No. 01-1806

In The

Supreme Court of the United States

JAMES E. RYAN, ATTORNEY GENERAL OF ILLINOIS,
Petitioner,

v.

TELEMARKETING ASSOCIATES, INC., ET AL.,
Respondents.

On Writ of Certiorari to the Supreme Court of Illinois

BRIEF *AMICI CURIAE* ON BEHALF OF Association of Fundraising Professionals, Association of Direct Response Fundraising Counsel, Council for Advancement and Support of Education, The Direct Marketing Association and The Direct Marketing Association's Nonprofit Federation, Direct Marketing Association of Washington, Direct Marketing Fundraisers Association, National Catholic Development Conference, National Health Council in support of Respondents

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CONSENT TO FILE

Consent to file this Brief *Amici Curiae*[1] has been obtained from Petitioner and Respondent.

INTEREST OF THE *AMICI*

Amici are "umbrella" groups representing both nonprofits and their fundraisers. Some are organizations with individual members and others are organizations which have nonprofits and/or commercial fundraising organizations as members. All are themselves nonprofit associations.

Amici range in size from the Association of Fundraising Professionals with approximately 27,000 individual members[2] to the Association of Direct Response Fundraising Counsel with fewer than fifty firms as members. These organizations have ethical guidelines for their memberships and seek to promote integrity in fundraising by a variety of methods.

Amici are more aware than most that nonprofits and fundraisers depend heavily upon public goodwill. Without goodwill, their messages could not be spread; their missions could not be advanced; they could not solicit donations based on those messages and missions. Therefore these "umbrella" organizations have a profound and steadfast interest in rooting out charitable fraud.

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[1] Neither party's counsel authored any portion of this brief nor made any monetary contribution to the preparation or submission of this brief. *Amici* provided financial support for this brief directly as well as through American Charities for Reasonable Fundraising Regulation, a nonprofit organization.

[2] The Association of Fundraising Professionals ("AFP") is the largest organization of its kind in the charitable sector. AFP has been in existence for more than 42 years and yet has never before participated in any proceeding before this Court. However, given the importance of the issues raised by Petitioner, AFP has joined the other Amici on this brief.

Amici generally support reasonable registration and reporting requirements intended to protect and inform the public. *Amici* unequivocally believe that when donors ask for financial information about a nonprofit, they are entitled to a full and honest answer. *Amici* support each Attorney General's power to prosecute fraud committed under the guise of charitable solicitation. Indeed, they wish more energy was focused on such prosecutions to rid the philanthropic sector of this element and the negative publicity that hobbles legitimate charitable solicitations.

Amici believe that state and federal regulatory officials should be free to collect information on various fundraising costs and ratios, however they may be calculated. *Amici* further believe that occasionally these data are useful in giving such regulators and prosecutors an indication of where they might wish to conduct further investigations to determine if, aside from the simple and often misleading "cost of fundraising" measure, there is evidence that fraudulent or other illegal activity is taking place such as "private inurement,"[3] "private benefit,"[4] or "excess benefit transactions."[5]

Amici do not appear here to support the specific arrangement between Respondents and VietNow or to endorse any particular form of such arrangements regardless of the method of fundraising employed.[6]

Finally, *Amici* vigorously support the Riley[7] decision because it correctly pointed out some of the pitfalls of relying on a cost of fundraising percentage or ratio ("fundraising

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[3] 26 U.S.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3)-1(c)(2).
[4] 26 C.F.R. § 1.501(c)(3)-1(a)(1).
[5] *See* 26 U.S.C. § 4958 ("intermediate sanctions" legislation which imposes "excess benefits" taxes on "disqualified" persons dealing with a charity) and 26 CFR § 53.4958-7 (implementing regulations).
[6] *Amici* reserve judgment on this issue because the facts have never been fully revealed or discovered.
[7] Riley v. National Federation of the Blind of North Carolina, Inc., 487 U.S. 781 (1988).

ratio") to root out fraud, namely: reliance on the fundraising ratio presumes that the nonprofit derives no benefit from the act of solicitation itself,[8] "donors are … undoubtedly aware that solicitations incur costs" therefore disclosure of the fundraising ratio does not necessarily advance a compelling state interest,[9] and the "compelled disclosure will almost certainly hamper the legitimate efforts of professional fundraisers to raise money for the charities they represent."[10]

Amici come before the Court to point out yet additional infirmities of the fundraising ratio and the notion that this unitary measure can alone be used as a predicate for a finding of fraud, particularly when there is no uniform, rational, objective manner by which the fundraising ratio can be calculated. No one, including no fundraising experts, government regulators, tax authorities, consumer advocates, nor Attorneys General, has defined the fundraising ratio in a uniform fashion or in such a way as to make it a useful or reliable indicia of fraud or philanthropic efficiency. This uncertainty reveals fatal constitutional flaws in Petitioner's theory.

Because *Amici* represent legitimate and ethical nonprofits and fundraisers, they are not only intimately familiar with the practical realities of charitable fundraising and the methodological difficulties of calculating the fundraising ratio, they are also the parties whose constitutional rights will be most directly encumbered by a fraud prosecution theory premised on the fundraising ratio.

SUMMARY OF ARGUMENT

Petitioner's relief should not be granted because there is no universal, rational, objective definition of the

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[8] Riley, 487 U.S. at 798.
[9] Riley, 487 U.S. at 799.
[10] Riley, 487 U.S. at 799.

fundraising ratio that has any value as an indicator of fraud or even of efficiency in fundraising once it is calculated.

In theory the fundraising ratio is an attractive device for evaluating charitable operations and fundraising. It is deceptively simple and convenient to those who have a "one size fits all" view of how one might evaluate the work of nonprofits and charitable fundraising. However, in practice it is not a reliable assessment of a nonprofit's effectiveness or integrity. Rather, it is an invitation, at a minimum, to confusion and error and, at worst, to manipulate data for illegitimate ends all disguised as an invitingly simple percentage figure. In the hands of those with the power to prosecute fraud, the fundraising ratio can be influenced through a variety of means, including the selection of the time period under consideration, the selection of particular fundraising campaigns to evaluate, the characterization of expenses, and the treatment of funds devoted to reserves, amongst other means.

