# RESPECTING FOUNDATION AND CHARITY AUTONOMY: HOW PUBLIC IS PRIVATE PHILANTHROPY?*

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## FORWARD: GROUNDING THE DEBATE

From Colonial times Americans have debated the role of philanthropy and the charitable sector in our social and political economy. These debates, while they can never be definitively resolved, are a healthy reflection of the diversity and plurality of views about the relative roles of the governmental, business, and nonprofit sectors. Recent years, however, have seen a disturbing increase in legal proposals or demands by certain members of the public and the government to interfere with the governance, missions, strategies, and decision-making of foundations and other charities. The debate has included calls for legislation to limit the number or characteristics of directors serving on nonprofit boards and calls to subjugate charitable purposes as determined by donors and charity boards to broad mandates addressing social justice and other mission-oriented issues.

Underlying much of these debates is the premise—stated or merely presumed—that foundation and charity assets are "public money" and that such entities therefore are subject to various public mandates or standards about their missions, operations, and decision-making. To the extent these assumptions are expressed, they are grounded on charities' public purposes, on the authority of the state to recognize the legal status of nonprofit or-

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ganizations, and on the tax-exempt status of charities and the deductibility of contributions to them. The ultimate outcome of such perspectives is an absence of principled limits on the right of the public to direct philanthropies and their resources.

As we have both participated in and observed the various debates, we and others wondered about the accuracy of the framework upon which the debates were grounded. We also realized that a comprehensive understanding of this framework had not been undertaken and that such an exegesis was necessary to ensure the proper context for legitimate debate on issues important to the sector and to its relationships to the governmental and business sectors. After all, an inaccurate context could inadvertently cause substantial harm to and disrupt the balance that voluntary organizations provide to our civil society and our economic and social systems. The potential consequences are too significant for the underlying debates not to be framed in an accurate context.

As such, this article does not purport to address the substantive areas of debate. Instead, it is concerned more narrowly with the underlying framework and the legal authority of the government and the public to impose restrictions on the governance, mission, and decision-making of private foundations and other charities. Specifically, the deceptively simple yet admittedly ambitious goal of this article is to examine the validity of the claim sometimes made—or even just assumed—that intrusions on philanthropic autonomy and independence are justified on the ground that charitable assets are "public money." In general, this article does not claim on behalf of foundations and other charities, "You can't do this to us," but rather, more modestly, "You can't do this to us on the basis that we are public agencies or that our assets are public."

Our experiences and research reveal three arguments that, singly or collectively, underlie claims that charitable assets are public money. The first argument conceives of foundations and other charities as "shadow governments" due to the requirement that they have public purposes and are subject to attorney general parens patriae oversight. The second argument asserts that, because philanthropies exist under state charters, they are government agencies, "state actors," or quasi-public bodies subject to constitutional constraints or accountable to the public in the same way as is government. The third argument asserts that revenue forgone on deductible charitable contributions and the tax exemption are a contribution from the state that endows the state or the public with a say in nonprofit governance structure, operations and decision-making. Of course, these positions overlap—and cumulate—and so the discussion below is necessarily intertwined.

In seeking to understand and consider each of these three arguments, this article explores numerous legal precedents, theories, and policies, including those that recognize the importance of philanthropic autonomy to our pluralistic society and culture and the various positions that threaten to undermine that autonomy. Ultimately, we conclude by emphasizing the covenant that foundations and other charities—as private, independent, autonomous enterprises—make to pursue and serve purposes that are charitable and worthy of exemption in their grant-making, operational programs, management, and governance. At the same time, foundations and other charities are not inherently public agencies or bodies, and their assets are not and should not be subject to broad-based government or public control. In its focus on premises and assumptions, this article seeks to re-ground the debates and put an end to misuse of the phrase "public money."

## INTRODUCTION: IS TERMINOLOGY DESTINY?

The charitable sector finds itself in a confusing semantic moment in time, with consequences for the critical but delicate balance that distinguishes this sector from the government and for-profit sectors. The semantic confusion originates with application of the word "public" to the sector—particularly as applied to grant-making foundations, including use of such phrases as the following: "it's the public's money" or "public benefit" or "for the public trust." These phrases and others are being invoked as justification for increasing intrusion by the public/government sector across the lines that separate the state from the charitable sector, thereby encroaching on that critical balance.[1]

Indeed, the charitable sector in the United States has long suffered in the court of public opinion due to a lack of a satisfactory term to describe itself. For at least the last forty years, in the lead-up to and adoption of the Tax Reform Act of 1969, no single term as emerged to refer to these essential participants in our society. English law does not share our terminologi-

1. For example, in 2008, Republican Governor Matt Blunt of Missouri tried to compel a private Missouri foundation to use 80 percent of its grant budget to support underfunded state health care programs. "There is a strong argument," he explained, "that those assets right belong to Missouri taxpayers." Editorial, *Friday Editorial: Yours, Mine, and His*, ST. LOUIS POST-DISPATCH, May 29, 2008, at C8 (quoting Letter from Matt Blunt, Governor of Missouri, to the Missouri Foundation for Health (May 27, 2008)), *available at* http://www.stltoday.com/blogzone/the-platform/published-editorials/2008/05/friday-editorial-yours-mine-and-his/. *See* also Maureen Glabman, *Health Plan Foundations: How Well Are They Spending the Money?*, MANAGED CARE MAGAZINE, August, 2008, at 16, *available at* http://www.managedcaremag.com/archives/0808/0808.foundations.html (last visited Feb. 22, 2009).

cal hesitation, having called these entities charities since even before the Statute of Charitable Uses of 1601. Indeed, U.S. trust law has carried over this terminology, distinguishing between private trusts and charitable trust. To the general public, however, the term "charity" often connotes purely donative, if not just alms'-giving or anti-poverty, institutions. Similar connotations also afflict the broader terms "philanthropic" and "benevolent."

Accordingly, those who drafted corporate statutes have gone in a different direction in adopting a term to embrace the wide variety of modern charities—the hospitals, universities, religious organizations, and arts and cultural organizations, as well as social service and grant-making organizations, that are not organized for the profit of owners. Yet the typical terms in corporate statutes are all in the negative: "nonstock corporations", "not-for-profit corporations", or, most commonly, "nonprofit corporations." The proprietary sector is usually called "for-profit," as we refer to it here. However, both sectors are private and both are permitted to earn a surplus from year to year. The prohibition more accurately is a prohibition on the *distribution* of profits, prompting Henry Hansmann to coin the unfelicitous phrase "nondistribution constraint." Nevertheless, the terms nonprofit and not-for-profit both improperly suggest that the entity must operate at a zero-profit margin.

More significantly, nonprofit corporations need not even be charities—think of social clubs, labor unions, and trade associations. The Revised Model Nonprofit Corporation Act (1987) offers three classifications of non-business corporations: public-benefit corporations, mutual-benefit corporations, and religious corporations. The term "public-benefit" has the advantage of being an affirmative statement of the outward-looking purposes of such organizations, but such a term has never been widely adopted. Indeed, the Revised Model Act's tripartite distinction has not proved popular with legislatures, and the Model Nonprofit Corporation Act, Third Edition (2008) omits reference to it, falling back on some special provisions for "charitable corporations."

Perhaps to deal with these terminological difficulties, it has become common to refer instead to these organizations by their designation under the Internal Revenue Code provisions for federal tax exemption. Thus, "nonprofit," "tax-exempt" and "section 501(c)(3)" have become interchangeable ways to refer to charities.[2] Unfortunately, there are problems

2. Internal Revenue Code § 501(c)(3) identifies the following organizations as exempt from federal income taxation:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the pre-

with this approach as well. First, not all charities are tax-exempt—that is, assets might be protected as charitable under state law even if the entity has never obtained, or subsequently forfeited, exempt status. Second, and most unhappily for our purposes, the Code distinguishes "private foundations" from non-private foundations, which are called colloquially "public charities"—even though there is no such thing in the Code as a "public foundation" or a "private charity"! Finally, a state-law charity might be federally tax-exempt under a different Code provision. Notably, as discussed below, a state-law charity that engages in too much lobbying to qualify for Code § 501(c)(3) status might instead qualify as exempt under § 501(c)(4). The largest trade association of §§ 501(c)(3) and (c)(4) organizations calls itself the Independent Sector, but this term has not broadly caught on as a way of referring to both types of exempt organizations.

Complicating these matters further is the ability of contributors to deduct donations from their income taxes. Donations to § 501(c)(3) organizations are normally deductible as charitable contributions, but, with minor exceptions, donations to other § 501(c) entities may only be deductible, if at all, as business expenses. Therefore, just as not all nonprofit entities are exempt from taxation, not all exempt organizations afford the benefit of deductibility for donations and membership dues.

We focus this article on those organizations that are nonprofit under state law, exempt from taxation under § 501(c)(3) of federal tax law, and that afford charitable deductions for donors—essentially foundations and charities in all of their various forms, structures, and permutations. Outside of the United States, the common referent to nonprofit entities is as "nongovernmental organizations" (and variants on that term). Again, though, the NGO label is in the negative—it says what these organizations are not. Perhaps, though, the emphasis on what charities are "not," as being "not government," best addresses recent threats to the autonomy of the sector in the United States.

> vention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3) (2006). Treasury Regulation § 1.501(c)(3)-1(d)(2) explains: "The term 'charitable' is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumerations in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of 'charity' as developed by judicial decisions." 26 C.F.R. § 1.501(c)(3)-1(d)(2) (2009). The regulation continues by identifying "lessening of the burdens of Government" as one example. *Id.* Code § 509(a) further distinguishes private foundations from other charities exempt from taxation under § 501(c)(3). I.R.C. § 509(a). For ease of reference, we sometimes refer to all organizations that are not foundations under § 509(a) as "other charities." In footnotes, we sometimes cite the Internal Revenue Code as "Code" or "I.R.C."

Today we might be facing a semantic transformation that characterizes foundations and other charitable assets as public money. Conflating public purpose with public ownership further suggests that the elements of private self-determination and private governance and decision-making over these assets have been negated or at best neutered. In the minds of some, the public thereby has expanded authority that could deny foundations and charities the autonomy, freedom, independence, flexibility, and the other features that have for centuries positioned them to serve society so well.

An early suggestion of this approach occurred when foundation assets began to be labeled as public money. In 1972, the president of the Danforth Foundation, Merriman Cuninggim, publicly struggled with a short-hand way to characterize foundation assets and the legal obligation under the tax code to dedicate those assets exclusively to charitable purposes. He called it "public money" because, he explained, it no longer belonged to the donor. At the same time, however, he also invoked the "immensely important distinction" that the decisions of foundations remained "private" and beyond the "hands of the general public or of Government."[3] Cuninggim proposed the term "non-governmental" as more accurate than "private" to describe foundations.[4]

More recently, however, some discount that "immensely important distinction" of private decision-making by invoking the fact that the money no longer belongs to the donor or by citing the tax-favored treatments of exemption and deductibility.[5] Some groups have claimed an entitlement to receive their "fair share" of charitable assets and to ensure representation

3. MERRIMON CUNINGGIM, PRIVATE MONEY AND PUBLIC SERVICE 4–5 (1972). Around the same time, the Council on Foundations declared that foundations should adopt a key guiding principle that recognizes that the assets are "not our money, but charity's" in order to "[t]o minimize any tendency to act out of concerns related to personal benefit or convenience." CHAIRMAN AND STAFF, COUNCIL ON FOUNDATIONS, *Private Foundations and the 1969 Tax Reform Act* (1975), *in* 3 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, 1557, 1592 (1977) [hereinafter FILER COMM'N RESEARCH PAPERS].

4. "A fuller definition might run to such a complicated, jawbreaking sentence as the following: Foundations are non-governmental agencies, privately established and managed, but in which the public has a stake and which are answerable to Government, possessing financial resources, usually in the form of endowment, and existing to serve the general welfare or some chosen segment of it, usually in the form of grants." CUNINGGIM, *supra* note 3, at 5.

5. Alan Pifer, the President of the Carnegie Corporation during that same era, rejected that view: "There is a common misunderstanding that the public character of the foundation, and hence the public stake in it, derives from its tax-exempt status. How frequently has one heard it said that foundations are really spending public money, and therefore should be subject to greater governmental control. Such a view, however, is based on fallacious reasoning and reveals either surprising ignorance or a dangerous disavowal of one of the basic tenets of the American system." Alan Pifer, *Report of the President of the Carnegie Corporation, 1968*, *in* FOUNDATIONS UNDER FIRE 54 (Reeves, ed., 1970).

on foundation and charity boards and in management.[6] A logical and not too far-fetched extension of this public-money view could result in perverting the fiduciary duties of trustees, officers, directors, and managers to require that charities be governed and managed for a democratically determined public, rather than privately determined charitable purposes. A further leap would have foundations and other charities be managed by "the public."

Recent years have brought debates—some reaching the level of legislative proposals[7]—about the relationship between board composition and good governance, and the policy implications.[8] A few states require that a majority of directors of a nonprofit corporation be financially disinterested.[9] Imposing certain governance practices not only could result in operational changes, but also could infringe on the autonomy of these entities

6. *See* NAT'L COMM. FOR RESPONSIVE PHILANTHROPY, CRITERIA FOR PHILANTHROPY AT ITS BEST: BENCHMARKS TO ASSESS AND ENHANCE GRANTMAKER IMPACT (2009), *available at* http://www.ncrp.org/paib.

7. For example, in 2004 the staff of the Senate Finance Committee proposed to condition federal tax exemption on a requirement that the size of the governing board be no fewer than three and no more than fifteen members. Senate Finance Committee Staff Discussion Draft, Tax Exempt Governance Proposals, June 22, 2004, at 13, *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf. *See* discussion under Myth III *infra*.

