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Compassion Without Competence¹

MANDATING A FINANCIAL OVERSIGHT COMMITTEE IN NEW DISASTER RELIEF NONPROFIT ORGANIZATIONS

INTRODUCTION

In recent years, nonprofit organizations have formed in the wake of major disasters in order to supplement disaster relief efforts. After the tragedies of September 11th and Hurricane Katrina alone, the number of newly created nonprofit organizations designed to serve disaster victims totaled three hundred forty-two² and four hundred, respectively.³ The explosion in the number of nonprofit organizations is matched by the growth of their assets. From 1975 through 1995, the assets of all tax-exempt organizations in the sector tripled.⁴ From 1994 through 2004, the assets of all tax-exempt organizations grew by an astounding ninety percent.⁵ The sector employs a larger portion of the workforce than that of utilities and construction, and its growth outpaces that of the economy in general.⁶

Nonprofit organizations operate with very little regulation. As a result, it is no surprise that the nonprofit sector has produced high-profile scandals that mirror similar problems in the for-profit sector.⁷ Even more

¹ MICHAEL F. MELCHER WITH ALEX MANDL, *THE PHILANTHROPIC RESPONSE TO 9/11* 15 (2003) (quoting September 11th Fund head's criticism of new nonprofit disaster relief providers: "[N]ewly created charities, decided to enter the cash-assistance business even though they lacked the experience and infrastructure . . . It was compassion, but not competence").

² Harvy Lipman, *Carving Out a Role in Disaster's Wake*, CHRON. OF PHILANTHROPY, Oct. 6, 2005, <http://www.philanthropy.com/free/articles/v18/i01/01002901.htm>.

³ Stephanie Strom, *Many Charities Founded After Hurricane Are Faltering*, N.Y. TIMES, Mar. 13, 2006, at A12.

⁴ JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 17 (3d ed. 2006) (1995).

⁵ THE NONPROFIT SECTOR IN BRIEF: FACTS AND FIGURES FROM THE NONPROFIT ALMANAC 3 (2007), available at http://www.urban.org/UploadedPDF/311373_nonprofit_sector.pdf. (last visited Feb. 23, 2009).

⁶ Garry V. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1122 (2007).

⁷ FISHMAN & SCHWARZ, *supra* note 4, at 150 (describing scandals at American University and Adelphi University); Katherine Boozang, *Does an Independent Board Improve Nonprofit Corporate Governance?*, 75 TENN. L. REV. 83, 87-98 (2007) (describing huge nonprofit scandals at the University of Medicine & Dentistry of New Jersey and the formerly nonprofit New York Stock Exchange); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 219, n. 1 (2003) (describing scandals in nonprofit sector exhaustively, including incidents at United Way and Hale House where executives used charity funds for personal gain). Smaller nonprofit scandals also commonly emerge in the news headlines. See Ralph Blumenthal, *Ex-University Head in Texas on Trial for Money Misuse*, N.Y. TIMES, Aug. 25, 2007, at A8 (Dr.

worrisome is the assumption that the majority of nonprofit scandals likely go unreported.⁸ Aside from scandals that reveal illegal activity, the nonprofit sector has also been described as inefficient and wasteful.⁹

This Note addresses the crisis of accountability in disaster relief nonprofit organizations and, by extension, the nonprofit sector as a whole, by arguing for the formation of a legally mandated financial oversight committee within new disaster relief organizations where no such governance mandate has so far existed. Part I explores how theft, fraud, waste, and the unique circumstances of the disaster relief context pose particular nonprofit accountability issues that warrant specific legal reforms.¹⁰ Part II demonstrates that the existing legal framework does not address and mitigate the particular problems laid out in Part I. Finally, Part III proposes the creation of a financial oversight committee on the boards of new disaster relief nonprofit organizations. This Part illustrates how such a governance structure will address financial accountability issues such as theft, fraud, and waste in the nonprofit disaster relief sector, and responds to likely criticisms of such a proposal.

I. DISASTER RELIEF ORGANIZATIONS: THEFT, FRAUD, AND WASTE

Disaster relief nonprofit organizations tend to receive rapid infusions of money for administration and program expenses that are spent on a faster timeline than in other contexts in which nonprofits serve even the neediest of victims. Charities received over two billion dollars after September 11th, with the majority of those funds coming in just two months after the tragedy.¹¹ The enormous level of aid donated for victims of 9/11 resulted in flooded coffers at established disaster relief organizations¹² and the fast expansion of budgets at existing foundations or new nonprofit organizations.¹³ On an even greater scale, charities

Priscilla Slade, president of Texas Southern University, was alleged to have stolen \$400,000); see also Julia Moskin, *An Early Departure for Beard Board Head*, N.Y. TIMES, Oct. 17, 2007, at F8.

⁸ Lumen N. Mulligan, *What's Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley Style Nonprofit Reforms*, 105 MICH. L. REV. 1981, 1982 (2007) ("In the seven years preceding 2002, officers and directors of major charitable organizations misappropriated at least \$1.28 billion from 152 nonprofit organizations. To make matters worse, a recent *Chronicle of Philanthropy* study contends that this figure, which is based upon newspaper reports, significantly underestimates the scope of abuses within the nonprofit community.").

⁹ See Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 235 & n.26 (1999).

¹⁰ This section draws specifically from the aftermath of 9/11 and Hurricane Katrina.

¹¹ N.Y. ATTORNEY GEN., SEPTEMBER 11TH CHARITABLE RELIEF: AN OVERVIEW AT ONE YEAR 1 (2002) (on file with author).

¹² *Id.* at 2; TOM SEESSEL, THE PHILANTHROPIC RESPONSE TO 9/11: A REPORT PREPARED FOR THE FORD FOUNDATION 13-43 (2002), available at http://www.fordfound.org/pdfs/impact/philanthropic_response.pdf (last visited Jan. 21, 2008) (cataloging donations received and allocated at major funds after 9/11).

¹³ SEESSEL, *supra* note 12, at 41; see also Strom, *supra* note 3 ("The rush to create more charities, while grounded in a desire to let the charity dollars flow to the most needy, is contributing to what many charity experts say is an overabundance of nonprofit groups, many of which will fail to deliver the support they promised when applying for tax-exemption.").

received more than \$4 billion dollars in donations following Hurricane Katrina.¹⁴ Given the potential for cash to flow into these new organizations, the fact that these organizations are often run by inexperienced people,¹⁵ and the unpredictable and urgent nature of disaster relief work,¹⁶ these organizations face unique circumstances that make easy for funds to be stolen by staff, fraudulently obtained by users, or simply wasted. Simply put, disasters create the perfect storm for a lack of nonprofit financial accountability.

A. *Theft*

A new disaster relief organization that grows from inception to receiving large amounts of revenue will generally not face the public scrutiny directed towards the large, established Red Cross.¹⁷ Funds donated for disasters can appropriately be set aside and used for administrative expenses for services unrelated to cash assistance, such as mental healthcare, that may be provided to victims in distress on an ongoing basis.¹⁸ However, because funds pour into the organization while the organization is creating ways to spend them, funds can also easily be stolen. As an example, one executive of a new September 11th charity formed to provide supportive services to all children who lost a parent in the attacks was later accused of stealing from his organization and using some of the stolen funds to pay his mortgage and credit card bills.¹⁹ The executive, whose brother was killed in the World Trade Center, also confessed to feeling continually grief-stricken and “hid[ing] from 9/11 in 9/11.”²⁰ The confession may not reflect the general attitude of executives running new disaster relief organizations. However, the wide latitude given to this grief-stricken founder of a disaster relief

¹⁴ Howard Kunreuther, Op-Ed, *Who Will Pay for the Next Hurricane?*, N.Y. TIMES, Aug. 25, 2007, at A15 (“Because of increasing development in hazard-prone areas and the effects of climate change, we are in a new era of catastrophic losses from natural disasters. Ten of the 20 most costly natural disasters have occurred during the past five years—all 10 of them hurricanes, typhoons or tropical storms.”).

¹⁵ N.Y. ATTORNEY GEN., *supra* note 11, at 2 (“Some of those funds were created spontaneously by organizations with no prior experience in administering charitable assets. All of the September 11th charities—whether newly-formed or long-established—have confronted a daunting administrative burden that has severely taxed their staffs and resources.”).

¹⁶ *Id.* at 3 (“The demand for relief was huge. The logistics of dispensing aid were further complicated at the early stages of the disaster by the incapacitation of the communications and transportation infrastructure of Lower Manhattan.”).

¹⁷ See *infra* Part II.A.2 for a discussion about the limited role of state Attorneys General in regulating charities.

¹⁸ IRS, DISASTER RELIEF: PROVIDING ASSISTANCE THROUGH CHARITABLE ORGANIZATIONS 4-5, available at <http://www.irs.gov/pub/irs-pdf/p3833.pdf> (last visited May 18, 2009) [hereinafter IRS DISASTER RELIEF Report]; see also *infra* Part II.B.2 (discussing the federal tax-exempt requirements of disaster relief organizations).

¹⁹ James Barron, *Behind Relief to 9/11 Families, A Man's Flaws*, N.Y. TIMES, Apr. 3, 2006 (“I realized as I sat there with that \$250,000 check in my hand, I was the only one who knew anything about it . . . and I could direct it as I saw fit.”).

²⁰ *Id.*

organization to receive and spend large checks by himself without a mandated financial oversight committee is the norm.²¹

B. Fraud

The propensity for money to be distributed to fraudulent disaster victim aid applicants further justifies the need for a governance mandate. The flow of funds and the ease with which they are distributed led to the creation of over four thousand websites run by scam artists just one month after Hurricane Katrina.²² Alternatively, new disaster relief organizations also run the risk of having their funds ferreted away through fraudulent applications in the rush to disburse funds. Because the Red Cross received public scrutiny for allocating 9/11 donations towards long-term goals and services,²³ all disaster relief providers now feel pressure to distribute cash assistance quickly despite the fact that this may hinder their ability to screen out fraudulent applicants.²⁴ While the majority of cash assistance pools come from large public agencies like the Federal Emergency Management Agency (FEMA) and large nonprofits like the Red Cross, new or small organizations do indeed raise funds for short-term cash assistance despite their lack of experience in the distribution of aid to disaster victims.²⁵

After September 11th and Hurricane Katrina, the level of fraudulently obtained money dispensed to alleged victims by governmental and nonprofit organizations led to an astounding loss of \$2.6 billion dollars.²⁶ By one report, fraudulent applications for September 11th aid totaled at least \$5.8 million,²⁷ while Hurricane Katrina fraud alone amounted to over \$2 billion.²⁸ Where the vast majority of the Katrina fraud involved false applications to FEMA programs, the *New York Times* reported that the Red Cross was

²¹ See *infra* Part II.B.2 for discussion of limited state and federal financial reporting requirements for new disaster relief organizations.

²² Les Christie & Jessica Seid, *Katrina Scams Mushroom*, CNNMONEY.COM, Sept. 23, 2005, http://money.cnn.com/2005/09/09/pf/beware_disaster_scams/index.htm.