By relying solely on the fundraising ratio as an indicator of and the premise for a finding of fraud, Petitioner seeks to vest too much discretion in the state by deciding how the fundraising ratio will be calculated and by deciding whom to prosecute once it is calculated, which can be essentially the same question. This Court has already ruled that the fundraising ratio has little value as an indicator of fraud.[11]

In this Brief, *Amici* will expand upon that reasoning as an incident to their primary argument: If Petitioner can arbitrarily and after-the-fact decide how the fundraising ratio should be calculated in his jurisdiction, then every other law enforcement authority has the same discretion to subject the entire nonprofit community to a complicated welter of conflicting regulations in violation of the Commerce Clause while at the same time significantly chilling communications

[11] Riley, 487 U.S. at 793.

between nonprofits and the public in violation of the First Amendment and subjecting charities and fundraisers to significant violations of their due process rights.

ARGUMENT

I. The fundraising ratio has deceptive significance

Reports of charitable fraud incite tremendous public outrage. In response government regulators and prosecutors as well as private sector "watchdog" organizations seek to separate the "good" nonprofits from the mismanaged nonprofits and outright scams. Both often fail to understand the complexities and unreliability of fundraising ratios.[12]

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[12] The problems with using this crude measure are revealed in numerous scholarly studies of the matter. See, generally, Espinoza, Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving, 64 Southern California Law Review 633 (1991); Frumkin & Kim, Strategic Positioning and the Financing of Nonprofit Organizations: Is Efficiency Rewarded in the Contributions Marketplace?, 61 Public Administration Review 266-275 (2001); Greenlee & Gordon, The Impact of Professional Solicitors on Fund-Raising in Charitable Organizations, 27 Nonprofit and Voluntary Sector Quarterly 277-299 (1998); R. Rettig, Cancer Crusade: The Story of the National Cancer Act of 1971 (1977); Rose-Ackerman, Charitable Giving and "Excessive Fundraising", Quarterly Journal of Economics 97 (1982); Sargeant, Using Donor Lifetime Value to Inform Fundraising Strategy, 12 Nonprofit Management and Leadership (2001); Smallwood & Levis, The Realities of Fund-Raising Costs and Accountability, The Philanthropy Monthly (September 1977) (also found at http://www.nonprofits.org/misc/fps/realities.html); Steinberg, Should Donors Care About Fundraising? in S. Rose-Ackerman, ed., The Economics of Nonprofit Institutions 347-364 (1986); Steinberg, Economic Perspectives on Regulation of Charitable Solicitation, 39 Case Western Reserve Law Review 775 (1988); Steinberg, Profits and Incentive Compensation in Nonprofit Firms, 1 Nonprofit Management and Leadership 137-151 (Winter 1990); Steinberg, The Economics of Fundraising, in D. Burlingame & L. Hulse (Eds.), Taking Fund Raising Seriously, 239-256 (1991); Steinberg, On the Regulation of Fundraising, in D. Burlingame (Ed.), Critical Issues in Fundraising 234-246 (1997);

The "cost of fundraising" or fundraising ratio purports to be the percentage or ratio of every charitable donation raised that was spent on fundraising expenses. In other words, it seeks to reduce a nonprofit's "efficiency" to a simple percentage. Thus, fundraising ratios are attractive to the government regulators and watchdogs that calculate them according to their own rules and use them to rate nonprofits, with little or no explanation, understanding, or context.

Many potential donors do not understand the lack of scientific or economic basis inherent in fundraising ratios and thus reports of such by government agencies[13] and watchdogs may be influential. And a fundraising ratio can grievously damage a nonprofit's reputation when it is calculated without regard to the proper context.[14] Of course, these agencies and

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Titus, Heinzelmann & Boyle, Victimization of Persons by Fraud, 41 Crime and Delinquency 54-72 (1995); Watkins, Discussion on the Cyber-Accountability List-Serv, archived at cyb-acc@CharityChannel.com., #2002-140 (Aug. 24, 2002), Are ratios useful? For donors? For the community? (found at http://www.nonprofit-info.org/npofaq/11/14.html)(1996).

[13] Some state regulators publish fundraising ratio data on state managed websites. See, e.g., Kansas' "Charity Check" website http://www.kscharitycheck.org/search.asp where fundraising ratio is based upon the ratio of "fundraising expenses" to "gross receipts." See also, http://web.dos.state.pa.us/charities/dsf/explain.cgi which explains the calculation done by Pennyslvania. Charity Navigator, one of several "watchdog" groups, measures amongst other things "fundraising efficiency" based on the percentage of total contributed revenue expended on fundraising. See, http://www.charitynavigator.org/index.cfm/bay/content.view/catid/2/cpid/35.htm.

[14] Economist Richard Steinberg who has extensively studied costs of fundraising notes:

> The costs of efficient fundraising are highly idiosyncratic, varying with organizational age, mission, press coverage, competition from other fundseekers, scale, experience, perceived levels of need, the economic well-being of potential donors and a variety of other factors [citations omitted]. Charities situated in favorable fundraising environments may be highly inefficient and still secure low fundraising shares,

watchdogs enjoy First Amendment protections for their views.

But for decades *Amici* and their members have seen the fundraising ratio mislead the public,[15] become misused for political and public relations purposes,[16] and have generally found it to be a vexatious concept. This is primarily because there is no demonstrably rational, objective basis upon which to calculate the fundraising ratio so that it lives up to its promise of being a unitary measure of fraud or efficiency for most nonprofits under most circumstances.[17]

> whereas charities advocating unpopular causes or prospecting for new donors will have high fundraising shares (perhaps exceeding 100%) even if they operate at the limits of efficiency. Steinberg, On the Regulation of Fundraising, in D. Burlingame (ed.), Critical Issues in Fundraising, 234-246 (1997) (parenthetical in original).

[15] A report critical of the inconsistent decision-making of one of the merged organizations that now comprises an *Amicus Curiae* in this case, the Better Business Bureau and its Wise Giving Alliance, takes the organization to task for failure to follow Generally Accepted Accounting Principles ("GAAP") in its analysis of the charities it reviewed. Emigh & Wills, NCIB Evaluates Charities Unfairly and Misleads the Public (National Federation of Nonprofits) (1994).

