BEFORE THE COMMITTEE ON THE JUDICIARY

TESTIMONY OF BENNETT RUSHKOFF
OFFICE OF THE ATTORNEY GENERAL
FOR THE DISTRICT OF COLUMBIA

on

BILL NO. 17-53
"NONPROFIT ORGANIZATIONS OVERSIGHT IMPROVEMENT AMENDMENT ACT OF 2007"

February 9, 2007

Good afternoon Chairman Mendelson and members of the Committee on the Judiciary. My name is Bennett Rushkoff. I am testifying today on behalf of the Office of the Attorney General, where I am Chief of the Consumer and Trade Protection Section. The Section's responsibilities include protection of nonprofit and charitable organizations and assets.

Thank you for the opportunity to testify today in support of Bill No. 17-53. This legislation is a revised version of Bill 16-759, which was proposed by the Mayor in order to give the Attorney General for the District of Columbia the basic enforcement tools needed to fulfill his or her statutory and common law role in the area of nonprofit organizations and charities. In particular, this legislation will help the Attorney General to determine whether D.C.-based nonprofit organizations are being operated consistently with their non-profit purposes. The District is home to more than 3000 nonprofit organizations, many of which operate on a national scale.

The Attorney General's common law authority to protect charities and their assets arises from the fact that a charity exists to benefit the public, rather than to benefit any particular beneficiaries. As a result, there is usually no individual with both the legal

standing and motivation to seek judicial relief against those who would operate a charity for personal gain or for some other improper purpose. It is left to the state attorneys general to represent the public interest in ensuring that charities are being operated consistently with their charitable purposes.

The Attorney General's enforcement authority in the area of charities has been expressly recognized by statute since 2004, the year that the Uniform Trust Code became law in the District. The Uniform Trust Code states that the Attorney General "has the rights of a qualified beneficiary with respect to a charitable trust having its principal place of administration in the District of Columbia." D.C. Code § 19-1301.10 (eff. Mar. 10, 2004). That means that the Attorney General, representing the public interest, has the same right to enforce the terms of a charitable trust as a private beneficiary has to enforce the terms of a private trust.

A second source of the Attorney General's enforcement authority in this area is the Healthcare Entity Conversion Act, which requires the Attorney General to review proposed for-profit conversions of charitable healthcare entities. The Attorney General may not approve a conversion unless "appropriate steps" are taken to "safeguard the value of [any] charitable assets." D.C. Code § 44-603(b). This statute provided the authority for the Office's review in 2002 of the proposed for-profit conversion and sale of insurer GHMSI, the congressionally-chartered, D.C. affiliate of CareFirst Blue Cross Blue Shield.[1] That review was never completed because the transaction was disapproved

[1] The nonprofit corporation law amendments proposed by Bill No. 17-53 would not apply to GHMSI because organizations that are subject to the District's insurance laws may not be organized under the District's nonprofit corporation law.

by the Maryland Insurance Commissioner in early 2003.[2] In early 2005, the Attorney General relied on this statutory authority in reviewing the proposed transfer of the nonprofit Thomas House senior housing facility to The Carlyle Group, a private equity firm based in D.C. The Attorney General approved the transaction, which provided for the creation of a $2 million benevolence fund, to be used to provide financial assistance to needy Thomas House residents who were residents at the time of the for-profit conversion.

A third source of authority is the District's Nonprofit Corporations Law. Charitable organizations in D.C. are typically organized as "not for profit corporations." A not-for-profit corporation may be "dissolved involuntarily" by a court if the District proves that "[t]he corporation has continued to exceed or abuse" its authority. D.C. Code § 29-301.53(a).

In recent years, the Office of the Attorney General has played an increasingly active role in charities-related enforcement. Since 2000, the Office has participated in a series of D.C. Superior Court proceedings involving reformations of charitable trusts. Most of these are easily-negotiated reformations that modify the terms of a charitable trust in order to ensure favorable tax treatment under the Internal Revenue Code.[3] In a far more contentious case, the Office is currently appealing a D.C. Superior Court judgment in favor of an heir who contends that her mother never intended to create a

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[2] Documents pertaining to the CareFirst conversion review are on the Attorney General's web-site at http://oag.dc.gov/occ/cwp/view,a,1224,q,531191,occNav,|31692|.asp. On March 4, 2005 and August 4, 2005, the Attorney General provided (what are now public) memoranda to the City Administrator analyzing issues raised by DC Appleseed regarding GHMSI's "charitable obligation."