²³ See *infra* note 93.

²⁴ Jacqueline L. Salmon, *Fraud Alleged at Red Cross Call Centers*, WASH. POST, Dec. 27, 2005, at A5 (“[C]harity experts say that in this era, when a highly visible disaster can trigger an outpouring of hundreds of millions of dollars, relief groups are under enormous pressure to disburse the money as quickly as possible or risk the ire of donors.”).

²⁵ Robert A. Katz, *A Pig in a Python: How the Charitable Response to September 11 Overwhelmed The Law of Disaster Relief*, 36 IND. L. REV. 251, 300 (2003).

²⁶ Erica Pearson, *Money for Rebuilding*, GOTHAM GAZETTE, Feb. 3, 2002, <http://www.gothamgazette.com/article/issueoftheweek/20030203/200/271> (describing “9/11 scam artists” who “invented brothers, husbands, [and] wives” in their applications to large relief funds which succeeded because a complete list of the dead and the families was not available until several months after the attacks).

²⁷ Thomas Zambito, *Con Artists Cashed in on \$5.8M from 9/11 Tragedy*, N.Y. DAILY NEWS, Sept. 9, 2007.

²⁸ Eric Lipton, “Breathtaking” Waste and Fraud in Hurricane Aid, N.Y. TIMES, June 27, 2006.

investigating over 7000 possible instances of fraud.²⁹ In New York alone, the Manhattan District Attorney had charged 245 people with making over \$3 million dollars in fraudulent 9/11 relief claims.³⁰ In another case after Hurricane Katrina, employees of the Red Cross schemed with outside individuals in order to steal money from the agency.³¹ All new disaster relief organizations that raise and disburse funds quickly face this particular risk of distributing aid to fraudulent applicants.³²

C. Waste

Like all new nonprofit organizations, new disaster relief organizations can waste their assets as a result of weak governance, particularly when the board is dominated by a founder.³³ In general, organizations run by founders are distinct from those run by successors because founders are often entrepreneurial as opposed to managerial.³⁴ In this context, directors who attempt to engage with the founder may only do so in futility.³⁵ Founder-led organizations with less board oversight of daily operations can be poorly managed and inefficient.³⁶ Oftentimes, founder-led nonprofits are governed by family members, friends, and business associates despite the fact that these “interlocking relationships” can undermine the “the level of independent judgment required of all board members.”³⁷ Particularly in disaster relief, if the founder provides

²⁹ *Id.*

³⁰ Edward Wyatt, *More Arrests Made in 9/11 Fraud Cases*, N.Y. TIMES, Apr. 11, 2003.

³¹ Jacqueline L. Salmon, *Fraud Alleged at Red Cross Call Centers*, WASH. POST, Dec. 27, 2005, at A5.

³² N.Y. ATTORNEY GEN., *supra* note 11 (“The public understandably has demanded that relief be made quickly with minimal red tape. The public has also expressed strong concerns that the charities take steps to avoid fraud and waste, to ensure some measure of equity in the distributions and to guard against any victim falling between the cracks.”) (internal quotation marks omitted).

³³ Boozang, *supra* note 7, at 124 (“Smaller nonprofits and [those] reliant on a single significant donor must resist the board acting as the alter ego of the entity’s founders or original board members. Fidelity to mission must guide all decisions, and the board is obliged to monitor management.”); Stephen R. Block & Steven Rosenberg, *Toward an Understanding of Founder’s Syndrome: An Assessment of Power and Privilege Among Founders of Nonprofit Organizations*, 12 NONPROFIT MGMT. AND LEADERSHIP 353, 354 (2002) (analyzing “unhealthy organizational situations in which founders are more heavy-handed and indifferent about the imbalance of their control over organizations”). Block and Rosenberg concluded that “founders are not necessarily skilled managers” and that founder-led organization board members were less involved in decision-making. *Id.* at 364-66.

³⁴ *Id.* at 365.

³⁵ FISHMAN & SCHWARZ, *supra* note 4, at 169 (“Powerful group dynamics constrain the willingness of directors to voice concern or dissent, discouraging them from openly questioning or contradicting management except in extraordinary circumstances.”).

³⁶ Block & Rosenberg, *supra* note 33, at 364 (“The new leadership that replaces the founder is likely to have more experience and skill in efficiently managing and maintaining an organization.”).

³⁷ PANEL ON THE NONPROFIT SECTOR, PRINCIPLES FOR GOOD GOVERNANCE AND ETHICAL PRACTICE 23 (Reference Ed. 2007), available at http://www.nonprofitpanel.org/report/principles/Principles_Reference.pdf [hereinafter PANEL ON THE NONPROFIT SECTOR].

poor operational oversight,³⁸ the new disaster relief organization will waste money and provide ineffective disaster relief.³⁹ While it would not be desirable to completely quash the motivation and drive of visionary founders, governance mandates will improve disaster relief nonprofits by separating entrepreneurial pursuits from managerial duties.

The short-term and long-term needs of disaster relief victims are best met through coordination and collaboration among the public, private, and non-governmental sectors.⁴⁰ At least in part, such coordination is necessary to determine which victims need aid and which victims have already been served.⁴¹ Because of this, new nonprofit organizations have been criticized for undermining such coordination and collaboration.⁴² With no formal or centralized leadership from within the nonprofit sector to coordinate efforts to serve disaster victims,⁴³ new nonprofit organizations with weak governance are likely to continue undermining disaster relief efforts. Despite condemnation of government relief services⁴⁴ and public distrust of large charities after the Red Cross

³⁸ Block & Rosenberg, *supra* note 34, at 364 (Smaller nonprofits are often solely run by their founders who “are less concerned with the opinions of others” and “may not be interested in the ideas and directional advice of others.”).

³⁹ MELCHER, *supra* note 1, at 33; SEESSEL, *supra* note 12, at 9.

⁴⁰ Gloria Simo & Angela L. Bies, *The Role of Nonprofits in Disaster Response: An Expanded Model of Cross-Sector Collaboration*, 67 PUB. ADMIN. REV. 125, 126-32 (2007) (discussing the cross-sector collaboration necessary for disasters such as Hurricane Katrina); DISASTER RELIEF AND RECOVERY: THE ROLE OF NONPROFITS BEYOND GROUND ZERO AND THE LEGAL IMPLICATIONS OF THEIR WORK 16 (Elizabeth M. Guggenheimer et al. eds., 2003) (“Alongside long-term plans for recovery and rebuilding from the September 11 attacks, nonprofit organizations throughout New York City are taking stock of lessons learned and creating plans for future crisis. They are recognizing the need for contingency plans to ensure that relief efforts are better coordinated and more effective in the event of a future large-scale disaster.”); MELCHER, *supra* note 1, at 11-12 (describing how use of existing charities reduces risk, but also conceding that new organizations can be innovative).

⁴¹ Gene Steurle, *Charities and Disaster Relief, Making Choices & Planning for the Future*, 35 TAX-EXEMPT ORG. TAX REV. 159, 160 (“Clearly, when many charities become involved, they can trip over each other. . . . [T]he small charity may believe that it enhances its own future by running its own little program, no matter how inefficiently. However, the sector as a whole could witness lesser charitable giving as a result.”).

⁴² *Id.* (assailing “waste” of small nonprofits that undertake disaster relief); MELCHER, *supra* note 1, at 15 (“Creating new programs poses risk and can be counterproductive. Some new organizations created after 9/11 had overly narrow purposes that could not keep up with quickly evolving needs. . . . In a crisis, organizations may attempt actions that are beyond their capabilities and inconsistent with their missions.”); SEESSEL, *supra* note 12, at 9 (“Philanthropic planning was complicated by the proliferation of new charities created to address 9/11 relief and recovery, many of which had inexperienced leadership and vaguely defined plans.”).

⁴³ MELCHER, *supra* note 1, at 16 (describing leadership problem that was partially resolved through September 11th Fund); Simo & Bies, *supra* note 40, at 135 (“Perceptions of government failure or inadequate relief efforts were widespread and described as serving to stimulate alternative relief and re-building solutions in the form of cross-sector collaborations.”); Debra Blum, *Review of 9/11 Response Finds Charities Missed Opportunity to Lead*, CHRON. OF PHILANTHROPY, Dec. 8, 2003, http://216.105.98.11/content/Practices/Practices57_2.

⁴⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, HURRICANE KATRINA: INEFFECTIVE FEMA OVERSIGHT OF HOUSING MAINTENANCE CONTRACTS IN MISSISSIPPI RESULTED IN MILLIONS OF DOLLARS OF WASTE AND POTENTIAL FRAUD 7 (2007) [hereinafter HURRICANE KATRINA], available at <http://www.gao.gov/new.items/d08106.pdf> (concluding that FEMA improperly spent over \$30 million in government funds).

scandal,⁴⁵ new disaster relief organizations that may fill some gap in the disaster response system should still be the subject of governance reform.

D. Unique Challenges of the Disaster Relief Context

While all nonprofit organizations face challenges and are under-resourced, the urgent and complex nature of disaster relief work is particularly prone to fraud, theft, and waste of assets when carried out by inexperienced staff.⁴⁶ “[C]reating and managing a new charitable organization involves expense, administrative responsibilities, and attention to legal compliance obligations . . . that are likely to be complex and challenging.”⁴⁷ The highly emotional nature of the work can lead staff to discontinue their work due to “burn-out.”⁴⁸ In addition, the administrative responsibility of fundraising in the years after a disaster⁴⁹ can lead to organizational failure. For instance, none of the twelve to fifteen organizations founded by nonprofit “rookies” after the Oklahoma City bombing survived for more than two years.⁵⁰ Even extremely high-profile charities suffered after September 11th.⁵¹ When organizations that aspire to help victims fail shortly after inception, this raises legal and policy issues involving the extent to which the board could have prevented its failure.

Lastly, to the extent that new disaster relief organizations are run by inexperienced people, they are ill-equipped to handle the diffuse,

⁴⁵ Strom, *supra* note 3 (people wanted to form their own charities as opposed to donate to large charities).

⁴⁶ Lipman, *supra* note 2 (“These organizations that pop up run a high risk of waste, inefficiency, and outright fraud. Even when you have individuals with the best intent, they are not experienced at raising and distributing money.” (quoting Marc Owens, head of the IRS oversight of nonprofits from 1999-2000) (internal quotation marks omitted)); Strom, *supra* note 3.

⁴⁷ Betsy Buchalter Adler & Barbara A. Rosen, *Disaster! Practices and Procedures for Charities Providing Relief After 9/11: A Case Study*, 96 J. TAX’N 297, 299 (2002).

