclosures that enable some affirmative oversight of charitable trust assets, including actions to enforce registration and disclosure requirements. In all other states, the attorney general's oversight is necessarily reactive rather than proactive as the question of inappropriate management or use of charitable trust assets originates elsewhere before coming to attorney general's attention. This mandatory reporting facilitates the attorney general's ability to ensure that assets held in trust will continue to serve their designated charitable purpose and will not be compromised. This requirement follows from the established common law principle that equity will afford protection to charitable donors through the attorney general's ability to compel property to be devoted to the charitable purpose for which it was given.[24] A state's nonprofit corporation laws, charitable trust statutes, and equitable principles applicable to charitable trusts under common law may all apply in evaluating whether the proposed transaction will have negative or illegal effects on assets held for designated charitable purposes.

21 Restatement (3d) of Trusts § 94(2).

22 Restatement (3d) of Trusts § 94, comment e; Uniform Trust Code § 405.

23 Uniform Trust Code § 1001.

24 Restatement (3d) of Trusts § 28, comment c.

The attorney general is an indispensable party to any proceeding to modify or terminate a charitable trust. Modification or termination of a charitable trust may be appropriate or necessary for a variety of reasons. A court can apply the doctrine of *cy pres* to modify the purpose of a charitable trust if the purpose has become unlawful, contrary to public policy, impossible to achieve or wasteful.[25] In so doing, the court will seek to redirect the trust assets to a purpose as close to the original purpose as possible. Application of the doctrine is not strictly limited to trusts. Courts will use the doctrine to redirect gifts to charitable corporations if the intended recipient program or entity ceases to exist or is not able to perform the terms of the gift.

A charitable trust's administrative terms may also be modified if there is a change in circumstances unanticipated by the settlor.[26]Any modification must be, to the extent practicable, in accordance with the settlor's probable intent, with fidelity to the goal that the settlor sought to accomplish.[27] This type of modification does not change the purpose of the trust. Rather, its goal is to further the purpose consistent with the common law doctrine of "equitable deviation."[28] The Uniform Trust Code (UTC) also permits modification of administrative terms when the existing terms are impracticable, wasteful, or impair the trust's administration.[29] Additionally, the UTC permits reformation of trust terms if clear and convincing evidence proves that a mistake of fact or law occurred.[30] A charitable trust can also be modified for tax compliance and tax benefits through a judicial proceeding.[31]

The UTC allows a trustee to terminate a small or "uneconomic" trust and distribute the trust property, upon notice to the attorney general and other qualified beneficiaries.[32] The focus of the action is always to prevent the waste of charitable assets. A charitable trust becomes uneconomical when the fees for administration are in excess of the annual return or when the fees materially impair the amount of benefit available for the charitable purpose. In addition, the court may modify or terminate a trust or appoint a different trustee if the value of the trust property is insufficient to justify the costs of its administration.[33]

25 Restatement (3d) of Trusts § 67; Uniform Trust Code § 410.
26 Uniform Trust Code § 412.
27 Uniform Trust Code § 412(a).
28 Uniform Trust Code § 412(a).
29 Uniform Trust Code § 412(b).
30 Uniform Trust Code § 415.
31 Uniform Trust Code § 416.
32 Uniform Trust Code § 414(a).
33 Uniform Trust Code § 414(b).

In some jurisdictions, the attorney general has the common law or statutory power to supervise gifts of real property, including conservation easements. The principles are basically the same: prevent diversion to non-charitable use, waste, misapplication, or failure of the gift. However, some jurisdictions have assigned similar or sole responsibility for this supervision to state agencies other than the attorney general. Therefore, consideration of the attorney general's role for a request to modify or terminate a conservation easement is jurisdiction-specific.

While the attorney general's standing to supervise and enforce charitable trusts is well-established through common, statutory and case law, the attorney general's standing to participate or intervene in will contests where a charitable interest is involved or to review charitable estate administration is less established. The attorney general's involvement is needed because questions can arise when another beneficiary claims an asset belonging to a charitable bequest, or when the bequest is unclear. As the sole representative of the public interest in charitable bequests and charitable trusts, attorneys general can play an important role in the administration of charitable estates, will contests and will construction suits to protect those charitable assets and ensure that the charitable intent of a decedent is carried out.

The courts in a number of states have held that the attorney general is an indispensable party in every court proceeding which affects a charitable interest, including a will contest.[34] For example, in *In re Estate of Stern*, the court stated that the attorney general's role in a will contest is to protect charitable assets and by initiating a will contest, "the attorney general was properly attempting to secure that the funds which were initially bequeathed to the charities were applied to their intended charitable use."[35] In some states, the courts have found that the attorney general is only a proper party and not necessarily an indispensable party to a will contest where a charitable trust or gift is involved.[36] In other states, the courts have limited the attorney general's intervention to suits challenging the validity of charitable trust or gift provisions of a will and not suits challenging the validity of the will itself.[37] Finally, in some states, the right of

34 *See, e.g., In re Seabrook*, 218 A.2d 648 (N.J.Sup.Ct. 1966) (attorney general is the protection of the common interest in charitable trust and, as such, he is an indispensable party where such interest is substantially involved in the litigation); *Ventura v. Canale*, 217 Cal.Rptr. 490 (Cal.App. 1963); *In re Voegtly's Estate*, 151 A.2d 593 (1959); *In re Will of Klaiber*, 437 N.Y.S.2d 617 (N.Y.Surr. Ct. 1981).

35 608 N.E.2d 534 (Ill.App.Ct. 1993).

36 *See, e.g., Sigmund Sternberger Foundation, Inc. v. Tannenbaum*, 161 S.E.2d 116 (N.C. 1968); *Murphey v. Dalton*, 314 S.W.2d 726 (Mo. 1958).