8. A group convened by the charity trade association Independent Sector recommended: "Both public charities and private foundations should be required to disclose which of their board members are independent, even though private foundations would not be required to have any independent members." *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY, GOVERNANCE, ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 78 (2005), *available at* www.nonprofitpanel.org/final/Panel_Final_Report.pdf. That report explained: "Private foundations are subject to stringent self-dealing rules that do not apply to public charities because of the assumption that their boards would not be independent. Many donors to private foundations wish to involve family members on the boards of their foundations to ensure that the donor's philanthropic intentions and the family's philanthropic tradition will continue through future generations." *Id.* That report also recommended that a public charity (except certain entities, such as churches) should be classified as a private foundation unless at least one-third of its board is independent. *Id.*

9. *See* the limitation in California law that charity managers may make up no more than 49 percent of the board positions. CAL. CORP. CODE § 5227. *See* also Maine, 13-B MRSA § 713-a(2) ("No more than 49% of the individuals on the board of a public benefit corporation may be financially interested persons."). The broadest prescription for governance structure—which contains exceptions for private foundations and religious organizations—appears in New Hampshire's Voluntary Corporations and Association statute, amended in 1996 to provide:

> In the interest of encouraging diversity of discussion, connection with the public, and public confidence, the board of directors of a charitable nonprofit corporation shall have at least 5 voting members, who are not of the same immediate family or related by blood or marriage. No employee of a charitable nonprofit corporation shall hold the position of chairperson or presiding officer of the board. This section shall not apply to . . . any organization qualified as a private foundation under the applicable provisions of the United States Internal Revenue Code, nor to religious organizations, churches, or the integrated auxiliaries thereof or to conventions or associations of churches. The provisions of this section may be waived with the approval of the director of charitable trusts after application for such waiver.

N.H. REV. STAT. ANN. § 292:6-a.

and their fiduciaries to determine their charitable purposes and how to carry them out.

Separately, in important but less visible ways, the Internal Revenue Service has increasingly focused on the governance, structures, missions, effectiveness, programs, and other operations of foundations and other charities, through its administration of the Internal Revenue Code. IRS determination letters denying or revoking exemption reveal that the Service has informally been staking out positions on a range of substantive issues about whether a particular activity or governance practice jeopardizes tax exemption. For example, it is understood that the Service demands a minimum of three unrelated board members—although, because such a requirement does not appear in the statute or regulations, the Service cannot deny exemption on this basis alone. The newly redesigned Form 990 requires detailed disclosure of board member independence, compensation, and other policies. In 2008, a high-level advisory board to the Tax-Exempt/Government Entities Commissioner observed: "Our personal experience and research for this report suggest . . . that the IRS may require specific governance practices on an ad hoc and inconsistent basis."[10] The Report found that, "[i]n various contexts, as the IRS has labored" to draw the line between taxable and exempt, "it has created a *per se* requirement for exemption that requires the organization be governed by an independent body. The IRS's position, however, has not always been sustained by the courts and we are concerned about *per se* requirements."[11]

Each of these positions is based on a belief that foundation and charity assets are public money in some tangible manner beyond mere semantics. As such, that phrase and its derivatives invite visions of certain rights and authority not actually contemplated by the law or our country's long history of respect for and dependence on foundations and charities and their broader roles in our society.

As noted above, our research and experiences suggest three primary arguments that underlie this transformation, which we characterize as the three "myths" addressed below. We call them myths because they seem to be cloaked in presumptive, factual accuracy despite evidence to the contrary. Myth I purports to deprive charities and foundations of their independence and autonomy based on their public purposes and attorney general oversight. Myth II relies on a mischaracterization of these entities

10. Advisory Committee on Tax Exempt and Government Entities, *The Appropriate Role Of The Internal Revenue Service With Respect To Tax-Exempt Organization Good Governance Issues* 3 (June 11, 2008), *at* http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf.

11. *Id.* at 31 (citation omitted).

as state actors and public or quasi-governmental bodies. Myth III, the argument that proponents seem to rely on most heavily, cites to tax-favored treatment as justification for intrusions. As we demonstrate below, none of these myths validates the types of impositions that the semantic transformation discussed above purports to warrant.

## I. MYTH I: HAVING PUBLIC PURPOSES AND BEING SUBJECT TO THE ATTORNEY GENERAL'S PARENS PATRIE POWER, FOUNDATIONS AND CHARITIES MUST SERVE THE SAME ENDS AS GOVERNMENT, AND GOVERNMENTS AND THE PUBLIC ARE ENTITLED TO A SAY IN DECISION-MAKING, GOVERNANCE, MISSION, AND EFFECTIVENESS OF FOUNDATIONS AND OTHER CHARITIES.

Myth I essentially characterizes foundations and charities as "shadow governments" accountable to the public as such as a matter of law.[12] In essence, the requirement that charities serve public purposes gets misconstrued into a requirement that *a particular charity's purpose* is susceptible to the will of the general public. The fact that health, education, and social-service-providing nonprofits derive significant funding from the government contributes to a blurred view of the sector. Of course, even if they wanted to, foundations will never be able to substitute for the vastly superior resources of government, which dwarf the resources of foundations.

### *A. Myth Debunked*

The requirement of a public benefit does not render a foundation or other charity a governmental agency, nor does the fact of their importance to society render foundation or charity assets or operations public. Those who create a foundation or other charitable organization can choose its particular charitable purposes (e.g., fields of focus), organizational form (as charity or corporation), and governance structure (foundations usually have no members with the right to elect the board). Subsequent boards and managers then have the broad authority to carry out (and even modify, subject to statutory requirements) those purposes as they see fit. The legitimate

12. *See* Jackson v. Statler Found., 496 F.2d 623, 627–28 n.6 (2d Cir. 1974), *cert. den.* 420 U.S. 927 (1975) ("Professor Jeffrey Hart speaks of foundations as 'shadow governments.' . . . Professor John Simon disagrees and presents a cogent defense of the unique role of these organizations."). *See generally* JENNIFER R. WOLCH, THE SHADOW STATE: GOVERNMENT AND VOLUNTARY SECTOR IN TRANSITION 217 (1990) ("A final and perhaps most troubling dilemma of the shadow state is that the voluntary sector may become a puppet or pawn in the service of goals that are antithetical to their organizational mission. Organizations that do not conform or are not 'ideologically correct' from the perspective of the state at a given historical moment may be denied access to direct and even indirect resources.").

interest of the public in the expenditure of foundation funds (and the operations of other charities) does not lead to the conclusion that the public has the legal right to dictate charity purposes and operations. Rather, the public's exercise of its right to participate in the robust debate about whether the charitable sector, and particular foundations or other charities, carry out their purposes occurs in the context of how those purposes are framed by their founders, supporters, and fiduciaries—and as they may properly be amended or modified.

Nor does the state's authority to regulate and supervise charities lead to the conclusion that their assets belong to the general public. For hundreds of years of Anglo-American common law, the state—usually through the parens patriae authority of the state attorney general—has the responsibility to ensure that charitable assets are used for the intended purposes. The attorney general has this role because there's often nobody else to enforce charitable fiduciary duties—*not* because these are public assets. The attorney general has broad investigative powers, and typically achieves reform through counseling charity fiduciaries on their duties and entering into settlements. Compulsory powers, however, are generally reserved to the courts. While the attorney general is vested with the authority to go to court to seek to correct breaches of charity responsibilities and of fiduciary duty that have not otherwise been remedied by the board, the attorney general is not a "super" member of the board. Indeed, we must be vigilant to guard against impermissible attorney general, legislative, and judicial parochialism and paternalism in charity oversight.

### *B. Private Parties Choose and Carry Out the Public Purpose*

The particular segment of the public being served by the foundation or other charity is one aspect of the organization's purpose. Importantly, the requirement of a public benefit does not imply that all members of the general public or of a particular political subdivision are necessarily the intended beneficiaries. Indeed, the use of the terms "public" or "community" is not necessarily geographic. Rather, founders and thereafter those governing the charity and its members (if any), determine whether the charity's operations will have a particular geographic scope. Moreover, there is no single version of public benefit: A wide variety of charities focus on complementary, overlapping, or even completing issues.

The issue arises from time to time—particularly with respect to federal or state tax exemption (discussed in Myth III, below)—about whether the requirement to have charitable purposes includes a specific obligation to serve the poor. For example, policy makers hear increasing demands for charities—notably the two largest nonprofit subsectors, hospitals and higher education—to provide greater distributional equity. Prompted by financial pressures on public finance systems, at both the state and federal level, politicians concerned about the health needs of the uninsured are tempted to define "charity" as "charity care" and impose it as a condition of tax exemption for nonprofit hospitals.

However, one can argue that an anti-poverty requirement for exemption has the normative policy backwards: that charity should *complement* not *supplement* government. Because of its ability to raise taxes and to allocate resources across the population as a whole, government has the comparative advantage in redistributing income or benefits in a fair and cost-effective way. At the same time, charities have the comparative advantage in ascertaining local and specialized needs, allowing for service delivery that is flexible and compassionate. Such a program can be as simple as government providing targeted funds (such as Medicaid or Medicare reimbursement) or tax benefits (such as the education tax credits) to individual consumers to obtain needed services. Indeed, a great deal of social services is provided through just such public-private partnerships or voucher programs: Government supplies the funding and the program requirements, but nonprofits (and sometimes even businesses) provide the services.[13]

Finally, a demand that foundations and other charities serve governmental purposes neglects the benefits that such organizations provide precisely because they are not the government. Nonprofits (including foundations) are important vehicles for expression. Views differ on many subjects (consider family planning, educational approaches, environmental issues), and many nonprofits express non-majoritarian ideas. Congruence with "the government" (whether at the community level, state level, or nationally) is neither the function of foundations or other charities nor desirable for our society.

### *C. Limited Role of the State in Charity Governance*

Those who create and govern foundations and other charities choose not only the charitable purposes to be served, but also the processes by which those purposes will be fulfilled. These means include the composition of the governing board. Importantly, the treatment of foundations and other charities as privately organized and operated bodies precludes the

13. *See* U.S. Government Accountability Office, Nonprofit Sector: Significant Federal Funds Reach the Sector through Various Mechanisms, but More Complete and Reliable Funding Data are Needed (GAO-09-193), *available at* www.gao.gov/new.items/d09193.pdf (Feb. 2009).

state—except in unusual circumstances (discussed under Myth II, below)—from mandating that the governing board members include public officials or representatives of the community it serves.[14] Similarly, the law generally refrains from dictating how a board should carry out its duties of setting policy and engaging and supervising officers.[15]

Inappropriate regulations and enforcement can effectively achieve confiscation of charitable assets. Consider the thwarted attempt by the Milton Hershey School Trust to diversify its holdings of Hershey Foods Corporation in 2002. Following an announcement by the Hershey Trust offering the stock for sale, the legislature and the attorney general began drafting legislation that would require, among other things, that a charitable trust considering a sale of a controlling business interest to consider the welfare of the affected community, as well as require attorney general and judicial approval. Invoking the proposed legislation, the attorney general—also a candidate for governor—filed suit to halt any sale without court approval.

Paragraph 14 of the attorney general's court petition asserted:

> Any public sale of the controlling interest in Hershey Foods Corporation by the School Trust, *while likely to increase the value of the trust*, could also result in profound negative consequences for the Hershey community and surrounding areas, including, but not limited to, the closing and/or withdrawal of Hershey Foods Corporation from the local community together with a dramatic loss of the region's employment opportunities, related businesses, and tax base.[16]

Invoking case law granting the attorney general authority "to inquire into the status, activities and functioning of public charities" and the view that "the ultimate beneficiary and real party in interest of all charitable

14. See, for example, a Texas appeals court decision refusing to authorize the expansion of the board of a $120-million family foundation from three to seven:

> If . . . a court could disregard the settlor's plan for administration of a public charity simply because the judge believed that another plan would be better, such rule would substantially discourage the establishment of charitable trusts, or, at least, encourage the settlors to seek other jurisdictions in which to establish them. The adoption of such rule also would upset the stability of many of the charitable foundations that now exist in Texas[, many of which ] . . . including the largest ones, have fewer than seven trustees.

Moody v. Haas, 493 S.W.2d 555, 567 (Tex. App. 1973). The court seemed particularly disturbed by expert testimony calling for representation on the board that reflect geographic, professional, and minority-group diversity, observing of these to-be-majority trustees: "The selection of individuals who are to administer the trust may substantially influence not only the manner in which the trust is administered but also the areas of the charitable purpose that will be emphasized." *Id.* at 562, 564.

15. *See generally* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement* 79 IND. L.J. 937, 1008–17 (2004).

16. Petition for Citation for Rule to Show Cause Why a Proposed Sale of Trust Assets Constituting the Controlling Interest in Hershey Foods Corporation Should Not be Conditioned upon Court Approval at 3, *In re* Milton Hershey Sch. Trust, No. 712, (Orphans' Ct., Ct. C.P., Dauphin Cty, Pa., Aug. 12, 2002), *available at* http://news.findlaw.com/hdocs/docs/hershey/pavhershey081202pet.pdf.

trusts is the general public to whom the social and economic advantages of the trusts accrue," the petition declared in paragraph 18 (emphasis in original): "Accordingly, the broad interests of the Attorney General necessarily entail protecting the public against any social and economic *disadvantages* which may be occasioned by the activities and functioning of public charities . . . ."[17] The Orphans' Court agreed with the attorney general that "[p]roperty given to a charity is in a measure public property," and that "the Attorney General has the authority to inquire whether an exercise of a trustee's power, even if authorized under the trust instrument, is inimical to the public interest."[18] The Pennsylvania Commonwealth Court upheld the preliminary injunction against the sale issued by the Orphans' Court.[19]

Well advised creators of charities—as well as donors having significant assets to bestow on society—keep a close eye on the regulatory environment. State attorneys general that overreach by interfering in the autonomy of charities organized in their states could discourage the creation of charities in-state—and could even prompt an exodus of charities from the jurisdiction.[20]

17. *Id.* at 4.

18. *In re* Milton Hershey Sch. Trust, 807 A.2d 324, 330 (Pa. Commw. Ct. 2002).

19. *Id.* at 335.

20. *See* Carl J. Schramm, *Law Outside the Market: the Social Utility of the Private Foundation*, 30 HARV. J.L. & PUB. POL'Y 355 (2006). Schramm comments: once attorneys general become involved, "the record shows that the scope of state investigation and action has far exceeded the common law power to ensure that funds within a foundation are being applied in the public interest. Furthermore, the vagueness of most state charity statutes allows investigations to proceed as though the attorney general actually possessed the authority to ensure that the funds are used in the subjectively-determined 'best' interest of the public." *Id.* at 412–13. Schramm concludes by calling for "an implicit private-public treaty" "among donors, trustees, and the government. He adds:

> The burden also falls on the donor and trustees to not tempt government to examine the actions of the foundation and potentially restrict its freedom. . . . [F]oundations must articulate programs that, using a wide perspective, advance human welfare in the context of democratic capitalism. For its part, government generally ought to defer to the trustees and executives, with four exceptions: egregious cases of obvious frivolous action, instances where foundation resources are diverted for private gain, programs that set out to erode or destroy aspects of our system of democratic capitalism, or instances where foundation resources are used to advance partisan political ends.
>
> Attorneys general must refrain from adopting the convenient notion that foundations are to operate democratically under the direction of either constituent groups or elected officials. Such an approach not only offends the historical legal theory of foundation freedom of action but also trades away the potential such organizations possess for long term fundamental change (since that change may offend current political sensibilities).

