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**Fraud in Charitable Fund-Raising**

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**Professional Solicitors for Charities: Fraud or Free Speech?**

Americans gave $212 billion to charitable organizations in 2001, of which $160.7 billion came from individual citizens. Historically, Americans give more to charity than the citizens of any other country in the world. While it may appear there is plenty of money to go around, intense competition for charitable dollars exists and as a result many charities use professional solicitors for fund-raising. The enormous amounts of money given to charities, and the fact that much of it is raised by professional solicitors, has understandably drawn attention from federal, state, and local governments. These authorities have made efforts to regulate charitable giving and to ensure that fraud is not perpetrated upon charities and donors by the professional fund-raisers. However, until the past few years—with stepped-up enforcement by the IRS and a new pronouncement by the U.S. Supreme Court—the states have been handcuffed in trying to protect the public.

Most regulation of charitable solicitation has come from state and local governments. Many state and local laws are aimed at professional solicitors and are particularly concerned with the percentage of donations the solicitors keep. It is not uncommon for a charity to have a contract with professional solicitors that allows the solicitors to retain more than 50% of the funds they raise. Despite the importance of preventing fraud in charitable fund-raising, many of the states’ efforts to regulate these contracts, and the percentages retained by professional solicitors, have been thwarted by First Amendment challenges.

**The States Strike Out with Three U.S. Supreme Court Losses**

The first major defeat of state regulation efforts came in *Schaumburg v. Citizens for a Better Environment.* Schaumburg involved a local ordinance that prohibited solicitation within the village unless the solicitor could prove at least 75% of receipts went directly for charitable (i.e., nonadministrative) purposes. Citizens for a Better Environment challenged the ordinance on First Amendment grounds. In a lethal blow to the regulation, the Court ruled that the ordinance was not narrowly tailored to the legitimate governmental interest of fraud prevention: “The flaw in the statute is ... that in all its applications it operates on a fundamentally mistaken premise that high solicitation costs are an accurate measure of fraud.”

The Court concluded, “the possibility of a waiver may decrease the number of impermissible applications of the statute, but it does nothing to remedy the statute’s fundamental defect.”

In response to Munson, the National Association of Attorneys General Committee on Trusts and Solicitations drafted *A Model Act Concerning the Solicitation of Funds for Charitable Purposes.* This Model Act aimed to address concerns that professional fund-raisers were keeping too large a percentage of the monies they raised, and to address the Supreme Court’s First Amendment rulings. The Model Act required charitable organizations to register with the state prior to commencing solicitations and placed greater registration and reporting requirements on professional solicitors. Forty states and the District of Columbia have now adopted charitable solicitation laws based on the Model Act.
However, the Model Act has not proven as successful as the Attorneys General might have hoped. In Riley v. National Federation of Blind of N.C., the Supreme Court struck down some provisions of the North Carolina Charitable Solicitations Act that, although passed prior to the Model Act, were very similar to provisions found in the Model Act. The provisions at issue in Riley included: 1) a prior registration requirement imposed on professional solicitors that did not apply to nonprofessionals, 2) a requirement that professional solicitors disclose their percentage of compensation, and 3) a percentage requirement, with a waiver provision, regarding how much money raised must go directly to the charity. The Court invalidated all three provisions as unconstitutional.

The North Carolina statute created a rebuttable presumption that professional solicitors’ retention of 20% or less of the gross receipts was reasonable, 20% to 35% was unreasonable unless public education or other recognized costs were proven, and retention of over 35% was unreasonable. In particular, the Court objected to the three-tiered percentage provision because it was still burdened with the fatal flaw discussed in Munson—the assumption that high solicitation costs are an accurate measure of fraud. The Court also struck down the requirement that fundraisers disclose to all donors, prior to asking for a donation, the percentage of the funds raised actually turned over to the charity. The Court found this “unduly burdensome,” as potential donors were already on notice that not all the money went to the charity because professional fund-raisers were required to disclose their professional status prior to asking for a donation.

The IRS Steps In
Given this seemingly endless losing streak with regard to the regulation of charitable solicitations, the IRS stepped in. In 1997, the IRS began a policy of revoking the tax-exempt status of charities that overpaid solicitors. This policy, however, was successfully challenged in United Cancer Council, Inc. v. Commissioner. Undeterred, the IRS then established what are known in the nonprofit community as “intermediate sanctions.” Intermediate sanctions constitute an excise tax of 25% imposed on any “excess benefits” transaction. An “excess benefits” transaction is one in which a disqualified person receives a greater economic benefit than the charity. A disqualified person is an individual who has “substantial influence” over the organization. Substantial influence can come from a variety of sources, including a revenue sharing relationship with the charity in which some or all of a noncharity’s compensation is based on the revenue of the charity. The effect of the intermediate sanctions is yet to be determined but it is a new tool to control professional solicitors that retain a high percentage of the funds raised.

The U.S. Supreme Court Provides More Firepower
In May 2003, the states finally won a battle of their own in combating fraud committed by professional fund-raisers. In Illinois ex. rel. Lisa Madigan v. Telemarketing Associates, Inc., defendants (Telemarketers), were Illinois for-profit fundraising corporations. National Headquarters, a charitable nonprofit, retained Telemarketers to solicit donations to aid Vietnam veterans. The contracts provided that Telemarketers would retain 85% of the funds raised in Illinois, leaving 15% for VietNow. Telemarketers also brokered contracts on behalf of VietNow to out-of-state fundraisers. Under those contracts, the out-of-state fund-raiser retained 70% to 80%, Telemarketers retained 10% to 20% as a finder’s fee and VietNow received 10% of the funds raised out of state. Between 1987 and 1995, Telemarketers collected approximately $7.1 million, keeping slightly more than $6 million for itself and leaving approximately $1.1 million for VietNow.