[16] Former California Attorney General Lungren issued a Press Release prior to Christmas in 1994 (Attorney General of California, Press Release 94-120) and a report Attorney General's Report on Charitable Solicitation by Commercial Fundraisers (1994) in which at least one charity, Christian Appalachian Project, was castigated for an excessively high fundraising ratio. Unfortunately, the report did not differentiate between full fledged fundraising campaign and small feasibility test conducted to determine whether a campaign was viable. In this case the charity conducted a small feasibility test of telemarketing to lapsed direct mail donors. The costs were, as might be expected, high because it was a small test. However the charity's annual report filed with the California Attorney General in that year showed its *overall* cost of fundraising *for the year* was a mere 18% of income.

The Attorney General of New York issues a similar report each year. See, Spitzer, Pennies for Charity – Where Your Money Goes (December 2002).

[17] [F]actors other than honesty and efficiency … drive the fund

Amici are particularly concerned about this case because Petitioner is a state Attorney General. Petitioner is relying on the failure to voluntarily disclose a fundraising ratio as a sole basis a for fraud prosecution[18] even though the fundraising ratio is far too imprecise a measure by which to

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raising cost ratio. For example:

- It could be a start-up charity without a donor base
- It could be an organization with an unpopular mission, such as a home for unwed mothers, where many people must be contacted in order to find a few concerned donors who are not deterred by social stigma
- It might be a national charity that is supported by a small but loyal group of donors who are scattered across the country and make relatively small donations per capita.
- It could be an organization that is precluded from using a fund raising method that tends to deflate the fund raising cost ratio, such as the use of volunteers to solicit door-to-door or special events to raise funds locally. ...

Even if it were feasible for an organization to use a fund raising method that will deflate the fund raising cost ratio, it may still be a responsible decision to use a method that boosts the ratio. For example, a cause-oriented group may need to maximize the number of adherents in order to further its program mission. For that group, it may be worth it to use direct mail even at a loss in order to find more adherents."

Miller, Suggestions to Improve Private Standard Setting for Charities: The NCIB Proposals, Philanthropy Monthly 14 (Nov. 1987).

[18] Petitioner denies that he improperly relies on the fundraising ratio (Petitioner's Brief at 11). The facts belie this assertion. Petitioner's twice amended Complaint repeatedly focuses on the fundraising ratio and mentions it in one form or another in ¶¶ 10, 12, 16, 23, 28, 31, 34, 37, 44, 52 (67F), 53 (67G), 54 (67H), 55 (67I), 57 (67K), 58 (67L), 59 (67M), 60 (67M), 66, 68, 70-74, 77, and 80. Petitioner also argues that this Court's rather clear jurisprudence to the contrary has, in fact, left him room to claim that fundraising ratios are *relevant* to a fraud prosecution (Petitioner's Brief at 43). He dismisses the Riley holding that "there is no nexus between the percentage of funds retained by a fundraiser and the likelihood that the solicitation is fraudulent" (47 U.S. at 793) by calling it a "shorthand description" of the Munson case. (Petitioner's Brief at 43, n. 32).

evaluate the effectiveness of a nonprofit, let alone for use to determine whether fraud has taken place.

In fact, those engaged in fraud have an even greater incentive to produce reports that show a lower cost of fundraising in order to avoid inviting too much inspection.

> It could well be that a charity run by a crook has a fund raising cost ratio of 30 percent. Another organization run by honest, ethical managers who make responsible fund raising decisions and execute them efficiently may have a fund raising cost ratio of 55%. . . . [We] strongly disagree with the presumption that deserving and undeserving organizations can be identified by their place on this exclusive yardstick. The fund raising percentage has no demonstrable reliability as an absolute indicator of efficiency (much less does it begin to define 'deserving'). Miller, Suggestions to Improve Private Standard Setting for Charities: The NCIB Proposals, Philanthropy Monthly 14-15 (Nov. 1987).

II. Calculating the fundraising ratio is problematic

In theory, the fundraising ratio is an elementary calculation.[19] One simply adds up all the money spent on a

[19] This case involves a contract with a fundraiser to provide certain services and to be compensated based on a percentage of funds raised. A minority of fundraising contracts have similar provisions, a practice frowned upon by some. See, e.g., Association of Fundraising Professionals, Code of Ethical Principles and Standards of Professional Practice, Standard 16 (2002)(found at http://www.afpnet.org/content_documents/2002_AFP_Code_of_Ethics.pdf). In most, cases, fundraisers and fundraising consultants are compensated on a fee-for-service basis. For example a fundraising consultant might be paid an agreed upon amount for each fundraising

solicitation campaign and then divides it by all the money raised by the campaign. This yields a percentage somewhere between zero and infinity.

A nonprofit could easily have a 0% cost of fundraising ratio if it was essentially dormant during the campaign period but received a bequest from a will drafted years earlier when the organization was much more active. A nonprofit could have an enormous fundraising ratio (or an infinite one) if its sole fundraising "special event" is cancelled as a result of the weather after most of the overhead expenses (food, promotion, site rental, etc.) have been paid. In neither case is the fundraising ratio indicative of the nonprofit's efficiency.

In the case of VietNow, the percentage is alleged to have been 85%. Or, perhaps it was lower because much of what Respondent was paid to do advanced the charitable mission of VietNow and was not solely fundraising activity.[20] Or, perhaps it was as high as 97%, because any one of the more than forty donors surveyed by the Attorney General of Illinois might have felt that they didn't care what percent was turned over to VietNow but rather what percent was spend by Viet Now to buy food baskets for veterans and their families.

Herein lies the problem: the calculated fundraising ratio can vary widely depending on how the calculation is

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letter he or she helped produce. Or a paid solicitor may be paid an hourly fee for his or her work.