[3] *E.g.*, *Estate of Florence Nesh*, No. 2005-441 (D.C. Super. Ct. Probate Div.) (modifying will provision regarding charitable trust); *In re: The Gordon Fay Willey Trust*, No. 2005-28 (D.C. Super. Ct. Probate Div.) (modifying trust to preserve tax-exempt status).

multi-million dollar family foundation, and that the foundation's assets should be distributed to members of the family instead of to charitable causes.[4]

In the course of its work relating to nonprofits and charities, the Office of the Attorney General has identified a number of statutory deficiencies that have the potential to interfere with effective enforcement of the District's nonprofit corporation, charitable solicitations, and consumer protection laws.

First, the District's Nonprofit Corporation Act does not expressly require that a nonprofit corporation be organized and operated for nonprofit purposes. It provides that a nonprofit corporation "may be organized . . . for any lawful purpose or purposes including, *but not limited to*," the purposes listed in D.C. Code § 29-301.04. The fact that it is called the "Nonprofit Corporation Act" strongly suggests that it was intended to apply only to corporations organized for nonprofit purposes. But the absence of any language expressly limiting a corporation's purposes to nonprofit purposes implies that the corporation can operate for *any* purpose, including the generation of profits or asset value, as long as profits or assets are not being distributed to owners.

This bill would amend D.C. Code § 29-301.04 to clarify that nonprofit corporations may be organized only for "lawful *nonprofit*" purposes. A "nonprofit purpose" is a purpose other than to make money. Requiring each nonprofit to organize only for nonprofit purposes would not prevent a nonprofit corporation from seeking to earn income or profits or to increase its assets or surplus. But it would prevent a nonprofit corporation from treating profits, or the value of its assets or surplus, as an end rather than as a means. In other words, it is perfectly proper for a nonprofit corporation to generate profits and using the profits to support activities that advance the nonprofit's

[4] *In re: Barbara J. Ingersoll*, No. 05-PR-337 (pending at D.C. Court of Appeals).

mission. However, the corporation cannot make generation of profits into its bottom-line purpose.

Second, the Nonprofit Corporation Act provides only one judicial remedy for exceeding or abusing corporate authority: involuntary dissolution of the nonprofit corporation. In most cases, when those responsible for operating a nonprofit corporation cause it to exceed or abuse its authority, the nonprofit corporation – along with the public – is a *victim* of the improper conduct. Only rarely does it make sense to punish a nonprofit corporation because the person or persons in charge of it have acted improperly. The goal of a court proceeding should normally be to get the nonprofit corporation back on track, pursuing its public-benefit purposes in a lawful and appropriate way. That is especially true when the "abuse" of authority involves straying from the corporation's charitable or nonprofit mission.

This bill would authorize the court to employ remedies short of involuntary dissolution when a nonprofit corporation acts inconsistently with its nonprofit purposes.[5] Specifically, the court would have express authority to appoint a receiver to take control of the corporation and recommit it to its nonprofit purposes. The court would also have authority to impose a constructive trust on compensation improperly paid to a director, officer, or manager, so that the funds could be preserved and eventually returned to the corporation. These are classic equitable remedies that, arguably, are *already* available to a Superior Court judge. But a judge who is uncertain of the court's remedial authority, and who sees a statute that speaks only of involuntary dissolution, is less likely to order

[5] The bill would also amend D.C. Code § 29-301.53 to clarify that actions to enforce the Nonprofit Corporation Act are brought by the Attorney General and that any relief ordered by the court must be based on findings by the court.

flexible, creative, and effective remedies than a judge who is confident that the statute gives the court a range of options short of involuntary dissolution.

In addition, the bill would provide the Office of the Attorney General with subpoena authority when investigating a nonprofit's activities so that the Office may obtain pertinent documents and testimony *before* making the decision to file an enforcement action. Right now, if the Attorney General suspects that a nonprofit corporation is acting inconsistently with its nonprofit purposes, an investigation is likely to depend on voluntary cooperation or on publicly-available information. If little information is available from third parties or from public sources, and if the corporation refuses to cooperate voluntarily, the Attorney General may have to choose between filing a court action (and getting discovery under the rules of civil procedure) or simply doing nothing.