37 *See, e.g., Watson v. Wall*, 93 S.E.2d 918 (1956); *Leo v. Armington*, 59 A.2d 371 (1948).

the attorney general to participate or intervene in a will contest is established by statute and is either mandatory[38] or at the discretion of the trial court.[39] In a few states, the courts have held that the attorney general is not a necessary party or does not have the right to intervene in a will contest merely because the will purportedly creates a charitable trust.[40]

In some states, the attorney general receives notice of the administration of charitable decedents' estates, as a matter of course, like any other specifically named beneficiary. The theory behind this notification is the same as with trusts, *i.e.,* the ultimate beneficiary of all charitable estates is the public at large.[41] The attorney general's review of a charitable estate's administration is like that of any beneficiary, and the attorney general has standing to complain about breaches of fiduciary duties.

The attorney general also has responsibilities under the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which governs how charitable organizations use, manage, invest, and make distributions from their endowment funds. UPMIFA was adopted by the Uniform Law Commission (ULC) in July, 2006 and has now been enacted in 49 states, with Pennsylvania being the exception. UPMIFA provides "guidance and authority to charitable organizations concerning the management and investment of funds held by those organizations."[42] Any violations of UPMIFA can be pursued by the attorney general.

UPMIFA applies to institutional funds, defined as "a person, other than an individual, organized and operated exclusively for charitable purposes; a government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; or a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated." It does not apply to individual trustees. Nor does UPMIFA apply to unrestricted or board-restricted funds. It applies only to an endowment fund defined as an

38 *See, e.g.*, Ohio Rev. Code Ann. § 109.25 and § 2707.73.

39 *See, e.g.*, Tenn. Code Ann. § 35-13-110.

40 *See, e.g., Estate of Roberts v. First National Bank of Coffeyville*, 373 P.2d 165 (Kan. 1962); *Commonwealth ex rel. Ferguson v. Gardner*, 327 S.W.2d 947 (Ky. 1959).

41 *See, e.g., Estate of Pruner*, 390 Pa. 529, 136 A.2d 107 (1957) ("[t]he beneficiary of charitable trusts is the general public to whom the social and economic advantages of the trust accrue. But because the public is the object of the settlor's benefactions, private parties have insufficient financial interest in charitable trusts to oversee their enforcement. Consequently, the Commonwealth itself must perform this function if charitable trusts are to be properly supervised.").

42 National Council of Commissioners on Uniform State Laws, Prefatory Note to the Uniform Prudent Management of Institutional Funds Act 2006.

"institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis."[43]

UPMIFA's most important requirement is prudence. If an institution breaches its duty to be prudent in investing or spending its permanently restricted funds, the attorney general can pursue the institution for that failure. Section 4 of UPMIFA sets forth factors for determining whether the prudence standard has been met. Those factors are

1. The duration and preservation of the endowment fund;
2. The purposes of the institution and the endowment fund;
3. General economic conditions;
4. The possible effect of inflation or deflation;
5. The expected total return from income and the appreciation of investments;
6. Other resources of the institution; and
7. The investment policy of the institution.

Unless a statute requires another standard, the institution may appropriate for expenditure so much of the fund as it deems "prudent," taking into consideration the factors described above. In certain cases, attorneys general may wish to consider asking the institution for documentation confirming its adherence to the factors in making decisions regarding accumulation or appropriation.

UPMIFA also codifies the process for the release or modification of restrictions on management, investment, or purpose of an institutional fund. A donor "may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund." If the donor is deceased, the attorney general may do so. But no release or modification may allow a fund to be used for a purpose other than a charitable purpose of the institution.[44]

43 *Id.* at 7.
44 *Id.* at 31.

Fighting Fraudulent and Deceptive Charitable Solicitations

In 2015, Americans donated over $370 billion to charity.[45] This value includes donations that charities directly solicited as well as donations that professional fundraisers solicited on behalf of charities. Soliciting funds is a core function of some charities and professional fundraisers and, particularly given the amount of money at stake, presents an opportunity for perpetrating fraud on the donating public. Attorneys general aggressively work to eliminate fraud and deception in charitable solicitations. Attorney general action is imperative to protect consumers, uphold the reputation of the charitable sector, and encourage the continued generosity of the public, on which many charities rely to fulfill their important missions. Fundraising has moved beyond mailings, phone calls and in-person solicitations to include websites, social media platforms, text messages, emails and retail co-promotions. States have given their attorneys general broad statutory powers to pursue fraud, which is tempered by robust First Amendment jurisprudence. In recent years, attorneys general have had to deal with many new, emerging issues and have begun to use multistate actions and federal law to pursue fraud.

Most states enable attorney general oversight and action by providing broad regulatory and enforcement authority over charitable solicitation.[46] This authority ranges from civil enforcement powers to criminal actions and provides attorneys general the power to fight persistent abuses by individuals and organizations that solicit charitable donations. With this power, attorneys general can prosecute a broad range of abuses—including making false or misleading statements in the course of a charitable solicitation—and pursue a wide variety of remedies.

The statutory authority for fighting charitable solicitation fraud often finds its natural home in a state's charitable solicitation act. These laws typically provide attorneys general with investigative powers and the authority to bring a civil suit. For example, the Massachusetts attorney general can conduct pre-suit discovery to obtain documents and sworn testimony to determine if an individual or organization has engaged in deceptive acts related to charitable solicitation.[47] And if the attorney general believes that an entity has engaged in such fraudulent practices, the Massachusetts charitable solicitation law enables her to sue it for

45 Giving USA, 'Giving USA 2016' Infographic.

46 *See* Robert T. Esposito, *Charitable Solicitation Acts: Maslow's Hammer for Regulating Social Enterprise*, 11 N.Y.U. J.L. & Bus. 463, 471 & n.37 (2015).