[20] Telemarketing Associates agreed to prepare a newsletter and promote goodwill and otherwise contact the public about VietNow and its charitable mission. Record 21-67. VietNow's "primary charitable mission" includes "help[ing] increase community awareness of the difficulties encountered by the veteran and their families" and "increas[ing] national awareness of the POW/MIA status in supporting other organizations involved in the effort of accountability and release of these veterans." See VietNow National Headquarters 2000 Form 990, Schedule D, Part III available at http://justice.hdcdojnet.state.ca.us/charitysr/default.asp.

performed. Presumably Petitioner argues that Respondent is committing fraud whether the fundraising ratio is 85% or 97%. But what if the two fundraising ratios were 45% and 57%? What is the threshold of fraud where there has been no affirmative misstatement in response to a donor's request for information? The question of how the fundraising ratio is calculated could decide whether a fraud prosecution would be filed.[21] And note that these two fundraising ratios were calculated by looking at the question of donation efficiency from just two perspectives. This is merely the tip of the iceberg because there are many different perspectives on this issue.

Petitioners emphasize that it is the individual donor's perspective that matters most here. Yet, conceivably, there are quite a few donors contacted by any campaign who would not feel defrauded if more than half of their donations went to the charitable purpose, but *would* feel defrauded if less than half did.

When a nonprofit solicits tens of thousands of individuals the sheer numbers of persons contacted produces a broad range of individual beliefs as to where is the line between reasonable and fraudulent fundraising ratios. But fraud does not normally require that thousands of prospective donors feel misled. Only one is required. So does that mean that the vagaries of how someone who is contacted may feel

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[21] The Maryland statute at issue in Secretary of State of Maryland v. Joseph H. Munson Co., Inc., 467 U.S. 947 (1984) declared fundraising ratios above 25% to be illegal. The Better Business Bureau decreed that fundraising costs of 35% or greater are "unreasonable." Brief of *Amici Curiae* of the Council of the Better Business Bureaus, Inc. et al. at page 13.

Conversely, the Association of Fundraising Professionals, one of the Amici on this brief, while prohibiting percentage-based compensation, does not establish a particular ceiling on fundraising costs specifically because of the unreliability of such arbitrary measures. See, http://afpnet.org/tier3_cd.cfm?Foldes_id=892&content_item_id=1348.

about this issue will, after the fact, determine whether fraud occurred?

The problems associated with calculating a fundraising ratio are legion:[22]

- What is the proper time period over which data is gathered? One month? One quarter? One year? Several years? The length of a particular campaign?
- Should the numerator include or exclude "joint expenses" involving fundraising but which also advance the mission of the organization?
- Is the denominator the total of the nonprofit's expenses (as is done in Illinois)[23] or the total revenue?
- How does one account for the residual value of byproducts of the solicitation? For example, what is the value of a deferred gift? What is the value of having identified a significant donor who will give over a period of many years? What is the value of recruiting an unskilled but loyal volunteer?

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[22] "[T]here is no uniform method for measuring fund-raising expenses. Indeed, there is disagreement within the nonprofit field over the definition of fund raising, including when and how to allocate costs between program and fund-raising activities." Hopkins, A Struggle for Balance, Advancing Philanthropy 26-31 (Fall 1995).

[23] Illinois Charitable Organization Annual Report (Form AG990-IL Revised 6/01)(found at: http://www.ag.state.il.us/charitable/ag990-annualreport.pdf) uses a calculation where the fundraising ratio is calculated as the proportion of three expense categories: Program Service, Management and General, and Fundraising. The proposed Standards for Charitable Accountability, Standard 9 of *Amicus* Better Business Bureau (found at http://www.give.org/srp/newstandards.asp) provides that a nonprofit should spend at least 65% of its total expenses on program activities so the denominator is total expenses and the numerator is "program" expenses. So any expenses for fundraising, management, legal, accounting, etc. are excluded from the resulting percentage.

What is the value of recruiting petition signers who choose not to donate?

- How does the nonprofit's commitment to building financial reserves factor into the fundraising ratio?
- How does one properly account for investments made in building a list of future donors – are these expenses or capital investment activities?
- Should the denominator be focused upon expenses or funds raised by any method or only by that particular campaign?
- Should the results of different methods of fundraising (e.g. telemarketing, direct mail, direct response TV, direct response radio, telethons, radio-thons, special events, corporate giving, foundation giving, government grants, major donor giving, lapsed donor renewal, membership recruitment and renewal, new donor acquisition, e-mail solicitation, etc.) each be measured independently for its own fundraising ratio or should the nonprofit be measured on its combined overall efforts?

This brief will discuss several of these issues in detail. But, ultimately, the lack of any consistency in the way in which these calculations are made and in the lack of meaning of any resulting calculation exposes the fatal constitutional flaws inherent in Petitioner's scheme to use fundraising ratios alone as indicia of common law fraud.

A. What is the proper time period over which data are gathered and reported?

Consider a hypothetical nonprofit that begins a program of soliciting contributions through direct mail.

Generally it must begin with a "prospect mailing" in which the nonprofit sends letters out to people who have not previously supported the nonprofit. Viewed alone, these campaigns have a very high cost. Often, they lose money.[24] The purpose of the prospect mailing is to identify donors willing to contribute in the future to the nonprofit's cause.

Once these new donors are identified, the nonprofit continues to solicit additional donations from these newly found supporters over a period of years, thereby recouping the initial cost and producing a net gain.

At some point in time, some of those donors will stop giving, and these "lapsed donors" must be replaced by prospecting for new donors, which begins the cycle again.[25]

How would the fundraising ratio be properly calculated?[26] Would one look at simply the first prospect

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[24] As this Court has observed in the past "a solicitation may be designed to sacrifice short-term gains in order to achieve long-term, collateral, or non-cash benefits." Riley, 487 U.S. at 792. "Experienced fundraisers seem to agree that direct-mail prospecting is considered effective if it breaks even (e.g., Bergen, 1991; Bush, 1991; Warwick, 1994)." Greenlee & Gordon, The Impact of Professional Solicitors on Fund-Raising in Charitable Organizations, 27 Nonprofit and Voluntary Sector Quarterly 277, 284 (1998).

[25] "One third to one half of first-time donors will never make a second gift. The pool of previous donors (the 'house list') also suffers from attrition or what Rosso (1991) calls 'the transiency factor.' According to Royer (1989), 60% of gifts to many charities come from people aged 60-76. As these donors die, lose interest, and so forth, the charity must find replacement donors. Accordingly, prospecting tends to be an ongoing process, but, for established organizations, the high cost is masked by the efficiency of resolicitations of the house list." Greenlee & Gordon, The Impact of Professional Solicitors on Fund-Raising in Charitable Organizations, 27 Nonprofit and Voluntary Sector Quarterly 277, 284-85 (1998).