For example, last year a group of concerned church members contacted our Office to allege mismanagement and possible misappropriation of church funds. We contacted the church's new minister, who then met with two assistant attorneys general, provided them with the church's financial statements, put them in touch with the church's accounting firm, and ultimately accepted their recommendations for a new "integrated accounting and management information system." This successful outcome was the result of the church's leadership actively facilitating review and input by the Office of the Attorney General in order to help the church to manage its funds in accordance with the church's own doctrine of financial accountability. Had the church leadership resisted government involvement, the Attorney General's only options may have been to sue the church or to go away. Indeed, the availability of subpoena authority, by allowing an

investigation to proceed in the absence of voluntary cooperation, actually makes voluntary cooperation more likely.

For similar reasons, the bill would provide the Attorney General with subpoena authority when investigating whether charitable solicitations are being made in compliance with the District's Charitable Solicitations Act. D.C. Code § 44-1701, *et seq*. Right now, without filing an action to enjoin unlawful soliciting,[6] the Office of the Attorney General cannot compel production of records showing whether funds collected for a charity are actually being used for the purposes described in the application that the solicitor filed with DCRA for a certificate authorizing the charitable solicitation. DCMR Title 16 § 1304.2(e).

Finally, the bill would effectively overrule holdings of the D.C. Court of Appeals that a nonprofit organization is not a "merchant" within the meaning of the Consumer Protection Procedures Act and, therefore, is not subject to the District's general consumer protection law. Since 1986,[7] the D.C. Court of Appeals has repeatedly held that a nonprofit organization is not a "merchant" for purposes of the Consumer Protection Procedures Act. However, non-profit organizations, including hospitals, health insurers, schools, and counseling agencies, are responsible for a substantial portion of the consumer services in our economy. By eliminating the judicially-created exemption for nonprofits, we can provide consumers who purchase from nonprofit businesses with the same legal protections as consumers who purchase from for-profit businesses.

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[6] D.C. Code § 44-1712(c) authorizes the Attorney General to file a court action "to enjoin any person from soliciting in violation of this chapter or in violation of any regulation made pursuant to this chapter."

[7] *Save Immaculata/Dunblane, Inc. v. Immculata Preparatory School, Inc.*, 514 A.2d 1152, 1159 (D.C. 1986).

Unfortunately, many of the consumer complaints received by the Office of the Attorney General involve what at least purport to be nonprofit organizations, especially in the area of credit counseling. In 1999, the District brought a consumer protection enforcement action against AmeriDebt, a Maryland-based credit counseling firm that, the District alleged, was misleading consumers in its role as marketing arm of a D.C.-based, for-profit lender. AmeriDebt moved to dismiss the case, arguing that its nonprofit status exempted it from the District's consumer protection law. Judge Burgess of the D.C. Superior Court denied the motion, ruling that the District's allegations, if proved, would subject AmeriDebt to the Consumer Protection Procedures Act because the company "would no longer be 'maintained' as a nonprofit organization with a nonprofit purpose."[8] Soon after this ruling, the case settled.

What made the District's case against AmeriDebt difficult was not that the consumer protection issues were unusually complex. The big problem from a prosecutorial perspective was trying to establish that AmeriDebt was not a *bona fide* nonprofit organization. Moreover, in the AmeriDebt case, the District was actually ahead of the curve, at least compared to federal and state enforcers. Not until October 14, 2003 did the Internal Revenue Service, the Federal Trade Commission, and state regulators issue a joint statement warning consumers that "some credit counseling organizations using questionable practices may seek tax-exempt status in order to circumvent state and federal consumer protection laws." (IR-2003-120) On April 5, 2005, the Commissioner of Internal Revenue testified at a Senate hearing that the IRS had "revoked or proposed revocation of tax-exempt status for credit counseling organizations representing over 20

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[8] *District of Columbia v. Infinity Resources Group*, Civ. No. 99-5664 (D.C. Super Ct.) (Memorandum and Order dated Feb. 8, 2000).

percent of the industry's gross receipts."[9] He added that, to "leverage [its] resources" in this area, the IRS had begun "partnering with the states and the Federal Trade Commission (FTC)."[10]