47 Mass. Gen. Laws Ann. ch. 68, § 30.

injunctive relief and civil penalties.[48] Similar powers can be found in the charitable solicitation laws of other states.[49]

Some state charitable solicitation laws also grant their attorneys general the power to impose sanctions administratively. In California, the attorney general may assess against any person or entity a penalty up to $1,000 for each act that qualifies as a deceptive practice during the course of charitable solicitation.[50] Similarly, the Hawaii attorney general may impose penalties for deceptive practices and may order the charity to cease fundraising activities.[51]

Attorneys general may be able to pursue civil remedies in consumer protection laws that prohibit unfair and deceptive acts and practices.[52] These statutes can complement[53] state charitable solicitation laws, and may otherwise impose harsher penalties.[54] Although some of these consumer protection laws expressly identify charitable solicitation fraud,[55] others do not but are still available to combat fundraising fraud.[56] Still other states offer a hybrid approach, wherein the charitable solicitation laws invoke the powers and remedies of consumer protection laws by

48 Mass. Gen. Laws Ann. ch. 68, § 32(e); *Attorney Gen. v. Bach*, 81 Mass. App. Ct. 1126 (2012) (unpublished).

49 *See, e.g.*, Conn. Gen. Stat. Ann. §§ 21a-190a to -194; Haw. Rev. Stat. Ann. § 467B-1 to -17; 225 Ill. Comp. Stat. Ann. 460/0.01 to /23; Vt. Stat. Ann. tit. 9, §§ 2453, 2471-2479.

50 Cal. Gov't Code §§ 12591.1(c), 12599.6(f)(2); Cal. Code Regs. tit. 11, § 315.

51 Haw. Rev. Stat. Ann. § 467B-9.7(b).

52 For instance, Missouri's consumer protection statute states that "The act, use or employment by any person of any deception, fraud, false pretense, false promise, misrepresentation, unfair practice or the concealment, suppression, or omission of any material fact in connection with . . . the solicitation of any funds for any charitable purpose . . . is declared to be an unlawful practice." Mo. Rev. Stat. § 407.020.

53 Or, in some cases, fill the void left by the absence of any charitable solicitation laws. See, for example, Nebraska, which does not have a charitable solicitation statutory scheme but enables attorney general action against fraudulent charitable solicitation through its Uniform Deceptive Trade Practices Act. Neb. Rev. Stat. Ann. §§ 87-302(a)(21), -303.02.

54 *See, e.g.*, Mass. Gen. Laws Ann. ch. 93A, § 11 (treble damages).

55 *See, e.g.*, Alaska Stat. Ann. § 45.50.471(b)(36); Iowa Code Ann. § 714.16(2)(a), (7); Neb. Rev. Stat. Ann. § 87-302(a)(21).

56 *See, e.g.*, Complaint, *Attorney Gen. v. Bach*, 2006 WL 6233843 (Mass. Super. June 30, 2006) (No. 2006-0383); *People v. Coal. Against Breast Cancer, Inc.*, 134 A.D.3d 1081 (N.Y. App. Div. 2015).

reference.[57] Individuals may be held criminally liable for their bad actions pursuant to statutes ranging from the narrowly tailored[58] to the generic.[59]

When pursing fraudulent charitable solicitations, attorneys general and their staff must bear in mind that charitable solicitations enjoy significant First Amendment protection. There have been four cases before the U.S. Supreme Court on this point. In general, attorneys general must seek to fight fraud in charitable solicitations through enforcement actions on a case-by-case basis and donor education, rather than by setting parameters for solicitation via legislation.

During the 1980s, three cases reached the United States Supreme Court. In that trilogy, *Village of Schaumburg v. Citizens for a Better Environment,*[60] *Secretary of State of Maryland v. Joseph H. Munson Co.,*[61] *and Riley v. Nat'l Fed. Of the Blind,*[62] the Supreme Court held that state statutes imposed unconstitutional restrictions on the soliciting organizations' freedom of speech and, accordingly, invalidated those restrictions. The law at issue in *Schaumberg* was a local ordinance that required that 75% of funds collected by a charity be used for its charitable purposes as opposed to administrative and fundraising costs. At issue in *Munson* was a Maryland statute that prohibited contracts between a charity and a professional fundraiser if the contract permitted the fundraiser to retain more than 25% of funds contributed. The North Carolina statute in *Riley* created a three-tiered standard for the reasonableness of fundraising fees, with up to 20 percent presumed to be reasonable; 20 percent to 35 percent presumed unreasonable, unless the solicitation included the dissemination of information and advocacy related to the charity's purpose; and more than 35 percent presumed to be unreasonable. The North Carolina law also required solicitors to disclose to potential contributors the percentage of funds contributed that were actually received by the charity and the percentage of funds paid for fundraising and administrative costs in the prior 12 months.

57 *See, e.g.*, Ark. Code Ann. § 4-28-416(a); Vt. Stat. Ann. tit. 9, § 2479; *cf.* Fla. Stat. Ann. § 496.416, 420 (oversight by Department of Agriculture and Consumer Services).

58 In Ohio, solicitation fraud is a felony. Ohio Rev. Code Ann. § 1716.14(A)(1); *State v. Hargrove*, 2015-Ohio-3125, ¶¶ 2-3. In Illinois, it is a misdemeanor for a person to use the name of another person to solicit charitable contributions, without that person's consent. 225 Ill. Comp. Stat. Ann. 460/11. *See also, e.g.*, Ala. Code §§ 13A-9-73 to -75; Conn. Gen. Stat. Ann. § 53-378a; Fla. Stat. Ann. § 496.417.

59 *See, e.g.*, *State v. Hargrove*, 2015-Ohio-3125, ¶ 2 (theft).

60 444 U.S.620 (1980).

61 467 U.S. 947 (1984).

62 487 U.S. 781(1988).

