MAKING DISCLOSURE REGULATION WORK IN THE NONPROFIT SECTOR

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Following the Sarbanes-Oxley Act's success using corporate disclosures to help regulate for-profit corporations, some state and federal lawmakers have sought to apply similar principles to nonprofit organizations. Significant differences exist between the for-profit and nonprofit sectors, however, that Britton argues make Sarbanes-Oxley-type provisions inappropriate in the nonprofit context. Under market-based theory, for-profit disclosure permits the securities market to internalize public information and more accurately value corporation securities. With no such market in the nonprofit sector, donors rather than investors, and no public valuation process, Britton argues that greater nonprofit disclosures will not result in increased corporate accountability or law enforcement in the nonprofit sector. Instead, Britton suggests adopting a voluntary disclosure system in which state and federal governments, acting in their roles as significant donors to the nonprofit sector, withhold government grants unless potential recipients voluntarily provide enhanced financial and management disclosures. In addition, Britton proposes new governmental agencies that will compile, organize, and compare these nonprofit disclosures. These agencies will then rate each nonprofit organization based on these disclosures, creating a false market that will enhance or harm the organizations' abilities to attract or retain donors.

I. INTRODUCTION

In the wake of accounting scandals that rocked the nation at the beginning of this century, Congress rushed to pass legislation meant to prevent similar future market failures. The result is commonly referred to as the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act). Although many commentators have criticized Sarbanes-Oxley as a hasty solution to a complicated problem that takes years to fully diagnose and cure,[1] it seems that the law has increased accountability in the corporate world.

1. *See generally* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE 100 (2006) (arguing that Congress passed the Act with insufficient deliberation of its costs and benefits).

In light of Sarbanes-Oxley's apparent success in the for-profit sector, state and federal lawmakers have recently sought to apply similar disclosure and transparency principles to nonprofit organizations. Such laws proposed in the states often feature provisions inspired by, or taken directly from, Sarbanes-Oxley.[2] At least one state has already enacted laws applying Sarbanes-Oxley-type principles to the nonprofit sector.[3] Similarly, the federal Congress is currently considering legislation that would impose Sarbanes-Oxley-type disclosures[4] on a large segment of the nation's nonprofits.[5] Like the hurry to pass Sarbanes-Oxley, many legislators now seem rushed to enact accountability measures for the nonprofit sector. Amidst this frenzy, few, if any, of the lawmakers have publicly paused to consider perhaps the most pertinent question: why is such legislation necessary?

The rationale used to support Sarbanes-Oxley in the for-profit context does not easily translate to the nonprofit sector. First, while there have been nonprofit accounting scandals,[6] none of them has been as large-scale, or had the devastating economic effects, as recent scandals related to for-profit companies.[7] Second, some suggest that disclosure-based regulation is passed on the theory that the public securities market internalizes and reacts to disclosures, thereby making a corporation's economic collapse (and a nation's economic slump) less likely.[8] There is no such nonprofit market, however, so how does Sarbanes-Oxley-type disclosure regulation fit into the role nonprofits play in the nation's eco-

2. States including New York, Massachusetts, Connecticut, Iowa, Ohio, and Minnesota have all introduced plans requiring some level of disclosure from nonprofit entities operating within their borders. *See* A. 10239, 226th Assemb., Ann. Sess. (N.Y. 2004); S. 1262, 2003–2004 Leg. Sess. (Cal. 2004); OFFICE OF MASSACHUSETTS ATTORNEY GENERAL TOM REILLEY, AN ACT TO PROMOTE THE FINANCIAL INTEGRITY OF PUBLIC CHARITIES: SUMMARY OF DRAFT 1.0 (2005), *available at* http://www.cof.org/files/Documents/Building%20Strong%20Ethical%20Foundations/Mass_AG.Act_to_promote_fin_integ_pub_charities.pdf. For more information on states that have considered increased disclosure for nonprofits see 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, 565 n.28 (2005).

3. *See* CAL. BUS. & PROF. CODE § 17510.4 (West 2006); CAL. GOV'T CODE §§ 12581–12599.7 (West 2006).

4. "Sarbanes-Oxley-type" legislation has become something of a term of art among commentators discussing the recent legislative proposals to apply laws similar to Sarbanes-Oxley to nonprofit corporations. *See generally* Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1316–17 (2003) (discussing effects of Sarbanes-Oxley-type disclosures on nonprofits).

5. *See* Care Act of 2005, S. 1780, 109th Cong. § 2 (2005) (mandating, among other things, disclosure of certain financial and governance information for small charities that are not currently required to file tax returns).

6. One example, the scandal at United Way, shocked many in the nonprofit world. JOHN S. GLASER, THE UNITED WAY SCANDAL: AN INSIDER'S ACCOUNT OF WHAT WENT WRONG AND WHY 4–5, 125–26 (1993).

7. Szymanski, *supra* note 4, at 1305 ("The nonprofit sector has not lacked for its own scandals, although their impact on the U.S. economy has been nowhere near comparable to the scandals of for-profit corporations.").

8. *See* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 478–80.

nomic landscape?[9] Who or what will internalize the information provided by additional disclosures? Donors, attorneys general, and the media could potentially benefit from these disclosures,[10] but none of these groups resembles the market for publicly traded securities.

It remains unclear whether laws designed primarily for use in a public market will have a beneficial effect when applied to nonmarket entities for use by nonmarket interests. It is unclear that the burden imposed on nonprofit organizations by requiring internal audits and disclosure of operating practices is, for example, likely to outweigh whatever benefit, if any, such disclosures will create. This note attempts to resolve these issues by offering a solution that addresses the concerns of those who desire more accountability in the nonprofit sector while acknowledging that Sarbanes-Oxley-type regulation is inappropriately tailored to a nonmarket setting.

This note proceeds in three parts. Part II gives a more detailed look into the Sarbanes-Oxley Act. It outlines the leading theories behind disclosure regulation in public markets and examines the provisions of Sarbanes-Oxley that are being modified and applied, or have been proposed to be applied, to nonprofit organizations at the state and federal levels. Part III suggests that Sarbanes-Oxley-type disclosure regulation is inappropriately tailored to the nonprofit sector and analyzes whether Sarbanes-Oxley-type disclosures thrust onto nonprofits will benefit the public or state attorneys general. Finally, Part IV suggests that state and federal governments should request detailed financial and governance disclosures from nonprofit organizations that wish to be considered for direct government aid. These governments must then perform the same functions the market performs in the for-profit sector, so that potential donors, the media, and law enforcement agencies are able to adequately internalize the disclosed information and react accordingly.

II. BACKGROUND

Sarbanes-Oxley has revolutionized the way public companies report their financial standing and corporate governance structure to the government and the general public. The Act mandates detailed financial disclosures prepared by independent board members and accounting firms,[11] and it requires company representatives to verify the accuracy of

9. *See* Cinda Becker, *Transparent Motives; UPMC Blazes Trail for Not-for-Profits in Sarbanes-Oxley Compliance*, MOD. HEALTHCARE, July 31, 2006, at 28, *available at* 2006 WLNR 14087652.

10. Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205, 219 (2004) (suggesting that attorneys general might attempt to use disclosed information); Sheffield Hale, *Oversight: Let the Donors Decide*, NONPROFIT TIMES, Sept. 1, 2005, at 12, 12 (suggesting that donors and media outlets might access additional disclosed information for their use and benefit).

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (2002) (codified as amended in scattered sections of 15 U.S.C.) (amending the Securities Exchange Act of 1934, 15 U.S.C. 78j-1 (2000)).

these disclosures.[12] This type of mandatory disclosure scheme may make sense for publicly held corporations because there exists a market that can internalize and react to the disclosed information.[13] Though the nonprofit sector lacks such a public market, state and federal governments recently began to consider applying Sarbanes-Oxley-type regulation to nonprofit corporations.[14]

To understand why applying this type of regulation to the nonprofit world may be inadvisable, it is helpful to understand Sarbanes-Oxley as well as some of the leading theories behind disclosure regulation. Part A of this section briefly explains relevant sections of the Sarbanes-Oxley Act. Part B outlines a leading theory behind disclosure-based regulation of the Sarbanes-Oxley type. Part C discusses state and federal governments that have begun to consider applying such legislation to nonprofit organizations.

A. An Overview of Sarbanes-Oxley

Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002,[15] commonly known as the Sarbanes-Oxley Act,[16] in the wake of corporate accounting scandals that shook the nation at the beginning of the decade.[17] Representative Michael Oxley introduced the original legislation shortly after the collapse of the Enron Corporation.[18] As accounting scandals surfaced at other prominent companies such as WorldCom,[19] Tyco,[20] and Adelphia,[21] the legislation grew cumbersome and was criticized by commentators as hastily passed and poorly organized.[22] Notwithstanding these early criticisms, many now acknowledge that Sarbanes-Oxley has had a positive effect on the corpo-

12. *Id.* § 302.
13. Manne, *supra* note 8.
14. *See supra* note 2; *infra* Part I.C.
15. Sarbanes-Oxley Act of 2002.
16. *Id.* § 1(a).
17. *See* Brakman Reiser, *supra* note 2, at 559.
18. H.R. Con. Res. 3763, 107th Cong. (2002); *see also Timeline of Enron's Collapse*, WASHINGTONPOST.COM, Sept. 30, 2004, http://www.washingtonpost.com/wp-dyn/articles/A25624-2002Jan10.html (offering a day-by-day outline of Enron's economic collapse).
19. *See WorldCom Malfeasance Revealed*, CBS NEWS, June 10, 2003, http://www.cbsnews.com/stories/2003/07/07/national/main562014.shtml (describing the "record collapse of WorldCom . . . " as an "$11 billion accounting scandal").
20. *See* Krysten Crawford, *Ex-Tyco CEO Kozlowski Found Guilty*, CNNMONEY.COM, June 21, 2005, http://money.cnn.com/2005/06/17/news/newsmakers/tyco_trialoutcome/index.htm (reporting that ex-Tyco Chief Executive Officer Dennis Kozlowski was found "guilty on 22 of 23 counts of grand larceny and conspiracy, falsifying business records and violating general business law").
21. *See* Dean Starkman, *Rigases Given Prison Terms*, WASH. POST, June 21, 2005, at D1 (describing the trial of Adelphia founder John J. Rigas and noting that "District Judge Leonard B. Sand told the elder Rigas that he had 'set Adelphia on a track of lying, of cheating, of defrauding' and described the Adelphia collapse as resulting from 'one of the largest frauds in corporate history'").
22. *See generally* BUTLER & RIBSTEIN, *supra* note 1.

rate climate.[23] Its once-progressive "best practices" have become the business norm—even companies to which the law does not apply began voluntarily adopting its provisions within a few short years.[24]

Sarbanes-Oxley creates several new standards with which publicly traded companies must comply. First, the law mandates that each corporation create and maintain an independent and competent audit committee.[25] This committee remains apprised of all "critical accounting polices and practices" used by the company's outside auditors.[26] Each member of the audit committee must be an independent member of the company's board of directors, which the Act defines as a person who holds a voting seat on the board but has no other stake in the corporation.[27]

Second, Sarbanes-Oxley requires that the lead partner of a company's outside auditing firm be rotated off the company's audit every five years.[28] This provision is meant to minimize the risk of collusion and illegal agreement between company and auditor.[29] Third, Sarbanes-Oxley mandates that a top corporate officer certify the accuracy of the company's financial statements.[30] This officer can be held personally liable for fraudulent claims in these disclosures.[31] Fourth, the Act prohibits an array of insider transactions and other conflicts of interest.[32]

Finally, Sarbanes-Oxley requires numerous corporate disclosures, including information regarding internal control mechanisms, corrections to past financial statements, and material off-balance sheet transactions.[33] Material changes in the operations or financial situation of a company must be disclosed to the government regularly.[34] Despite these numerous provisions, only two segments of Sarbanes-Oxley apply to nonprofit

23. This note makes no value judgments as to the success or failure of Sarbanes-Oxley as a regulatory tool in the for-profit sector.

24. *See* Stephen J. McNally & Joseph T. Steuer, *Case Study: Can Sarbanes-Oxley Hold the Keys to Nonprofit Governance?*, WEBCPA, Feb. 13, 2006, http://www.webcpa.com/article.cfm?articleid=18822&print=yes.

25. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (Supp. 2005).

26. *Id.* § 204.

27. *Id.* § 301(3).

28. *Id.* § 203 ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner . . . has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.").

29. BOARDSOURCE & INDEP. SECTOR, THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS 5 (2003), *available at* http://www.boardsource.org/clientfiles/Sarbanes-Oxley.pdf.

30. Sarbanes-Oxley Act § 906.

31. *Id.* § 906(c).

32. Section 206 states that "[i]t shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if [an officer of the corporation] was employed by that registered independent public accounting firm . . . ." *Id.* § 206. Section 306 bans certain insider trading. *Id.* § 306. Section 402 bans most personal loans by the corporation to its officers or directors. *Id.* § 402.

33. *Id.* §§ 302, 404, 705.

34. *Id.* § 401 (requiring that "[e]ach financial report that contains financial statements . . . shall reflect all material correcting adjustments that have been identified by a registered public accounting firm").

organizations—those regarding document destruction and whistle-blower protection.[35]

B. *Market-Based Regulation: A Leading Rationale Behind the Enactment of Sarbanes-Oxley-Type Disclosure Regulation*

Disclosure regulations like those being proposed in the nonprofit sector have long served as regulatory tools in the securities field.[36] The federal government required publicly traded corporations to disclose financial information well before Sarbanes-Oxley, which only increased the amount of information that companies must reveal.[37]

Leading theories behind disclosure regulation suggest that markets internalize corporate financial disclosures and react accordingly.[38] For example, if the players in a market learn that a major financial shift has occurred within a corporation, they will appropriately revalue that corporation by buying or selling its shares on the open market. As a result of disclosure, corporations are properly valued, and shareholders are protected from the economic effects of sudden corporate collapses, like Enron in 2001.[39]

In short, increased disclosure gives investors more information with which to make wise investment decisions.[40] Additionally, greater disclosure provides corporate executives less opportunity to perpetrate fraud.[41] Because investors are able to make better investment decisions and because of decreased instances of corporate fraud, stock prices more accurately reflect a corporation's underlying value.[42] Under this market-based theory, disclosure helps prevent major corporate scandals and economic collapse. As one commentator has stated, increased disclosure may not "do any good, but [at] least it can't hurt."[43]

A burgeoning field of thought, however, suggests the costs of increasing disclosure imposed on corporations may lead to unintended

35. *Id.* §§ 802, 806.