*Id.* at 413–14.

## II. MYTH II: BECAUSE, ALONG WITH CERTAIN ADDITIONAL FACTORS, FOUNDATIONS AND OTHER CHARITIES ARE CHARTERED BY THE STATE, THEY AMOUNT TO STATE ACTORS OR MUST BE OVERSEEN AND HELD TO ACCOUNT AS QUASI-GOVERNMENTAL BODIES.

Myth II assumes that because nonprofit corporations cannot exist without a state charter, the charter carries with it the approval of the state. (Certain other permissible forms for charity, notably the charitable trust and unincorporated charitable associations, organize under state law without a charter from the state.) Moreover, this relationship gives the state the authority to alter charitable purposes and governance structure and otherwise intervene in the operations of foundations and other charities.[21]

Separately, this Myth asserts that certain additional factors transform foundations and other charities into state actors, so that their behavior is constrained by constitutional protections applicable to those who operate under color of state law. Under Myth II, foundations and charities should be subject to legislative mandates that impose public-sector standards of transparency and accountability, possibly including such things as the following or some combination thereof: open board meetings, open decision-making, open records, government appointed boards, and programs that serve the needs of the public as dictated by those in power as government.[22]

### *A. Myth Debunked*

Most foundations and other charities derive their existence under state laws allowing the formation and operation of nonprofit corporate enterprises. However, the mere granting of a charter does not equate with state endorsement or adoption of the enterprise, nor does it justify interfering with the underlying contract that the charter represents or subjecting such organizations to the requirements of the Equal Protection or Due Process clauses of the Constitution.

21. In a striking example, a bill introduced in the New York state assembly in March 2009 proposed legislative findings that the state's right to impose restrictions on asset sales by New York museums is based on the fact that "all" museums in the state are "creatures of State government" and, therefore, "are subject to the public interest" all because they are "directly chartered by the legislature." State Assembly A6959—A, 2009-10 Reg. Sess. (N.Y. 2009) *available at http://assembly.state.ny.us/leg/?bn=A06959&sh=t* (last visited Feb. 18, 2009).

22. Of course, there would be some limits on the openness of records and meetings regarding personnel matters, pending litigation, active negotiations to acquire real estate, and the few other things generally recognized as exceptions to state and federal sunshine laws.

In a landmark ruling that recognized a nonprofit corporation's right to a charter, the high court of New York emphasized that the issuance of a charter is not to be viewed as state endorsement of the particular purpose of the organization.[23] Speech and associational rights would lose their meaning if the state could withhold charters from organizations dedicated to lawful, societal goals but taking positions with which the state—or even a majority of the public—disagreed.

Moreover, the United States Supreme Court held in the seminal 1819 case of *Trustees of Dartmouth College v. Woodward*[24] that the charter of a nonprofit corporation is a contract protected under the Contracts Clause of the U.S. Constitution against unilateral state legislative amendment. Rejecting the New Hampshire legislature's attempt to expand the number of directors of the college and to convert it into a university, Chief Justice John Marshall, writing for the court, declared: "This [act] may be for the advantage of this college in particular, and may be for the advantage of literature in general; but it is not according to the will of the donors, and is subversive of that contract, on the faith of which their property was given."[25] Not incidentally, Justice Marshall emphasized that "the objects of the contributors, and the incorporating act, were the same[:] the promotion of [C]hristianity, and of education generally, not the interests of New-Hampshire particularly."[26] The *Dartmouth College* case has not only stood firm and unblemished for almost two hundred years, but also it has been resolutely cited for the principles at stake. (Today, such protections against impermissible action by a state would likely be found under the Due Process Clause of the Fourteenth Amendment.)

From the other direction, if receiving their charter or other factors were to render foundations and other charities "state actors," these otherwise private organizations would be held liable for violating the Equal Protection and Due Process Clauses of the U.S. Constitution, which can be violated only by government action. While having a state charter alone is not enough, litigation arises from time to time about what factors lead to the conclusion that a nonprofit organization is "acting under color of law," thus subjecting it statutorily to requirements imposed on governments.[27] As

23. Ass'n for Pres. of Freedom of Choice v. Shapiro, 174 N.E.2d 487, 490 (N.Y. 1961). *See generally* NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR (2001).

24. Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518 (4 Wheat.) (1819).

25. *Id.* at 653.

26. *Id.* at 640.

27. Of course, finding state action does not require finding that the state action is unconstitutional. Moreover, at least in theory, a nonprofit treated as the state would, by the same token, enjoy such benefits as sovereign immunity.

with the other Myths, because the implications of this label can be so destructive to the otherwise private organization and to the proper role of government, the Supreme Court and other courts have been deliberate in developing and applying criteria for determining if an otherwise private enterprise should be considered a state actor, and not very many foundations or charities qualify. Efforts to uniformly classify foundations or charities as public, state, or governmental (or quasi-government) bodies—without applying a proper case-by-case analysis—would have substantial negative consequences. Judge Henry Friendly makes this point so eloquently and forcefully that we refer to his jurisprudence extensively in the discussion below.

Even when not deemed a state actor, a specific nonprofit organization might properly be treated as a quasi-governmental public body under one or more state or federal narrowly defined Sunshine Laws. However, while, as described under Myth III, voluntarily pursued operational transparency of foundations and charities can be a powerful means of earning the public trust, open-meetings and open-records laws intended to ensure oversight of government do not broadly apply to foundations and charities. Legislative bodies and courts have been appropriately careful in establishing criteria for determining if an entity should be subject to these laws, and there are not compelling reasons to expand these special cases to encompass foundations and charities generally (even if such an expansion is possible without violating the U.S. Constitution).

If the charter argument held, then the autonomy, privacy, and independence of any enterprises—including business corporations—that receive their legal status from the state would be in jeopardy, such that they could be declared public at any time.

### *B. Granting of a State Charter Does Not Render Nonprofit Organizations Government Agencies*

In his influential concurring opinion to the 1819 *Dartmouth College* decision, Justice Joseph Story declared: "That the mere act of incorporation will not change the charity from a private to a public one, is most distinctly asserted in the authorities."[28] Justice Story observed: "The fact, then, that the charit[able purpose] is public, affords no proof that the corporation is also public; and, consequently, the argument, so far as it is built on this foundation, falls to the ground. If, indeed, the argument were correct, it would follow, that almost every hospital and college would be a public

28. 17 U.S. at 670 (Story, J., concurring).

corporation; a doctrine utterly irreconcilable with the whole current of decisions since the time of Lord Coke."[29]

The state, of course, retains appropriate regulatory authority over corporations. Thus, the state sets basic ground rules for the governance structures and practices of business corporations in order to protect their shareholders, just as the state regulates the governance structures and practices of nonprofit corporations in order to protect the purposes they serve. Justice Story explained, though, what the state may not do:

> When the corporation is said [by the state] . . . to be public, it is not merely meant, that the whole community may be the proper objects of the bounty, but that the government have the sole right, as trustees of the public interests, to regulate, control, and direct the public interests, to regulate, control, and direct the corporation, and its funds and its franchises, at its own good will and pleasure. Now, such an authority does not exist in the government, except where the corporation is in the strictest sense public; that is, where its whole interests and franchises are the exclusive property and domain of the government itself.[30]

Within generally applicable legitimate requirements, those who create a foundation or charity are free to choose the organizational form (such as trust or corporation), governance details and structure (like many operating charities, foundations usually have no members with the right to elect the board), and strategies for pursuing charitable mission.

States still occasionally try to overreach, and experiences in Maryland, Illinois, and New Hampshire serve as clarion calls. Almost 140 years after *Dartmouth College*, the high court of Maryland similarly prevented the effective confiscation-by-regulation of assets held for the benefit of, but outside, the University of Maryland system.[31] In ruling on an Illinois stat-

29. *Id.* at 671 (footnote omitted).

30. *Id.* at 671–72. Justice Story added: "Yet, who ever thought before, that the munificent gifts of private donors for general charity became instantaneously the property of the government; and that the trustees appointed by the donors, whether corporate or unincorporated, might be compelled to yield up their rights to whomsoever the government might appoint to administer them? If we were to establish such a principle, it would extinguish all future eleemosynary endowments; and we should find as little of public policy, as we now find of law to sustain it." *Id.* at 672.

31. In 1951, Maryland adopted a statute replacing the nine current members of the Endowment Fund (a nonprofit corporation) with the Regents of the University of Maryland (and anyone else the Regents appoint). In *Board of Regents of the University of Maryland v. Trustees of the Endowment Fund of the University of Maryland*, 112 A.2d 678 (Md. 1955), the Maryland high court ruled that the legislature had gone too far in reserving an absolute right unilaterally to amend the nonprofit corporation's charter. *Id.* at 686. Quoting a decision of the United States Supreme Court, the court declared: "'The reserved power is not unlimited and cannot be exerted to defeat the purpose for which the corporate powers were granted . . . or arbitrarily to make alterations that are inconsistent with the scope and object of the charter or to destroy or impair any vested property right.'" *Id.* at 683 (quoting Philips Petroleum Co. v. Jenkins, 297 U.S. 629, 634 (1936)). Ruling the legislative change to be fundamental, the court commented: "The charter plan was designed to retain to the donors, through the exercise of discretion by their chosen representatives and their self-appointed successors, a voice in the management and expenditure of the fund, subject, of course, to a veto power by the Regents. The views of this

ute, the Seventh Circuit in 2004 refused to find a foundation that was created under specific legislation and having public officials as board members to be part of the state, such that the legislature could directly confiscate its assets for the state's own purposes, as determined by those in power.[32] Citing *Dartmouth College*, Judge Richard Posner wrote:

> The fact that the state legislature authorized the creation of the plaintiff foundation does not make the foundation a state agency; for the legislature also authorizes the creation of business and professional corporations, not to mention religious and charitable corporations, without thereby acquiring a right to confiscate such entities' assets.[33]

In 2009, a New Hampshire court, in a successful derivative suit brought by policyholders of a state-created medical malpractice insurance nonprofit organization (although not a charity), blocked the state from claiming for its general fund a $110 million surplus earned by the organization.[34] Therefore, overreaching efforts by the state to assert control over otherwise private nonprofit assets are neither dated nor obsolete.

independent group may, from time to time, differ widely from those of the current managers of the University." *Id.* at 684.

32. Ill. Clean Energy Cmty. Found. v. Filan, 392 F.3d 934, 936–38 (7th Cir. 2004). The decision raised the question of who controls a $225 million nonprofit corporate foundation established by Commonwealth Edison of Illinois as a condition to obtaining approval to sell its seven fossil-fuel power plants for $4.8 billion. *Id.* at 935. According to the enabling statute, the Foundation's mission is to make grants to public and private institutions in Illinois for projects to conserve energy and improve the environment. *Id.* But then the state of Illinois needed money. Subsequent legislation sought to compel the Foundation "to turn over to the state's treasury and state environmental agencies up to $25 million, which is to be used for funding the agencies and repaying state general obligation bonds." *Id.* at 936. Judge Posner differentiated permissible regulation from impermissible takings:

> The coercive element in the history of the authorizing statute is irrelevant. Suppose the state didn't think that lawyers should be permitted to incorporate, and passed a law requiring that all professional corporations of lawyers be converted to partnerships. Would the partnership assets be public property? Obviously not. Supposing the state could indeed have forced ComEd to disgorge $125 million of its profits from the sale of the power plants, or indeed much more, to the ratepayers, could it then, years later, have ordered the ratepayers to contribute their rebates to the state treasury, on the ground that it was really the state's money? We cannot see what difference it makes that the disgorgement was to a foundation rather than to individuals. By forcing a transfer of private property from one private entity to another, the state did not destroy the private character of the property. If the state orders a criminal to make restitution of a sum of money to the victim of his crime, it cannot snatch the money back from the victim on the ground that it's the state's money.

*Id.* at 937. Judge Posner added: "This suit would go nowhere had the statute creating the plaintiff foundation reserved the right of the state to confiscate the foundation's assets. There is no such reservation." *Id.* at 937.

33. *Id.* at 936–37 (citing *Trs. of Dartmouth Coll.*, 17 U.S. (4 Wheat.) at 638–40). Judge Posner concluded: "All the state is left to argue is that the appointment of five-sixths of the foundation's trustees by state officials made the foundation a state agency. Not so. By whomever appointed, the trustees of a charitable foundation have a fiduciary duty to conserve the foundation's assets. . . . It would be a fiction therefore to suggest that because public officials appoint most of the trustees, the state 'controls' the foundation. If it really controlled it, we wouldn't have this lawsuit." *Id.* at 937–38 (citations omitted).

34. Tuttle v. N.H. Med. Malpractice Joint Underwriting Ass'n, No. 09-E-0148, slip op. at 26-27 (Belknap Cnty. Super. Ct., July 29, 2009), *available at*

### *C. In General, Foundations and Other Charities Enjoy Constitutional Freedoms of Association and Expression, and Are Not Subject to Constitutional Constraints Imposed on State Actors*

As mentioned above, a state agency—such as a public college or government employer—must adhere to the Equal Protection and Due Process Clauses of the Fourteenth Amendment (for action by one of the states) and to the Due Process Clause of the Fifth Amendment (for federal action), as well as other constitutional requirements. By the same token, if a foundation or charity is treated as part of the state (as described next), it presuma-

http://www.courts.state.nh.us/superior/superorders/tuttle.pdf, *aff'd*, —-A.2d ——, 2010 WL 313403, *2 (N.H. Jan. 28, 2010). Under the insurance regulations, the JUA has a seven-person board of directors that is appointed by the Insurance Commissioner from a list nominated by the board; three are health care providers, two are representatives of member insurers, and two are members of the public. Board meetings must be publicly noticed and held under the Right to Know Law, and minutes are available to the public. *See* N.H. CODE ADMIN R. ANN. INS. §§ 1703.03–.05 (2009). Profits are to be used to reduce future payments by member insurers or distributed to them on liquidation.