In *Schaumburg* and *Munson*, the Court held that the states could not limit fundraising costs via legislation as a method of preventing fraud and again recognized that charitable solicitation is protected speech. In *Riley*, the Court stated that "using percentages to decide the legality of the fund-raiser's fee is not narrowly tailored to the State's interest in preventing fraud."[63] The *Riley* Court held that the three-tiered definition of reasonableness did not protect charitable solicitation from infringement of free speech rights. The Court rejected the idea that permitting a charity to prove its solicitation was reasonable avoided an unconstitutional burden. The Court also found that: (1) "small or unpopular charities . . . must often pay more than 35 percent of the gross receipts collected to the fundraiser due to the difficulty in attracting donors;"[64] (2) "there is no nexus between the percentage of funds realized by the fundraiser and the likelihood that the solicitation is fraudulent;"[65] and (3) "mandating speech that a speaker would not otherwise make necessarily alters the content of the speech."[66]

Aside from basic and neutral identifying information (solicitor's name and professional status), the Court held that solicitors acting on behalf of charitable organizations may not be compelled to advise the public of financial information concerning prior solicitations at the point of solicitation. The Court found that such a requirement "will almost certainly hamper the legitimate efforts of professional fundraisers . . . [since] this provision necessarily discriminates against small or unpopular charities which must usually rely on professional fundraisers."[67]

Riley also stated that "the State may vigorously enforce its antifraud laws to prohibit professional fundraisers from obtaining money on false pretenses or by making false statements."[68] Attorneys general have since accepted the Court's suggestion by taking action against charities and their fundraisers to curtail fraudulent and misleading solicitation, both individually and together in multistate actions, against charities and fundraisers that prey on their citizens.

In 2003, the U.S. Supreme Court confirmed that the First Amendment cannot be used as a shield against prosecution for fraud. In its unanimous decision in *Madigan v. Telemarketing Associates, Inc.,*[69] the Court held that "consistent

63 487 U.S. 781 at 789.

64 487 U.S. 781 at 793.

65 *Id.*

66 487 U.S. 781 at 795.

67 487 U.S. 781 at 799.

68 *Id.*

69 538 U.S. 600 (2003).

with our precedent and the First Amendment, States may maintain fraud actions when fundraisers make false or misleading statements designed to deceive donors about how their donations will be used."[70] *Madigan* succinctly stated that "what the First Amendment and our case law emphatically do not require is a blanket exception from fraud liability for a fundraiser who misleads."[71] Moreover, while states cannot prohibit high fundraising fees by statute, such fees can be a factor in a fraud prosecution.[72] The complaint in the *Madigan* case alleged that telemarketers attracted donations by misleading potential donors into believing that a substantial portion of their contributions would fund specific programs or services, when the amount the charity received was not sufficient to fund those programs. The Court held that such representations concerning the percentage of funds used for charitable purposes were not protected by the First Amendment.

Multistate actions are favored by attorneys general in pursuing fraudulent charitable solicitations for a number of reasons. Multistate actions allow states to pool their resources and expertise, and give states whose charities enforcement is under-resourced the opportunity to join the action and remove scammers from their state. Most sham charities use telemarketing and direct mail to collect money, thus they operate in many, if not all, states at once. Nearly every state forbids deception in charitable solicitations. The federal Telemarketing Sales Rules, discussed below, allow the states to bring one multi-plaintiff case in one federal forum. Nationwide multistate announcements concerning sham charities can generate massive amounts of press, essentially free public education. Finally, if just one state brings a case, the fraudulent charity or fundraiser is only banned in one state and can still operate in others. That results in an odd situation where the entity is free to continue operations even though it has engaged in deceptive conduct.

The Cancer Fund multistate is an excellent example of all of these reasons to bring a multistate case. In that matter, all 50 states participated and more than 20 made significant contributions of attorney and investigator time. The group pursued four corporations and four individuals who misappropriated $187 million over five years. The matter was resolved after all 50 states and the Federal Trade Commission filed a single action in the U.S. district court in Arizona. The wide range of states participating meant the group was able to call upon a deep pool of expertise for many issues. The Cancer Fund entities were chosen as the target, in part, because although at least eight states had sued them before and

70 538 U.S. at 624.
71 538 U.S. at 621.
72 538 U.S. at 624.

obtained judgments or settlements, the Cancer Fund entities actually took in even more donations through deceptive means, indicating that the states needed to act as a group to stop them. Cancer Fund was also particularly well suited to a multistate solution because its fundraisers used the same basic deceptive claims in every state. Each state could join the federal court action under the Telemarketing Sales Rule and the states' talent and resources were focused in one case.

In addition to enforcement tools provided by state and common law, federal law, 15 U.S.C. § 6103, authorizes state attorneys general to file actions in federal court against for-profit companies, including fundraisers and sham charities, for violations of the federal Telemarketing Sales Rule ("TSR"), 16 C.F.R. Part 310. The TSR prohibits telemarketers from making false or misleading statements to induce charitable contributions[73] and specifically bars misrepresentations about "the nature, purpose, or mission of any entity on behalf of which a charitable contribution is being requested; the tax deductibility of any donation; the purpose for which a charitable contribution will be used; the percentage of a contribution that will go to charity or a particular charitable program; any material aspect of a prize promotion; and any charity or telemarketers affiliation with or sponsorship by any person or government entity.[74] The TSR also requires that telemarketers seeking charitable contributions disclose the identity of the charitable organization on behalf of which the request is being made; and that the purpose of the call is to solicit a charitable contribution.[75]

Although the TSR does not prohibit charitable solicitation calls to numbers registered with the Do Not Call Registry, several calling restrictions do apply. These include prohibitions against threats, intimidation, or use of profane or obscene language; repeated harassing calls; interfering with the right to be placed on an entity-specific no-call list; pre-recorded messages (robocalls); and calls before 8 am or after 9 pm. Other provisions of the TSR that apply include those that prohibit any person from assisting and facilitating a violation of the rule, certain provisions about use and disclosure of credit cards, and some recordkeeping provisions.

73 16 C.F.R. Part 310.3(a)(4).
74 16 C.F.R. § 310.3(d).
75 16 C.F.R. Part 310.4(e).