[26] As noted above, many contracts for fundraising services are based on flat fees for particular services rather than percentages. Therefore the fundraising ratio cannot be determined merely by reference to a commission set in the contract. Instead, revenues or expenses and costs of fundraising for like periods must be compared after the fact.

mailing? If so, it is quite likely that the fundraising ratio will be "too high."[27] This would stop the campaign before it starts.[28] Moreover, this would be misleading.

The whole point of the prospect mailing was to identify long term donors. Wouldn't it be less misleading if some of the long term value these donors will provide to the nonprofit could be included in the fundraising ratio calculation?

This then leads to the question – over what time period should this cost (investment) vs. revenue (return on investment) be calculated? – one quarter? – one year? – the estimated period during which the donor will continue to donate?

What about an analysis of a whole campaign? There are two immediate problems with this approach. First, it is unlikely that Petitioner or other regulators would consider a fundraising ratio reported at the end of a multi-year campaign to be timely and useful information. Second, there is no accepted industry definition of "campaign." When does one campaign begin and another end?

Choosing any period can skew the results depending upon the fundraising activities in which the charity may be engaged, which is why this measure is simply not useful. If, for example the charity is just commencing a major fundraising drive, then the fundraising ratio for that year may be significantly higher than for the subsequent years when that first year's investment produces a return. Yet U.S. accounting rules prohibit nonprofits from amortizing the

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[27] See, *supra*, note 24.

[28] The nonprofit, fearing a reputation-damaging fraud investigation, would likely be too afraid to even begin a direct mail campaign. Even if it did begin, the nonprofit might face a fraud investigation just after the prospect mailing which would prevent the nonprofit from ever recovering the investment it made in the prospecting.

investment in creating a mailing list so as to properly match expense (investment) and revenue (return on investment).[29]

Thus, a start-up charity may not amortize or allocate the fundraising expense to the same periods in which the income is realized, but rather must suffer from a very high initial cost of fundraising as the charity makes significant investments in its future.

Once new donors are identified, their names and addresses often go onto a general mailing list that is used for other fundraising purposes including appeals for special projects, capital campaigns for new buildings, seeking gifts through wills and bequests, quarterly newsletters that may include an incidental opportunity to donate, and any number of other communications.

Even if the fundraising ratio of a campaign is calculated by the charity, it is often based only on the immediate results and not the value of having identified donors who may, for example, leave bequests. There is no logical time period during which such a calculation can be made.

Sometimes charities have multiple distinct charitable missions or programs, each of which has "earmarked" fundraising. Should each one have a different calculated fundraising ratio? If not, doesn't that mean that the "campaign" is effectively indefinite since the other missions will continue even if one is completed?

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[29] Instead of treating the ongoing operational investment in building a mailing list just as any other asset that might be purchased and then expensed over a number of years, U.S. accounting rules require treating such operational investments as expenses in the year made despite the fact that revenue associated with those expenses will occur later. See, American Institute of Certified Public Accountants, Audit and Accounting Guide for Nonprofit Organizations ¶ 13.06 (2002). By contrast, other countries such as Germany, the Netherlands, France, etc. allow nonprofits to amortize investments in mailing lists just as investment in any other asset may be amortized.

There is no agreed upon definition of the fundraising ratio in part because there is no agreement on any particular time period over which the calculation should be made.

B. What expenses and income are properly allocated to the fundraising ratio's numerator and denominator?

Assuming that the measuring period problem could be solved, there's still a problem of classifying what goes into the numerator and what goes into the denominator in order to calculate the fundraising ratio.

Each state may formulate its own methodology, some of which are vague. West Virginia requires nonprofits to calculate their "fund-raising percentage" by dividing "fund-raising expenses" by "income derived from fundraising."[30] Missouri requires nonprofits to report the "percentage of funds directly spent on fund-raising or directly allocated for fund-raising activities"[31] And Utah requires nonprofits to report "fundraising costs as a percentage of contributions" using data from the nonprofit's most recent Form 990.[32]

1. The Numerator: Solicitation expenses

Presumably the numerator is the amount of money spent soliciting donations or "fundraising." Money spent advancing the charitable mission should not be included.[33]

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[30] See http://www.wvsos.com/forms/charity/chr1.pdf at page 4.

[31] See http://www.ago.state.mo.us/charities/charityannualreport.pdf at page 1.

[32] See http://www.commerce.utah.gov/dcp/downloads/permitapps/charitableorganization.pdf at page 4.) Although, for Utah, a nonprofit can rely on the Form 990 instructions for a degree of certainty in calculating his fundraising ratio, Missouri and West Virginia give very little guidance on how they expect the fundraising ratio to be calculated.

[33] This is the subject of the highly controversial American Institute of Certified Public Accountants, Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local

Of course, this seems a simple distinction in theory; but in reality it is quite nettlesome. This Court has already recognized this problem to a certain extent.[34] In many instances, the act of solicitation advances the charitable mission.[35]

Consider a nonprofit dedicated to women's health. A particular mass mailing might remind women to conduct a periodic breast self-examination. In part to defray the costs of the mailing and also to advance other aspects of the organization's mission, the letters might also include a solicitation for donations. The act of solicitation is inextricably bound up with the nonprofit's mission.[36]

Should the cost of these "educational" mailings be included in the fundraising ratio numerator or not? Apparently Illinois thinks they should not because their

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Government Entities that Include Fundraising, Statement of Position 98-2 ("SOP 98-2") regarding accounting for expenses that are allocable between fundraising and program services.

[34] Munson, 467 U.S. at 961. Riley, 487 U.S. at 798.

[35] "Campaigns may directly accomplish the charitable mission as a side effect of fund raising. For example, political fund raising may also raise the candidate's profile, and fund drives for Mothers Against Drunk Driving (MADD) may educate the public about the dangers of drunk driving while also raising money." Steinberg, The Economics of Fundraising, in D. Burlingame & L. Hulse (Eds.), Taking Fund Raising Seriously 239-256 (1991).