36. Manne, *supra* note 8, at 478–79 ("Our securities regulatory regime is a disclosure regime, and large, publicly traded corporations are under considerable obligation from multiple legislative and regulatory sources to disclose information.").

37. Sarbanes-Oxley Act §§ 302, 404, 705.

38. Manne, *supra* note 8.

39. *Id.* at 479 n.23 (quoting Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764 (1995) ("The dominant view is that the goal of required securities disclosure is to make prices in securities markets more accurate.")).

40. *Id.* at 479 (stating that when investors are given more financial information regarding a particular corporation, then they "will make better investment decisions").

41. *Id.* at 479–80 (stating that "fraud will be deterred because 'sunlight is the best disinfectant'" (quoting LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 13 (1913))).

42. *Id.*

43. This statement is somewhat dubious as it fails to account for the costs associated with disclosure regulation. The SEC and Executive Compensation: A Little Regulatory Chicken Soup, Ideoblog, http://busmovie.typepad.com/ideoblog/2006/01/the_sec_and_exe.html (Jan. 10, 2006, 06:14 CDT).

consequences.[44] Professor Manne notes that those who receive information enjoy decreasing benefits from increasing amounts of financial disclosures.[45] Moreover, Professor Manne asserts that additional disclosures impose greater costs to the firms themselves, despite the common assumption that maximum disclosure is both beneficial and inexpensive.[46] These criticisms of the disclosure theory of regulation, as well as Manne's own theory criticizing the perceived advantages of increased regulation, suggest that hidden and indirect costs of disclosure may outweigh its benefits, especially as greater amounts of disclosure are required. It is likely that there is a point at which the benefits from additional disclosure no longer outweigh the costs to firms and enforcement agencies.[47]

C. Disclosure in the Absence of Markets: Sarbanes-Oxley-Type Regulatory Schemes Applied to Nonprofits

Following the apparent success of Sarbanes-Oxley in the for-profit sector, state and federal lawmakers began attempting to apply Sarbanes-Oxley principles to nonprofits as well. This portion of the note examines this movement in detail. It begins with legislation introduced in New York by state attorney general Elliot Spitzer, continues with the successful passage of such measures in California, and concludes with ongoing efforts to advance nonprofit disclosure regulations at the federal level.

1. New York Attorney General Elliot Spitzer Leads the Movement by the States

Within a few years following passage of the Act, several large nonprofits, led by healthcare and education companies, adopted various Sarbanes-Oxley-type disclosure requirements as "best practices," though the law itself did not impose such requirements on nonprofits.[48] Many of these firms perceive the benefits of preemptively adopting Sarbanes-

44. Manne, *supra* note 8, at 485 ("[W]here the costs of disclosure may be avoided at lower cost by substituting other, unintended behavior, the effect is, at best, ambiguous.").

45. *Id.* at 480 ("From the point of view of information recipients, the additional disclosures provide diminishing returns and increasing costs, some of which may be born directly by the recipient, most notably when the recipient is a stockholder in a company subject to the disclosure regulation.").

46. *Id.* at 481 ("Many commentators, however, seem to take for granted that increased disclosure is beneficial—and cheap—and therefore recommend disclosure regulation even where they would shun more-intrusive regulation.").

47. Professor Manne claims that "mandatory disclosure has important and ill-considered consequences." *Id.* Although the consequences of mandatory disclosure are important and ill-considered in the for-profit context, the consequences of mandatory disclosure in the nonprofit context have not been publicly considered by the legislators promoting Sarbanes-Oxley-type laws at all. As this note argues, the consequences may in fact be devastating for small nonprofit organizations, while the benefits, if any, are likely to be negligible.

48. *See, e.g.*, A. Nagorski, *Sarbanes-Oxley Isn't Just for Public Firms*, INTERNAL AUDITOR, June 2006, at 20; *see also* Becker, *supra* note 9 (discussing the University of Pittsburgh Medical Center's preemptive Sarbanes-Oxley "compliance").

Oxley-type policies in the absence of legal mandates to do so.[49] Perceived benefits include increased public confidence in both the individual nonprofit corporation and the nonprofit sector as a whole, as well as improved internal accountability among nonprofit directors.[50] Some nonprofit directors believe the application of Sarbanes-Oxley-type disclosure requirements to nonprofit entities is inevitable and prefer to have the policies in place as a preemptive measure.[51] Such beliefs are not unfounded.

In January 2003, then–New York Attorney General Elliot Spitzer began a charge to apply Sarbanes-Oxley-type accounting disclosure provisions to the state's nonprofit organizations.[52] Spitzer sought to strengthen state laws "to protect . . . donors."[53] The bills languished in committee and were redrafted several times.[54] Spitzer later softened his stance on nonprofit reform, though revised versions of the bills were considered before the New York legislature.[55]

Several states soon followed New York's lead and proposed their own versions of legislation applying Sarbanes-Oxley-type standards to nonprofit organizations operating within state borders.[56] California became the first state to pass such a law after Attorney General Bill Lockyer introduced a bill enhancing disclosures required of nonprofits operating in California in February 2004.[57]

2. *The Federal Government Takes Notice: Financial Disclosure Through Internal Revenue Service Form 990*

The federal government took notice of the flurry of proposed state legislation requiring Sarbanes-Oxley-type disclosures by nonprofit organizations. In 2004, the Senate Finance Committee held a hearing titled *Charity Oversight and Reform: Keeping Bad Things from Happening to*

49. *See* Becker, *supra* note 9.

50. *Id.*

51. *See* David Wren, *Nonprofits Feel Pinch of Firmer Financial Rules: Strand Agencies' Scandals Spotlight Need for More Scrutiny, Analysts Say*, SUN NEWS, Nov. 13, 2006 at 1A ("[M]any auditors and agency directors are holding their groups to Sarbanes-Oxley standards because Congress has indicated similar accounting laws for nonprofits are inevitable.").

52. *See* Claude Solnik, *NY State Atty. General Laying Down the Law for Nonprofits*, LONG ISLAND BUS. NEWS, Dec. 17, 2004, *available at* http://findarticles.com/p/articles/mi-qn4189/is_20041417/ai_n10171470/print.

53. Jeff Jones, *N.Y.'s Attorney General Seeking To Apply Sarbanes-Oxley Act*, NONPROFIT TIMES, Mar. 1, 2003, *available at* http://www.nptimes.com/Mar03/npt2.html..

54. *See, e.g.*, S. 4836-B, 226th Leg., Reg. Sess. (N.Y. 2004).

55. The revised proposal was referred to as the Nonprofit Accountability Bill. *See* NONPROFIT COORDINATING COMM. OF N.Y., NYS LEGISLATIVE SESSION (2005), http://www.npccny.org/info/gov_rel_080105b.htm.

56. *See supra* note 2.