The problem here is not that the nonprofit sector – or even the credit counseling field – is a natural source of bad actors. The problem is that bad actors in our society are attracted to a regulatory vacuum. To quote again from the IRS Commissioner's testimony, our concern is that "the potent combination of exemption from income tax and from consumer protection laws is encouraging those who are motivated by profit rather than charity to seek tax exemption."[11] The Commissioner's testimony summarized a range of abuses involving tax-exempt entities, including the use of charitable organizations to provide benefits to their founders, abuse of conservation easements, and excessive compensation to executives.[12]

This bill represents a necessary first step in addressing the regulatory vacuum that now jeopardizes the integrity of our nonprofit sector and the public's trust in nonprofit organizations. It does not involve an overhaul of the District's Nonprofit Corporation Act[13] or the imposition of any new regulatory obligations or requirements. There will be no new forms for anyone to fill out. It simply enhances the Attorney General's ability to

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[9] Written Statement of Mark W. Everson, Commissioner of Internal Revenue, before the Committee on Finance, U.S. Senate Hearing on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction, April 5, 2005, at 8.
[10] *Id.*
[11] *Id.*
[12] *Id.* at 6, 9-12.
[13] The District of Columbia Nonprofit Corporation Act, D.C. Code § 29-301.01 *et seq.*, is virtually unchanged since it went into effect in 1962. The Office of the Attorney General welcomes the opportunity to work with the Council and interested groups on a general reformation of this important law. However, the Office recommends that the critical oversight enhancements offered by Bill No. 17-53 be enacted now rather than coordinated with a longer-term legislative initiative.

oversee and enforce the *current* legal obligations of those who operate nonprofit organizations and who solicit charitable contributions, and ensures that consumers are covered by the District's consumer protection law when they do business with merchants organized as nonprofits.

I have several proposed amendments to Bill No. 17-53:

- In Section 2(a), in the list of nonprofit purposes, the semi-colons in "professional; commercial; industrial; business; or trade association" should be changed to commas so that – as in the current statute – the phrase reads: "professional, commercial, industrial, business, or trade association." The idea here is to continue to allow nonprofit business or trade associations to be formed for the purpose of advancing the common interests of their for-profit members.

- Also in Section 2(a), the last sentence of the paragraph (*i.e.*, the sentence beginning "No corporation may be organized under this subchapter . . .") should be deleted. This sentence would treat private inurement as applying only to a corporation's *net earnings*, while the statute's definitional section states that a "not for profit corporation" is "a corporation no part of the *income* of which is distributable to its members, directors, or officers." D.C. Code § 29-301.02(3) (emphasis added). The concept of private inurement would be more appropriately addressed as part of a bill to overhaul the nonprofit corporation law than as part of a bill to enhance the Attorney General's oversight authority.

- In Section 2(b), the three new grounds for seeking court relief – grounds (5), (6), and (7) – propose new standards of conduct that raise more questions than they answer. What does it mean to conduct "more than an insubstantial amount of activities that are inconsistent" with a corporation's nonprofit purposes? What does it mean to maintain "substantial assets" of a corporation "in a manner that does not serve" the corporation's nonprofit purposes? These standards of conduct should be replaced with a more general standard, such as: "The corporation has continued to act contrary to its nonprofit purposes." Once again, detailed standards of conduct would more appropriately be addressed as part of a general overhaul of the nonprofit corporation law.

- In Sections 2(b) and 3(b), the standard for issuance of investigatory subpoenas by the Attorney General should be changed. As currently drafted, the bill would require the Attorney General to have "reason to believe that a corporation has committed a material violation" of the law. This standard is inconsistent with the standards applicable to the Attorney General's investigatory authority in the areas of consumer protection and antitrust. Moreover, it would encourage the Attorney General to conclude that the law had been violated before the Attorney General had obtained the information needed to determine whether the law had been

violated. A better standard for issuance of a subpoena is the one set forth in the District's Antitrust Act for issuance of a civil investigative demand: whether the Attorney General "has reason to believe that any person may be in possession, custody, or control of any documentary material, or may have any information, relevant to" the Attorney General's investigation. D.C. Code § 28-4505.

- In Section 4, the definition of "merchant" for purposes of the Consumer Protection Procedure Act needs to modified to make sure that the Act is not applied to special events – like church bake sales – that are not part of a regular course of business. Inserting the phrase "in the ordinary course of business" would clarify that the consumer protection law applies only to those who are selling or supplying goods or services "in the ordinary course of business."

That concludes my prepared remarks. I would be happy to respond to questions.