Emerging Issues

Post-Disaster Fundraising

In the wake of a natural or civil disaster, attorney generals' offices have a number of important responsibilities. In the charities arena, attorney general offices may be called upon to: (1) combat fraudulent fundraising; (2) monitor and report on the use of the donated funds to ensure they go to their intended recipients; (3) assist in/expedite the registration of new charities that form to respond to the disaster; (4) educate the public about how to give wisely and avoid scams; (5) educate charities about their regulatory and fiduciary duties in managing large influxes of donations. Each one of these roles requires significant planning and coordination. Attorney general offices around the country share information and expertise to help them prepare for these unfortunate events.

Some states have promulgated special rules regarding registration for groups that form after a disaster. For example, states have provided expedited registration (e.g. New York after Hurricane Sandy in 2012). Others have agreed to waive late fees for registration. When providing registration assistance, offices must balance the desire to support new charities with an appropriate degree of scrutiny. In the disaster relief context, one of the most important questions will be whether the organization qualifies as a charity under state and IRS regulations. The IRS requires that the intended beneficiaries constitute a sufficiently broad "charitable class." A charitable class "must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance."[76] The IRS has made exceptions or reinterpreted the charitable class requirement on an ad hoc basis.[77]

Attorney general offices can also play a key role in educating the public about wise giving in connection with natural disasters. Numerous states have tip sheets to promote wise giving and help consumers avoid scams.[78] Attorney general offices also educate charities about their duties in managing their operations after a disaster strikes. In some cases, a pre-existing charity may broaden its mission to include disaster relief. For instance, a local organization dedicated to helping job seekers or new immigrants may want to leverage its knowledge of

76 IRS Publication 3833, *Disaster Relief: Providing Assistance Through Charitable Organizations*, at 9.

77 *See* Ellen P. Aprill, *Charitable Class, Disaster Relief, and First Responders*, 153 Tax Notes 949 (Nov. 14, 2016).

78 *See, e.g.,* Press Release, Office of the Attorney General of Connecticut, "State Cautions Residents on Charitable Giving: Beware of Potential Scams" (Dec. 19, 2012).

the community to provide disaster relief assistance. Organizations should have systems in place to prevent fraud, embezzlement, and duplication in connection with a large influx of donations.

One of the most important roles the attorney general's office can play is in combatting fundraising fraud in the wake of disaster. Education, as described above, is a key part of that effort, but scammers will persist nonetheless. Investigators will want to monitor social media. States may want to consider having a dedicated hotline for consumers to report suspicious solicitations, and a dedicated staff person to follow up on complaints in real time. Attorney general offices may also want to coordinate in advance with other law enforcement agencies.

In recent years, some states have undertaken efforts to monitor and report on fundraising and spending after major disasters. For example, New York and Connecticut conducted surveys and issued reports about organizations soliciting from the public after 2012's Hurricane Sandy and the tragic shooting at Sandy Hook Elementary School, respectively. These efforts help regulators and the public understand the landscape of the organizations involved in disaster relief efforts. Such reports can shed light on the amounts raised, how the funds are used, whether the money is being spent consistently with the solicitations, and the amounts being distributed. When monitoring and reporting on the speed of distribution, it is important to appreciate that some charities may not have the capacity to distribute a sudden influx of donations. Also, some charities may not be distributing all funds raised because they intend to reserve funds for longer-term effects of a disaster. Offices may find it helpful to let charities know that the attorney general is interested in ensuring that the collected money is distributed and intended beneficiaries are helped as expeditiously as possible.

Finally, it is important to keep in mind that, after a disaster, normal modes of communication between the attorney general and the public may be compromised. The office should be prepared to issue any guidance and instructions to the public and the sector in advance, and at the time of the disaster, through alternative means. These may include pre-printed materials that are distributed at shelters or other relief centers, radio public service announcements, and other means of communication developed for emergencies. It is critical that the attorney general proactively connect and coordinate with community stakeholders in responding to a disaster.

Online Fundraising for Individuals

Another emerging area of interest to attorneys general is online fundraising by individuals using social media. The requests for help can range from payment of vacation travel expense to medical bills. The target audience may be friends and family, but the appeal may reach the requester's entire social network. In recent years, web-based crowdfunding platforms like GoFundMe have enabled people to broadcast their appeal more widely and more successfully. GoFundMe claims that it has helped individuals raise more than $3 billion from more than 25 million donors since its formation in 2010. Since individuals are not considered to be charities under federal tax and state statutory definitions, these appeals have received little attention.

Crowdfunding for individuals has skyrocketed following terrorism or weather related disasters, such as the Pulse Nightclub and Sandy Hook shootings, Louisiana floods and California fires. Traditional charities that provide disaster relief, such as the Red Cross, may see donations diverted toward individual fundraising appeals. As a result, the most sympathetically presented appeals may receive the greatest assistance without any filtering by professionals. Apart from dislocating traditional charitable organizations, there are opportunities for abuse with individual fundraising appeals. People can make fraudulent claims of illness or injury, or an individual raising funds on behalf of a victim may not use the money as intended, or the money raised may exceed the amount needed.

The Uniform Law Commission has appointed a study committee to examine potential legislation to impose a trust-type relationship for individual fundraising. One issue is whether oversight of individual fundraising is within the jurisdiction of charity regulators, consumer protection regulators, both, or neither. A few states treat individual fundraising appeals as charitable solicitations requiring registration. Some states are considering whether the web platforms themselves should be considered paid solicitors or fundraising counsel, which is a key determination for the registration issues discussed below.

Telemarketing

Another issue for attorneys general is telemarketing by charities. Charities often employ professional fundraisers to solicit donations by telephone. Regulation and enforcement actions against those telemarketers present unique challenges for a number of reasons. Because of the limitations on charity regulation discussed above, telemarketers may retain as much of a donation as the charity is willing to pay. In some instances, the telemarketer may keep up to 99% of the donation they solicit. Telemarketers may also charge charities additional fees related to the solicitation, like fees to donation payment processors. The telemarketer's commission alone, however, cannot be the basis of an enforcement action. Unless it is clearly unconscionable, an unreasonable commission must be connected to a larger deceptive scheme in order to form the basis of an enforcement action.