[36] Economist Richard Steinberg suggests:

> Even if public education is not one of the charity's goals, the public is educated about the charity through the solicitation process, and this information is not valueless. ... Solicitation expenditures may provide socially valuable information even when they result in a decrease in donations. The information contained in solicitation literature may convince a donor who was otherwise predisposed to contribute that his interests would be better served by spending his money elsewhere. Thus, the 'public education' defense extends far beyond those charities which explicitly count advocacy or education among their goals.

Steinberg, Regulation of Charity Fundraising: Unintended Consequences, Working Paper, Indianapolis: IUPUI Dept. of Economics (1991).

calculation of fundraising costs do not account for these activities.[37]

If the position taken by the Attorney General of Illinois is upheld, nonprofits and fundraisers would never know if they were in compliance with the law. They would, in good faith, calculate their fundraising ratio, according to the various rules and decisions promulgated by 50 attorneys general (and by an unknown, but potentially significant number of local prosecutors and regulators[38]). But the

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[37] The Supreme Court of Illinois has already discussed this very problem:

> [H]igh solicitation costs, and a solicitor's high rate of retaining receipts, can be attributable to a number of factors. Certain types of fund-raising campaigns, for example include a wide range of activities that must be paid for. The present case illustrates this point. … [The] contracts [attached to the Complaint] show that, in exchange for its fee, Telemarketing agreed to supply and pay the salaries of all marketing personnel, as well as pay all costs for an office and phones. In addition, Telemarketing agreed to be responsible for producing, publishing, editing and paying all costs for the annual publication of more than 2,000 copies of an advertising magazine that would "increase community awareness of [VietNow]." The contract required Telemarketing to conduct "an efficient and professional marketing program, promote goodwill on behalf of [VietNow], and enhance good public relations." … Defendants in this case were contracted to perform a wide range of activates on behalf of VietNow, all of which were to be paid for out of [Telemarketing's contractual portion of] the solicited funds." Ryan v. Telemarketing Associates, Inc., 198 Ill. 2d 345, 359-60 (2002).

[38] There are already numerous localities that regulate charitable solicitations even though the states in which they are located also regulate charitable solicitations. So nonprofits seeking to solicit in those localities must register again, even though they are registered with the state. See, e.g., Los Angeles, Cal, Mun. Code Ch. IV, Art. 4; Pinellas Co., Fla, Code Ch. 42, Art. VII; and Jefferson Co., Ky., Code Ch. 117. Local registration requirements present a troubling trend that has the potential to grind nationwide charitable solicitations to a halt under the weight of the

calculation would be significantly different in various jurisdictions. This will then permit, on a selective basis, one or more attorneys general to recharacterize, after the fact, the nonprofit's good faith actions as fraud.

If the calculation of the numerator in the fundraising ratio is based on mission related expenses then the calculation depends upon a precise definition of the charity's mission. Is it the mission as set forth in the organization's articles of incorporation? Is it the mission as enunciated in its application for tax exemption and upon which exemption was granted? Is it the mission as stated in its informational tax return on IRS Form 990? Is it the nonprofit's current mission statement? Or is it the content and tenor of a specific appeal?

2. The Denominator: The amount raised

Calculating the denominator in the fundraising ratio, the amount of money raised, presents difficulties as well. Of course, determining the value of cash, checks, securities and even donated property such as works of art is straightforward. But the eleemosynary act takes many forms. How are donated services valued? The tax rules place a particular value on them only if they are derived from special skills while unskilled labor is assigned no value at all. Will state attorneys general and local regulators follow this rule?

There are, of course the same definitional problems as previously discussed. What is to be included in the denominator? Are funds raised only from a particular medium (e.g. telemarketing or a special event) to be included in both the numerator and denominator? Or, should one include all funds raised from all types of public solicitations in the denominator? Or, instead, should one include all revenue regardless of source (including government grants,

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administrative and financial costs of registering with tens of thousands of jurisdictions rather than a maximum of fifty states.

service income, bequests, etc.) thereby lowering the fundraising ratio as a result of, for example, revenue from patients or government grants?

What about the value of future donations from new donors identified in prospecting campaigns? What about pledges and other promises to give (e.g. "I've left some money for your organization in my will")? They are not normally considered current income under U.S. accounting rules. Should charities avoid soliciting such gifts because the costs of solicitation will be recorded immediately while the substantial benefits may not occur until a later time period, thereby subjecting the charity to allegations of fraud? What if the nonprofit knows from years of experience that it can expect a certain percentage of pledges to be honored? If Petitioner allows that assumption, what happens if pledges are honored or dishonored at an unusual rate in a particular year and the fundraising ratio reported earlier turns out to be in error?

C. Characterization of reserves

Assuming that one could resolve the measuring period problems and the numerator/denominator problems, there's still the difficulty of how to account for nonprofits that build reserves. Many nonprofits make it a priority to save a certain percentage of their income to build an endowment, to create a "rainy day" fund, to build new facilities, or to advance some other legitimate purpose. Some applaud this approach and view it as responsible management.

Others find the practice irresponsible and claim the nonprofit is not advancing its mission as aggressively as possible and is essentially "making a profit" from its charitable solicitations.[39] Petitioner apparently agrees.[40]

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[39] The American Institute of Philanthropy, a watchdog organization, "*reduces* the grade of any group that has available assets equal to three to

Will the more than fifty other state and local regulators view the practice in a consistent way?

Consider the Nature Conservancy which was cited in Worth magazine as one of the best nonprofits in the US. The authors went out of their way to explain that "'the conservation groups' ratios are skewed because they are forced to report land acquisitions as a capital cost rather than a program expense."[41] Retained earnings from other nonprofits would not necessarily be handled this way.[42] Should such variations in accounting and reporting rules, which have a powerful effect on a nonprofit's fundraising ratio, become the basis for the exercise of a prosecutor's

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five years of operating expenses." See, http://www.charitywatch.org/criteria.html.