⁴⁸ Domenica Marchetti, *September 11 Charities Face Challenges Beyond the Ordinary*, CHRONICLE OF PHILANTHROPY, Mar. 7, 2002, www.philanthropy.com/free/articles/v14/i10/10001101.htm (“Very often there is a desire to memorialize someone But if there is no fundamental understanding of the issue you’re trying to address, the passion will eventually burn out and you’re left with a somewhat inexperienced group of people tackling something they aren’t equipped to tackle.” (quoting Oklahoma City Community City Foundation Executive Director Nancy B. Anthony) (internal quotation marks omitted)); *cf.* Families of September 11, <http://fos11.org> (last visited Mar. 20, 2009).

⁴⁹ DISASTER RELIEF AND RECOVERY, *supra* note 40, at 29.

⁵⁰ Marchetti, *supra* note 48 (“Sustaining a charity over the long term is probably the biggest challenge a September 11 groups face,” one disaster relief expert stated.).

⁵¹ *Id.* The Todd Beamer Foundation sought to provide mental health support for traumatized children who lost a loved one in the September 11th attacks, expanded its mission to support children traumatized by events other than September 11th, and yet spent more on consultants than on services and is now faced with financial problems. *Beamer Foundation Making Hard Choices*, THE NONPROFIT TIMES, Feb. 12, 2007, <http://nptimes.com/07Feb/news-070212-1.html> (“Renamed Heroic Choices some three years ago, the organization ended 2005 with \$177,539 in net assets, according to its most recent Form 990, down from more than \$2.7 million at the same time two years ago, while spending more on fundraising and consultants than program services or contributions. The past two years have seen more than a third of the nonprofit’s \$2.8 million in total expenses go for ‘fundraising expenses’ with less than \$1 million listed for ‘program services.’”).

unpredictable, and often long-term nature of disaster victims' needs.⁵² Disaster relief is a comprehensive process that encompasses acute and long-term needs and extends well beyond the mere provision of blankets, food, and medical care in the days after a tragedy.⁵³ For example, the attacks of September 11th took a direct toll on thousands of lives and left hundreds of thousands of people economically deprived and psychologically traumatized.⁵⁴ Many relief providers in New York City were influenced by the response to other disasters, such as the Oklahoma City bombing, where the mental health needs of victims worsened as time went on instead of vice versa.⁵⁵ Accordingly, aid encompassed cash assistance, loans for small businesses, government benefits, as well as ongoing mental healthcare for several years.⁵⁶ Service providers after Hurricane Katrina, Rita, and Wilma similarly assisted a large evacuee population with short-term subsistence measures, and long-term assistance with housing, healthcare, mental healthcare, and education.⁵⁷

The waste of donor dollars or resources by new disaster relief organizations may also be rooted in, or at least partially explained by, the wide range of disaster relief goals. *The Chronicle of Philanthropy* reported that disaster relief organizations fast-tracked for tax-exemption after September 11th sought to create animal-friendly license plates in Missouri and Kansas, promote music education in Colorado, support orphans in Bangladesh, and stop bias against the practice of chiropractic medicine in Ohio.⁵⁸ Similarly, *The New York Times* reported that disaster relief organizations fast-tracked for tax-exempt status after Hurricane Katrina provided leather jackets to sadomasochists and sent money to children in China.⁵⁹ To the extent that such wide-ranging goals undermines donor intent after a disaster, directors of new nonprofit organizations should prevent this from occurring.

⁵² See *infra* Part I.C for discussion of consequences of disaster relief organization ineffectiveness. The best support for this proposition comes from the strong disapproval of such organizations by leading sector experts, lawyers, and even the Internal Revenue Service.

⁵³ DISASTER RELIEF AND RECOVERY, *supra* note 40, at 6-10. See generally Carol J. De Vita & Elaine Morley, *Providing Long-Term Services After Major Disasters*, URBAN INST., Aug. 2007, at 1.

⁵⁴ SEESSEL, *supra* note 12, at 1 (reporting that a total of 2823 people were killed on four hijacked airplanes, in the Twin Towers, and at the Pentagon). In the months following the attacks, 700 businesses closed and over 100,000 jobs were lost. Seven thousand people were displaced from downtown Manhattan. *Id.*

⁵⁵ *Id.* at 5 (describing opinion of Nancy B. Anthony, Executive Director of the Oklahoma City Community Foundation).

⁵⁶ DISASTER RELIEF AND RECOVERY, *supra* note 40, at 6-9, 13-14.

⁵⁷ *The Face of Recovery: The American Red Cross Response to Hurricane Katrina, Rita & Wilma*, 2-9 (2007) (on file with author).

⁵⁸ See generally IRS, DISASTER RELIEF Report, *supra* note 18. See *infra* Part II.B. for discussion of federal tax-exempt guidelines and expedited application process for disaster relief organizations; see also Harvy Lipman, *IRS Handling of September 11th Charities Shows Weakness of Approval System, Critics Say*, CHRON. OF PHILANTHROPY, Mar. 7, 2002, <http://www.philanthropy.com/free/articles/v14/i10/10000802.htm>.

⁵⁹ Strom, *supra* note 3.

The problems outlined in this section have already been the subject of widespread criticism. One commentator has derided these new organizations as “knee-jerk reactionary efforts” that waste “money and administrative resources.”⁶⁰ The former head of the Charity Bureau in the New York Attorney General’s office described new disaster relief organizations as follows: “I doubt they have much impact. There were plenty of existing, accountable vehicles for donors to give to.”⁶¹ One charity watchdog group urged donors to “[a]void newly-formed charities”⁶² after a disaster, and urged charities to refrain from entering into the field of disaster relief when other organizations already had an infrastructure in place.⁶³ Similarly, a report on the role of nonprofits after Hurricane Katrina revealed that new disaster relief organizations actually created conflict among existing public and nonprofit relief providers due to their lack of expertise.⁶⁴ Finally, despite the fast-track tax-exemption

⁶⁰ JACK SIEGEL, *DOING GOOD DOES NOT JUSTIFY AD HOC TAX BREAKS: LESSONS FROM VIRGINIA TECH, HURRICANE KATRINA, TSUNAMIS, AND OTHER TRAGEDIES* (2007), http://www.charitygovernance.com/charity_governance/2007/04/doing_good_does.html.

⁶¹ Lipman, *supra* note 2 (quoting William Josephson, the head of the Charities Bureau in the N.Y. Attorney General’s office from 1999 to 2004).

⁶² Charity Navigator, 5 Lessons For Donors to Take to Heart, *available at* <http://www.charitynavigator.org/index.cfm?bay=katrina.article&cpid=454> (last visited Apr. 1, 2009). Charity Navigator offers an explanation for why new charities struggle to survive:

Avoid newly-formed charities. While the IRS decided to legitimize anyone claiming to provide Katrina-related aid by fast-tracking their applications for nonprofit status, Charity Navigator advised donors to avoid groups that suddenly popped into existence. Establishing a new charity is hard enough, but in a crisis, the odds of succeeding are slim to none. Think of it this way: would you entrust all your savings in a financial firm that just opened, doesn’t even have stationery, and whose employees have no experience in investing money? Doubtful. Even the most ethical and well-intentioned newly formed organizations were doomed to fall short, as evidenced by the Bush-Clinton Katrina Fund. Many gave to the fund under the premise that two former presidents could better provide aid than any other charity in existence. But even this organization ran into trouble. One year after Katrina hit, seven out of nine religious leaders gave up their posts as advisors, prompting the exodus of the executive director and revealing the organization’s struggle to effectively disperse its funds.

Id.

⁶³ SIEGEL, *supra* note 60 (“We hope that state secretaries of state are discouraging people from creating these new organizations. Experience has shown that these knee-jerk reactionary efforts often produce no results while wasting money and administrative resources. The well-intentioned folks behind these startups should be encouraged to donate their time or money to existing charities. We already have too many charities.”).

⁶⁴ Simo & Bies, *supra* note 40, at 135. Simo and Bies explain the skepticism that start-up nonprofits face:

In the Tulane/Canal neighborhood and in southwest Louisiana, a number of new nonprofits emerged in the aftermath of the storms. Although some of these new entities proved to be innovative and filled important gaps, a number of respondents reported wariness and conflict in their interactions with the new agencies, viewing them with suspicion and questioning their motivations. Other respondents viewed the new agencies as “self-appointed” and misguided in their belief that they alone were “the ones who would provide services because they believed no one else would, or could, do it,” suggesting that these new agencies suffered from naiveté and “did not understand the nonprofit landscape, especially in New Orleans, and basically just mucked things up—

program implemented after September 11th and Hurricane Katrina by Congress,⁶⁵ even the Internal Revenue Service has conceded that disaster relief organizations with an established infrastructure are better equipped to serve disaster victims. The Internal Revenue Service described existing charitable organizations, such as the Salvation Army, United Way, and Red Cross as:

a more practical approach than the establishment of a new charitable organization. . . . In the rush to provide help, organizers spend time and funds establishing and qualifying a new charitable organization. This may be appropriate when the organizers have long-term goals or where no suitable existing charity is present.⁶⁶

The echoed sentiment of these lawyers, self-regulatory and governmental agencies, clearly supports the proposition that new disaster relief nonprofit organizations, while lawfully formed, should be required to have active, responsible board members who can guide the organization's staff as it raises money and serves disaster victims.

II. OVERVIEW OF STATE AND FEDERAL LAW

Nonprofit organizations are governed by state nonprofit corporation law and federal tax law.⁶⁷ The disaster relief organization is typically a state incorporated nonprofit organization and a federally tax-exempt organization.⁶⁸ This Part argues that state and federal laws fail to enforce fiduciary duties in such a way as to make new disaster relief organizations more financially accountable.

A. State Law

Nonprofit organizations can become state incorporated entities for any lawful purpose and are not pre-screened by the state or the judiciary.⁶⁹ State judicial scrutiny over the nonprofit incorporation process, once the norm, eroded as a result of ideological changes and

creating conflicts and even ignoring other organizations that had been working in the neighborhoods for years.

Id. (quoting respondents to study of nonprofit participation in disaster relief).

⁶⁵ See *infra* Part II.B for discussion of IRS "expedited" process.

⁶⁶ See IRS, DISASTER RELIEF REPORT, *supra* note 18; see also Lipman, *supra* note 2 ("When there's a disaster, people's first instinct is to say, 'Let's form an organization and collect money or goods. Let's accomplish something.' What we want people to do is take a breath and see if there's an existing organization that could use their support before they go through all the expense related to forming a new organization. But if one does not exist, then we're saying we will offer this expedited process." (quoting Marvin Friedlander, senior manager in IRS exempt-organizations division) (internal quotation marks omitted)).

⁶⁷ FISHMAN & SCHWARZ, *supra* note 4, at 60-61. Part II will address the law as it relates to charitable organizations as opposed to mutual benefit organizations and trusts.

⁶⁸ Katz, *supra* note 25, at 258.