57. *See* Nonprofit Integrity Act, S. 1262, 2003–2004 Legis. Sess. (Cal. 2004); Memorandum from the Cal. Att'y Gen.'s Office, The Nonprofit Integrity Act of 2004: Introduced by Sen. Byron Sher, D-Stanford, Sponsored by Attorney General Bill Lockyer, *available at* http://ag.ca.gov/newsalerts/cms04/04-018.pdf.

Good Charities.[58] Soon after, the Committee solicited comments on an array of nonprofit regulation proposals it was considering. The proposals emphasized the need for increased disclosure-based regulation in the nonprofit sector.[59] Over the last two years, the Senate Finance Committee has held numerous hearings related to this issue.[60]

As part of this effort, the Committee has also held conversations with Independent Sector, a nonprofit umbrella group representing several hundred nonprofit entities.[61] Independent Sector has prepared reports for Congress outlining areas of possible reform and increased disclosure in the nonprofit sector.[62] Commentators supporting the nonprofit sector have mounted a campaign criticizing the potential federal legislation, including the common concern that such legislation would be "a 'one-size-fits-all' approach to [nonprofit organizations] whose needs and resources vary greatly [and that the requirements would be] too costly and administratively burdensome in comparison with the potential benefits to be derived therefrom."[63]

Because the proposed enforcement regulations would likely be enacted through the Internal Revenue Code, the Internal Revenue Service (IRS) has appeared before the Senate Finance Committee as well.[64] On June 22, 2004, Mark Everson, Commissioner of the IRS, testified before the Committee: "I share your view that we must quickly and effectively act now. If these abuses are left unchecked, I believe there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised."[65] The Commissioner continued, calling for laws forcing nonprofit organizations to disclose greater amounts of information:

> Disclosure is an important way for the IRS to identify participants in abusive transactions. However, our disclosure scheme,

58. *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities*: *Hearing Before the S. Comm. on Finance*, 108th Cong. (2004) [hereinafter *Charity Oversight Hearing*].

59. *See, e.g.*, PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS 37 (2005), *available at* http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf.

60. *See, e.g.*, *Charity Oversight Hearing*, *supra* note 58.

61. *See* INDEP. SECTOR, COMMENTS IN RESPONSE TO ANNOUNCEMENT 2002-87 (2002), *available at* http://www.independentsector.org/PDFs/990CommentsFinal.pdf [hereinafter INDEP. SECTOR, COMMENTS]; Indep. Sector, Panel on the Nonprofit Sector, http://www.independentsector.org/panel/main.htm (last visited Sept. 4, 2007).

62. *See* PANEL ON THE NONPROFIT SECTOR, *supra* note 59.

63. M. Ridgeway Barker & Randi-Jean G. Hedin, *The Impact of Sarbanes-Oxley on Not-For-Profit Companies—Part II*, METROPOLITAN CORP. COUN., Mar. 2006, at 5 ("The proposed legislation encountered substantial criticism across the nonprofit sector, including that it applied a 'one-size-fits-all' approach to NFPs whose needs and resources vary greatly and that its requirements would be too costly and administratively burdensome in comparison with the potential benefits derived therefrom.").

64. Press Release, IRS, IRS Commissioner Testimony: Charitable Giving Problems and Best Practices, June 22, 2004, *available at* http://www.irs.gov/pub/irs-news/ir-04-081.pdf [hereinafter IRS Press Release].

65. *Id.* at 2.

which originally was developed to address the taxable sector, does not yet fit all tax-exempt participants because the method of reporting does not fit all tax-exempt entities well [since some entities do not have to report under the current scheme].[66]

According to the Commissioner, increased disclosure can be obtained through tax return Form 990. Form 990 and Form 990-pf are tax return forms for charities and private foundations, respectively.[67] These forms were originally designed as tax forms only, rather than vehicles for public financial disclosure.[68] Using media sources like GuideStar,[69] however, people have begun using Form 990 to evaluate where to donate their money.[70] Form 990 proved to be a useful, though somewhat convoluted, tool for evaluating nonprofits because companies file it with the IRS every year and it is readily available at the public's request.[71] Further, the Internet's explosion over the last decade has allowed groups like GuideStar to compile and post Forms 990 for many American nonprofit organizations.[72] Many nonprofits now post their own Forms 990 on their web sites for public review.[73]

On June 7, 2006, the Advisory Committee on Tax Exempt and Government Entities released its Report of Recommendations to Congress.[74] The report focused on the revision of Form 990 to increase financial disclosure by nonprofits.[75] Form 990's main drawback as a source of information, however, is its dense, technical, and unclear format. The form has gone through several revisions over more than half a century.[76] As a result, according to the Advisory Committee, "the form has grown like a patchwork quilt, so that today the form lacks a coherent organization and the questions on related topics are scattered throughout the form."[77]

66. *Id.* at 11.

67. A copy of Form 990 is available for review on the IRS website. IRS, Form 990 (2006), *available at* http://www.irs.gov/pub/irs-pdf/i990-ez.pdf.

68. *See* IRS Press Release, *supra* note 64, at 8 (discussing IRS plans to heighten disclosure requirements in Form 990).

69. GuideStar is a web based service that "[c]onnect[s] people with nonprofit information." GuideStar, http://www.GuideStar.org/ (last visited Sept. 4, 2007).

70. *Id.*

71. *See* 26 U.S.C. § 6104 (2000).

72. GuideStar's website explains that its basic membership is for "users who want to verify a nonprofit's legitimacy, learn whether a contribution will be tax deductible, view a nonprofit's recent Forms 990, or find out more about its mission, programs, and finances. Thanks to the generosity of a number of foundations, GuideStar Basic is available at no charge to users." GuideStar, Using GuideStar, http://www.GuideStar.org/using/index.jsp?source=dnusing (last visited Sept. 4, 2007).

73. *See, e.g.*, RedCross.org, 2004 Form 990, http://www.redcross.org/pubs/car05/990fy2005.pdf (last visited Sept. 11, 2007).

74. ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, POLICIES AND GUIDELINES FOR FORM 990 REVISION (2006), *available at* http://www.irs.gov/pub/irs-tege/tege_act_rpt5.pdf.

75. *Id.*

76. *Id.* at 6–10.

77. *Id.* at 10.