In June 2009, a month prior to the superior court decision cited above, the court had ruled that the state attorney general's office is disqualified from representing the JUA because "[t]he JUA is a quasi-public/private entity . . . separate . . . from the Insurance Department . . . and not part of the executive branch of State government." *Tuttle*, No. 09-E-0148, slip op. at 10 (quoting Tuttle v. N.H. Med. Malpractice Joint Underwriting Ass'n, No. 09-E-0148 (Belknap Cnty. Super. Ct. June 25, 2009)). In the July decision, the court ruled that the JUA is not a state agency after finding, among other factors, that: (1) the "JUA board has exclusive control over its operating fund"; (2) the "State did not financially contribute to the creation of the JUA and has not contributed any funds since that time"; (3) the "State is not responsible for any JUA shortfalls and does not guarantee performance of JUA obligations"; and (4) "the JUA board and its staff are not state employees." *Id.* at 11—12. Looking for analogies in other jurisdictions, the court cited *Texas Catastrophe Property Insurance Association v. Morales*, 975 F.2d 1178 (5th Cir. 1992), which had ruled that that association is not a state agency; accordingly, the court struck down a provision in the enabling legislation that required the association to be represented in all matters by the state attorney general rather than by an attorney of its choosing. *Id.* at 13—14.

The superior court's July 2009 decision ruled that the oversight authority of the state insurance commission—including the requirement that the commissioner must approve the distribution of dividends to policyholders, who are ultimately entitled to any surplus (as well as liable for any shortfall)—"does not negate the private nature of the entity. 'That the state holds, and exercises, the coercive power to force private insurers doing business in Texas to cover certain risks does not mean that the money coming out of the companies' bank accounts is state money. It is private money directed to pay private claims.'" *Id.* at 14 (quoting *Texas Catastrophe*, 975 F.2d at 1182–83.) Finally, the court rejected the argument that JUA's tax-exempt status make it a part of state government; rather, tax-exemption is among the financial tools "that states may offer to mandatory risk sharing plans such as the JUA to shift to the government a portion of the burden of insuring high-risk individuals or entities who would otherwise be unable to find coverage in the voluntary market . . . ." *Id.* The court held that the New Hampshire statute violates the Takings Clauses of the federal and state constitutions, as well as an impairment of the UJA's contract obligations under the Contracts Clause of both constitutions. *Id.* at 27.

By a three to two vote, the New Hampshire supreme court affirmed on Contracts Clause grounds, without addressing the issue of whether the JUA is a state agency. While the court did not rule on the takings claim, it observed that the "funding scheme is qualitatively different from social or economic regulatory legislation which establishes a broad-based mechanism for addressing a public need." *Compare* Brody, *supra* note 15, at 1026–32 (describing the experience in New York involving the conversion of Empire Blue Cross to a taxable entity, and the acquiescence by the charity's board that nearly all of the sale proceeds should be contributed to a state fund).

bly also would enjoy such benefits as sovereign immunity and, for an accrediting association, exemption from antitrust law.

State action can appear in various guises. In particular, 42 U.S.C. § 1983 creates a remedy for violations of federal constitutional rights against persons acting under color of state law. From time to time, the assertion is made that a charity must abide by constitutional requirements imposed on the government, or is subject to a federal statute that applies to agencies of the United States or to a state statute that applies to a state or lesser government. "Like the state-action requirement of the Fourteenth Amendment," however, "the under-color-of-state-law element of § 1983 excludes from its reach 'merely private conduct, no matter how discriminatory or wrongful. . . .'"[35] Moreover, "[i]n cases involving extensive state regulation of private activity," the Supreme Court has "consistently held that 'the mere fact that a business is subject to state regulation does not by itself convert its action into that of the State for purposes of the Fourteenth Amendment.'"[36]

Holding a foundation or other charity to government standards could affect practices in employment matters, service delivery, and a range of other activities. For a charity having members, constitutional and statutory due process requirements would apply to disciplinary or expulsion procedures. The consequences of being characterized as a state actor could be catastrophic, and broadly characterizing foundations and other charities as state actors would upset the traditional relationships between such organizations and government. Accordingly, courts have insisted on a fact-intensive, case-by-case analysis of the issue, and they have refused to approve any categorical assertions that such organizations are subject to state-actor constraints. Under the criteria developed and applied by the courts, it is the rare foundation or charity that would qualify as such.

By contrast, constitutional constraints do not apply to private persons not acting under color of law. Private organizations generally can operate in all their fractious and insular splendor, free of what Nancy Rosenblum calls the "logic of congruence"—the demand "that the internal life and organization of associations mirror liberal democratic principles and practices."[37] We might not like the structure or internal organization of some

35. Am. Mfrs. Mut. Ins. Co. v. Sullivan, 526 U.S. 40, 50 (1999) (quoting Blum v. Yaretsky, 457 U.S. 991, 1002 (1982) (citations omitted)).

36. *Id.* at 52 (quoting Jackson v. Metro. Edison Co., 419 U.S. 345, 350 (1974)). *See Blum*, 457 U.S. at 1004.

37. NANCY L. ROSENBLUM, MEMBERSHIP AND MORALS: THE PERSONAL USES OF PLURALISM IN AMERICA 36–41 (1998). *See generally* Evelyn Brody, *Entrance, Voice and Exit: The Constitutional Bounds of the Right of Association*, 35 U.C. DAVIS L. REV. 821 (2002).

nonprofits—such as groups that exclude from membership and leadership positions those who do not believe in God or who are homosexuals. While the public is free to criticize such a structure or practice, any pressure brought to bear on an expressive organization to change its membership criteria cannot be backed up by legal compulsion.[38]

Much, if not most, of the diversity of the charitable sector is viewed as desirable, and its availability a spur to philanthropy and participation. Thus, a grant-making foundation can devote its funds to providing scholarships to students from a particular school district; to research into a cure for a disease that afflicted the founder's child; or to the preservation of a dying Native American language. A private membership organization can provide rules for internal decision-making, such as granting some members greater voting power than others, or denying some classes of members the right to vote. Membership groups effectively enjoy the power of exile through the right to expel members who breach their rules. Educational institutions traditionally accord their faculty with a strong governance role, as well as academic freedom. Diversity of beliefs is not limited to religious groups. Nonprofits can and do form on all sides of a contentious issue; moreover, an expressive organization need affirmatively not take positions on contentious issues to enjoy protection. Justice Powell famously praised "the important role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints."[39]

Painful as the result might be, a member unhappy with a group's policy, and who is unable to persuade the group to change policy, can always exercise the power of exit, and form another group, just as a dissatisfied donor can use her market power to withhold future contributions. Indeed, the simultaneous exercise of voice and exit after the *Boy Scouts* case dramatically illustrates both the virtues and consequences of a freedom to associate. In the end, we accept high transaction costs in entering and exiting association because the alternative—obliteration of difference—brings higher social costs in the form of reduced autonomy and liberty.

As a threshold matter, when litigation arises about whether a particular private entity can properly be treated as a state actor, and thus subject to the constitutional constraints and potential liabilities that apply to government, a foundation or charity cannot claim nongovernmental status based simply on a functional distinction between the public and nonprofit sectors. Justice Harlan described the difficulties of applying such a test: "While this proc-

38. *See* Boy Scouts of Am. v. Dale, 530 U.S. 640 (2000).

39. Bob Jones Univ. v. United States, 461 U.S. 576, 609 (1983) (Powell, J., concurring). *See generally* Myth III, *infra*.

ess of analogy might be spun out to reach privately owned orphanages, libraries, garbage collection companies, detective agencies, and a host of other functions commonly regarded as nongovernmental though paralleling fields of governmental activity, the example of schools is, I think, sufficient to indicate the pervasive potentialities of this 'public function' theory of state action."[40]

Acknowledging the difficulty of making a state-actor determination, the Supreme Court has discussed the controlling policy:

> Our cases try to plot a line between state action subject to Fourteenth Amendment scrutiny and private conduct (however exceptionable) that is not. The judicial obligation is not only to "'preserve an area of individual freedom by limiting the reach of federal law' and avoid the imposition of responsibility on a State for conduct it could not control," but also to assure that constitutional standards are invoked "when it can be said that the State is *responsible* for the specific conduct of which the plaintiff complains." If the Fourteenth Amendment is not to be displaced, therefore, its ambit cannot be a simple line between States and people operating outside formally governmental organizations, and the deed of an ostensibly private organization or individual is to be treated sometimes as if a State had caused it to be performed. Thus, we say that state action may be found if, though only if, there is such a "close nexus between the State and the challenged action" that seemingly private behavior "may be fairly treated as that of the State itself."[41]

Courts have almost uniformly refrained from declaring that, without more, a foundation or charity is a state actor merely because it organizes under a state-issued charter or has tax-exempt status, receives and expends public funds, or has public officials on its board of directors.

A common set of nonprofits vulnerable to treatment as state actors are those that were spun off by the state, such as some public hospitals and public museums. Indeed, one "variant [of] the 'public function' cases concern particular activities or facilities so clearly governmental in nature that the state cannot be permitted to escape responsibility by allowing them to be managed by a supposedly private agency."[42] Typically, enabling legisla-

40. Evans v. Newton, 382 U.S. 296, 322 (1966) (Harlan, J., dissenting).

41. Brentwood Acad. v. Tenn.Secondary Sch. Athletic Ass'n, 531 U.S. 288, 295 (2001) (emphasis in original) (citations omitted).

42. Powe v. Miles, 407 F.2d 73, 80 (2d Cir. 1968). In *Hack v. President and Fellows of Yale College*, 237 F.3d 81 (2d Cir. 2000), the Second Circuit ruled that Yale University was not a state actor or instrumentality, and so did not violate plaintiffs' religious rights protected under the Constitution and § 1983 by requiring all unmarried freshmen and sophomores under the age of twenty-one to reside in college dormitories, all of which are co-educational; nor did Yale's refusal to exempt religious observers from co-educational housing violate the Fair Housing Act, 41 U.S.C. § 3601 *et seq*. Because Yale is so old that it came into being by a specific statute, the *Hack* court followed a 1995 Supreme Court case setting forth the test for such a corporation: "[O]nly if (1) the government created the corporate entity by special law, (2) the government created the entity to further governmental objectives, and (3) the government retains 'permanent authority to appoint a majority of the directors of the corporation' will

tion or the governing documents provide that some or all of the members of the governing board are appointed by state officials (and perhaps are themselves designated officials, such as the governor, state legislators, or county or city officials); that financing comes directly from the state or the state makes assets available at low or no cost; and that, upon liquidation, the charity's assets will be transferred to the state. An umbrella statute applicable to all quasi-public bodies or the enabling statute itself might legitimately constrain activities in some way, for example by requiring hiring practices and compensation schedules to follow the rules for public employees. Conditions can also appear in the governing documents and contracts or memoranda of understanding providing for governmental funding.

The issue of whether a grant-making foundation was a state actor arose in the early 1970's when a private plaintiff alleged that thirteen charitable foundations in the Buffalo, New York area discriminated against himself, his children and his foundation in that the appellee "foundations refused to hire him as a director of their foundations, refused to give scholarships to his children, and refused to grant money to his foundation, all for reasons of race."[43] The plaintiff also alleged that the foundations pursued a "pattern of discriminatory employment and investment."[44]

A panel of the Second Circuit Court of Appeals refused to dismiss the case. Nevertheless, it enumerated a list of factors for a finding that a private entity amounts to a state actor:

> (1) the degree to which the "private" organization is dependent on governmental aid; (2) the extent and intrusiveness of the governmental regulatory scheme; (3) whether that scheme connotes government approval of the activity or whether the assistance is merely provided to all without such connotation; (4) the extent to which the organization serves a public function or acts as a surrogate for the State; (5) whether the organization has legitimate claims to recognition as a "private" organization in associational or other constitutional terms.[45]

However, the panel added: "The formulation of this definition of 'state action' is applicable only to claims of racial discrimination . . . . [C]onduct

the corporation be deemed a government entity for the purpose of the state action requirement." 237 F.3d at 84 (citation omitted). The *Hack* court ruled, "[h]ere, the first two factors are easily satisfied: the State of Connecticut created the corporate entity by special law, and higher education is a governmental objective (although not the exclusive province of government). Two of nineteen board members is, however, a long way from control." *Id.* at 84. Moreover, the court added, "It is equally clear that the state could not control Yale's policies and operations even if it chose to become involved. Yale, as a private university, did not act under color of law." *Id.*

43. Jackson v. Statler Found., 496 F.2d 623, 625 (2d Cir. 1974).

44. *Id.* at 625. Jackson "sought injunctive and declaratory relief, damages, the revocation of appellees' tax exempt status under the Internal Revenue Code, and an order directing the foundations to surrender all their assets to the United States Treasury." *Id.*

45. *Id.* at 629.

which is admittedly part private and part governmental must be more strictly scrutinized when claims of racial discrimination are made."[46]

In remanding for further proceedings, the court found that the appellee foundation enjoyed financial support from its tax treatment and was subject to close regulation. Moreover, the panel wrote:

> The exemptions in question are not the type of government assistance such as police or fire protection, which is routinely provided to all without any connotation of approval. Organizations must apply for exempt status. Moreover, the acts of application and approval are not value neutral. In effect, the government would appear to be certifying that every foundation on its tax-exempt list is laboring in the public interest.[47]

Even when citing the *Statler Foundation* factors quoted above, the courts almost always found the private entity not to be a state actor.[48] Moreover, after *Statler Foundation*, the Supreme Court "has tightened the proof required for a showing of state action."[49] *Statler Foundation* remains an unusual case, perhaps because would-be beneficiaries of private philanthropy rarely have standing to sue for largess or over the tax-exempt status of a nonprofit organization.[50] More significantly, the 1983 Supreme Court decision in *Bob Jones University v. United States* has shifted the debate over racially discriminatory schools from the question of whether these entities violated private plaintiffs' rights to whether the entities are entitled to federal tax exemption under Internal Revenue Code § 501(c)(3) as a matter of public policy.[51] Indeed, Justice Powell's concurrence in *Bob Jones* cited Judge Friendly's dissent to the Second Circuit's denial of a rehearing en banc in *Statler Foundation*.[52]

*Statler Foundation* lives on more for Judge Friendly's blistering dissent (joined by two of the three other dissenters) from the denial of a rehearing by the full Second Circuit. He has provided a cogent analysis for

46. *Id.* at 635.