⁶⁹ NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR 83-115 (2001).

new scholarly arguments that constitutional rights of association and speech justified lenient rules for nonprofit formation.⁷⁰ The nonprofit formation process mirrors that of corporations. However, unlike corporations, new nonprofit organizations normally incorporate and operate in the same state as a result of costs and the need to attract local donors.⁷¹ Today, as a result of the liberalization of state incorporation rules for nonprofit formations, new disaster relief organizations can form with ease despite the presence of numerous large and established public and nonprofit organizations already in the business of responding to disasters.⁷²

1. Fiduciary Duties

State law requires that board members abide by the duties of care, loyalty, and obedience. The duty of care merely obligates board members to make reasonably informed decisions, act in good faith, and carry out their role with the care of an “ordinarily prudent person.”⁷³ The duty of loyalty requires board members to act in the best interests of the organization and bars them from engaging in a self-dealing transaction carried out at the expense of the organization.⁷⁴ Accordingly, fiduciaries must make decisions with objectivity and receive approval from the corporation to complete any transaction involving a conflict of interest that impairs their objectivity.⁷⁵ Lastly, the duty of obedience requires directors to faithfully carry out the goals of the organization.⁷⁶ In general,

⁷⁰ *Id.* (discussing how the civil rights and women’s movements led to greater mainstream appreciation of the role that marginalized groups play in a strong political democracy when they are allowed to formally associate with one another through nonprofit legal entities).

⁷¹ Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 *FORDHAM L. REV.* 767, 787 (2007); Jenkins, *supra* note 6, at 1165-68.

⁷² Lipman, *supra* note 2.

⁷³ REVISED MODEL NONPROFIT CORP. ACT (RMNCA) § 8.30 (1987) (“A director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.”). The American Bar Association’s RMNCA (1987) was adopted in twenty-three states and its original version (1952) was adopted in six states and the District of Columbia. PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 22; N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (2005) (providing that “[d]irectors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions”); FISHMAN & SCHWARZ, *supra* note 4, at 167.

⁷⁴ RMNCA § 8.31 (1987) (barring directors from engaging in a transaction where they have a direct or indirect financial interest unless it is disclosed to and approved by the board); N.Y. NOT-FOR-PROFIT CORP. LAW § 715 (2005) (when a board member has a “substantial financial interest” in a transaction it must be disclosed in good faith to the rest of the board); FISHMAN & SCHWARZ, *supra* note 4, at 176-79.

⁷⁵ Steven R. Smith, *Directors and Officers: On Behalf of the Board*, in *THE NONPROFIT LEGAL LANDSCAPE* 26-27 (Thomas K. Hyatt ed., 2005).

⁷⁶ FISHMAN & SCHWARZ, *supra* note 4, at 219 (describing how a director may be sued if a corporation enters into an *ultra vires* transaction that is not contemplated by its governing legal documents); Smith, *supra* note 75, at 26.

the duty of obedience is less important today in order to allow a nonprofit organizations to operate with flexibility.⁷⁷

The duties of care and loyalty are not meaningful constraints on management for numerous reasons.⁷⁸ The duty of care is ambiguous because state statutes do not clearly specify the extent to which a board member should monitor the activities of the organization.⁷⁹ The duty of loyalty is difficult to enforce because conflicts of interest are extremely common in the nonprofit sector.⁸⁰ More significantly, donors and consumers of nonprofit services do not have a private right of action against a nonprofit's directors.⁸¹ Finally, while the duties of care and loyalty can be enforced by state Attorneys General in lieu of donors and consumers, enforcement by the public sector is rare.

2. Enforcement by State Attorneys General

Despite its limited resources, prosecution by the charity bureau of the state Attorney General for fiduciary duty violations is the most valuable state regulatory constraint over nonprofits.⁸² The Red Cross scandal illustrates this fact. Just after the terrorist attacks of September 11, 2001, the Red Cross created the "Liberty Fund," which, rather than merely assisting September 11th victims, more closely resembled a "war

⁷⁷ FISHMAN & SCHWARZ, *supra* note 4, at 219 (describing the duty of obedience as analogous to the "emasculated" *ultra vires* doctrine in corporate law); Linda Sugin, *Resisting The Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 897 (2007) (explaining that fiduciary "duty of obedience" has become the "stepchild" of nonprofit fiduciary duties because charity goals simply could not be met if nonprofits were held to such a narrow, rigid standard, and arguing for a more flexible duty of obedience standard).

⁷⁸ FISHMAN & SCHWARZ, *supra* note 4, at 149 ("The fiduciary obligation is notably elusive as a concept. The particular duties it imposes vary in different contexts, as does the justification for imposing the obligation itself.").

⁷⁹ Karyn R. Vanderwarren, Note, *Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function*, 77 CHI.-KENT. L. REV. 963, 968 (2002) ("Noticeably absent from the Model Act are any expectations that directors ensure that management is engaging in sound practices.").

⁸⁰ FISHMAN & SCHWARZ, *supra* note 4, at 176-78 ("Conflicts of interest, divided loyalties, and transactions among directors, officers, and charitable corporations abound in the nonprofit sector. Breaches of loyalty are not only much easier to identify than breaches of care, they are more prevalent." Typical breaches may include using the organization's property for more than de minimis personal use and paying high salaries to directors that are not in the best interest of the organization.)

⁸¹ Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 466-67 (1996) ("[B]ecause of the lack of classes of private persons with standing to sue, in many ways this fiduciary duty is really a legal obligation without a legal sanction.") (footnotes omitted); Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable Donor Standing*, 41 GA. L. REV. 1183, 1188 (2007) ("[T]he traditional rule that a donor lacks standing to complain in court about a charitable donee's use of a restricted gift can baffle and even infuriate."); Manne, *supra* note 9, at 236.

⁸² Manne, *supra* note 9, at 251 ("The attorney general is the most important, and probably least well-equipped, source of enforcement in the charitable sector.").

fund” for new, imminent terrorist attacks and possible military action.⁸³ This was a departure from the typical practice, used for more than a century of serving disaster victims, where the Red Cross had put all donations into one general, multi-disaster fund.⁸⁴ Donors, media, and Congress scrutinized and condemned the broader purpose of the Liberty Fund.⁸⁵ The Attorney General of New York accused the Red Cross of acting fraudulently and ordered the agency to spend its funds on only 9/11 victims’ families.⁸⁶ The agency soon changed its position and allocated all present and future donations to the Liberty Fund—over \$1 billion—to the short and long-term needs of victims’ families.⁸⁷

The New York Attorney General’s actions represented a rare example of a threat of prosecution against a charity for violating its duty of care, which encompasses the obligation to honor the intent of donors.⁸⁸ Yet, fiduciary duty violations in the nonprofit sector are said to occur elsewhere “with unsettling frequency.”⁸⁹ Prosecution by state Attorneys General occurs on behalf of the public only in extreme cases due to limited staff and resources.⁹⁰ Extreme lapses commonly include cases of intentional wrongdoing, such as embezzlement, by a nonprofit staff or board member,⁹¹ whereas fraudulent aid applicants are themselves prosecuted by the district attorney pursuant to criminal law. Lastly, Attorneys General have incentives not to prosecute problems in the

⁸³ Katz, *supra* note 25, at 308-09 (“When she created the Liberty Fund, Dr. Bernadine Healy believed that future terrorist attacks were imminent, and that the United States Government was mobilizing for military action. She was summoning the agency to shift into war mode, and to do so on a scale not seen since the world wars. In this respect, the Liberty Fund was a war fund. Its monies were restricted in the sense that they would only be used to support agency activities related to preparing and responding to anti-U.S. terrorist attacks and U.S. military action. The Red Cross retained discretion to allocate funds among this broad set of activities as it saw fit.”) (internal quotations omitted).

⁸⁴ Deborah Sontag, *Who Brought Bernadine Healy Down?*, N.Y. TIMES, Dec. 23, 2001, § 6 (Magazine), at 81 (“Since the Red Cross can raise serious money only in the wake of a high-profile disaster, it uses the high-profile disasters to beef up general disaster-relief funds. . . . This practice of the Red Cross has come under fire many times—after the San Francisco earthquake of 1989, the Oklahoma City bombing of 1995, the Red River floods of 1997, the wildfires in the San Diego area last January.”).

⁸⁵ Katz, *supra* note 25, at 312.

⁸⁶ *Id.* at 316-18 (discussing the difficulty in ascertaining donor intent).

⁸⁷ *Id.* at 280-81 (explaining that that despite the broad discretion given to charities to spend the money the way that they want, and despite the Internal Revenue Service’s initial reluctance to allow victims’ families to receive funds even when they were not financially needy, the Red Cross scandal prompted a change in tax law).

⁸⁸ *Id.* at 280, 287.

⁸⁹ FISHMAN & SCHWARZ, *supra* note 4, at 150.

⁹⁰ Brody, *supra* note 81, at 486 (discussing Attorney General standing in place of shareholders but only in the “extreme case of malfeasance”); Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT L. REV. 559, 598 (2005) (discussing that state AGs offices have very limited resources); see also Boozang, *supra* note 7, at 115-16 (“[A]ttorneys general have great difficulty obtaining information about nonprofit corporations’ internal operations, and most states are functionally and financially incapable of dealing with anything but the most egregious nonprofit behavior.”); Manne, *supra* note 9, at 237.

⁹¹ Fishman, *supra* note 7, at 236.

nonprofit sector aggressively. They are elected by the public and pursue nonprofit cases when it is politically advantageous.⁹² Yet, the public is rarely interested in seeing do-gooders prosecuted. The New York Attorney General's role in pressuring the Red Cross to allocate all of its 9/11 donations for the aftermath of that disaster was unique in that regard.⁹³

Even if a suit is brought against directors of a disaster relief organization, the business judgment rule provides significant protection from liability for "unwise or erroneous" decisions.⁹⁴ Further strengthening this shield from liability is the fact that it is difficult to link a director to any damage done to the organization because a nonprofit organization lacks a "bottom line" of profit.⁹⁵ Even if the business judgment rule did not apply, rigorous enforcement of fiduciary duty obligations would likely not be pursued due to policy considerations, including the fact that the threat of litigation against nonprofit fiduciaries interferes with everyday decision-making,⁹⁶ impedes innovation,⁹⁷ and deters people from volunteering to join boards.⁹⁸ Thus, relying on state Attorneys General to enforce the fiduciary duties of new disaster relief organizations does not prevent the fraud, theft, and waste that may plague such organizations.

B. Federal Tax Law

Nonprofit governance is under the jurisdiction of state law. Yet, federal tax law can indirectly enforce state fiduciary duty law more effectively than state law or state Attorneys General because the Internal Revenue Service screens applications for tax-exempt status and examines tax returns.⁹⁹ While the entire tax code does not even include the word "governance," the Internal Revenue Service is becoming more

⁹² Manne, *supra* note 9, at 251.

⁹³ Katz, *supra* note 25, at 258, 312; SEESSEL, *supra* note 12, at 32 (describing the "public outcries" over the Red Cross allocation of money for future disasters though it had been soliciting funds for what people thought was an exclusively 9/11-related "Project Liberty" Fund).

⁹⁴ Smith, *supra* note 75, at 28; Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205, 232 (2004).

⁹⁵ FISHMAN & SCHWARZ, *supra* note 4, at 142 ("The bottom line, the talisman of profit-seeking activity, is easier to measure than nonprofit effectiveness.").