[40] It appears that Petitioner believes this money should not be counted. In footnote 21 of his brief, Petitioner claims that "VietNow … devotes only *one-fifth* of the remaining 15 percent – or *3 percent of the total* – to charitable programs of any kind, including public education efforts" (emphasis in original). This three percent figure is based on the $118,000 amount devoted to "program services" as reported on VietNow's 2000 Form 990. But the same Form 990 indicates that VietNow had excess earnings, or a "gain" of $157,827 for that year. Petitioner does not account for the possibility that some of this money will be used to advance VietNow's charitable mission in the future. And when VietNow does so, the money will never be counted in VietNow's favor in Petitioner's calculation of the fundraising ratio because Petitioner only looks at a percentage reported in the fundraising contract and does not account for funds raised in one year being spent to further the charitable mission in a subsequent reporting year. See VietNow National Headquarters 2000 Form 990, Part I, lines 13 and 18 available at http://justice.hdcdojnet.state.ca.us/charitysr/default.asp for the above cited figures.

Petitioner's footnote 21 intimates that VietNow's public education mission is negligible or illusory because it is funded only by some portion of the above referenced three percent of public support. Quite the contrary, and as noted above in footnote 20, a portion of Respondents' fee was compensation for furthering VietNow's public education mission.

[41] Yaqub, America's Top 100 Charities, Worth, December 2002.

[42] See, *supra*, note 40.

discretion as to whether or when to charge a charity or its fundraiser with fraud?

III. Who decides?

Clearly every question raised above can be answered as a matter of official policy. But the sheer complexity of the problem is not the only issue. Each quandary begs the question: Who decides? Who decides the time period? Who decides what's included in the numerator and denominator? Who decides if retained earnings are good or bad? Who decides all the other issues associated with calculating the fundraising ratio?

A. Regulators

Petitioner might answer that he, as the chief law enforcement officer of Illinois, would ultimately resolve these issues as they relate to solicitations in Illinois.[43] But many nonprofits raise money nationwide.[44] Thus, each regulatory official would have to resolve these same issues as

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[43] For Petitioner's case to proceed, he must first provide his definition of the fundraising ratio and that definition must then be applied to calculate the charity's fundraising ratio in any particular case. Otherwise, there will be no way for the charity's fundraising ratio to be compared with the donor's expected fundraising ratio to determine if a substantial, actionable misrepresentation was made.

Currently, Petitioner appears not to have addressed these concerns about how the fundraising ratio is to be calculated and is merely using the percentage figures from the contracts between VietNow and Respondents. He does so despite the fact that the contracts plainly indicate that a portion of these fees are compensation for Respondents' public education work on behalf of VietNow. See, *supra*, notes 20 and 37. It is unclear how Petitioner would pursue common law fraud actions against fundraisers and nonprofits operating under fee-for-service contracts where a specific ratio is not stated in the contract.

[44] Some charities raise funds internationally and must abide by other recognized accounting regimes in the various host countries where they have subsidiaries or affiliates.

they relate to his or her own constituency. And no state would be under any obligation to resolve the issues in a manner consistent with any other state.[45]

To continue exercising their First Amendment rights to communicate their charitable message and solicit donations, nonprofits soliciting nationwide would be compelled to abide by each regulatory regime, account for their income and expenditures as dictated by each regime, report the appropriate fundraising ratio to the proper regulatory authority, and disclose that fundraising ratio in each solicitation.

In effect, this would result in compelling speech from charities in the form of a disclosure.[46] Petitioner's theory is that fraud occurred if the donor expected a certain percentage of his donation to go to a given purpose when, in fact, a different percentage was dedicated to that purpose. If fraud prosecutions may move forward on this basis, nonprofits will have little choice but to affirmatively disclose their estimated fundraising ratios for each purpose and they would still be subject to after-the-fact prosecution based on poorer than expected results. Otherwise, they will face the near certainty that at least *one* donor will have had a different fundraising ratio in mind and feel misled.

To permit a state to impose such an approach would impose immense administrative, legal, and accounting costs on nonprofits. In practical terms such requirements would redirect precious charitable resources away from charitable missions and toward accountants and lawyers, thus driving up the fundraising ratios and depriving the public of value for their donations. For some, it would mean the difference

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[45] More than forty states and many localities regulate charitable solicitations. While some of the statutory schemes are similar, many are unique and definitions, required disclosures, fees, etc. vary widely. A listing of the state regulators can be found at http://www.nasconet.org.

[46] Of course, such compelled speech is unconstitutional under Riley, 487 U.S. at 795-801.

between continuing to pursue their charitable mission and being compelled to close their doors.[47]

In addition to the stark First Amendment problems this scheme poses for charities,[48] Petitioner's prosecution theory also runs afoul of the Constitution's "dormant Commerce Clause." This Court has consistently held that the Commerce Clause is more than an affirmative grant of power: it has a negative sweep as well.[49] This negative sweep, also known as the Dormant Commerce Clause, reflects the Founding Fathers' policy preference for free trade in a unified common market among the several States.[50] In practice, the Dormant Commerce Clause bars certain state actions that interfere with interstate commerce.[51]

The Commerce Clause bars States from subjecting actors in interstate commerce to a welter of complicated rules.[52] This rule prohibits States from passing laws that

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[47] This is so because of the chilling effect of the threat of a fraud prosecution. "The lack of an upper limit defining when the proportion of expenses to charitable contributions rises to the level of fraud creates uncertain results." Steinberg, Economic Perspectives on Regulation of Charitable Solicitation, 39 Case Western Reserve Law Review, 775, 775-76 (1988) (summarizing the views of Kevin Suffern, Director of the Division of Public Charities and Assistant AG, Massachusetts and co-chairman of the National Model Law Project as expressed in an article appearing in Philanthropy Monthly, Feb.1986.)

[48] These First Amendment concerns are discussed extensively in briefs submitted by other *Amici Curiae* in this case and while certainly the *Amici* represented here also feel such concerns should be determinative of this case, in the interests of judicial economy those arguments are not duplicated here.

[49] Quill Corp. v. North Dakota, 504 U.S. 298, 309 (1992).

[50] See, e.g., Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520, 529 (1959); Kassell v. Consolidated Freightways Corp. of Delaware, 450 U.S. 662, 669 (1981).

[51] See, e.g., Quill, 504 U.S. at 309.