47. *Id.* at 633 (citations and footnote omitted).

48. *See, e.g.*, Gilinsky v. Columbia Univ., 488 F. Supp. 1309, 1312 (S.D.N.Y. 1980). The *Statler Foundation* suit itself eventually foundered when the *pro se* plaintiff failed to pursue the case. *See* Jackson v. Statler Found., 1975 U.S. Dist. LEXIS 11389, 36 A.F.T.R.2d (RIA) 75-5579, 75-2 U.S. Tax Cas. (CCH) P9721 (W.D.N.Y. 1975).

49. Fulani v. League of Women Voters Educ. Fund, 684 F. Supp. 1185, 1191–92 (S.D.N.Y. 1988) (citation omitted) (citing Blum v. Yaretsky, 457 U.S. 991, 1011 (1982), Rendell-Baker v. Kohn, 457 U.S. 830, 842 (1982), and Jackson v. Metropolitan Edison Co., 419 U.S. 345, 350 (1974)).

50. *See* generally Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing*, 41 Ga. L. REV. 1183 (2007).

51. *See generally* Myth III, *infra*.

52. Bob Jones Univ. v. United States, 461 U.S. 574, 610 (1982) (Powell, J., concurring) (footnote omitted) ("Given the importance of our tradition of pluralism, '[the] interest in preserving an area of untrammeled choice for private philanthropy is very great.' Jackson v. Statler Foundation, 496 F.2d 623, 639 (CA2 1974) (Friendly, J., dissenting from denial of reconsideration en banc).").

why foundations and charities should not easily be declared to be state actors. Beginning by observing the novelty of the plaintiff's claim, Judge Friendly termed the panel opinion "the most ill-advised decision with respect to 'state action' yet rendered by any court and unless corrected will be the source of enormous damage to the great edifice of private philanthropy which has been one of this country's most distinctive and admirable features."[53]

Invoking the Supreme Court decision in *Walz* (discussed under Myth III, below), Judge Friendly observed:

> Because of its broad availability, a tax exemption, in itself, has never previously been thought to impose the government's imprimatur sufficiently to convert the recipient into a *de facto* arm of the government. An exemption or other tax benefit, available to a wide range of institutions, has always been regarded as the least possible form of government support, except for the police and fire protection provided all citizens.[54]

Judge Friendly also dismissed the "the panel's reliance on the government's regulation of foundations to prevent abuse of the tax exemption." He explained: "The 'state action' cases that have stressed the heavy presence of government regulation are those in which private institutions are carrying out state policy against the plaintiffs or in which the state is benefiting directly from the private activity."[55] He commented tersely: "Private action does not become state action simply because government regulation has not gone so far as a plaintiff would like."[56]

Judge Friendly was equally concerned with protecting the values of foundation activity and practices and with the dangers of imposing artificial governmental constraints on them:

> The interest in preserving an area of untrammeled choice for private philanthropy is very great. Even among philanthropic institutions, the activities of charitable family foundations, receiving no government benefit other than tax exemption, should be the last to be swept, under a "sifting of facts and exercise of judgment," within the concept of state action. There are hundreds of thousands of foundations ranging from the giants to the pygmies. While most foundations, particularly large ones, give mainly to institutions serving all races and creeds, although hardly in the completely non-discriminatory way required of public institutions, I see nothing offensive, either constitutionally or morally, in a foundation's choosing to give preferentially or even exclusively to Jesuit seminaries, to Yeshivas, to black colleges or to the NAACP. Indeed, I find it some-

53. *Jackson*, 496 F.2d at 637 (Friendly, J., dissenting from denial of rehearing en banc). Judge Friendly noted, however, that his dissent does not apply to the holding with respect to the defendant Buffalo Foundation, *id*. at 637 n.1, a majority of whose board is appointed by public officials.

54. *Id.* at 638.

55. *Id.* (footnote omitted).

56. *Id.* at 639.

> thing of a misnomer to apply the pejorative term "racial discrimination" to a failure to make a charitable gift.[57]

Judge Friendly cautioned that "[d]onors are not going to be willing to spend their time and money, or to have directors and staffs of foundations spend theirs, in defending actions like this one. If the federal courts take over the supervision of philanthropy, there will ultimately be no philanthropy to supervise."[58] Moreover, he expressed deep concern that "the decision will spawn countless civil rights suits against charitable foundations by disgruntled minority applicants, add unnecessarily to the crushing burden on the district courts and the courts of appeals, and, worst of all, seriously discourage private philanthropy by subjecting donors to the necessity of justifying their decisions in court." Indeed, even the record of the "several of the defendant foundations [that] commendably have given liberally to black and other minority causes" will not save them or others "from the necessity of full factual exploration and explanation of just what they have done over the years, with the attendant burdens on foundation directors and staffs and the courts."[59]

### *D. Foundations and Charities are Generally Not Subject to Public Access Laws*

Foundations and other charities might be subject to registration and reporting rules, as well as to any regulation required because of a particular industry in which they might operate. Separate is the issue of when state Sunshine Laws granting the public access to governmental agencies—allowing the public to access, attend meetings of, and obtain records—apply or should apply to nonprofit organizations on the basis that they purportedly function as quasi-governmental bodies. That is, separate from the question of whether a quasi-public body is subject to constitutional constraints on its behavior is when public access laws apply or should apply to foundations and charities.

Application of public access statutes has been frequently litigated. Courts have no trouble rejecting suits that seek records held by typically private institutions. Recently, for example, the high court of Massachusetts ruled against application of the state public records law against Harvard.[60] In situations that overlap with those just described, proponents assert that a

57. *Id.* at 639–40.
58. *Id.* at 640.
59. *Id.*
60. Harvard Crimson, Inc. v. President and Fellows of Harvard Coll., 840 N.E.2d 518 (Mass. 2006).

government that spins off the performance of government functions, or that depends on a private organization to perform essential government functions, cannot evade the public's access to information. Notably, media often probe contributions to state-institution-related private bodies, and what, if anything, donors might be getting in return.[61] "State-institution-related foundations" raise issues of private access to and control over public assets (including such intangible assets as the public institution's name and goodwill); their role in soliciting and managing gifts, investments, and campus facilities; and their role in governance of the state institution (notably, the recent trend to supplement—if not pay the bulk of—the public university president's salary). Most contentious is information about the names and contribution levels of individual donors, who have a privacy interest in protecting their wealth and supported causes.[62]

Whether an entity is subject to state public access laws depends on one or more, but usually a combination of, factors that include the following: (1) whether the organization is primarily performing a public function, including under agreements with government; (2) whether the organization was created by specific statute; (3) whether the organization exercises powers of government (such as enacting policies or rules that affect citizens as citizens, or having the power to tax); (4) whether the board is comprised of or appointed by public officials; (5) the extent to which state grants or contracts comprise the entity's revenue stream; (6) whether a public agency previously operated the facility or provided the specific services; (7) whether action by government is necessary to dissolve or divest assets from the entity; (8) whether the organization's employees are employed by gov-

61. For cases finding a nonprofit organization subject to the state's open records laws, see State ex rel. Toledo Blade Co. v. Univ. of Toledo Foundation, 602 N.E.2d 1159 (Ohio 1992) (finding defendant is a "public office" and is required to produce names of donors); Gannon v. Board of Regents, 692 N.W.2d 31 (Iowa 2005) (similar); Champ v. Poelker, 755 S.W.2d 383, 390-93 (Mo. App. 1988) (finding convention and visitors bureau performs public functions and is a quasi-governmental public body). Most recently, in *Cape Publications, Inc. v. University of Louisville Foundation, Inc.*, 260 S.W.3d 818 (K. 2008), the court declared the defendant to be a public agency that must disclose the names of 47,000 donors. While the court found that the public's interest in how the institution's fund-raising arm operates outweighs concerns for donors' privacy, the court upheld the privacy rights of sixty-two donors who requested anonymity because, at the time of each of these anonymous donations, the courts had not yet determined the status of the Foundation as a public entity for purposes of the Open Records Act. For an unsuccessful suit, see, for example, Lee Publ'ns., Inc. v. Dickinson Sch. of Law, 848 A.2d 178 (Pa. Comm'w. Ct. 2004) (rejecting a suit by a group of newspapers with respect to a nonprofit corporation formed to monitor and enforce the terms of a merger of a private law school into a state university).

62. Following the Iowa decision in *Gannon*, cited in the previous footnote, in 2006 the Iowa legislature amended the statute setting forth exceptions from disclosure. *See* IOWA CODE § 22.7(52) (2009) (listing what information about donors to public colleges is and is not subject to public disclosure). *Compare id.*, *with* I.R.C. § 6104(b) (2008) (resolving the privacy/disclosure tension as follows: Series Forms 990 returns are subject to public disclosure, including the information about donations made to private foundations, but the identities of donors to public charities, while included in filings with the IRS, are exempt from public disclosure).

ernment and/or receive government benefits and/or can participate in programs sponsored by government for its employees; and (9) whether the entity must comply with state audit or procurement requirements or must maintain its money on deposit with the state. No one of these factors is generally determinative for qualifying as a public or quasi-governmental body.[63]

Most foundations and charities do not satisfy these factors or any reasonable subset of them, and the factors and their underlying rational would be misapplied if a blanket of "publicness" were to be thrown upon them. Individual organizations that do satisfy enough of the factors become public for purposes of the sunshine laws, as the cited cases attest. Moreover, when particular nonprofits are found to be subject to a state Sunshine Law, the courts first evaluated how the various factors described above applied to the specific entity. They did not presume publicness, and, if anything, the required fact-intensive analyses militate for a presumption of privateness that distinguishes foundations and charities from the state and its corresponding responsibilities.

## III. MYTH III: FOUNDATION AND CHARITY ASSETS AND RESOURCES ARE "PUBLIC MONEY" BECAUSE TAX-FAVORED TREATMENT AMOUNTS TO A SUBSIDY ENTITLING GOVERNMENT TO INTERJECT ITSELF IN THE GOVERNANCE OF FOUNDATIONS AND OTHER CHARITIES, PASS JUDGMENT ON THEIR PROGRAMMATIC AND OPERATIONAL EFFECTIVENESS, AND OTHERWISE INTERFERE WITH THEIR AUTONOMY, INDEPENDENCE, AND INTERNAL DECISION-MAKING.

This Myth evolves from two tax policies. First, foundations and other charities generally are not required to pay income, property, and other taxes.[64] Second, donors who itemize their deductions are able to deduct the value of their charitable contributions from their taxable income, within certain limits.[65] As a result of these tax-favored treatments, government forgoes taxes that would otherwise be collected on income or contributions and must find other sources for this lost revenue from other taxpayers. Consequently, Myth III continues, these forgone amounts constitute a sub-

63. For example, the Seventh Circuit Court of Appeals found that an organization was not public even though created pursuant to a state enabling statute, it receive dedicated funds from public sources, and the board includes public servants or people appointed by those in government. *See* Ill. Clean Energy Cmty. Found. v. Filan, 392 F.3d 934 (7th Cir. 2004), discussed at the end of Part II.B, *supra*.

64. I.R.C. §§ 501(c)(3) and 509(a)..

65. I.R.C. § 170.

sidy from the government, which makes government (and the public) a co-contributor to these enterprises. This Myth concludes that, as a co-contributor, government (and the public) is justified in dictating choice or focus of mission, mandating details of governance, making judgments about programmatic and operational effectiveness, and intervening in other aspects of internal operations of foundations and other charities.

A corollary to Myth III is the belief that, in exchange for tax benefits, foundations and other charities must deliver services or (in some cases) products that would otherwise be the responsibility of government. At a minimum, this *quid pro quo* thinking demands that the nonprofit sector provide quantifiable, objective benefits for the public in an amount that is at least equal to the forgone taxes.[66] Variations of this corollary seek to impose quotas or fair-share expectations for the return on the subsidy that must serve their specific charitable causes to some meaningful degree.[67] Alternatively, some variants try to ensure that the subsidy is not used to more than an unspecified degree for charitable purposes believed to be unacceptable, even though meeting long-held standards for charitability.[68]

### *A. Myth Debunked*

This argument is classified as myth for at least five independent reasons. Whether individually or in the aggregate, the positions set forth below militate against treating foundation and charitable assets as public money, much less referring to them as such. More important than the semantic distinction, however, is that the positions below emphasize the innate authority of foundations and other charities to make and implement decisions on governance, structure, mission, performance, and other aspects of their operations, provided such decisions are in pursuit of charitable purposes and otherwise comply with the law.

1. This Myth overstates the covenant that attaches to the tax-favored treatment. Generally, the covenant is that assets of foundations and other charities must be dedicated to and used in furtherance of recognized chari-

66. *See* Suzanne Perry, *Paying It Forward—and Back*, THE CHRONICLE OF PHILANTHROPY, Sept. 9, 2008 (citing Hon. Xavier Becerra and Sen. Charles Grassley), *available at* http://www.jewishresearch.org/v2/2008/articles/philanthropy/9-4-08.htm (last visited Feb. 18, 2010).

67. *See* Makani Themba-Nixon, *Can Counting Really Make the Difference?*, 1 CRITICAL ISSUES FORUM 14 (2008); Arturo Vargas, *Philanthropic Initiative for Racial Equity*, 1 CRITICAL ISSUES FORUM 16 (2008); Pablo Eisenberg and John Gamboa, *Hudson Institute Bradley Center for Philanthropy and Civic Renewal Forum: Mandating Cultural Munificence?*, *available at* http://www.hudson.org/files/pdf_upload/Transcript_2008_04_07.pdf (Apr. 7, 2008). *See* also JOEL FLEISHMAN, THE FOUNDATION: A GREAT AMERICAN SECRET; HOW PRIVATE WEALTH IS CHANGING THE WORLD 52 (2007).

68. *See* NAT'L COMM. FOR RESPONSIVE PHILANTHROPY, *supra* note 6.

table, tax-exempt purposes and may not be used for private purposes. Additionally, nothing in the legislative history of the tax exemption or charitable deduction substantiates tax-favored treatment as a way for government or the public to intrude on the autonomy and independence of fundamentally private enterprises.

2. Tax-favored treatment for foundations and other charities and their donors is not qualitatively different from deductions, tax credits, and other forms of tax-favored treatment afforded individuals and businesses, whose assets and enterprises are not thereby deemed public, nor are those taxpayers treated as if they possessed or were responsible for public money.