The IRS has long been aware of these problems. In Announcement 2002-87, it sought advice from nonprofit groups and the general public on the content and quality of information in Form 990.[78] Several groups, including Independent Sector, responded with myriad suggestions for reform, indicating they shared the government's concern that Form 990 had become an unwieldy, difficult-to-interpret document.[79] There is also concern in the nonprofit sector that many nonprofit groups are not conscientiously completing Form 990, potentially providing faulty information.[80] Two nonprofits in similar situations may look very different in their respective Forms 990 due to the seriousness with which they take their reporting obligations and the accounting methods they employ.[81]

Notably, in its recommendations, the Advisory Committee steered clear of any suggestion that Sarbanes-Oxley-type disclosure should be obtained through Form 990.[82] Instead, the Committee suggested that "[e]videntiary questions should be formulated to obtain evidence or facts which will reveal whether the filer has complied with federal tax law."[83] The Committee continued that "there should be some clear correlation between the questions asked and the possible determination of wrongdoing. Questions regarding governance 'best practices,' . . . are probably insufficiently connected to the elements of any violation of the tax code to prompt the efficient use of enforcement resources."[84]

3. *Forcing Reform Through Additional Disclosure: Senator Grassley's Nonprofit Mission*

To address perceived problems in the nonprofit sector, some members of Congress have sought increased disclosure from, and oversight of, nonprofits. In June 2006, the Senate Finance Committee, under Chairman Senator Charles Grassley, passed a series of measures designed to address potential abuses in the nonprofit sector.[85] These measures followed several hearings wherein the Senate Finance Committee heard testimony from the director of the IRS, state attorneys general, and leaders from the nonprofit world.[86] Facing resistance or indifference from much of Congress, Grassley ultimately persuaded the Committee to pass

78. I.R.S. Announcement 2002-87, 2002-39 I.R.B. 624, *available at* http://www.irs.gov/pub/irs-irbs/irb02-39.pdf.

79. INDEP. SECTOR, COMMENTS, *supra* note 61, at 1, 3.

80. *See* Joshua B. Nix, *The Things People Do When No One is Looking: An argument for the Expansion of Standing in the Charitable Sector*, 14 U. MIAMI BUS. L. REV. 147, 168–69 (2005).

81. *See id.* At present, nonprofits are not required to employ standardized accounting principles as are for-profit entities. *See* infra text accompanying notes 115–18.

82. *See* ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, *supra* note 74, at 10, 23.

83. *Id.* at 26.

84. *Id.*

85. GuideStar, *Senate Committee Passes New Accountability Rules: Passage of Giving Incentives Now in Doubt*, http://www.GuideStar.org/DisplayArticle.do?articleId=1037 (last visited Sept. 11, 2007).

86. *See Charity Oversight Hearing*, *supra* note 58.

the accountability legislation by attaching it to a bill making changes in the telephone excise tax that was unanimously approved.[87]

These measures force even the smallest charities, those receiving annual donations of $25,000 or less, to disclose far more financial information to the government than they did previously.[88] They levy "higher penalties on top officials at private foundations or charities who engage in illegal financial transactions with the organization, and stiffen the penalties for nonprofit officials who approve such transactions."[89] The measures increase costs on these charities by forcing them to check and double check the accuracy and sufficiency of required financial disclosures.

III. ANALYSIS

Disclosure regulation is a market-based initiative. Sarbanes-Oxley was created on the theory that the securities market will react in part based on the corporate disclosures it receives and internalizes under the Act.[90] In turn, the corporate stock price is more likely to reflect the firm's underlying value.[91]

There is no such market in the nonprofit world. Nonprofit corporations do not issue shares and are not traded on a public market.[92] Instead, their value is limited to their assets. There are no investors who need accurate information to avoid making poor investments. Donors are not equivalent to investors in the for-profit world. Donors, as a class, have little use for or interest in the type of detailed financial information that investors seek before purchasing or selling stock.[93] Absent a market, disclosure can still be used as an enforcement tool by providing state attorneys general with information useful in identifying fraud and misman-

87. *See* STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF S. 1321, THE "TELEPHONE EXCISE TAX REPEAL ACT OF 2005" AND S. 832, THE "TAXPAYER PROTECTION AND ASSISTANCE ACT OF 2005" (2006), *available at* http://www.house.gov/jct/x-28-06.pdf.

88. The new burden on these, the smallest of nonprofit corporations, is likely onerous. The provisions state:

> The proposal requires organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under $25,000) to furnish to the Secretary annually, in electronic form, the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements.).

Id. at 23.

89. GuideStar, *supra* note 85.

90. Manne, *supra* note 8, at 478–81.

91. *Id.* at 479.

92. *See* Becker, *supra* note 9, at 28 (noting comments by University of Pittsburgh Medical Center's Chief Financial Officer Robert DeMichiei stating that although the nonprofit organization is not owned by shareholders, it is owned by the community at large).

93. *See* ANDREW BLAU, GLOBAL BUS. NETWORK & MONITOR INST., WHY DONORS ARE NOT INVESTORS 2 (2005), *available at* http://www.futureofphilanthropy.org/files/donors.pdf.

agement in nonprofit organizations. In general, however, enforcement agencies have neither the funds nor the expertise to interpret and use Sarbanes-Oxley-type disclosures.[94] Applying Sarbanes-Oxley to nonprofits imposes heavy costs on those entities without offering any appreciable public benefits by curbing financial impropriety in the nonprofit sector.

Subpart A of this section examines the differences between donors and investors. Subpart B explains that IRS Form 990 is an inadequate and inappropriate tool for disclosure of nonprofits' financial information. Subpart C shows that disclosure regulation of the Sarbanes-Oxley-type is improperly tailored to a nonmarket setting. Subpart D demonstrates that, although the benefits of disclosure regulation in the nonprofit sector may be low, the costs of mandatory disclosure on nonprofits and regulatory agencies may be very high.

A. Apples and Oranges: Comparing Donors to Investors

As discussed, there has been a call "to increase the mandated disclosure of a nonprofit's mission, operations and effectiveness [to allow] increased monitoring by donors."[95] Indeed, some commentators have suggested that nonprofit donors are analogous to for-profit investors. Some claim that "nonprofits that rely on contributed funds are already more 'public' than companies traded on the New York Stock Exchange"[96] and that those entities should treat their public disclosures as would a public company. According to such logic, "[w]hat company is more 'public' than one that depends on annual individual investments to carry out its mission (nonprofits are always in the midst of a public offering of their 'shares') and whose 'capital' consists entirely of good will?"[97] Some members of Congress have wholeheartedly adopted the idea that the benefits of disclosure will transfer easily and effectively into the nonprofit realm. As one commentator has noted, "in all of [the legislative] proposals, legislative drafters' faith in the ability of disclosure to improve accountability is evident."[98]

However, the legislative drafters' faith may be misplaced. While some nonprofit entities may be dependent upon the good will of the public, they do not offer shares and are not public in the sense that publicly traded companies are.[99] In addition, there is doubt as to whether the average donor investigates a nonprofit's financial disclosures before con-

94. Brakman Reiser, *supra* note 2, at 607.

95. *See* Hale, *supra* note 10, at 12 (stating "nonprofits that rely on contributed funds are already more 'public' than companies traded on the New York Stock Exchange" and should be "treating their disclosure to donors and the general public as though they were a public company").

96. *Id.*

97. *Id.*

98. Brakman Reiser, *supra* note 2, at 561.

99. *See* Becker, *supra* note 9, at 28.

tributing to that company's cause.[100] To the extent that individual donors make large donations, it is likely they already look into the nonprofit's financial standing as a condition of the donation.[101] Lastly, and perhaps most importantly, the largest section of the nonprofit sector, comprised of healthcare and related organizations, does not rely heavily on public donations for its income.[102] For example, nonprofit hospitals, like any profit-generating business, provide services for a fee. They also collect government subsidies. They rely very little, however, on private donations to fund their annual operating budgets.[103]

B. The Inadequacies of Internal Revenue Service Form 990 as a Disclosure Regulation Device

Some commentators suggest that members of the public do, in fact, check the financial health of a nonprofit organization before making a donation.[104] They point to organizations like GuideStar that collect information from sources such as IRS Form 990 for an array of nonprofit organizations and publish the information in a searchable online index.[105] While some investors do use services like GuideStar[106] to help make their donation decisions, the IRS has said that Form 990 is a tax form not designed for easy access and interpretation by the public.[107] The average donor has neither the time nor the skill to interpret the large and confusing document.[108] As one commentator states, "the form is extremely difficult to read and understand. It is a tax return, not a document designed for disclosure of information to a person of average business knowl-

100. Indeed, there is doubt as to whether the average investor cares whether the nonprofit to which he or she gives money spends that money wisely. *See* Gabrielle Berman & Sinclair Davidson, *Do Donors Care? Some Australian Evidence,* 14 VOLUNTAS: INT'L J. VOLUNTARY & NONPROFIT ORG. 421, 421–29 (2003).