⁹⁶ Katz, *supra* note 25, at 279-80 (discussing how courts do not order nonprofits to spend their money in particular ways based on the deference to nonprofits under the "best judgment rule," the nonprofit analogue to the private sector "business judgment rule").

⁹⁷ Brakman Reiser, *supra* note 94, at 231-33.

⁹⁸ FISHMAN & SCHWARZ, *supra* note 4, at 157-58 (describing the "widespread attitude that nonprofit directors are essentially volunteers, and aggressive attempts to enforce their responsibilities are inappropriate and will discourage individuals from board service" and concluding that "courts and attorneys general tend to be overly solicitous of directors, which may explain why so few cases reach trial").

⁹⁹ Fishman, *supra* note 7, at 265 ("Though the attorney general historically has been responsible for charities' accountability, because of a lack of resources, the IRS has become the primary regulator of nonprofit behavior. The IRS's Division of Tax-Exempt and Government Entities is responsible for regulatory oversight.").

involved in promoting good governance due to the belief that it will lead to tax law compliance.¹⁰⁰

1. Weak Enforcement

Three main tax rules could make disaster relief organizations more financially accountable and effective: the bar against private benefit, the bar against inurement, and the intermediate sanctions rule. Section 501(c)(3) of the Federal Internal Revenue Code provides that a tax-exempt organization must be organized for charitable purposes.¹⁰¹ Accordingly, tax-exempt disaster relief organizations must serve the poor, distressed, or underprivileged.¹⁰² Tax-exempt organizations are barred from allowing any person with a personal or private interest in the organization to receive any undue financial benefit.¹⁰³ Similarly, they are barred from allowing any disinterested outsider to receive a substantial financial benefit even if it is incidental to the charitable operation of the organization.¹⁰⁴ Violations of either rule can lead to revocation of tax-exempt status.¹⁰⁵ As an alternative to revocation of its tax-exempt status, an organization may merely receive penalties for any “excess economic benefits” under the intermediate sanctions rule.¹⁰⁶ However, this penalty is only imposed *after* there has been some misuse of funds and does not preempt fraud, theft, and waste of funds.¹⁰⁷

2. New Governance Reporting

Federal tax reporting requirements are, by their very nature, unable to deter fraud, theft, and waste and do not incentivize compliance with fiduciary duties so as to prevent such malfeasance from occurring.¹⁰⁸ Ongoing compliance for tax-exempt status requires the filing of a Form 990 tax return that declares income, assets, expenses, fundraising

¹⁰⁰ See Remarks of Steven T. Miller, Commissioner of Tax and Government Entities of the Internal Revenue Service, Given at the Panel on Nonprofit Governance at the Western Conference on Tax Exempt Organizations in Los Angeles, California (November 20, 2008), http://www.irs.gov/pub/irs-tege/stm_loyolagovernance_112008.pdf [hereinafter IRS Commissioner Speech] (describing the IRS’s new involvement in governance).

¹⁰¹ I.R.C. § 501(c)(3) (2006).

¹⁰² IRS DISASTER RELIEF REPORT, *supra* note 18, at 4.

¹⁰³ Treas. Reg. § 1.501(c)(3)-1(c)(2) (2007).

¹⁰⁴ *Id.* §§ 1.501(c)(3)-1(c)(1), 1.501(c)(3)-1(d)(ii) (2007).

¹⁰⁵ *Id.*; see *supra* note 103.

¹⁰⁶ I.R.C. § 4958 (2006); FISHMAN & SCHWARZ, *supra* note 4, at 476 (“Historically, the Service has invoked the inurement limitation only in the most egregious cases of insider conduct. Since the only sanction was the ultimate death sentence—revocation of exemption—enforcement was lax.”).

¹⁰⁷ SILBER, *supra* note 69, at 151-58 (arguing that regulation of organizations should not be based on federal tax law, which primarily reviews revenue, and does not look for other problems).

¹⁰⁸ *Id.*

expenses, and a list of the highest paid salaries.¹⁰⁹ Medium to large organizations that fail to file a Form 990 are fined, but only a continuous failure to file will result in the revocation of an organization's tax-exempt status.¹¹⁰ Small organizations with budgets of less than \$25,000 that were not previously required to file a Form 990 tax return are now required to file an "electronic postcard" tax return and will similarly have tax-exempt status revoked if they do not do this for three years.¹¹¹ To the extent that reporting requirements deter malfeasance, the public remains unable to sue even if the itemized financial information, made available to the public, allowed for allegations of fraud, theft, or waste.¹¹²

In a major new initiative to promote good governance practices, the Internal Revenue Service revised the annual Form 990 to include a detailed set of questions about governance, management, and disclosure.¹¹³ An entire section in the new annual tax return form includes questions about internal controls and the board's composition, compensation, and independence.¹¹⁴ "We care about governance because we believe . . . that a well-governed organization is more likely to be compliant with the tax law, while poor governance can easily lead to trouble."¹¹⁵ The agency commissioner also remarked that the IRS would enter into a "dialogue" and make "recommend[ations]" with an organization about good governance practices whether or not there was a link between governance and a tax law compliance problem.¹¹⁶ Additionally, the commissioner stated that the IRS would use new software in 2009 that would ask tax-exempt status applicants questions about governance in order to educate and promote good governance practices at the outset of the tax-exemption process.¹¹⁷ It is unclear to what extent the IRS can require organizations to have certain governance structures in place.¹¹⁸

¹⁰⁹ IRS, COMPLIANCE GUIDE FOR 501(C)(3) PUBLIC CHARITIES 5-10, 18 (2006-2007), available at <http://www.irs.gov/pub/irs-pdf/p4221pc> [hereinafter IRS COMPLIANCE GUIDE]; Vanderwarren, *supra* note 79, at 969.

¹¹⁰ IRS COMPLIANCE GUIDE, *supra* note 109, at 10.

¹¹¹ *Id.* at 9-10.

¹¹² Vanderwarren, *supra* note 79, at 974.

¹¹³ IRS Commissioner Speech, *supra* note 100.

¹¹⁴ IRS Form 990, Return of Organization Exempt from Income Tax (2008), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> (last visited Jan. 6, 2009); see also April, *supra* note 71, at 784; IRS, IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Thresholds to provide Transition Relief, Dec. 20, 2007, <http://www.irs.gov/newsroom/article/0,,id=176722,00.html> (describing the IRS's interest in having nonprofits "explain their activities" in more detail).

¹¹⁵ IRS Commissioner Speech, *supra* note 100, at 3.

¹¹⁶ *Id.* at 5.

¹¹⁷ See *id.* at 6.

¹¹⁸ Christopher Quay & Fred Stokeld, *IRS's Lerner Details Discussion Draft of Resigned Form 990*, TAX NOTES TODAY, June 15, 2007 ("It is relevant to both ask whether the IRS should be incentivizing behavior which is not required by the Internal Revenue Code and for which there is no direct connection to requirements of the Internal Revenue Code." (quoting Suzanne Ross McDowell, Steptoe & Johnson LLP) (internal quotation marks omitted)).

3. Disaster Relief Compliance with Tax-Exempt Criteria

All disaster relief organizations have to abide by specific criteria, though no federal enforcement that is specifically tailored to the disaster relief context ensures that these criteria are met. To apply for tax-exempt status, one need only fill out a formal application and provide a description, with supporting documents, of the organization's current and future financial activities, services, and governance structure.¹¹⁹ A new organization that has been incorporated to serve victims of disasters can apply for tax-exempt status when it serves a charitable purpose fulfilled through assistance to disaster relief victims.¹²⁰

According to an IRS publication, the disaster relief organization must abide by three main criteria.¹²¹ First, the organization must provide aid to a "large or indefinite" charitable class in such a way as to benefit a community that has been affected by a disaster, as opposed to a few injured individuals hurt in an accident.¹²² For example, in the case of September 11th, the narrowest legal class involves families of groups such as uniformed personnel, those on the airplanes, or those killed in the World Trade Center.¹²³ A more expansive and acceptably defined class might include low-wage workers or displaced residents of lower Manhattan.¹²⁴ Second, the organization must establish and use a "needy or distressed test" that objectively evaluates individual victims to determine whether they are financially needy at the time of the grant.¹²⁵ Third, the organization must maintain records demonstrating that the assistance was provided to meet a victim's particular needs.¹²⁶ Even a wealthy disaster victim could be "needy and distressed" in the immediate aftermath of a disaster and a relief organization could lawfully provide that victim with blankets, food, and crisis counseling.¹²⁷ Documentation should describe the aid, why it was given, the charity's objective criteria of a victim's needs, how that analysis was done for each victim, contact information and award size for each victim, and disclosure of any relationship between an assisted victim and an organizational insider.¹²⁸

The problem with the needy and distressed test is that the IRS defers to the organization to analyze and provide relief for victims in a

¹¹⁹ PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 10.

¹²⁰ Adler & Rosen, *supra* note 47, at 297; see IRS DISASTER RELIEF REPORT, *supra* note 18, at 2.

¹²¹ IRS DISASTER RELIEF REPORT, *supra* note 18, at 5-10; see also Katz, *supra* note 25, at 259-61.

¹²² IRS, DISASTER RELIEF REPORT, *supra* note 18, at 5-7; Catherine E. Livingston, *Disaster Relief Activities of Charitable Organizations*, 35 EXEMPT ORG. TAX REV. 153, 156 (2002).

¹²³ See Katz, *supra* note 25, at 267.

¹²⁴ See *id.*

¹²⁵ IRS DISASTER RELIEF REPORT, *supra* note 18, at 7-8.

¹²⁶ *Id.* at 9-10.

¹²⁷ *Id.* at 7.

¹²⁸ *Id.* at 9-10.

way that furthers the charitable purpose of the organization.¹²⁹ As a result, disaster relief organizations run by inexperienced people have latitude in how to disburse funds and can be particularly prone to fraud, theft, and waste. The organization must simply use its best efforts to further its charitable purpose and evaluate “all pertinent circumstances” of a victim’s financial situation to avoid bestowing upon them the impermissible private financial benefit.¹³⁰ Nonprofits do not have any obligation to make victims “whole” again,¹³¹ yet disaster relief organizations may use the needy and distressed test to provide wealthy victims with longer-term assistance in the form of services.¹³²

Finally, two further legal developments impacted the field of nonprofit disaster relief work. First, the relaxation of the needy and distressed test in 2001 enabled disaster relief organizations to provide cash to wealthy victims who were no longer needy and distressed as the test was traditionally construed.¹³³ While not enacted after later disasters, the new law established an ongoing social norm that disaster relief organizations’ proper and effective role is to raise and expeditiously give away money to a narrow class of victims.¹³⁴ Second, an expedited tax-exempt process established after September 11th and Hurricane Katrina has reinforced a social norm that disaster relief organizations can be run by inexperienced people despite the existence of established, existing disaster relief organizations. Any individual, regardless of past professional experience, can easily form a federally tax-exempt nonprofit corporation to serve victims of a disaster.