Unscrupulous telemarketers also go to great lengths to conceal their identities from donors and regulators, and will often misrepresent material elements of the solicitation, like the telemarketer's relationship with the charity or the purpose of the charity. Telemarketers will also base their operations in obscure locations, sometimes abroad, to avoid regulation; and will contract and sub-contract with other entities to disguise the money trail. Finding telemarketers and tracking their revenue streams can be the most difficult part of a charity fraud investigation.

Charitable phone solicitations are usually exempt from "Do Not Call" registries and telemarketers often target vulnerable populations, like the elderly and homebound. Donor lists with known givers from a vulnerable population are sought after. While these lists should remain the property of the charity, they often become the property of the telemarketer and provide an additional source of revenue. Charitable telemarketers repeatedly call these potential donors on behalf of all the charities they represent, and then sell the lists to other charitable and commercial telemarketers who start the cycle again.

Financial Disclosure Misrepresentations

The program, fundraising, and administrative costs of a charitable organization are material facts for prospective donors to consider when making an informed giving decision. These numbers are widely available since the IRS has mandated that annual informational tax returns, the Form 990, be made public for all nonprofits. Several websites post every Form 990 filed with the IRS. Charity rating agencies also rate nonprofits based upon numbers reported on the Form 990 and publish their ratings for prospective donors to consider. Nonprofits also publish their program, fundraising and administrative costs on their own websites, frequently using colorful percentage-based pie charts and other graphic illustrations in order to attract donations.

The information presented in the Form 990, in charitable solicitations, and on charity websites can be manipulated to hide low program costs, high executive compensation, and high fundraising costs. Thus a purported charity can disguise very low percentages of donated dollars actually being spent for charitable programs. This manipulation of program, fundraising, and administrative costs and percentages is meant to increase donor appeal by falsely representing an organization as more efficient or effective than it really is. One popular method of hiding a charity's high fundraising and administrative costs is through the use of gift-in-kind (noncash) ("GIK") donations, particularly donations of pharmaceuticals. The "GIK Scam" involves a charity overvaluing GIK donations it receives, sometimes by many millions of dollars, and/or claiming the full value of the GIK, even though it only acted as a "pass-through," simply passing the GIK from one organization to another, without ever owning or possessing it. The charity may include these high, false GIK values in its Forms 990, in its solicitations, and on its website, which inaccurately minimizes its fundraising and administrative costs.

Another method of donor deception through a charity's misrepresentations in its financial reporting involves an accounting principle called "joint cost allocation," which allows a charity to "shift" some fundraising costs to program costs, but only if certain criteria are met. Some charities deceive prospective donors by using joint cost allocation in their financial reporting, even though they are not entitled to do so.

Charitable Gaming

Many states allow gambling-type activities if they benefit charitable organizations. The most common types of charitable gaming include bingo and raffles. Some charities and fundraisers also use sweepstakes promotions to solicit donations. Charitable gaming is an attractive option for fundraising because it can reach potential donors who would not normally contribute to charity, or contribute as much without the opportunity to receive something in return. Unfortunately, charitable gaming also provides additional opportunities for fraudulent activities. Bingo operations have been prone to abuse, particularly by bingo operators who may have minimal association with the sponsoring charity.[79] For example, a bingo operator's association with a charity may merely be a front to run a gambling operation in a state in which it would otherwise be illegal.[80] In such instances, maximizing the profits of the bingo greatly outweigh the legal purpose of raising money for the charity. Moreover, bingo promoters often charge high fees and operation expenses, which results in very little of the money raised going to the charity.

Charitable sweepstakes have also been the subject of enforcement actions by attorneys general and other regulators. In 2006, a multistate action was brought against the professional fundraiser Newport Creative Communications for deceptive solicitation practices involving sweepstakes promotions.[81] The fundraiser not only used the sweepstakes to entice consumers to donate to various

79 *See* James V. Competti and Conrad Rosenberg, *Detecting Fraud in Charity Gaming*, Exempt Organizations Continuing Professional Education Technical Instruction Program, Internal Revenue Service.

80 *See* Ronald Smothers, *Tennessee Republicans See an Election Weapon in State's Bingo Scandal*, N.Y. Times, January 28, 1990.

81 *See* Associated Press, *Firm to pay $400,000 in settlement,* Boston Globe, January 27, 2006.

charitable causes, but also implied that the consumers would win a prize if they made a donation.

Cause-related Marketing

Branding is an important marketing tool in the for-profit sector. Nonprofit organizations raise money by lending their names and logos to commercial firms for use in advertising or labeling on their products. Regulators have been monitoring these activities in light of their potential use for deceptive purposes. One example is the practice of some health-related nonprofits to lend their names to commercial products related to their purpose but whose qualities they have neither tested nor intend to endorse. There are concerns, also, that claims of donations or support are not as extensive as the impression given by the packaging. The attempt to sell a good or service by referring to the name or purpose of a charitable organization is defined as a charitable solicitation in many states. Other states, including Alabama, Massachusetts and Washington, have laws that specifically govern cause marketing, called "commercial co-venture," which generally define the elements of deception, contracts, accountability, disclosures and remedies.[82] Yet the ever-evolving world of co-venturers consistently creates challenges for defining just who is acting as a solicitor under existing laws.

Registration

The fourth area of law through which attorneys general protect charitable assets and entities is registration. As discussed in other sections of this chapter, attorneys general exercise their authority to oversee charitable assets in a variety of ways. One way is through state laws mandating registration and financial reporting by charities that solicit contributions and by the fundraising professionals soliciting on their behalf. Some states also require registration for all entities that hold charitable assets or conduct business in their state. Not only do registration and financial reporting requirements compel increased transparency and accountability by organizations soliciting and administering charitable assets, but they also assist states in enforcing solicitation laws and laws governing the administration of charitable assets.