In 1991, the Illinois Attorney General filed suit against Telemarketers, alleging common law and statutory fraud and breach of fiduciary duty. The complaint alleged the 85% fee was “excessive” and “not justified by expenses,” but primarily the complaint dealt with misrepresentation. Affidavits attached to the complaint alleged that Telemarketers told donors that a significant portion, in some cases more than 90%, of the funds raised would go directly to VietNow to support its endeavors to aid Vietnam veterans. Affiants also said they were told there were no “labor expenses” because all members of VietNow were volunteers. Written materials provided by Telemarketers said the donations would be “used to help and assist VietNow’s charitable purposes.”

Telemarketers moved to dismiss the fraud claims, urging they were barred by the First Amendment as a prior restraint on speech. The trial court granted the motion and its order was affirmed by the Illinois Court of Appeals and the Illinois Supreme Court. Those courts relied heavily on Schaumburg, Munson, and Riley. The Illinois Supreme Court acknowledged the Telemarketers case was different because it did not involve a statute regulating charitable solicitations but nevertheless found the attorney general was in essence attempting to regulate Telemarketers’ ability to engage in protected activity based on a percentage-rate limitation, precisely the kind of regulation that was invalidated in Schaumburg, Munson, and Riley.

The Supreme Court granted certiorari to address the application of the First Amendment to individual fraud actions against fundraisers. The Court acknowledged that the First Amendment protects fund-raising but noted that Schaumburg, Munson, and Riley left room for fraud actions to protect the public from false or misleading charitable solicitations. Fraudulent charitable solicitation is unprotected speech, so the issue was whether Telemarketers’ activities amounted to fraud. To prove a defendant liable for fraud under Illinois law, the complainant must show that the defendant made a false representation of material fact, knowing that the representation was false, and that the representation was made with the intent to mislead the listener and succeeded in doing so. These showings must be made by clear and convincing evidence.

The Court focused on the two primary allegations in the com-
plaint: 1) that Telemarketers affirmatively represented that “a significant amount of each dollar donated would be paid over to VietNow”; and 2) that the charitable solicitation was essentially a façade because the money paid to the charity was merely incidental to the Telemarketers’ private pecuniary gain. These allegations, targeting misleading affirmative representations about how the donations would be used, were clearly distinguishable from the issues presented by Schaumburg, Munson, and Riley.25

Telemarketers argued, as the lower courts had held, that to allow a fraud action such as this was essentially the same as imposing a prior restraint on free speech. Telemarketers also argued the attorney general was trying to make an end run around Riley, which struck down a requirement that fund-raisers disclose their fees to all potential donors prior to asking for money.26 The Court rejected these arguments, finding that Telemarketers had deliberately misled potential donors by affirmatively misrepresenting about how much would be given to the charity:

[High fund-raising costs, without more, do not establish fraud. And mere failure to volunteer the fund-raiser’s fee when contacting a potential donee, without more, is insufficient to state a claim for fraud. But these limitations do not disarm States from assuring that their residents are positioned to make informed choices about their charitable giving. Consistent with our precedent and the First Amendment, States may maintain fraud actions when fund-raisers make false or misleading representations designed to deceive donors about how their donations will be used.27]

In the wake of intermediate sanctions from the IRS, and the holding in Telemarketers, the federal and state governments now have at least some tools to combat fraud in charitable fund-raising. These tools are all the more important given the growing use of the Internet as a fund-raising mechanism. Even if perpetrators of fund-raising fraud can be identified, the issue of jurisdiction remains. In part to establish a basis for personal jurisdiction, several states have extended their registration requirements to charities that solicit on the Internet within the state’s borders.

NASCONet
In addition, the U.S. Department of Commerce recently gave Guidestar, the national database of nonprofit information, a grant to develop a one-step registration system for charities.28 This nationwide system, known as NASCONet, will interconnect state charity offices. Charities currently must register individually in each of the 40 states requiring registration. NASCONet, however, will create a common registration system and will allow states to share information, streamlining the registration process and saving charities money. The system will also help states more efficiently regulate charities and their contracts with professional solicitors. The system, which should be operational by late 2005, will serve state regulators, charities, and donors, and most important, assist in preventing fraud in charitable fund-raising.

Conclusion
States considering enactment of regulations regarding charitable fund-raising must be careful not to assume that high-solicitation costs are an accurate and reasonable way to measure fraud, a premise that the Supreme Court has consistently rejected on First Amendment grounds. At the same time, in Telemarketers, the Court demonstrated that states are not powerless to protect charitable organizations, and the public, from fraud in charitable fund-raising. This holding, combined with the tax code provisions and systems such as NASCONet, can be used effectively to protect charities and donors from fraud in an industry whose annual receipts exceed $200 billion and in which all of us have an important stake.

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Endnotes
4. 444 U.S. 620, 100 S. Ct. 826, 63 L. Ed. 2d 73 (1980).
5. Id. at 632.
6. Id. at 638.
7. Id. at 636.
9. Id. at 800.
10. Id. at 802.
11. Id. at 803.
14. Id. at 793.
15. Id. at 798. See also Melissa Liazos, Can States Impose Registration Requirements on Online Charitable Solicitors?, 67 U. CHI. L. REV. 1379 (2000).
16. 165 F.3d 1173 (7th Cir. 1999).
19. I.R.C. 4958(c)(2).
21. Id. at 1834.
22. Id. at 1835.
23. Id. at 1840.
24. Id. at 1841.
25. Id. at 1839.
26. Id. at 1842.
27. Id.
28. For a more complete discussion, see www.guidestar.org/about/press.