[52] Quill Corp. v. North Dakota, 504 U.S. 298, 313 n.6 (1992). Nor could a state hamper interstate charitable solicitations, an activity enjoying *more* constitutional protection than mere commerce, by similar means.

conflict with the legitimate regulatory regimes of other States.[53] As this Court explained before,

> If the power of Illinois to impose [the regulation at issue] were upheld, the resulting impediments upon the free conduct of interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other state, and every other political subdivision with the power to impose [such regulations]. The many variations in ... administrative record keeping requirements could entangle ... interstate business in a virtual welter of complicated obligations to local jurisdictions....The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable entanglements.[54]

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[53] Healy v. The Beer Institute, 491 U.S. 324, 336 (1989) (holding that "the practical effect of the statute must be evaluated not only by considering the statute itself, but also by considering how the challenged statute may interact with the legitimate regulatory regimes of other States *and what effect would arise if not one, but many or every, State adopted similar legislation*")(emphasis supplied).

[54] National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois, 386 U.S. 753, 759-60 (1967).

Petitioner's proposed prosecutorial scheme would also fail the Commerce Clause's Pike test. This Court has held that:

> [w]here the statute regulates even-handedly to effectuate a legitimate local public interest … it will be upheld unless the burden imposed on … commerce is clearly excessive in relation to the putative local benefits. … And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate commerce. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

Petitioner's prosecution scheme would certainly impose an excessive burden on fundraising in relation to the putative local benefit.

If more than fifty government regulators can create more than fifty independent regulatory regimes for calculating fundraising ratios, and nonprofits seeking to communicate their charitable speech and solicit donations nationwide must comply with each regime, that will certainly subject nonprofits to a "complicated welter" in violation of Quill.

B. Citizens

Petitioner might answer that there need be no strict or uniform definition of the fundraising ratio. Instead, the question would rest entirely in the hands of individual citizens. If a citizen, as a result of an after-the-fact survey, simply felt that he or she were misled about the amount of their donation going to the charitable purpose, that would seemingly be enough for a *prima facia* case of common law fraud.[55] If not, what standard does the Petitioner propose so that charities and fundraisers may know how many must feel defrauded before a prosecution may ensue?

This position, that the discretion is not in the hands of the Attorney General but rather the citizen, is premised on the donor having in mind a clear but unspoken definition of fundraising ratio. The citizen would thus evaluate, for example, whether paying for overhead such as rent, electricity, telephone, etc. at the nonprofit's headquarters was

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The burdens of allowing each state and local law enforcement authority to define how fundraising ratios will be calculated have already been discussed. And this Court has already ruled that there is no necessary nexus between fraud (the prevention of which is a legitimate interest) and high solicitation costs. Munson, 467 U.S. at 961.

In addition, fraud prevention could be promoted as well or better through means having a lesser impact on interstate commerce and free speech. Riley, 487 U.S. at 795. Village of Schaumburg v. Citizens for a Better Environment, 444 U.S. 620, 639 (1980).

[55] Pet. Br. at 28 n. 23 suggests that what matters for purposes of establishing fraud is not what Petitioner thinks is reasonable but rather what the citizens understood from what they were told.

a legitimate use of his donation; whether public education in the form of a combined newsletter and solicitation was a legitimate use; whether staff salaries were a legitimate use; and so on.

This formulation runs even further afoul of the Commerce Clause because it essentially holds nonprofits to fundraising ratio definitions of an infinite number and variety, limited only by the imagination of millions of potential donors. Moreover, it places unbounded discretion in the hands of Petitioner and other regulators. Under this regime, there will *always* be *some* donor to *every* nonprofit who is dissatisfied with how his donation was spent. Petitioner would merely have to draft a survey affidavit, send it out to enough donors, and find at least one who felt misled in order to selectively target that nonprofit.

Thus, every nonprofit and fundraiser faces a fraud prosecution at any time as long as they continue soliciting donations. The only means to protect themselves are (a) elaborate and burdensome disclosures, including disclosures of fundraising ratios that they can only hope that donors and regulators will agree are calculated properly and (b) the regulator's mercy exercised through prosecutorial discretion.[56]

CONCLUSION

The most extensive database on nonprofits and their reported annual financial results in the United States has been

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[56] This is similar to the situation commented upon by Chief Judge Posner in United Cancer Council v. Commissioner of Internal Revenue, 165 F.3d 1173 (7th Cir. 1999): "We were not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decision in this area, said that it was the 'facts and circumstances' of each case. That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS." Id. at 1179.

compiled and published on the Internet as "Guidestar."[57] The chief executive of Guidestar's parent nonprofit organization has spent a great deal of time thinking about the various ratios that can be calculated to measure the performance of nonprofits. He says:

> In the final analysis the worthiness of a charity is a function of the unique value set of the individual donor. Some donors like large, endowed institutions that work on a long-term society need. Others like fast growing, cash-poor organizations that attend to acute needs. There are scores of potential models for assessing the value of a charity. In our opinion, "efficiency" per se, based upon certain financial ratios is probably not a good measure unless you are looking at a single organization's financial progress over time or at a group of very similar peer organizations. If you are looking at ratios as an indicator of worthiness, remember that the age, growth rate, dependence upon donations from the public (as opposed to foundation or government grants or earned revenue), and type of work (research, education, direct service, resource pass-through, etc.) will likely all have far more to do with the reported ratio than the fundamental operating efficiency of the organization.[58]

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[57] This can be found at http://www.guidestar.org and was compiled by Philanthropic Research, Inc. a nonprofit organization. A discussion of fundraising cost ratios and their calculation and usefulness can be found on the "Guidestar" website at http://www.guidestar.org/news/features/ratios.stm

[58] Found at http://societytalk.guardian.co.uk/WebX?14@189.mim4cojfuLb.0@.ee902fb/3.

Petitioner's prayer for relief should be denied not only because there is no nexus between fundraising ratios and charitable fraud, but also because it would violate their First Amendment rights by compelling speech, and it would subject nonprofits to an infinitely complicated and conflicting regulatory regime that would essentially end mass charitable solicitations under massive administrative expenses in violation of the Commerce Clause.

Thus, the judgment of the Supreme Court of Illinois should be affirmed.

Respectfully submitted,

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