82 *See, e.g.*, Ala. Code § 13A-9-71; Mass. Gen. L. ch. 68, § 24; Wash. Rev. Code § 19.09.020.

Charitable registration laws serve several important purposes. The registration material and financial reports are public records to which potential donors may refer for information to assist them in making informed giving decisions. Additionally, attorneys general and other law enforcement agencies use the information contained in these filings and their investigatory authority to detect and prosecute illegal conduct or mismanagement. Unlike traditional consumer fraud, fundraising fraud often can be difficult to detect from consumer complaints alone and internal mismanagement can easily be concealed. Registration statutes provide information for investigations into potential fundraising fraud.

Registration and financial filings can reveal violations of law such as excess compensation, failure to use assets for charitable purposes, improper self-dealing, mismanagement of charitable assets, and outright fraud. Because these filings are publicly available, organization insiders can review the filings and report fraudulent and false filings; investigative reporters can use the filings as a source of information when reporting wrongdoing; charitable organizations are protected from unfair or abusive practices by fundraisers; and the public can have confidence in charitable giving.

Financial filings are also an important resource for donors who use them to identify potential recipients of their contributions. As a service to the public, many of the states post annual filings on line. Some states also use the filings in reports to disclose what portion of the public's contributions are used for fundraising expenses and what portion is used for charitable programs remitted to charitable organizations.[83] Other states use the reports to draw the public's attention to both the best and worst of charitable organizations.[84]

Thirty-nine states require registration by charitable organizations that solicit contributions within their boundaries.[85] Many of these states also require the registration of professional solicitors as well as other types of fundraisers,

83 *See, e.g.*, California Attorney General's Reports on Commercial Fundraisers; New York Attorney General's "Pennies for Charity" Reports, Michigan Attorney General's Professional Fundraising Charitable Solicitation Reports, Washington Secretary of State's Commercial Fundraiser Activity Reports (available on websites of the respective offices).

84 *See, e.g.*, Oregon Attorney General's 20 Worst Charities List - 2014"; South Carolina Secretary of State's "Scrooges and Angels" Report (available on websites of the respective offices).

85 Registration is required in Alaska, Alabama, Arkansas, California, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Hawaii, Illinois, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin.

such as professional fundraising counsel and commercial co-venturers.[86] Twenty-two states have bifurcated systems with registration, financial reporting, and other enforcement responsibilities housed in another agency, typically the Secretary of State.[87] A few states require registration for all entities that hold charitable assets or conduct business in their state.

Registration of charities requires the filing of basic information about the charity, including its name, address, officers and directors, charitable purpose and whether it is tax exempt; and the submission of organizational documents. Registration in some states is annual and in others it is a one-time-only requirement. Most states exempt certain categories of charities, typically religious organizations and those with minimal revenue or assets. Registered charities are also required to file annual financial reports, which are usually copies of the organizations' IRS Form 990 or 990-EZ. Many states are currently moving toward electronic filing systems to increase efficiency and public availability of this information. Some states including California, New Mexico, New Hampshire, New York, Texas, and Tennessee have enacted statutes that clarify and expand the application of charitable registration and reporting requirements specifically to public safety organizations such as police, firefighter and other first responder associations.

In most states, the attorney general is responsible for enforcing laws governing registration. In states in which this duty is bifurcated, however, it is important that the attorney general maintain a cooperative relationship with the other agency. In states in which a separate agency handles registration and financial reporting, the attorney general and the registration agency typically work jointly to develop cases that address not only deficiencies in registration and financial reporting, but also issues of solicitation fraud and breach of fiduciary duties. Without such cooperation, resources may not be used efficiently, resulting in increased fraud.

The states are very aware of the issues caused by the diversity of registration laws and understand the frustrations of the nonprofit sector of having to comply with 39 different regulatory schemes. A group of states is creating a single online portal where nonprofits will be able to comply with all state registration

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86 Although the state of Vermont does not require registration of charitable organizations, it requires registration of paid fundraisers and solicitors.

87 Bifurcated systems are found in Colorado, Connecticut, the District of Columbia, Florida, Georgia, Kansas, Maine, Maryland, Mississippi, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, and Wisconsin.

requirements at one time. This project, the Single Portal pilot project, remains a work in progress and will evolve over the next few years.

The portal is intended to maximize efficiency, data transparency, and information sharing by enabling compliance with registration requirements for all participating states without duplication of data entry. It will make the collected data available to the public in a searchable and interactive format, or as bulk data available in an open data format. Multistate registrants will realize reduced administrative costs and inefficiencies in complying with 39 states' different registration requirements, allowing more resources to be devoted to charitable mission. State filing fees will be collected and disbursed to states through the Single Portal. Analytics will enable regulators to better understand charitable resources and solicitations, to better focus law enforcement and fraud prevention resources, and enable better policy making for protection of charitable resources. Electronic filing will allow states to direct their limited resources from processing paper to our core regulatory responsibilities of preventing fraud and abuse of charitable funds.

Nonprofit Healthcare Asset Sales and Conversions

A healthcare "for-profit conversion" is the sale of all or a substantial part of the assets of a charitable entity, typically a hospital, to a for-profit entity. [88] Nonprofit hospitals enter into conversions as a means of accessing capital funding or as a means of establishing strategic connections they perceive as necessary for survival in the health care marketplace. Some nonprofit hospitals justify their conversion by pointing to the substantial resources necessary to implement the requirements of the Patient Protection and Affordable Care Act,[89] as well as general market pressures and expectations.

Under the common law in most jurisdictions, the attorney general is mandated to oversee the due application of charitable funds and to ensure that nonprofit directors and senior management fulfill their fiduciary duties to the nonprofit corporation. The attorney general may act under a specific state for-profit conversion statute or the office's *parens patriae* authority and will often review a proposed for-profit conversion transaction to ensure that it conforms to antitrust law, as well as charitable trust law.