101. *See* Robert Parker, *The Most Good for Your Charity Dollar*, BW ONLINE, Nov. 16, 2001, http://www.businessweek.com/bwdaily/dnflash/nov2001/nf20011116_2662.htm (last visited Nov. 11, 2007) (describing the activities one wealthy investor takes to investigate a charity before donating to it and suggesting that other potential donors do the same).

102. *See* Nat'l Ctr. for Charitable Statistics, How Much Does the Government Spend in the Nonprofit Sector?, http://nccsdataweb.urban.org/FAQ/detail.php?linkID=190&category=11&xrefID=2368 (last visited Sept. 11, 2007) (indicating that in 1997, $137.7 billion out of a total $207.8 billion in government aid for the nonprofit sector went to nonprofit health care entities).

103. *See* Julie Appleby, *Scales Tipping Against Tax-Exempt Hospitals*, USATODAY.COM, Aug. 24, 2004, http://www.usatoday.com/money/industries/health/2004-08-24-nonprofit_x.htm?POE=click-refer.

104. *See* Hale, *supra* note 10, at 12 (suggesting the best way to cure abuses in the nonprofit sector is through "most importantly, increased monitoring by donors, the news media and watchdog groups").

105. *How To Check a Charity's Effectiveness: Several Web Sites Help Measure How Nonprofits Spend Their Money*, HOLLANDSENTINEL.COM, Jan. 4, 2004, http://hollandsentinel.com/stories/010404077.shtml.

106. GuideStar offers detailed assistance to individual donors that want to investigate a nonprofit organization before donating to it, including information on using the GuideStar service itself, a donor's "Bill of Rights," and tips for giving wisely. GuideStar, GuideStar for Donors, http://www.GuideStar.org/using/donors.jsp (last visited Sept. 4, 2007).

107. *See* ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, *supra* note 74, at 16.

108. *Id.* at 10 (stating that Form 990 "has grown like a patchwork quilt").

edge."[109] Adding additional information to Form 990 will make it no more accessible to the average donor. Commentators have called for Form 990 to undergo "major revisions to become an adequate vehicle for increased accountability."[110]

Even if it can be made more accessible and understandable by the average donor, it is unclear why Form 990 should operate beyond its function as a tax document. It is not the mission of the Internal Revenue Service to increase public access to disclosed financial information.[111] Indeed, the Service is already overworked and underfunded in trying to achieve its actual goal in this sector, to enforce nonprofit law through auditing and to offer tax reporting assistance to nonprofit entities.[112] Even if the IRS provided easily accessible information to services such as GuideStar, it is unclear whether the bulk of the general public would use the information before donating.[113] GuideStar itself notes that the information it collects is accessed primarily by individuals with specialized knowledge of and interest in the nonprofit sector.[114]

Moreover, nonprofit corporations are not required to employ the same standardized accounting principles as for-profit firms.[115] As a result, "different charities [use] different methods of [financial] calculations . . . ."[116] This lack of standardization has resulted, for example, in "charities erroneously reporting fundraising and general expenses as program expenses on their Form 990s."[117] Form 990 is an "all too brief statement of information" that makes it "very difficult to decipher these forms and discover any questionable accounting or out-and-out fraud by the organization."[118] Requiring additional financial disclosure will not resolve these problems.

109. Hale, *supra* note 10, at 13.

110. *Id.*

111. The IRS mission is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." IRS, The Agency, Its Mission and Statutory Authority, http://www.irs.gov/irs/article/0,,id=98141,00.html (last visited Sept. 11, 2007).

112. *See* Michael Rezendes & Sacha Pfeiffer, *Underfunded IRS Unable To Monitor Trusts*, BOSTON GLOBE, Oct. 9, 2003, at A43, *available at* http://www.boston.com/news/nation/articles/2003/10/09/underfunded_irs_unable_to_monitor_trusts/.

113. *See* Berman & Davidson, *supra* note 100, at 428.

114. GuideStar lists students, professors, researchers, policy makers, reporters, and nonprofit executives as the people most likely to access its information. *See* ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, *supra* note 74, at 16.

115. *See* Elizabeth K. Keating & Peter Frumkin, Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation 10–11 (unpublished manuscript), *available at* http://www.northwestern.edu/ipr/publications/papers/keating.pdf.

116. Nix, *supra* note 80, at 170.

117. *Id.*

118. *Id.*

C. Disclosure as an Enforcement Tool in the Absence of a Market

Some commentators suggest that additional disclosure will be used by state attorneys general and the Internal Revenue Service to improve regulation and oversight of nonprofits.[119] While the information in government-mandated disclosures may help enforce state and federal nonprofit laws, the scope of enforcement is necessarily limited.[120] State attorneys general, for example, focus their enforcement efforts mainly on the financial integrity of nonprofit organizations.[121] They do not focus on other aspects that necessarily affect the success of nonprofits, like ensuring that organizations adhere to their charitable purposes or that nonprofits are run efficiently.[122] An attorney general's main focus in this area is donor and asset protection.[123] Enforcement agencies may use additional disclosed information to meet these goals, but doing so will not ensure improvement in the nonprofit sector because other unenforced aspects are equally important to nonprofit viability.[124]

Additional disclosure may be useless even within the limited range of enforcement activities undertaken by state attorneys general. As commentators have noted, "[n]either state [attorneys general] nor the IRS have the capacity to analyze and manage the information presently disclosed to them, let alone more frequent or more voluminous submissions."[125] With that in mind, the IRS recently suggested that it needs more funding appropriated toward its enforcement efforts.[126] More money may increase the viability and usefulness of additional disclosures, but whether the IRS will receive additional funds is unclear at best. Even if it does receive additional resources, it is unknown how many fiscal years these funds will be available and whether the additional funds will even allow the agency to gain the ability to analyze and utilize all the information it already receives from nonprofit organizations. Thus, it is unlikely that additional Sarbanes-Oxley-type mandatory disclosure will have an appreciable impact on state or federal agencies' law enforcement efforts in the nonprofit sector.

119. *See, e.g.,* Szymanski, *supra* note 4, at 1309–11.

120. Brakman Reiser, *supra* note 10, at 219 ("The recent legislative proposals for nonprofit reform . . . exemplify the limited manner in which AGs address organizational accountability, namely by attempting enforcement in this area almost exclusively when it is linked to uncovering or preventing financial abuse.").