3. This Myth seeks to involve government in the affairs of foundations and charities to degrees greater than when government engages with private entities in more direct ways, such as with government grants or contracts.

4. The doctrine of "unconstitutional conditions" limits the ability of government to interfere with the governance and operations of foundations and other charities.

5. This Myth ignores the fact that foundation and other charity assets consist mostly of private contributions and privately earned funds dedicated to charitable, tax-exempt purposes.

### *B. The covenant that attaches to the tax-favored treatment under law and public policy mandates that assets be dedicated to and used in furtherance of charitable purposes and may not be used for private benefit.*

The federal tax exemption for foundations and other charities derives from § 501(c)(3) of the Internal Revenue Code. The statute identifies the form of organizations that are exempt if they are organized and operated for certain specifically described purposes, provided that there is no impermissible private benefit, no more than insubstantial effort to influence legislation,[69] and no attempt to intervene in political campaigns. The deductibility of charitable contributions is found at Code § 170, which essentially repeats these criteria.

There is an ongoing debate about the purported reasons for enacting and maintaining the tax-favored treatment for foundations and charities, including whether that benefit is properly categorized as a subsidy or rec-

69. The limitations on foundations' ability to influence legislation are more restrictive than are the limits on public charities. *See* I.R.C. § 4945 and corresponding regulations, 26 C.F.R. §§ 53.4945-1 to -6 (2009).

ognition that charitable income falls outside the proper tax base.[70] There are also those who believe that tax-favored treatment is justified because these organizations serve higher purposes that should be encouraged as a matter of law and policy and that should not be inhibited financially by taxing them on their charitable activities.[71] However justified, tax exemption for charities and deductions for donors results in reduced tax revenues for government.

It is that apparently lost tax revenue that prompts the *quid pro quo* approach to exemption and deduction. Under the narrowest conception of this approach, the state bestows exemption because charities lessen the burdens of government, for which the reciprocal obligation of the entity is to undertake that which is the obligation of government.[72] Such a rationale, however, fails to address some important types of exempt entities whose activities are not a responsibility of government—not just churches, in whose activities government is constitutionally prohibited from engaging, but also many associational and other exempt organizations. Neither the charitable deduction nor the income-tax exemption is limited to those organizations that lessen the burdens of government.[73] Even broader applications of *quid pro quo* thinking generally look principally to a type of monetary exchange and neglect intangible benefits provided by foundations

70. *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 595 (1998). Note that while the "tax expenditure budget" prepared by the U.S. Congress's Joint Committee on Taxation calculates the forgone taxes from the charitable-contribution deduction and from tax-exempt bonds issued by nonprofit hospitals and educational institutions, it views the income-tax exemption of charities as part of the properly determined base. Thus, current federal tax policy for charitable activity combines subsidy and base-defining approaches.

71. *See* John Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 682 n.124 (2001) (discussing War Revenue Act of 1917 and citing Senator Hollis).

72. *See* Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 430 and n.34 (1998) (citing H.R. Rep. No. 75-1860, at 19 (1938)); John D. Colombo, *Why Is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 862 (1993) (citations omitted); Laurens Williams & Donald V. Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations*, 4 FILER COMM'N RESEARCH PAPERS, *supra* note 3, at 2099–2129, 2112 (quoting H.R. Rep. No. 1860, 75th Cong, 1st Sess. 20 (1938)).

73. State property-tax regimes increasingly require an exempt charity to reduce the burdens of government as well as to provide some (unspecified) level of benefits to those who cannot afford the charity's fees. *See* Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quo Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269 (2007). In whatever form, the subsidy theory places charities in a position subordinate to the state, which can decide the parameters of its burdens. The Supreme Court suggested that to the extent the state is unhappy with or simply uninterested in subsidizing certain activities, the state can fine-tune the property-tax exemption. Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 598-600 (1997) (Scalia, J., dissenting). *See generally* PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD (Evelyn Brody ed., Urban Institute Press, 2002).

and charities by asking only the limited question: "what are we/society getting in return for the tax favored treatment?"[74]

Each of the major theories seeking to justify exemption similarly appears oversimplified and incomplete. Each theory seems unable to explain at least some aspect of current and even historic law in this area. Why, as a matter of tax policy, are exemption and deductibility of contributions available only to organizations and not also to individuals for charitable activities?[75] If exemption is a subsidy for providing charitable activity, why limit lobbying or ban political activity when legislative or even political change might most efficiently accomplish a charitable purpose? The most thorough analysis of the very complicated U.S. tax treatment of foundations and other charities groups a variety of policy goals under four headings dubbed the support function (subsidy), the equity function (notably redistribution), the regulatory function (constraints on managerial behavior), and the border patrol function (that is, between charities and both the business and public sectors).[76]

Of course, one reason for some of the theoretical difficulties is the absence of substance in the legislative record about why Congress permitted exemptions and charitable deductions in the first place. This vacuum has resulted in theories being developed and documented after the fact. On the other hand, some posit that the void is not remarkable at all but instead reflects deference to the conviction that exemption for certain purposes is self-evident.[77]

74. *See* Howard Husock, *Nobody Does it Better*, WALL ST. J, Oct. 24, 2008, at W13, *available at* http://online.wsj.com/article/SB122480190174464653.html; Editorial, Ray D. Madoff, *Dog Eat Your Taxes,* N.Y. TIMES, July 9, 2008, http://www.nytimes.com/2008/07/09/opinion/09madoff.html?_r=1; Perry, *supra* note 66 (citing Hon. Xavier Becerra and Sen. Charles Grassley). Interestingly, no court following a quid-pro-quo rationale for exemption—notably the Supreme Court's decisions in *Walz v. Tax Commission*, 397 U.S. 664, 676 (1970), and in *Regan v. Taxation With Representation*, 461 U.S. 540, 544 (1983)—has quantified the degree to which the public gain must equate or relate to the forgone tax revenue.

75. Colombo, *supra* note 71, at 678, 682. There are practical explanations for not allowing deductions for contributions to individuals and not allowing individual income to be tax-exempt. For instance, it is harder to hold an individual accountable for ensuring that they pursue charitable purposes and that they do not engage in private benefit; the current systems' inefficiencies are the price of achieving a higher degree of oversight and accountability.

76. John Simon, Harvey Dale & Laura Chisolm, *The Federal Tax Treatment of Charitable Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 267–306 (Walter W. Powell & Richard Steinberg, eds., Yale University Press, 2006).

77. Borris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 301 (1976) ("But neither upon their initial enactment nor during the ensuing decades have these exemptions elicited more than cursory legislative explanation, save for matters of technical detail. Commentators have been almost equally silent. These decades of benign neglect may have reflected a conviction that the wisdom of tax exemption was self-evident, that the basic policy was politically invulnerable to change, or that taxation in this area would bring in little revenue."). *See also* GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF

The history that does exist contains a desire expressed in conjunction with passage of the first American income tax in 1874 that exempt organizations should not "suffer under the bill"; similarly, the 1917 enactment of a deduction for charitable contributions was justified by the burden that high wartime marginal tax rates imposed on generous donors who might no longer be able to support the equally-patriotic Red Cross.[78] In any event, the legislative history is clear that there was no "original bargain" that can be pinpointed. In many ways, the absence of a single, comprehensive explanation for the exemptions and charitable deduction, and the dearth of specific legislative history, support giving due deference to longevity and an appropriate unwillingness to discount long-standing, centuries-old practices and policies that still work. Moreover, the absence of an explanation implicitly recognizes that foundations and charities benefit society in financial and nonfinancial ways that are of extraordinary importance that should be encouraged and not disturbed lightly.[79]

Instead of focusing on the debate (after the fact) and speculating about whether tax-favored treatment constitutes a subsidy, the more important question for our purposes in addressing this Myth III is the nature of the obligations or conditions imposed on and accepted by foundations, charities, and their respective donors who benefit from the tax-favored treatment. Most obviously, in return for exemption and the privilege of receiving deductible contributions, organizations must commit their missions and operations to charitable purposes under the requirement of the Internal Revenue Code and corresponding regulations. While Congress can remove exemption from a class of charities, the starting point for defining

THE UNITED STATES 275, 275–276 (1863), citing Commissioner Decision 110 (May 1863) ("The income of literary, scientific, or other charitable institutions, in the hands of trustees or others, is not subject to income tax."); Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, *supra* note 70, at 605–06 ("The first federal income tax statute [see Boutwell, *supra*], enacted to finance the Civil War, applied only to individuals, and exempted trustees of charitable trusts. Just a year later, however, a revenue-hungry Congress expanded the income tax and extended an excise tax to corporations, making no general exemption available to charities. However, when Congress enacted a broad income-tax statute in 1894, without explanation it exempted all charities from tax. Again in the corporate excise tax statute of 1909, Congress exempted charities. This time Congress explicitly considered the possibility of a surplus-generating activity, and as a condition of exemption imposed a prohibition on the 'inurement' of the entity's profits to the private benefit of any person."); Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, 4 FILER COMM'N RESEARCH PAPERS, *supra* note 3, at 2025.

78. *See* John A. Wallace & Robert W. Fisher, *The Charitable Deduction Under Section 170 of the Internal Revenue Code*, 4 FILER COMM'N RESEARCH PAPERS, *supra* note 3, at 2131. *See also* Colombo, *supra* note 71, at 682.

79. Atkinson refers to "metabenefits" to society derived from the way in which foundations and charities produce their goods or deliver their services. Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 402–03 (1997) (among these metabenefits are a spirit of volunteerism, pluralism, initiative, experimentation, and an educated population).

charitable purposes under Code § 501(c)(3) is broad, as described under Myth I, above; for the restrictions on lobbying and political activity, see Part III.E, below.

Public charities must comply with the requirements of Internal Revenue Code § 4958 to ensure against excess benefit transactions. Private foundations operate under additional regiments that include a mandatory minimum payout rate; a one- or two-percent tax on investment income; disclosure of specific investment activities and the identities of donors as part of their information tax return; and prohibitions on self-dealing transactions (other than the payment of reasonable compensation for services), excess business holdings, jeopardy investments, and certain other transactions, such as impermissible lobbying and political activity.[80] Exempt organizations also agree to public disclosure requirements designed to allow government and the public to hold those entities accountable for their obligations. Among these requirements are filing an information tax return about their finances and activities and making that return publicly available.[81]

While the wisdom, design or extent of these statutory constraints could be debated, they are legitimate within a tax exemption system defined by the specific terms of § 501(c)(3) focused on charitable activities rather than private ones. However, these restrictions do not otherwise impinge on foundation and other charity governance, structure, effectiveness, and decision-making—matters that are internal to the organizations and generally committed to their discretion as autonomous, independent entities.

Therefore, to the extent a covenant between Congress (and states to the extent of corollary positions) and foundations and charities does exist, it may be summarized as follows: Organizations exempt from taxation and that receive charitable contributions for which donors receive deductions commit under § 501(c)(3) to using their resources and assets to further charitable, exempt purposes and not private benefit, including compliance with statutes and regulations that provide more detailed guidance about what constitutes charitable activity and what may not. As a subset of that overall commitment, such organizations also must provide information relevant to demonstrating their specific compliance with § 501(c)(3). As a matter of law, the covenant does not compromise, threaten, or undermine the genetic character of these organizations as private creatures of state law entitled to autonomy and independence.

80. *See* I.R.C. ch. 42.
81. I.R.C. §§ 6033, 6104.

### *C. Individuals and for-profit businesses also receive tax-favored treatment, but their assets and resources are not thereby considered public, nor do tax benefits render such individuals or businesses governmental entities.*

Throughout American history, governments at all levels have used tax abatements and other incentives to encourage certain activities.[82] Early state governments made no sectoral distinctions in bestowing or withholding tax subsidies: New England canal, turnpike, bridge and manufacturing companies enjoyed the same tax exemption extended to eleemosynary entities such as Yale College. In the first wave of tax reform under President Ronald Reagan, certain sectors of the business community enjoyed negative income tax rates through the combination of accelerated depreciation and investment tax credits on new equipment. The ongoing multi-billion-dollar (if not multi-trillion-dollar) rescue of the financial, housing, and automobile sectors dwarfs public subsidies provided to nonprofit organizations[83]—but organizations in these industries are not viewed as governmental, and any limits on their independence are not derived solely from tax-favored treatment.

The list is long of tax-favored treatments—such as deductions, exclusions from income, credits, exemptions, abatements, deferrals—that various levels of government afford to individuals and business, for reasons other than the proper measurement of income, without impacting the underlying autonomy and private nature of the beneficiaries of such treatment. Individuals, for example, enjoy deductions for mortgage interest and property taxes paid on their homes, exclusion of all or most gain on the sale of their principal residence, deductions or exclusions for retirement contributions, health insurance, and tuition, as well as tax credits for higher education, dependent care, and children.[84] Government and the public do not become entitled to dictate lifestyle, consumption or savings patterns, child

82. *See* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 440 (1996).

83. *See* Government Accountability Office, GAO-09-193, Nonprofit Sector: Significant Federal Funds Reach the Sector through Various Mechanisms, but More Complete and Reliable Funding Data are Needed (GAO-09-193) (2009), *available at* www.gao.gov/new.items/d09193.pdf (last visited Feb. 21, 2010).

84. *See* Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 416 (1999) (noting that tax expenditure analysis challenges us to analyze the home mortgage deduction, child tax credit, earned income tax). Other examples include the following: exclusion of scholarships from income, IRC § 117; tuition tax credit, IRC § 25A; limited interest deduction for educational loans, IRC § 221, interest exclusion for Education Savings Bonds used for tuition payments, IRC § 135(a). *See* Colombo, *supra* note 71, at 660 n.12; Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687 (1999).

bearing and rearing choices, furniture tastes, college major or course of study, or to make any other decisions for the individuals who claim such deductions and credits.

Similarly, businesses benefit from tax-favored treatment designed to encourage certain activities deemed by the legislative body to be in the public interest and worthy of public support. Examples of tax provisions not necessary for the proper measurement of business profits include the research and experimentation tax credit, accelerated depreciation deductions for equipment investment, tax credits for activities deemed "green," and tax benefits associated with economic development activities such as tax increment financing. Government and the public do not thereby become entitled to determine the nature of the underlying research or strategies regarding exploitation of results, the timing for upgrading equipment, whether to merge with a competitor or draw down a line of credit, whether the board should have five or nine directors, or if the organization is doing well or poorly. Indeed, nothing inherent in this tax-favored treatment is even contingent on the businesses being efficiently or effectively run.