¹²⁹ *Id.* at 8 (“A charitable organization is responsible for taking into account the charitable purposes for which it was formed, the public benefit of its activities, and the specific needs and resources of each victim when using its discretion to distribute its funds.”).

¹³⁰ *Id.* at 11; Katz, *supra* note 25, at 263-64 (“In addition to aiding a sufficient number of persons, a charity cannot provide too much aid relative to the charitable goals that it ostensibly advances. . . . More broadly, an exempt organization cannot provide excess benefits to *any* private entity or individual, including organizational outsiders. This is known as the ‘private benefit’ doctrine.”) (footnotes omitted).

¹³¹ *Id.* at 7-8 (emphasizing that disaster relief aid is not tantamount to providing something akin to insurance payouts); Katz, *supra* note 25, at 271 (“[D]isaster relief is not insurance.”); Livingston, *supra* note 122, at 156.

¹³² IRS DISASTER RELIEF REPORT, *supra* note 18, at 7.

¹³³ Victims of Terrorism Tax Relief Act of 2001, 26 U.S.C. § 501 (2006); IRS DISASTER RELIEF REPORT, *supra* note 18, at 7, 10-11. This resulted in families of 9/11 victims receiving approximately \$1.78 million each. See Press Release, Department of Justice, Monday, December 22, Is Deadline to File Claim in September 11th Victim Compensation Fund (Dec. 18, 2003), available at http://www.usdoj.gov/opa/pr/2003/December/03_civ_708.htm (“The average amount of compensation paid to date to the families of those who died on September 11 is \$1.78 million. Individual death compensation amounts have ranged from \$250,000 to \$6.9 million. Those physically injured as a result of the attacks have received Fund compensation ranging from \$500 to \$7.9 million.”).

¹³⁴ Stephanie Strom, *Here’s My Check, Spend It All at Once*, N.Y. TIMES, Jan. 20, 2008 (providing support for the proposition that after a disaster donors now expect to direct their funds wherever they choose despite the fact that the victims may not need additional funds and the organization may need to use funds for another purpose).

Through the disaster-relief specific expedited process, individuals have received tax-exempt status in a mere few days,¹³⁵ rather than sixty days or six months in the normal application and approval process.¹³⁶ The goal of the expedited process is to allow nonprofit providers to raise money through a tax-exempt organization to meet the unmet needs of disaster victims.¹³⁷ While the number of disaster relief groups formed through the expedited process represents a small number of the total applications approved for tax-exempt status every year, the policy has received heavy criticism.¹³⁸ Because the federal law and regulations have allowed formation of new disaster relief organizations run by inexperienced people, governance reform is needed to ensure that these organizations reduce the potential for theft, fraud, and waste.

III. PROPOSED FINANCIAL OVERSIGHT COMMITTEE IN NEW DISASTER RELIEF ORGANIZATIONS

Part III proposes that new disaster relief organizations can be effectively regulated by a financial oversight board committee specifically geared to reducing theft, fraud, and waste.¹³⁹ This Part describes the type of comprehensive financial oversight committee tasks that may improve the financial accountability of new disaster relief organizations and considers the limits of such a proposal. This Part further considers the advantages and limitations to the enforcement of the financial oversight committee by public agencies, accrediting agencies, and large funders. Part III ultimately argues that despite the limitations discussed, the prevention of theft, fraud, and waste will improve the accountability of new disaster relief organizations, better meet the acute

¹³⁵ See IRS DISASTER RELIEF REPORT, *supra* note 18, at 3 (requiring only a cover letter and brief description of the disaster and explaining why there is a need for urgent processing of tax-exempt status); Strom, *supra* note 3 (describing how an organization called “Drop Yer Drawers” received tax-exempt status within eight days after applying, and another organization, Angel Pray Child Charity Foundation, of Pennsylvania, received tax-exempt status in fifteen days though as of 2006 it had not served any children victimized in the Hurricane).

¹³⁶ Strom, *supra* note 3.

¹³⁷ IRS DISASTER RELIEF REPORT, *supra* note 18, at 2-3; Where Most Needed, IRS Too Responsive after Katrina, Say Critics, http://www.wheremostneeded.org/2006/03/irs_too_respons.html (Mar. 15, 2006).

¹³⁸ Where Most Needed, *supra* note 137 (describing how IRS adds 80,000 new organizations per year); see also Lipman, *supra* note 2; Strom, *supra* note 3; *supra* Part I.D (describing new organizations that received expedited tax-exempt status, and criticism of the expedited process).

¹³⁹ FRANCIE OSTROWER, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY 16 (2007), available at http://www.urban.org/UploadedPDF/411479_Nonprofit_Governance.pdf (last visited Jan. 21, 2008) (concluding that even though small nonprofit organizations reported to the study that they would have difficulty implementing governance reforms, “[h]aving organizational members that elect one or more board members was positively associated with activity in multiple internal and externally oriented roles (e.g., fundraising, financial oversight, planning, monitoring programs, setting policy)”).

and long-term needs of disaster victims, and restore the nonprofit sector's tarnished reputation.

A. Overview

The financial oversight committee should primarily ensure that a new disaster relief organization has systems in place to assess and manage the risks involved in receiving and allocating large sums of money.¹⁴⁰ The concept of a financial oversight committee improves upon existing reforms that call for audit committees only when an organization reaches a certain size.¹⁴¹ Instead, a board committee focused on financial oversight should be mandated regardless of the organization's size. Such a mandate should be enforced through government agencies, self-regulatory bodies, and large funders because current legal channels cannot ensure financial accountability until after fraud, theft, or waste have already occurred.¹⁴²

While the formalization of a board committee specializing in financial oversight may be the most traditional type of governance reform in terms of mirroring governance structures required in publicly held corporations,¹⁴³ it is also the most appropriate governance reform for new disaster relief organizations precisely as a result of its "concreteness."¹⁴⁴ This will ground the board in refining policies and procedures around one metric, as opposed to metrics that are hard to define such as whether or not the organization is best serving disaster relief victims. Moreover, the clear delineation of responsibilities among board members, a rarity in new nonprofit organizations,¹⁴⁵ may even

¹⁴⁰ Vanderwarren, *supra* note 79, at 986-87 (persuasively arguing how a formalized audit committee can prevent theft at small organizations despite the fact that it is widely assumed that small organizations do not need formalized board committees).

¹⁴¹ The California Nonprofit Integrity Act of 2004 requires nonprofit organizations to have an audit committee comprised of people who do not serve as staff members when gross revenues reach \$2 million per fiscal year. CAL. GOV'T CODE § 12586(e)(2) (West 2009); Aprill, *supra* note 71, at 770-73 (describing how the Nonprofit Integrity Act requires an audit committee for organizations with revenue of \$2 million per year, whereas the Panel on the Nonprofit Sector had proposed that organizations with revenues of \$1 million per year should have audit committees, and the Senate had proposed that organizations with revenue of just \$250,000 per year should have audit committees).

¹⁴² Analyses of how to enforce reforms through public and private channels is common in nonprofit legal scholarship. For some examples of these analyses, see Fishman, *supra* note 7, at 272-75 (arguing for state "charity commissions" situated in each judicial district and composed of private citizens appointed by the governor); Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT L. REV. 803, 830-34 (2005) (lauding the self-regulatory standards established by the Maryland Council of Nonprofit Associations); Vanderwarren, *supra* note 79, at 987 (arguing that governance oversight can potentially prevent scandals).

¹⁴³ Brakman Reiser, *supra* note 94, at 258-68. New governance requirements proposed in New York and Massachusetts, and incorporated into California law, were based on Sarbanes-Oxley corporate requirements of board composition, committees and duties. *Id.*

¹⁴⁴ *Cf. id.* at 222 (describing the "concreteness" of financial accountability as suitable focus of the Attorney General).

¹⁴⁵ FISHMAN & SCHWARZ, *supra* note 4, at 218.

trigger the formation of similar committees in other areas of governance and provide for an altogether better board of directors.¹⁴⁶

1. Composition

First, the financial oversight committee should be comprised of “independent” members. This requirement responds to the assumption that a dispassionate and objective perspective results in improved decision-making and financial accountability.¹⁴⁷ Board members are considered independent when they are not employed by the organization, receive no financial compensation from the organization, and are not in the immediate family of other board or staff members.¹⁴⁸ The need for independent directors reflects an ongoing debate in corporate and nonprofit law.¹⁴⁹ Therefore, the requirement of a financial oversight committee composed of independent members at even new disaster relief organizations would be consistent with some state laws and recent governance proposals.

The ever-present problem of how to form this committee at a small organization¹⁵⁰ could be solved by allowing the committee to be flexibly comprised of any number of board members that best suits the size of the organization.¹⁵¹ In fact, disasters may provide the best environment for new organizations to be connected to independent financial oversight committee members. Because disasters galvanize emotion and support, new organizations may have access to numerous pro bono, financially literate volunteers who want to help victims in a meaningful way.¹⁵² Accordingly, financial oversight committees might

¹⁴⁶ Boozang, *supra* note 7, at 131 (“A strong and qualified board will work only if it knows what is really going on inside the organization.”).

¹⁴⁷ Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 *FORDHAM L. REV.* 795, 809-10 (2007).

¹⁴⁸ PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 23 (proposing that two-thirds of the board of a charity should be “independent” in that they (1) do not receive compensation as an employee, (2) do not receive compensation that is determined by someone who is compensated by the organization, (3) do not stand to materially, financially benefit from the organization, and (4) are not related to and do not live with individuals described in (1),(2) or (3)).

¹⁴⁹ See *supra* notes 145-147; see *supra* note 37 (proposing a supermajority of independent directors who meet certain criteria). In contrast, New Hampshire requires that all boards comprise a minimum of five members who are not “of the same immediate family or related by blood or marriage.” N.H. REV. STAT. § 292.6-a (1999); California requires that not more than forty-nine percent of a board may be “interested,” in that they cannot be compensated by the organization or cannot be a “brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law” of any compensated person. CAL. CORP. CODE. § 5227 (2009).

¹⁵⁰ OSTROWER, *supra* note 139, at 22 (describing how small organizations have reported themselves to have difficulty implementing governance mandates).

¹⁵¹ Boozang, *supra* note 7, at 129 (endorsing as least a few “formally designated” monitoring directors to improve governance); Vanderwarren, *supra* note 79, at 983 (describing how a committee convened specifically to monitor the external auditor does not need to be “one-size-fits-all”).

¹⁵² *Id.* at 770 (describing how criticism of independent director requirements has centered on the low likelihood that anyone would have “adequate time, incentives, and information to conduct effective oversight” (internal quotations omitted)).

easily draw members from accountant trade associations who are able to fulfill the committee roles with very little training and oversight.¹⁵³ Finally, in a new disaster relief organization with a sizable budget, a committee with multiple board members may be appropriate. However, even in a new and small disaster relief organization, the financial oversight committee function could be accomplished through even one board member.