121. *Id.*

122. *See id.* at 208 ("Simply protecting nonprofit assets from theft and charitable contributions from misdirection is not enough to ensure comprehensive nonprofit accountability. A healthy nonprofit sector also requires organizations to function efficiently and adhere to their missions.").

123. *See id.* at 219 ("Although a comprehensive view of nonprofit accountability includes financial, mission, and organizational components, state AGs are neither equipped nor encouraged to enforce all of them with equal intensity.").

124. *Id.* at 208.

125. Brakman Reiser, *supra* note 2, at 607.

126. *See* Albert B. Crenshaw, *Bigger IRS Enforcement Budget Sought*, WASH. POST, Feb. 2, 2005, at E03.

D. The (Not So) Hidden Costs of Additional Disclosure

Imposing additional disclosure requirements on nonprofit organizations may have a variety of side effects. One possible side effect is an increase in the operating expenses of nonprofit organizations.[127] Higher expenses could squeeze smaller nonprofits out of the sector or hinder their ability to achieve their missions.[128] Even where nonprofit organizations are able to bear the financial burden of complying with increased mandatory disclosure, doing so will leave less money for the entities' missions due to the time and labor necessary to meet the requirements of the law.

Another possible side effect of Sarbanes-Oxley-type regulation in the nonprofit realm is its impact on nonprofits' ability to attract and retain competent executives. Otherwise willing and qualified professionals may be dissuaded from participating in the nonprofit sector because they may be exposed to personal liability for inaccurate disclosure, similar to the liability for-profit executives face under Sarbanes-Oxley.[129]

To summarize, Sarbanes-Oxley is designed in part to help regulate the securities market by requiring detailed disclosure of a corporation's financial situation. Disclosure regulation operates on the market-based theory that a better-informed marketplace will more accurately value publicly traded securities. The benefits of disclosure-based regulation in the for-profit sector, however, do not translate easily into the nonprofit world. Although those who deal in securities have the power to affect the overall value of a corporation, no such power exists among the stakeholders in a nonprofit. Further, although shareholders have incentives to closely monitor the financial positions of a publicly traded company, nonprofit stakeholders, in general, have neither the resources nor the incentive to zealously investigate nonprofits. Indeed, donors to nonprofits are not collectively organized in the way for-profit shareholders are by organizations such as the New York Stock Exchange,[130] nor do state or federal governments have nonprofit oversight agencies that parallel the U.S. Securities and Exchange Commission.[131] Instead, the burden of regulating nonprofits falls on overworked and underfunded state attorneys general, who are also responsible for a number of other areas of law enforcement and who work on limited budgets. Most nonprofit financial

127. *See* Manne, *supra* note 8, at 480–81 (noting that additional disclosure generally imposes increasing costs on companies).

128. Nix, *supra* note 80, at 171–72.

129. *Id.*

130. *See* JAMES J. ANGEL, MARKET MECHANICS: A GUIDE TO U.S. STOCK MARKETS 1 (release 1.2) (2002), *available at* http://www.nasdaq.com/about/market_mechanics.pdf ("[S]tock prices provide important signals about where the most productive opportunities are. These signals channel *capital* to the areas that investors think are most productive.").

131. *See* U.S. Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://sec.gov/about/whatwedo.shtml (last visited Sept. 11, 2007).

information currently available is derived from IRS Form 990, a dense and unwieldy tax return document not intended to serve disclosure purposes. Finally, requiring financial disclosure by nonprofits will likely impose significant costs and labor burdens upon nonprofits, potentially forcing the organizations to scale back their work or even to close their doors altogether.

IV. Recommendation

It is clear that Sarbanes-Oxley-type disclosure regulation was not designed for the nonprofit sector. However, this does not mean that greater regulation of nonprofits is inappropriate. Indeed, while less prevalent and less devastating than for-profit scandals, the nonprofit sector has certainly seen its own share of financial wrongdoing that may have been prevented through greater statutory oversight.[132] To address these accountability concerns, state and federal governments should devise a voluntary regulatory system for all nonprofit entities. The governments should then create agencies to perform the essential functions of a market so that this information serves a useful purpose.

A. Creating a Voluntary System of Disclosure for Nonprofits

To date, Sarbanes-Oxley-type proposals for regulating nonprofit corporations have required mandatory disclosure on the part of *all* nonprofits with operating budgets over some *de minimis* amount.[133] For-profit corporations, on the other hand, may remain private or closely held and thus exempt themselves from the depth of disclosure regulation that is imposed upon public corporations.[134] Nonprofits have no such choice under currently proposed disclosure regulation legislation. This "one-size-fits-all" approach is inappropriate in the nonprofit sector because different entities have different operating budgets, costs, and even accounting methods.[135]

Instead of requiring disclosure by all nonprofits, state and federal governments should utilize their power as donors to obtain voluntary detailed financial disclosure from nonprofit corporations.[136] The federal

132. *See, e.g.*, GLASER, *supra* note 6 (detailing a financial scandal that took place with the nonprofit United Way organization); *see also* Szymanski, *supra* note 4, at 1305–06.

133. *See* Mark Hrywna, *The Sky Isn't Falling, Fear of SOX Is Waning*, NONPROFIT TIMES, Apr. 1, 2006, at 19, 22 (listing various state laws and the minimum revenue a nonprofit must take in before having to disclose information under those laws).

134. *See generally* Idelle A. Howitt, *Valuing Closely Held Stock. (High Net Worth: The Accoutrements of Success)*, CPA J., Sept. 1993, http://www.nysscpa.org/cpajournal/old/14476929.htm (last visited Nov. 11, 2007) (noting that valuation of closely held stock is difficult in the absence of a market).

135. *See* Barker & Hedin, *supra* note 63.

136. Some states, like Minnesota, have considered such an approach. *See* H.F. 961, 84th Legis. Sess. (Minn. 2005) (imposing "certain disclosure requirements on nonprofit organizations that receive a grant or a direct appropriation from the state").

government, for example, gives over four hundred billion dollars in annual grant awards to various groups, including nonprofit organizations.[137] State governments offer similar grants.[138]

As donors, the governments can demand to review the financial health of a nonprofit corporation before making a donation. Governments could devise uniform requirements for all nonprofits that wish to be considered for government grants. Such rules might require, for example, that the organization answer a series of questions regarding its financial health, investment history, governance practices, and executive compensation. Nonprofits could submit this information on new forms prepared for this purpose rather than disclosing similar information in a revised Form 990. Governments could mandate nonprofit audits that adhere to generally accepted accounting principles. Governments could also require directors to certify the accuracy of these statements under penalty of law.[139] In short, governments could apply many of the disclosure-based rules of Sarbanes-Oxley to nonprofit corporations that hope to receive government grants.

Voluntary participation is the key to this system. The organization is free to acquiesce to these government requests or deny them at the cost of losing the potential donation. Nonprofit corporations will need to assess the potential costs and benefits of becoming eligible to receive grants offered by state and federal governments. To maintain eligibility, many nonprofits might meet the requirements of the law regardless of whether they actually receive government aid in any given year. Other nonprofits would quickly adhere to the law's requirements to continue receiving invaluable government aid. A nonprofit may realize it cannot afford to opt out of the voluntary program, potentially resulting in internal changes and improvements to its operations before filing the required documents with the government.