Likewise, it is not the tax-favored treatment that for-profits receive that justifies or even supports the regulation of business. Laws and regulations with respect to such areas as securities, banking, and the environment do not depend on tax-favored treatment. For instance, securities and commodities trading laws and regulations arose because these markets functioned in an uneven playing field that threatened the underlying stability of the market as a whole.[85] Sarbanes-Oxley arose because significant fraudulent behavior destroyed prominent businesses and the accompanying jobs, savings, and investments and had nothing to do with tax treatment. In the wake of the 2008 economic meltdown, the discussions of greater regulation of the banking industry have involved not the tax preferences enjoyed by the industry but rather the behavior of the banks themselves and government as explicit shareholder, bondholder, and/or creditor. The current discussion about regulating executive compensation in the banking industry is tied directly to avoiding the poor incentives that led to a near collapse of the financial sector.

Recipients of a tax benefit are usually obligated to demonstrate that they actually undertook the activity or incurred the expense giving rise to the tax-favored treatment. Nothing else is compromised by the tax treatment, and the taxpayers' assets are not deemed public, nor are the taxpayers deemed to become public as a result. There is no compelling reason to

85. *See* THOMAS K. MCCRAW, PROPHETS OF REGULATION (1984).

hold foundations or other charities to a different standard with regard to their autonomy, privacy, independence, and decision-making. For the most part, then, and consistent with tax-favored treatment afforded other sectors, the *quid pro quo* for beneficial tax treatment is for foundations and charities to use the funds for charitable, exempt purposes, and to document and report that they have done so. It does not mean that government or the public can dictate mission or methods or impose sanctions or rewards for levels of effectiveness.

### *D. Myth III seeks to involve government and the public in the affairs of foundations and charities to degrees greater than when government engagement with private entities is more direct, such as in the case of government grants or contracts.*

Harvard University's longest serving President, Charles W. Eliot, in the 1870s labeled as "sophistical and fallacious" the assertion that "to exempt an institution from taxation is the same thing as to grant it money directly from the public treasury."[86] While the Supreme Court elsewhere has referred to tax-exemption as a subsidy, in *Walz v. Tax Commission*, the Court described exemptions and deductions as "qualitatively different" from general subsidies, direct grants, and contracts with government.[87] The net effect on the public treasury may be the same, but the decision-makers and what happens in each instance are very different. These differences deserve attention because similar effect on the treasury should not automatically equate with the same treatment in other areas, much less assigning harsher treatment to tax benefits involving the least government involvement.

With regard to decision-making, exemptions and deductions involve very little engagement by government, whose involvement is fundamentally passive. With regard to the charitable-contribution deduction, the donor (not government) makes decisions about which organizations receive or do not receive contributions and any designations or restrictions that might accompany the donation.[88] Nor does exemption involve any decision to

86. Belknap, *supra* note 77, at 2038 (quoting Harvard's President Charles Eliot).

87. Walz v. Tax Comm'n of New York, 397 U.S. 664, 690–91 (1970) (Brennan, J., concurring). The tax-exempt bond subsidy, likewise, is not akin to a direct expenditure. *See* Steele v. Indus. Dev. Bd., 301 F.3d 401, 413 (6th Cir. 2002) (ruling that the tax-exempt bonds issued to a religious university to construct a library dominate by religious literature "are analogous to an indirect financial benefit conferred by a religiously neutral tax or deduction").

88. *See* FLEISHMAN, *supra* note 67, at 22 (benefit of exemptions and deductions "rather than direct government subsidies" allows individuals to make choices about directing their support "rather than through the haggling and logrolling of politically elected legislative bodies or the choices of a particular governmental administration, Congress, or agency").

favor specifically identified organizations. A distinguished foundation commentator astutely observed that exemptions "insulate private charitable enterprises from the government domination which is invited by the alternative method of direct grants by government."[89]

Contrast these with true subsidies and government grants and contracts in which government personnel affirmatively decide which organizations receive how much money, for which purposes, and subject to what restrictions. In *Walz*, the Supreme Court characterized general subsidies as "pregnant with involvement" by government, a description that aptly applies to government grants and contracts as well.[90] In that case, concurring Justice Brennan explained the distinction between direct subsidies and tax exemption as follows: "A subsidy involves the direct transfer of public monies to the subsidized taxpayers as a whole. An exemption, on the other hand, involves no such transfer. It assists the exempted enterprise only passively, by relieving a privately funded venture of the burden of paying taxes."[91] Justice Brennan explained that direct subsidies involve government "forcibly" diverting the income of taxpayers to the recipient, whereas exemption involves government "merely refrain[ing] from diverting to its own uses income independently generated . . . through voluntary contributions."[92]

Tax-favored treatment of charity—even if an economic subsidy—should not imply the same government involvement and control that can properly accompany a government grant or contract. In the case of grants and contracts, nonprofit and for-profit organizations affirmatively exercise their independence and autonomy in deciding to accept the terms of the grant or contract, perhaps at the price of compromising decisions they would otherwise make. Ultimately, they return to full autonomy, privacy, and independence upon completion of their grant or contractual obligations. For example, any number of for-profit defense, aeronautic, and space contractors generate all or substantially all of their revenues from government contracts. These entities may be required to behave in certain ways to fulfill requirements imposed by the specific government grant or contract (such as letting bids for subcontracts, engaging percentages of minority- or

89. Belknap, *supra* note 77, at 2038.

90. *Walz*, 397 U.S. 664, 675 (1970) ("Obviously a direct money subsidy would be a relationship pregnant with involvement and, as with most governmental grant programs, could encompass sustained and detailed administrative relationships for enforcement of statutory or administrative standards, but that is not this case."). *Walz* involved a challenge to property-tax exemption for churches, which the state could not directly fund because of the Establishment Clause of the First Amendment.

91. *Id.* at 690–91 (Brennan, J., concurring).

92. *Id.* (citations omitted).

women-owned businesses, or even adopting certain fiscal controls), and they may be required to publicly report information about the specific contracts that would otherwise be private. Similarly, nonprofit social-service organizations that accept more than $500,000 in government grants or contracts agree to be subject to the Single Audit Act, among other requirements. Like government-funded entities, whether for-profit or nonprofit, tax-exempt organizations' assets are not thereby public, and, like entities directly funded by government, they retain fundamental control over their governance, decision-making, and policies in furtherance of charitable purposes.[93]

### *E. Tax benefits and even direct grants are protected from unconstitutional conditions demanded by government.*

The American system of government is founded on certain core, bedrock principles, one of which is that government itself is and must be limited, particularly with respect to intruding on individual and private rights. The Founding Fathers carved essential elements of the Constitution from a classical liberalism that charged government with preserving liberty and not burdening it, that distrusted government, and that placed its faith in "individual actions . . . left untrammeled."[94] These virtues apply to benefit

93. *See* Pifer, *supra* note 5, at 54–55 ("Throughout our history we have believed in pluralism and have practiced it. We have recognized that the nation's public purposes are considerably more extensive in scope than its governmental purposes, and, through the aegis of the state, we have enabled a wide variety of private institutions, including foundations, to be chartered to accomplish certain public, though nongovernmental, purposes. We have also, through the aegis of the state, given tax exemption to these institutions to facilitate their work and have regarded this as being eminently in the public interest. Therefore, to attribute the public stake in the foundation to its tax-exempt status or to regard this status as a 'privilege' is wholly erroneous. It is, in Professor Milton Katz's pithy phrase, 'to mistake an effect for a cause.'").

Compare the requirement in Australia that for a charitable body to be to tax exempt, it must be independent of government. For a discussion of boundary between government and charities, see the High Court decision in *Central Bayside General Practice Association, Ltd. v. Commissioner of State Revenue*, [2006] HCA 43, ¶ 40 (Aug. 31, 2006) ("The mere fact that the appellant and the government both have a purpose of improving patient care and health does not establish that the appellant has the purpose of giving effect to government purposes, abdicating any independent fulfilment of its own. The appellant's purpose is charitable. It remains charitable even though the government is the source of the funds it uses to carry out that purpose. Its consent to the attachment by the government of conditions to the employment of those funds does not establish that the appellant is not independently carrying out its purpose.").

94. Belknap, *supra* note 77, at 2031 (noting that exemption "probably" developed in America from widely present political philosophy in spirit of classical liberalism, the "dominant tenets" of which "were distrust of government and faith that the progress and well-being of mankind could best be achieved by natural forces harmonizing the individual actions of men who were left untrammeled."). *See* also Heather Higgins, *To Whom Does Your Money Belong?*, Editorial, WALL ST. J., Oct. 31, 2008, at A16 ("As Thomas Jefferson put it, 'A wise and frugal government, which shall leave men free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor and

the nonprofit sector too. Federal appellate court Judge Richard Posner warned about the danger of the IRS's being able to revoke exemption simply because it disagrees with a decision of a nonprofit entity's management, without a finding that fiduciary duties have been breached.[95]

When engaged in direct grant-making and contracting, the government may generally choose the message it wishes to express, either directly or by funding the speech of others. A government grant or contract is not a constitutional right; thus, the government may condition such a benefit on the recipient's waiver of otherwise available constitutional rights, notably including the rights of free speech and association. However, the Constitution provides an outer limit to the conditions that governments can impose on grants or contract benefits. Under the Supreme Court's doctrine of "unconstitutional conditions," while the state may condition a government grant or contract on the affected party's waiver of otherwise available constitutional rights—notably, exercise of free speech and associational rights—the state may limit only what a grantee does with money provided directly by government.[96] For example, the government may condition a contract on the charity's not engaging in lobbying with contract funds, but may not use the contract to ban lobbying by the charity with its other funds.[97]

Similarly, tax exemption is not a constitutional right, and so imposing conditions on tax-exempt status does not generally give rise to the argument of unconstitutional conditions. The Constitution grants broad latitude to the federal government and the states in designing tax schemes that offer exemptions to charities (including churches). Notably, the Supreme Court upheld Congress' refusal to allow § 501(c)(3) organizations the right to engage in more than insubstantial lobbying and in any political campaign

bread it has earned—this is the sum of good government.'"), *available at* http://online.wsj.com/article/SB122541316091086509.html (last visited Feb. 21, 2009).

95. *See* Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 583 n.152 (1999) (quoting Judge Posner in United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1178–79 (7th Cir. 1999)).

96. In applying the doctrine of unconstitutional conditions to a federal funding decision, the Supreme Court in *Rust v. Sullivan*, 500 U.S. 173 (1991), upheld federal rules prohibiting federally funded family-planning programs from providing abortion counseling, because the grantee "can continue to perform abortions, provide abortion-related services, and engage in abortion advocacy . . . through programs that are separate and independent from the project that receives Title X funds." *Id.* at 196. *See generally* Richard Epstein, *Foreword to the Supreme Court, 1987 Term: Unconstitutional Conditions, State Power, and the Limits of Consent*, 102 HARV. L. REV. 4 (1988); Kathleen M. Sullivan, *Unconstitutional Conditions*, 102 HARV. L. REV. 1413 (1989); Conference Papers from Emanations from *Rust*: The Impact on the Nonprofit Sector of the Doctrine of Unconstitutional Conditions, National Center on Philanthropy and Law, New York University School of Law (1992).

97. *See, e.g.*, 42 U.S.C. § 2000d (2006) (commonly known as Title VI of the Civil Rights Act of 1964, prohibiting discrimination under federally assisted programs on grounds of race, color, or national origin); 20 U.S.C. § 1681 (2006) (commonly known as Title IX of the Education Amendments of 1972, prohibiting sex discrimination by federally funded schools).

activity. Importantly, though, the Court's decision in *Regan v. Taxation With Representation*[98] was based on the authority of a § 501(c)(3) organization to create an affiliated § 501(c)(4) organization to engage in lobbying for the affiliated nonprofit group.[99] As a result, charitable activity—including advocacy activity that does not amount to lobbying or political activity—can be supported by tax-deductible charitable contributions, but the (c)(4)'s lobbying activity will not.

The unconstitutional conditions cases "involve situations in which the government has placed a condition on the recipient of the subsidy rather than on a particular program or service, thus effectively prohibiting the recipient from engaging in the protected conduct outside the scope of the federally funded program."[100] A condition that the grantee give up the right to structure and govern itself as it sees fit—for example, by requiring that all directors be elected by members in a democratic process—could impinge on the grantees' First Amendment rights of expressive association.[101] Practical difficulties might be more of an impediment. For example, if Congress were to impose a minimum and maximum board size on nonprofit corporations, we could expect foundations to form as or convert to charitable trusts, perhaps with a single trustee. The foregoing discussion of the doctrine of unconstitutional conditions, however, was necessarily simplistic, given that the courts have not set out a complete framework for it.[102]

98. 461 U.S. 540 (1983). The Court distinguished *Speiser v. Randall*, 357 U.S. 513 (1958), which ruled as an "unconstitutional condition" California's requirement that anyone seeking property tax exemption must sign a declaration stating that he did not advocate the forcible overthrow of the Government of the United States. The *Speiser* court declared that "[to] deny an exemption to claimants who engage in certain forms of speech is in effect to penalize them for such speech." *Id.* at 518. By contrast, declared *Taxation With Representation*: "Congress has merely refused to pay for the lobbying out of public moneys. This Court has never held that Congress must grant a benefit such as TWR claims here to a person who wishes to exercise a constitutional right." 461 U.S. at 545.

99. And, if desired, the § 501(c)(4) organization can create a separate segregated fund or political action committee (PAC) under § 527 to engage in political activity.

100. *Rust*, 500 U.S. at 197.

101. A Maine legislative proposal, applicable to nonprofit corporations receiving at least twenty-five percent of their total funding from one or more municipal, county, state or federal sources, would prohibit compensating an officer or director in excess of $250,000 per year. In addition, excessive compensation of a director or officer is added as a ground to dissolution pursuant to court order. March 29, 2007, available in LEXIS at 2007 ME S.B. 636. As enacted, though, the state merely adopted a requirement that a "public benefit corporation that receives at least twenty-five percent of its total funding from one or more municipal, county, state or federal sources shall provide to the public information about the total compensation paid by the corporation to any director or officer of the corporation if the compensation exceeds $250,000 in any twelve-month period. The corporation shall make the information available by posting the information on its publicly accessible website or through other comparable means. 'Compensation' includes all remuneration and benefits." Me. Rev. Stat. Ann. tit. 13-B, § 713.A(2-A) (2005).