88 For simplicity, this discussion will refer to the conversion of nonprofit hospitals.

89 Public Law 111-148 (2010).

In July 1998, NAAG adopted a model conversion act based upon the experiences of the attorneys general of California, Ohio, Massachusetts and New Hampshire, who had applied the *cy pres* model to hospital conversions in their states. In 2016, at least 25 states had specific statutes or regulations concerning these transactions. Most of these states require some or all of the following of non-profit hospitals being transferred to a for-profit entity or otherwise converted to for-profit status: notice that contains the proposed agreements and financial analyses, review that requires a report by an independent healthcare expert or consultant on the transaction's effect on the community, a public meeting within the community, approval by the attorney general, with or without conditions, and post-transaction monitoring that includes the submission of annual reports, filing of a legal action, or revocation of the hospital's license.

Under the *cy pres* doctrine,[90] any proceeds resulting from the for-profit conversion must be used for purposes as near as possible to the historical purposes of the converting hospital.[91] Sale proceeds could therefore be used for unmet health needs of the same class of beneficiaries in the selling hospital's geographic region, such as screening, health promotion, providing access to care, subsidizing insurance premiums, or free care.[92] Sale proceeds from hospital conversions are often transferred under the *cy pres* doctrine to a new or existing foundation because the selling nonprofit hospital lacks the capacity to carry out its original purposes after sale of all of its assets. Moreover, in most cases, the for-profit buyer will require the selling hospital to agree not to compete with the buyer. In some instances, the net proceeds are transferred to a community foundation to be used for health care services for residents in the selling hospital's service area.[93]

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90 *Cy pres* means "as near as possible" and is the legal principle that requires charitable funds to be used according to the charitable purposes for which they are held, unless it is impossible or impracticable to continue to do so. If it is impossible or impracticable to carry out the original charitable purpose, court approval is usually required to change the way the funds are used, and the changed purposes must be as near to the original purposes as possible.

91 A.W. Scott, Scott on Trusts §§ 381, 399 (W. Fratcher, ed., Little Brown & Co., 4th ed., 1987).

92 The fair market value of the assets transferred may sometimes be equal to the outstanding liabilities of the hospital, and accordingly there may be little in sale proceeds left to allocate for charitable purposes.

93 A community foundation is a tax exempt, non-profit, publicly supported philanthropic organization with the long term goal of building permanent, named funds, for the broad-based public benefit of the residents in a given area.

The NAAG model act and the state conversion statutes it spawned have also expanded on the conversion analysis to add evaluation by the attorney general of whether the proposed transaction is in the public interest. This has resulted in attorney general consideration of the impact the transaction may have on the hospital's traditional patient community (likely to be most directly affected) and on the health care system overall, including accessibility and availability of services (especially for indigent patients or those with care needs that are historically under-reimbursed such as behavioral health services).

Attorneys general reviewing proposed hospital conversions often condition their approval of the transactions on requirements such as maintaining historical charity care and community benefit commitments, participating in government payor programs such as Medicaid and Medicare, maintaining their status as acute-care hospital, and providing certain essential health care services, such as emergency services for a period of time after the acquisition. Attorneys general have also occasionally required the insertion of contract provisions allowing the selling hospital or the community to buy back the hospital under certain circumstances as well as requiring that the selling hospital or community will share in any profit above the original purchase price if the for-profit buyer resells the hospital in a short period of time. Finally, as some statutes expressly require, attorneys general can support transparency and public input into the process by posting transaction documents on the attorney general's website and requiring the seller to post it on its website, and conducting public meetings to obtain input about particular concerns the community may have about the transaction.

The attorney general will also examine whether the selling hospital's board and senior managers have satisfied their fiduciary duties of care and loyalty in connection with a proposed conversion. The attorney general must ensure that the selling hospital board members have satisfied their duty of due care by determining whether: (i) the proposal is in the best interest of the nonprofit hospital[94]; (ii) fair market value will be received for the hospital's assets; and (iii) the proposed transaction terms are fair and reasonable and adequately protect the hospital's interest.

94 See discussion above regarding the question whether the "best interest" determination by the board is sufficient, or whether the board's evaluation must include a preference for nonprofit options.

Similarly, the attorney general must ensure that sale proceeds are controlled and administered independent of any influence from the purchasing for-profit hospital system and that they will not be used to subsidize or otherwise benefit the for-profit buyer's programs, services, or community benefits. Thus, the attorney general will require that the foundation receiving the sale proceeds have a board of trustees and management that does not overlap with the for-profit buyer's board and management and that the foundation is not otherwise subject to the control or influence of the buyer.

The attorney general must also ensure that the selling hospital's board and managers fulfill their duty of loyalty. Fiduciaries of the selling hospital must avoid conflicts of interest resulting from divided loyalties that could place them in a position to control or influence the selling hospital's decision-making process for their own personal benefit. In the for-profit conversion context, this can occur when a for-profit bidder makes promises of future employment, consulting contracts, or other financial benefit to the selling hospital's board members or senior managers in return for their support for the prospective purchaser's conversion bid. Therefore, the attorney general's analysis of the proposed transaction should include careful examination of the hospital board's conflict of interest disclosure and assessment and management process during the board's consideration of conversion and alternatives.

Complex or significant healthcare transactions are likely to present a variety of legal issues that require the attention of attorneys general even if the transaction is not a conversion to a for-profit entity but rather one involving two nonprofit corporations. For example, concerns about potential conflicts between charitable missions may arise in the context of the consolidation of a nonprofit provider and a nonprofit insurer. Mergers or acquisitions that cross state lines may raise concerns about alienation of charitable assets from the state of origin to another state. Religious healthcare providers encounter particular management challenges in considering transactions with non-religious partners and challenges concerning the religious healthcare provider's prohibition of certain health care services. Therefore it is important that attorneys general consider all areas of their traditional jurisdiction when assessing healthcare transactions.