Other nonprofit entities may wish to opt out of the voluntary government program and lose any potential government aid. They might choose to opt out because they find it unlikely they will be otherwise eligible for government funding. These organizations may feel the costs in terms of both money and time required to compile the necessary financial information outweigh the value of potentially receiving government aid. In addition, some nonprofit organizations may wish to operate with relative autonomy and minimal governmental oversight. The value of doing so might, for reasons as individual as the entities themselves, outweigh the potential benefit of government aid through grants. These en-

137. Grants.gov, About Grants.gov, http://www.grants.gov/aboutgrants/about_grants_gov.jsp (last visited Sept. 11, 2007).

138. *See, e.g.*, N.Y. State Gov't Info. Locator Serv., Information on Grants Available in New York State, http://www.nysl.nysed.gov/ils/topics/grants.htm (last visited Sept. 11, 2007).

139. As previously discussed, such a provision may result in a smaller pool of willing and qualified nonprofit directors, at least within the group of nonprofits that choose to disclose information under the voluntary system. *See supra* note 129 and accompanying text.

tities would be allowed to opt out of increased levels of financial disclosure, at the cost of receiving direct government aid.

B. Creating Agencies to Perform the Applicable Functions of a Market

Creating a voluntary system of disclosure regulation for nonprofit entities does not address the issue that disclosure regulation is primarily effective in a market-based system. To address this issue, state and federal governments should create new agencies to perform the essential functions of a market, beginning with collecting and interpreting financial information from those entities that choose to submit financial statements under the law in order to maintain eligibility for grants. It is conceivable that these functions could also be performed by a private entity. Indeed, in the for-profit world, a combination of governmental and private entities provide "a variety of tools to help market . . . investors monitor trading activity and keep the pulse of the market."[140] However, any compilation and interpretation of nonprofit data regarding nonprofit entities by private organizations would necessarily involve costs which would have to be passed on to potential information consumers. While news agencies and even governments might pay for such information in order to carry out investigations of nonprofit entities, individual donors may not. This cost barrier, along with other potential problems,[141] means that performing the functions of a market with respect to information collected from nonprofit organizations is a role probably best filled, at least in part, by government agencies.

These agencies would be responsible for creating and collecting the newly required financial disclosure documents. The agencies could collect, organize, and analyze this information in a comparative fashion. Thus, tables might reflect the financial position and stability of any given nonprofit organization in comparison to, for example, all other nonprofits, or nonprofits that have similar missions, operating budgets, or geographic operational boundaries. These comparisons could then be disseminated to interested parties in easy-to-understand public reports.

The information in these reports would, for example, be easy for national and local news agencies to access and analyze. As a result, news reports detailing the financial health and operational procedures of both national and local nonprofits and identifying those nonprofits choosing

140. NYSE Euronext, Market Information, http://www.nyse.com/marketinfo/1089312752882.html (last visited May 10, 2007). The New York Stock Exchange (known as NYSE Euronext after a 2007 merger), provides an array of tools that potential investors can use to investigate publicly traded companies. These tools compliment information provided by government agencies like the Securities and Exchange Commission, which publishes an array of market data. *See, e.g.*, U.S. Sec. & Exch. Comm'n, About the SEC, http://sec.gov/about.shtml (last visited Oct. 21, 2007).

141. The private entities disseminating information about nonprofits have conflicts, for example, since those organizations would likely be nonprofits as well. For example, GuideStar could potentially fill a private role in this area, and is a public charity. GuideStar, About Us, http://www.guidestar.org/about/index.jsp?source=dnabout, (last visited Oct. 21, 2007).

not to participate in the voluntary reporting programs could become far more commonplace. Individuals might take this information into account when deciding whether to donate to any given organization. Similarly, news agencies might identify nonprofit groups choosing not to take part in the disclosure program and attempt to determine the reasons behind their decisions by further investigating that organization, to the benefit of potential donors.

The agency responsible for compiling the reports might also develop a system for valuing the financial health and stability of nonprofits that take part in the elective disclosure program. These signposts could be applied using data compiled over the course of years, and be updated each year as new information about the entity becomes available, such as the stability of its directors, the amount of each dollar received that goes toward its mission, its directors' salaries, whether it adheres to and achieves its charitable mission, and the nature of its investments. This valuation system could be as simple as assigning a number between one and one hundred to each entity, with a few short paragraphs explaining the reason for the valuation and whether the rating rose or fell in comparison to recent years.

Such a rating system offers an easily understandable way for donors to value the nonprofit organizations competing for their money. Donors would be able to research the differences between various entities and offer their donation to the organization that best meets their desired purpose. In turn, charities would be forced to respond by either maintaining a high rating or working to improve their rating in order to attract more donations. By evaluating and artificially valuing nonprofit organizations, the government agencies would create a faux market among donors. Those donors would react to the information disclosed to the government by nonprofit organizations and alter their behavior accordingly, similar to the effects of disclosure regulation in a market-based system. Like corporations, participating nonprofits would have to adjust to the demands of the marketplace in order to maintain their viability.

Furthermore, the information collected and compiled by the government agencies could be used by state attorneys general to police nonprofits and hold them accountable for financial wrongdoing. This would be easier to accomplish for state attorneys general than it is now because currently the attorneys general must acquire, organize, and interpret financial information compiled using various accounting methods before ever identifying and targeting organizations and enforcing the laws regulating nonprofit entities. By performing these initial functions, the new agencies would help facilitate better overall policing of nonprofit corporations. Through the information collected, organized, and disseminated by the new government agency, attorneys general could more easily identify nonprofit entities that may require more in-depth investigation.

Thus, through the market effect of evaluating and disseminating information disclosed by participating nonprofit organizations to news agencies and the general public, and the policing effect of offering easily interpretable information regarding the financial status of nonprofits to state attorneys general, these government agencies would increase the accountability and oversight of not only participating nonprofit organizations, but also those nonprofits that choose not to participate at the risk of garnering added attention from the media—and in some cases law enforcement agencies. Moreover, state and federal governments themselves would be able to better identify those organizations that best serve the public good and act as a conscientious donor by offering grants to those organizations.

V. CONCLUSION

Since the passage of Sarbanes-Oxley, several states and the federal government have sought to apply similar disclosure requirements and penalty provisions to the nonprofit sector.[142] The rush to apply such provisions to nonprofits is driven by concerns that fraud and mismanagement in the nonprofit sector cost the American people a significant amount of money.[143] However, applying the rules of Sarbanes-Oxley to nonprofits is inappropriate since the very mechanism that makes disclosure an effective regulatory tool in the for-profit world, a working market, is absent in the nonprofit sector. To address legitimate concerns of mismanagement and inefficiency in the nonprofit sector, state and federal governments should utilize their power as donors to require increased disclosure from those nonprofit organizations that wish to be considered for federal grants. The governments should then create government agencies to collect this information and perform the essential functions of a market. By creating an artificial market, disclosure can be used as an effective regulatory tool to increase accountability and decrease financial misconduct in the nonprofit sector.

142. *See supra* note 2.
143. *See* Marion R. Fremont-Smith, *Pillaging of Charitable Assets: Embezzlement and Fraud*, 46 EXEMPT ORG. TAX REV. 333, 340 (2004).