102. *See* Simon, Dale & Chisolm, note 76 *supra*, at 276 ("Because governmental conditions on benefits may reach further than direct government proscriptions, and because any level of govern-

### *F. Myth III presumes that all foundation and other charity assets are public despite the fact that such assets consist mostly of private funds.*

The tax exemption and contribution deduction permit foundations and other charities to use money that would presumably otherwise be paid into the public treasury. Efforts to dictate these organizations' governance and activities, beyond requiring that their purposes and activities be charitable, seem most often to rely on this fact. At least three points frequently get lost with this myth. First, there is an overwhelming part of the charitable deduction, likely to be substantially more than half of it, that would not have been paid to Treasury in any event. This point is discussed further below. Second, but for the magnanimity and generosity of the donor, the funds at issue might not have been dedicated to charitable purposes at all, thereby denying society the benefit of these resources. This is related to the third frequently forgotten point, which is that donors may implement any number of tax planning strategies or make other choices regarding the funds such that there is no guarantee that the tax revenue lost from the charitable deduction would have found its way to the public treasury.

With regard to the first point, as a threshold matter, individual taxpayers can deduct their contributions only if they itemize their deductions (and only about a third of taxpayers do). At the other extreme, a donor whose gifts exceed a certain percentage of income must carry forward the excess (and an unused carryforward expires after five years).[103] Otherwise, the "price" of giving varies by the taxpayer's marginal tax rate, and so there is no tax justification for claiming as public money the amount of the donation in excess of the donor's applicable tax rate. An example might help. A charitable donation of $100 by a donor in a 35-percent marginal tax bracket allows the donor to save $35 in taxes (absent application of other tax rules). The balance of $65 would not have been paid to Treasury and remains "private" money.

ment—federal, state, or local—may impose them, the much-needed clarification of the parameters of the unconstitutional conditions doctrine is likely to require years if not decades of additional litigation and scholarship.").

103. Simplifying the rules of I.R.C. § 170, if the donee is a public charity, then cash contributions may reduce the donor's adjusted gross income (AGI) by up to fifty-percent. If the donee is a private foundation, then cash contributions may reduce AGI by up to only thirty-percent. If instead the donor contributes appreciated capital assets and deducts fair market value rather than basis, then the percentage-of-income limit is thirty-percent for a public charity donee and twenty-percent for a private foundation. Furthermore, for private foundations, only publicly traded securities qualify for the fair-market-value deduction. Corporate donors, generally subject to the same rules, can deduct up to 10% of gross income in any one year. An unlimited estate-tax deduction is available for charitable bequests. This discussion ignores the alternative minimum tax, other rules that affect marginal tax rates, and the estate tax (whose top rates have sometimes exceeded top income-tax rates).

Similar logic attends the tax exemption (assuming that tax policy can effectively identify what should be treated as income and counted as expenses and apply a proper tax rate in the nonprofit context). Again an example may be useful. A nonprofit in a hypothetical 35-percent marginal tax bracket that generates $100 in net taxable income would otherwise pay $35 to Treasury, but the remaining $65 would not have found its way to the public fisc and would have been private money to be devoted to charitable, exempt purposes as managed by private nonprofit entities. Moreover, because an operating charity would often have little or no taxable income, the tax exemption for foundations and other charities is generally better thought of only as an exemption on investment income.[104]

Unless income-tax rates exceed 50 percent for a prolonged period of time, most of the resources of foundations and other charities will be private.[105] Organizations managing mostly private assets for charitable, exempt purposes should not suffer diminished autonomy because a portion of their assets might otherwise have been paid as taxes. Even if tax rates exceeded fifty percent, such a narrow application of the *quid pro quo* approach risks focusing solely on objective valuation metrics to the exclusion of the intangible but no less valuable contributions that foundations and other charities provide to society.

Some public-money advocates acknowledge this weakness by referring to philanthropic assets as "partially public money." The partially-public-money argument appears to view the government as being entitled to influence the purposes, governance, and operations of foundations and other charities just as would a donor. Of course, donors can restrict the charitable use of their gifts, as the government does in its capacity as active grant maker. However, donors—even major donors—are not *as donors* endowed by the law with a role in determining the governance of the organization.

## CONCLUSION

Foundations and other charities exist at a critical intersection between the governmental and business sectors of our political, economic, and social system. They are dedicated to serving the public through the pursuit of

104. *See* Daniel Halperin, Does Tax Exemption for Charitable Endowments Subsidize Excessive Accumulation?, *at* http://ssrn.com/abstract=1143458 (June 10, 2008).

105. Moreover, policy makers can alter the tax treatment of contributions. For example, the Obama administration has proposed to cap the tax savings from itemized deductions (including charitable contributions) at twenty-eight percent; but doing so should not impact on the independence, autonomy, or privacy of the donee organizations.

charitable purposes but are created and operate as private, autonomous organizations. Their accountability is complex in nature and extent, derived in part from law and in part from the need for legitimacy. This complexity enables charities to serve as private arenas for the development of the public virtues of idealism, inventiveness,[106] and civic association; to provide essential goods and services that are undersupplied by government and the marketplace;[107] and to offer both an alternative to dependence on government and a softening of the rough edges of capitalism.[108] It is in this sense that charities and foundations are "a 'powerful third force,' distinct from government and business," as one term for the charitable sector—"independent sector"—suggests.[109]

We have concluded that based on more than four centuries of law and policy, foundations and other charities are not inherently public bodies and their assets are not "public money." As Justice Story warned in *Dartmouth College*, each attempt of the legal system to conclude otherwise brings us closer to government asserting the right to control and direct foundations and other charities, conflating the government and nonprofit sectors, and subjecting charitable assets and operations to the "good will and pleasure" of the persons and prevailing ideas that happen to hold political power at any particular time.[110]

At the same time, abuses within the charitable sector are dangerous to the general society and culture just as are abuses within the government or business sector, particularly when the abuse is rampant and pervasive. It is elemental that foundations' and other charities' purposes may not be private and that their assets may not be used for private benefit. Federal and state laws and regulations are in place to protect against such abuses. Moreover, it is in the interest of the sector, as well as society as a whole, that foundations and other charities devote sufficient internal resources to achieving compliance with these laws and regulations and to detecting, correcting, and imposing consequences for their violation.

106. K. Martin Worthy, *The Tax Reform Act of 1969: Consequences for Private Foundations*, 39 LAW & CONTEMP. PROBS. 232, 254 (1975).

107. *See generally* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004); Crimm, *supra* note 72, at 439; Colombo, *supra* note 72, at 864–65; Leslie Lenkowsky, *In Philanthropy, It's Not Just About the Numbers*, CHRONICLE OF PHILANTHROPY, *available at http://www.philanthropy.com/premium/articles/v21/i07/07005501.htm* (Jan. 29, 2009).

108. *See* CLAIRE GAUDIANI, THE GREATER GOOD: HOW PHILANTHROPY DRIVES THE AMERICAN ECONOMY AND CAN SAVE CAPITALISM 14 (2003). *See also* Schramm, *supra* note 20, at 368.

109. FLEISHMAN, *supra* note 67, at 14; *See also* GAUDIANI, *supra* note 108, at 23. *See* the Introduction, above, regarding the term "independent sector."

110. *Dartmouth College*, *supra* note 22, 17 U.S. at 671 (Story, J., concurring).

Thus, as in other sectors, it can be appropriate to modify applicable laws, regulations, and enforcement priorities in the charitable sector to bring clarity and certainty to the law when vagueness causes compliance problems. It may even be necessary to effect large-scale, revolutionary reforms when insidious and wide-spread abuses infect the sector and enforcement of existing law cannot suffice to restore order and credibility.

However, the consequences of fundamental change in the relationship between foundations and other charities and government could be significant. Such organizations might face increased pressure to accede to strong feelings or prejudices on the part of prospective grantees, rejected applicants, politicians, or the general public.[111] To judge by the present operations of the governmental sector, charities might also be expected to place increased emphasis on their short-term metrics at the expense of long-term goals.[112] Charities could find that they have fewer incentives to take reasonable, let alone controversial, programmatic risks that government and business may not responsibly take. If so, we may face the loss of innovative solutions to social problems.[113]

The most significant harm that could result from a wholesale change in the traditional relationships is that the philanthropic sector would no longer be the product of pluralistic choices, freely made, regarding the expenditure of monetary and human resources. Autonomy has been one of the defining characteristics of American foundations and other charities; such entities are free to support and pursue differing and even contrary programmatic visions, strategies, methods, and structures provided that

111. *See* FLEISHMAN, *supra* note 67, at 61–62, 250; DAVID F. FREEMAN & COUNCIL ON FOUNDATIONS, THE HANDBOOK ON PRIVATE FOUNDATIONS 77 (1991); Bittker, *supra* note 77, at 342; Schramm, *supra* note 20, at 370; Lawrence M. Stone, *The Charitable Foundation: Its Governance*, 39 LAW & CONTEMP. PROBS. 57, 65 (1975); Homer C. Wordsworth, *Private Foundations and the Tax Reform Act of 1969*, 39 LAW & CONTEMP. PROBS. 255, 259 (1975). Some may view a lack of responsiveness to public demands as a weakness. However, the philanthropic sector has limited resources, especially when compared to those of the government or business sector. In addition, foundations—and other charities—are required to be faithful to donor intent. This responsibility will result in the rejection of applications by otherwise worthy applicants. More generally, foundations simply cannot responsibly fund every grant applicant; those that try to do so may find, more often than not, that they have either abdicated their decision-making responsibilities or impaired their obligations to their charitable purposes. Foundation autonomy helps protect against these inevitable pressures and their potentially harmful consequences.

112. *See* FLEISHMAN, *supra* note 67, at 245-48. Bittker, *supra* note 77, at 342.

113. *See* 93 Cong. Rec. 33952, 33954 (1974); Advisory Committee, *supra* note 10, at ii (quoting John Gardner); FREEMAN, *supra* note 111, at 6; CURTIS W. MEADOWS, JR., PHILANTHROPIC CHOICE AND DONOR INTENT: FREEDOM, RESPONSIBILITY AND PUBLIC INTEREST 3 (2002); Bittker, *supra* note 77, at 342; Stone, *supra* note 111, at 58, 61 n.9; Wadsworth, *supra* note 111, at 259. *See also* Colombo, *Marketing*, *supra* note 67, at 692.

they do not stray from their mandate to serve charitable purposes.[114] Observers have credited this pluralism with helping to preserve fundamental American values such as individual choice and initiative;[115] advancing civilization and promoting general welfare;[116] multiplying, rather than concentrating, sources of power;[117] representing society's preference for reasonable discretion rather than government-imposed uniformity;[118] enhancing the vibrancy of our democracy through their capacity to challenge conventional wisdom;[119] and allowing charities—particularly, but not only, religious organizations—freedom to choose their missions and to make their decisions without government involvement.[120]

Clearly, impairing the independence, autonomy and fundamentally private nature of foundations and other charities could have serious consequences for them, the sector, and broader society, particularly if grounded on a theory that lacks meaningful support in law, history, or policy. Fortunately, such compromises are not necessary for constructive debate to proceed on such issues as the direction and role of the independent sector, donor intent, perpetuity, governing board composition, measuring effectiveness, mission-related investing, and governance best practices.[121] Discussion of these and other issues informs donors, board members, and

114. *See* Advisory Committee, *supra* note 10, at ii. *See also* Susan Berresford and Lorie Slutsky, *Foundations' Longevity Should be Valued*, CHRONICLE OF PHILANTHROPY, *available at* http://philanthropy.com/premium/articles/v20/i22/22003101.htm (Sept. 2, 2008).

115. MEADOWS, *supra* note 113, at 2 ("As a free people we want the right to live our lives with as much freedom and individual choice as possible, including the making and selection of philanthropic and charitable choices"); Colombo, *supra* note 72, at 865 (quoting Bruce Hopkins' view of exemptions as a "bulwark against overdomination by government and a hallmark of a free society" and of exempt organizations as "help[ing] nourish the voluntary sector of this nation and preserve individual initiative, and reflect[ing] the pluralistic philosophy that has been the guiding spirit of democratic America"); Belknap, *supra* note 77, at 2025, 2036–37 (quoting NATIONAL PLANNING ASS'N, THE MANUAL OF CORPORATE GIVING (Beardsley Ruml, in collaboration with Theodore Geiger, ed.)), Ch. 1 (1952), as to the need for "preserving to the maximum extent possible the decentralized and private character of the decision-making process in all phases of our national life"); Belknap, *supra* note 73 at 2036–37 (quoting statement of M.M. Chambers, CHARTERS OF PHILANTHROPIES 2 (1948), that operation of the voluntary sector "accords with the historic idea of a wide sphere of individual liberties").

116. Belknap, *supra* note 77, at 2034 (quoting People *ex rel*. Seminary of Our Lady of Angels v. Barber, 42 Hun. 27 (1886), *aff'd*, 13 N.E. 936 (N.Y. 1887)).

117. FLEISHMAN, *supra* note 67, at 33.

118. Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1406–07 (1998) (stating society prefers reasonable discretion exercised by different participants under different conditions to the uniformity of government-directed action).

119. FLEISHMAN, *supra* note 67, at 56, 250; FREMONT-SMITH, *supra* note 107, at 2; Lenkowsky, *supra* note 107 ("Philanthropy's value goes far beyond its social and economic benefits"); Stone, *supra* note 111, at 66.

120. Sugin, *supra* note 84, at 435 ("Regardless of whether individual choice is socially desirable, it is constitutionally significant because it can separate the government's intent from the ultimate recipient of tax benefits.").

121. See also the American Law Institute's ongoing project on Principles of the Law of Nonprofit Organizations, for which one of us, Evelyn Brody, is Reporter.

managers of foundations and other charities and can help these organizations make decisions that are best for them in their specific circumstances.

However, those debates and conversations deserve an appropriate framework within which to proceed. By debunking the idea that foundations and other charities and their assets belong to the public at large and are subject to democratic control, we hope to better focus the current debates and conversations more appropriately on the merits of the underlying substantive issues without distractions and the false confidence associated with misapplication of the phrase "public money."