B. How a Financial Oversight Committee Will Mitigate Theft, Fraud, and Waste

1. Reduced Theft and Fraud

The committee should guide the staff and board in the decision-making process so that the organization spends funds in accordance with tax-exempt guidelines.¹⁵⁴ Because the circumstances in which new disaster relief organizations operate allow inexperienced managers and staff easy access to liquid assets,¹⁵⁵ it is imperative that such liquid assets are not solely received and spent through the “complete and unchecked access” of management and staff.¹⁵⁶ In doing so, financial oversight committees should strive to check the behavior of the grief-stricken disaster relief executive director who, in receiving checks left and right, can siphon funds away.¹⁵⁷ Additionally, if the organization provides cash assistance that requires a needy and distressed test analysis,¹⁵⁸ the financial oversight committee should regularly review how that analysis is being done. At a minimum, the financial oversight committee should be educated and trained to understand that the unique circumstances of disaster aftermath can lead an organization to experience a cash windfall, and appreciate the risk involved in rushing to provide aid to individuals whose claims may be fraudulent.

2. Reduced Waste

Through continuous review of policies and procedures grounded in receiving and allocating money, the financial oversight committee will also serve a programmatic function. The committee should decide which programs to fund in order to protect the long-term health of the organization. This requirement would essentially formalize the

¹⁵³ Vanderwarren, *supra* note 79, at 981 (“Many CPA societies have a public interest section geared at helping small nonprofit organizations recruit board members.”).

¹⁵⁴ IRS DISASTER RELIEF REPORT, *supra* note 18, at 5-8 (describing the requirements of analyzing needy and distressed victims, and recording the information adequately).

¹⁵⁵ See *supra* Part II.A for a description of embezzlement by the founding director of a new disaster relief organization.

¹⁵⁶ Vanderwarren, *supra* note 79, at 983.

¹⁵⁷ Barron, *supra* note 19.

¹⁵⁸ IRS DISASTER RELIEF REPORT, *supra* note 18, at 7.

recommendation made by existing regulators that board members should evaluate programs,¹⁵⁹ particularly in the wake of a disaster. Additionally, an independent financial oversight committee should oversee how money is spent by highly charged, emotional, and even grief-stricken staff members.

Critics of board committee requirements contend that nonprofits should spend their resources on more process-oriented reforms.¹⁶⁰ The nonprofit sector is already resource-strapped and new organizations may be less inclined to expend resources on implementing novel governance practices.¹⁶¹ Additionally, donors might dislike the fact that disaster relief organizations will focus on governance, not victims.¹⁶² However, the promulgation of sector-wide standards for a financial oversight committee, especially if enforced effectively,¹⁶³ may diffuse donors' anxieties about more Red Cross type scandals and enable new disaster relief organizations to form and rely on financial oversight committees.

Finally, while some optimism in the less bureaucratic channels of small disaster relief organizations is warranted,¹⁶⁴ this should not be taken to mean that no governance committee is necessary. Small, new disaster relief organizations providing cash assistance might screen victims more carefully than a large organization like FEMA or the Red Cross in order to eliminate fraudulent applicants. However, small nonprofit organizations are as likely, if not more so, to experience theft and waste of funds as larger nonprofit organizations.¹⁶⁵ Furthermore, the intimacy and informality of small nonprofits warrant a greater need for

¹⁵⁹ ANDREW CUOMO, INTERNAL CONTROLS AND FINANCIAL ACCOUNTABILITY FOR NOT-FOR-PROFIT BOARDS 12-13 (2007), available at http://www.oag.state.ny.us/bureaus/charities/pdfs/internal_controls.pdf.

¹⁶⁰ See generally Mulligan, *supra* note 8; see also Aprill, *supra* note 71, at 771; Brakman Reiser, *supra* note 90, at 593.

¹⁶¹ Nonprofit legal scholars commonly argue that government regulation of nonprofit governance leads to agency costs that may detract from the money spent on the mission. For examples of these arguments, see Brakman Reiser, *supra* note 90, at 586 ("If the burdens of compliance with regulation push nonprofits to scale back their programs or force them out of existence, beneficiaries, communities, and society will bear a real loss."); Manne, *supra* note 9, at 244 (condemning costs bound to be incurred by nonprofits through state review boards); Mulligan, *supra* note 8; Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Governance*, 2003 UTAH L. REV. 1303, 1316-20 (2003) (government mandated board duties designed for private corporations are inapplicable to nonprofits that depend on donations for operating costs).

¹⁶² Strom, *supra* note 134 (providing timely support for the proposition that donors following a disaster do not want their money going to the organization's overhead or administrative expenses).

¹⁶³ See *infra* Parts III.A-C for a discussion of how various entities may offer effective enforcement of a financial oversight committee function within new disaster relief organizations.

¹⁶⁴ Small nonprofit organizations are generally more community-oriented and therefore can interact in a more flexible way with victims of a disaster. See DISASTER RELIEF AND RECOVERY, *supra* note 40, at 8 ("Nonprofits organizations with roots in the community are well-positioned to provide appropriate services, such as skills training, resume services and job placement, and to take advantage of wage subsidies.").

¹⁶⁵ Vanderwarren, *supra* note 79, at 986-87 (describing the "small-time scandal" of Illinois Federation of Families, where nearly \$50,000 was stolen); Barron, *supra* note 19.

segregation of duties and a financial oversight committee that prevents management's unchecked access to funds.¹⁶⁶ No governance reform can guarantee an end to theft, fraud, and waste. However, board members with a "blueprint"¹⁶⁷ of how to run a good organization with strong accounting practices and internal controls are unequivocally in a better position to mitigate and prevent such problems.¹⁶⁸

C. *Enforcement*

1. Government Enforcement

New state statutes requiring financial oversight committees for such a narrow category of nonprofit activity is unlikely. However, public sector agencies should mandate the formation of financial oversight committees in the boards of directors of new disaster relief organizations. This would formally integrate the federal and state governments' liberal tax-exempt and incorporation laws, respectively, with their own recommendations for good governance practices.¹⁶⁹ Such heightened fiduciary duties might be effectively enforced by the Internal Revenue Service or state Attorneys General.

The federal government can successfully enforce a financial oversight committee at a new disaster relief organization for various reasons. First, the federal government already regulates financial reporting of tax-exempt organizations,¹⁷⁰ it has already recommended standards for good governance for tax-exempt organizations,¹⁷¹ it already regulates governance requirements in publicly-traded corporations,¹⁷² and it already leads disaster relief efforts through the Federal Emergency Management Agency (FEMA). However, it is likely too farfetched to suggest that a blending of all of these responsibilities would occur at the federal level. While commentators have advocated the creation of a federal agency that regulates nonprofit governance analogous to the Securities and Exchange Commission, the day has not yet come.¹⁷³ The

¹⁶⁶ OSTROWER, *supra* note 139, at 22 ("Smaller nonprofits that engage in financial transactions need to have more formal policies in place . . ."); Vanderwarren, *supra* note 79, at 983.

¹⁶⁷ Brakman Reiser, *supra* note 90, at 590.

¹⁶⁸ *Id.* (discussing how internal controls, when defined, can "provide a blueprint for how to accomplish such improvements . . . by demanding the creation of individualized internal controls within organizations").

¹⁶⁹ See IRS, GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS 8, available at http://www.irs.gov/pub/irs-tege/governance_practices.pdf (last visited Mar. 6, 2009) ("[A] charity with substantial assets or revenue should consider obtaining an audit of its financial statements by an independent auditor. The board may establish an independent audit committee to select and oversee an independent auditor.").

¹⁷⁰ See *supra* Part II.B.2.

¹⁷¹ *Id.*; Aprill, *supra* note 71, at 783.

¹⁷² ARTHUR PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 128-32 (LexisNexis 2004).

¹⁷³ Fishman, *supra* note 7, at 268.

Federal Emergency Management Agency (FEMA), with its pre-existing grantor-grantee relationships with numerous, smaller disaster relief organizations,¹⁷⁴ should perhaps be required to make its own post-disaster grants contingent upon the formation of a financial oversight committee function in new disaster relief organizations. However, the reputation of FEMA is so mired in controversy surrounding its own lack of financial accountability that it would also be unrealistic to expect it to require good governance practices in grant recipient organizations after the next disaster.¹⁷⁵ Lastly, if the IRS required a financial oversight committee, it is unclear what it would do to penalize organizations that do not comply. Tax revocation is not clearly within the remit of the federal government on the issue of nonprofit governance.¹⁷⁶ Ultimately, the limited resources of the federal government might make it impossible for the federal government to effectively regulate the governance of the nonprofit sector, in all of its breadth,¹⁷⁷ and perhaps its role should be limited to reflect this.¹⁷⁸ Critics that wish to maintain regulation in states, despite states' very lax regulatory environment, disapprove of the general extension of this "federalization"¹⁷⁹ of the nonprofit sector.

The IRS may only be left with a limited but important role of education at the outset of the tax-exemption process and also in response to information gathered in Form 990s.¹⁸⁰ First, governance recommendations for financial accountability after a disaster should be included in the application process for tax-exempt status.¹⁸¹ Second, the two pamphlets cited in this Note, one for disaster relief, and another one for good governance practices, should at the very least be integrated, published, and disseminated each time a new disaster relief organization receives tax-exempt status. Finally, the IRS should base renewal of tax-

¹⁷⁴ For a description of FEMA's \$150 million grant program after 9/11, see April Naturale, *Someone to Lean On: Addressing Emotional Needs Through Project Liberty*, http://www.fema.gov/remember911/911_lean.shtm (last visited Mar. 1, 2009).

¹⁷⁵ Spencer S. Hsu, *Leaders Lacking Disaster Experience*, WASH. POST, Sept. 9, 2005, at A01 ("[I]nexperience in FEMA's top ranks is emerging as a key concern of local, state and federal leaders as investigators begin to sift through what the government has admitted was a bungled response to Hurricane Katrina.").

¹⁷⁶ See *supra* Part II.B.2.

¹⁷⁷ Fishman, *supra* note 7, at 272 ("It is doubtful that there will be a substantial increase in funding for enforcement activity at either the federal or state levels. The only realistic way to increase nonprofit accountability and to create new norms of fiduciary behavior is to leverage existing regulators' efforts by making them more efficient.").

¹⁷⁸ Vanderwarren, *supra* note 79, at 973 ("The IRS is not the appropriate agency to regulate charities; its role should continue to be limited to collecting revenue.").

¹⁷⁹ Aprill, *supra* note 71, at 769, 792 (proposing that the IRS should only establish minimum nonprofit governance standards and withdraw from regulating nonprofit governance if state law is adequate).

¹⁸⁰ The broader idea of educating board members as a means of governance reform is not original. See, e.g., *id.* at 792; Brakman Reiser, *supra* note 94, at 276-78 (describing the importance of "[t]raining and [e]mpower[ment] [of] [n]onprofit [a]ctors" as a reform mechanism).

¹⁸¹ See *supra* text accompanying note 116.

exempt status upon directors' completion of educational programs that address the problem of financial accountability after a disaster.¹⁸²

Alternatively, the regulation of new disaster relief organizations' financial oversight committees may better belong to the office of the each states' Attorney General. In New York, the Attorney General recommends that all nonprofit organizations have internal controls, such as "policies and procedures that . . . promote compliance with laws and regulations and achieve effective and efficient operations . . . and include procedures for . . . handling funds received and expended by the organization . . . [and] evaluating staff and programs."¹⁸³ The Attorney General further recommends that the board be separate from management, that no one person receive or deposits checks, and that board members perform a periodic evaluation of the nonprofit's programs for efficiency and effectiveness.¹⁸⁴ However, the Attorney General must do more than make recommendations for general governance practices that can be easily ignored after a disaster.

To the extent that a state Attorney General cannot enforce fiduciary duties because of its lack of resources and the rarity of prosecution power, one scholar has proposed the creation of a state Attorney General "charity commission" to fill the gap in regulation.¹⁸⁵ A charity commission might have more flexibility than the Attorney General's office to rapidly and continually monitor the work of new disaster relief organizations after they are incorporated by the state. The commission should review the composition and performance of an organization's financial oversight committee. While regulation from a new state entity might lead to "regulating some charities out of existence,"¹⁸⁶ the benefits of centralized, state leadership to all nonprofits in the aftermath of a disaster may outweigh the costs.

2. Self-Regulatory Approaches

A financial oversight committee norm¹⁸⁷ can also be enforced by self-regulatory agencies after a disaster. Self-regulatory approaches to nonprofit accountability are based on establishing and applying best

¹⁸² Aprill, *supra* note 71, at 792.

¹⁸³ ANDREW CUOMO, *supra* note 159, at 2.

¹⁸⁴ *Id.* at 2-8, 12-13 (Many other policies and procedures are recommended, including conflict of interest statements, the establishment of a code of ethics, training, job descriptions, personnel policies, and a CPA).

¹⁸⁵ Fishman, *supra* note 7, at 240-46 (arguing that citizen-staffed charity commissions under the auspices of the state Attorney General will improve adherence to fiduciary duties); *see also* FISHMAN & SCHWARZ, *supra* note 4, at 249.

¹⁸⁶ *Id.* at 267 ("Centralized standards are bound to have needlessly disastrous effects on the margin, even regulating some charities out of existence.").

¹⁸⁷ FISHMAN & SCHWARZ, *supra* note 4, at 243 ("Norms are informal social regularities that individuals feel obligated to follow because of an internalized sense of duty or a fear of external nonlegal sanctions. Norms can transform the abstract mandates of the statutory fiduciary requirements into practice guides.").

practices in governance.¹⁸⁸ After a disaster, charity watchdog organizations should evaluate new disaster relief organizations and rate them according to whether or not they have a financial oversight committee.¹⁸⁹ Watchdog groups should also educate donors about which organizations have strong enough financial oversight to justify donations.¹⁹⁰ Self-regulatory nonprofit accountability is inexpensive, promotes voluntary adherence to best practices and preempts the need for government regulation.¹⁹¹ When a watchdog organization rates a new disaster relief organization, it can provide a “seal of approval”¹⁹² that helps donors, and potentially users, access comparative information on nonprofit governance to show that the board is committed to closely reviewing the receipt and allocation of funds.¹⁹³ Both sophisticated and small-time donors should rely on self-regulatory disaster relief ratings to be better informed in the rush to donate after a disaster.¹⁹⁴ Moreover, founders or board members of new organizations will comply with self-regulatory standards in order to compete for donations.¹⁹⁵

The self-regulatory evaluation of new disaster relief organizations requires funding and staff that the sector’s private

¹⁸⁸ PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 60; Brakman Reiser, *supra* note 94, at 273 (specifically describing benefits of rating agencies). As an example of one rating agency’s standards, see BETTER BUSINESS BUREAU, STANDARDS FOR CHARITY ACCOUNTABILITY, <http://www.bbb.org/us/Charity-Standards> (last visited Apr. 1, 2009).

¹⁸⁹ PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 52-59 (cataloging numerous watchdog organizations that set standards and evaluate nonprofit organizations).

¹⁹⁰ See *supra* note 62 and accompanying text (discussing Charity Navigator, a watchdog group that evaluates and rates 5000 nonprofit organizations and that has urged donors after Hurricane Katrina not to contribute to “newly formed charities” after a disaster); see also Charity Navigator, <http://www.charitynavigator.org/> (last visited Apr. 1, 2009); Charity Navigator, 5 Lessons For Donors to Take to Heart, available at <http://www.charitynavigator.org/index.cfm?bay=katrina.article&cpid=454> (last visited Apr. 1, 2009).

¹⁹¹ Brakman Reiser, *supra* note 94, at 273 (describing how such private sector “intermediaries” such as Better Business Bureau can rate charities and therefore lead to improved performance); Sidel, *supra* note 142, at 835 (arguing that self-regulation can prevent government involvement, which creates a situation where nonprofits are “diluted from their crucially important social roles or some charities are pushed out of the picture due to their size, a strong sense of autonomy, or their innovative spirit”).

¹⁹² See PANEL ON THE NONPROFIT SECTOR, *supra* note 37, at 62. Self-regulatory approaches function in a variety of ways, including “accreditation, best practices, codes of ethics, seals of approval, and ratings.” *Id.* at 58.

¹⁹³ Brakman Reiser, *supra* note 94, at 274 (“Donors do seem interested in information regarding the percentage of donated funds used for charitable purposes, as opposed to administrative costs. Similarly, they might like to know whether an organization to which they plan to contribute adheres to its mission and operates in line with its legal governance structure.”).

¹⁹⁴ *Id.* As an example, Families of September 11 is an organization that has met the Better Business Bureau “Seal Program” for meeting a number of accountability standards. Families of September 11, FOS11 Governance, <http://www.fos11.org/governance.aspx> (last visited Mar. 20, 2009).

¹⁹⁵ Manne, *supra* note 9, at 254 (supporting the general proposition that a nonprofit’s reputation impacts fundraising and concluding that “a donative charity perceived as uncontrolled in the midst of well-controlled alternative charities will be at a competitive disadvantage for the scarce dollars given to nonprofits”); Sidel, *supra* note 142, at 809 (arguing that self-regulatory standards have two purposes: to improve the function of nonprofits and to elevate the credibility of nonprofits by comparing them to one another).

watchdog groups may not currently have.¹⁹⁶ Time constraints might be overcome if a fast-track accreditation system is designed to assess and rate new disaster relief organizations. On balance, a self-regulatory rating system that verifies at least the existence of, or continuing improvements to, a financial oversight committee in new disaster relief organizations provides a much more expedient solution to enforcement than existing government channels.

3. Foundations

Foundations have the opportunity and responsibility to encourage the formation of a new financial oversight committee at new nonprofit disaster relief organizations.¹⁹⁷ First, foundations are dramatically different from individual donors based on their expertise in how to direct funds after a disaster. Also, foundations may have expertise in good governance and financial accountability because they can carefully plan and spend their own funds in a manner that pleases their own donors.¹⁹⁸ Foundations can provide grants to improve nonprofit governance where donors may not.¹⁹⁹ While disasters stir emotions and lead to enormous and even historic levels of impulsive giving from many small-time donors,²⁰⁰ such donors lack disaster relief expertise, let alone knowledge of what governance structure will ensure that their donation is well spent after a disaster.

Finally, while foundations are limited in the extent to which they control what a nonprofit grant recipient does with its donation,²⁰¹ they can condition grants after a disaster to new disaster relief organizations based on the formation of a financial oversight committee. Effectively, grants from foundations that implement such mandates lend legitimacy to a new organization. In contrast, self-regulatory watchdog groups lack the direct influence over a new disaster relief organization. Encouraging all foundations to condition grants on the formation of a financial oversight committee norm may be more effective than government

¹⁹⁶ Aprill, *supra* note 71, at 789-90.

¹⁹⁷ Sugin, *supra* note 77, at 893 (describing how increasingly “donors[] . . . impose their vision on the organizations they support”); Vanderwarren, *supra* note 79, at 979 (“Donors have the power to withhold their contributions if they believe an organization is not being managed properly. Such donors include rank-and-file public donors, foundations, and even . . . governments in their capacity as ‘donors.’”).

¹⁹⁸ Brakman Reiser, *supra* note 94, at 270.

¹⁹⁹ Strom, *supra* note 134.

²⁰⁰ NETWORK FOR GOOD, THE YOUNG AND THE GENEROUS: A STUDY OF \$100 MILLION IN ONLINE GIVING TO 23,000 CHARITIES 9, available at http://www.networkforgood.org/downloads/pdf/Whitepaper/20061009_young_and_generous.pdf (last visited Apr. 1, 2009) (“Disaster relief is the leading category of giving and ranks among top [online] searches . . .”).

²⁰¹ Manne, *supra* note 9, at 258 (“[I]t is in the nature of nonprofits that nearly all donors (and many beneficiaries) are unable to control or even observe the disposition of the corporation’s income.”).

mandates and self-regulatory evaluation, though ideally, the three approaches should compliment one another after a disaster.

CONCLUSION

The potential for theft, fraud, and waste creates financial accountability issues in new disaster relief nonprofit organizations that jeopardize the effectiveness of disaster relief in general which, in turn, tarnishes the reputation of the nonprofit sector. Accordingly, this Note strives to add to nonprofit legal scholarship on accountability by addressing a risky context in which nonprofits operate without necessary governance mandates. Despite the criticism offered in this Note, new disaster relief organizations do have extraordinary opportunities to perform a useful role.²⁰² Particularly in the wake of a disaster when public trust and faith in public institutions can be diminished, small or new disaster relief organizations can provide the necessary one-on-one interaction, especially with disenfranchised groups, that helps communities recover from a disaster.²⁰³ By improving the efforts of so many courageous people who endeavor to help disaster victims, the healing process will be enhanced. Therefore, society should embrace these nonprofit disaster relief “rookies”²⁰⁴ and their board members with higher expectations, as opposed to lower ones. The failures of accountability in some new disaster relief organizations to date should not preclude new organizations with good governance practices from continuing to offer vital responses to disaster victims.²⁰⁵

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²⁰² DISASTER RELIEF AND RECOVERY, *supra* note 40, at 8 (arguing that newly formed organizations with “roots in the community” can be uniquely poised to “provide appropriate services”).

²⁰³ *Id.*

²⁰⁴ See *supra* note 50 and accompanying text.

²⁰⁵ Milton Cerny, *Tsunami: NGO Response: Now and the Future*, 47 EXEMPT ORG. TAX REV. 181, 187 (2005) (“[T]here should also be room for private citizens to form new organizations that contribute in new and innovative ways. To the extent that NGO[s] . . . discourage the formation of new organizations in response to new needs, they limit the diversity and vitality that are the hallmarks of a civil society.”).

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