What Nonprofits Should Learn From AG Lawsuits Against NRA

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On Aug. 6, New York Attorney General Letitia James and D.C. Attorney General Karl Racine brought blockbuster lawsuits against the National Rifle Association and the National Rifle Association Foundation, alleging that these nonprofit organizations had been systematically looted by their directors and officers, in violation of myriad laws governing nonprofits.

Similar to earlier lawsuits these attorneys general brought against the Donald J. Trump Foundation and President Donald Trump's inaugural committee, the NRA actions garnered headlines due to the high-profile entities involved and, in the case of James' lawsuit against the NRA, her effort to dissolve the 149-year-old organization.

Yet these actions are merely the most visible manifestation of a broader trend, that of state attorneys general aggressively policing the activity of nonprofits operating within their states, including concerning activities ordinarily monitored by federal regulators.[1]

The U.S. is home to over 1.5 million nonprofit organizations, which generate $1 trillion of annual economic activity.[2] While these organizations range in size and purpose — from small nonprofits with local missions to large institutions with global ambitions — all nonprofit leaders should take note of these and other significant investigations by state attorneys general, which highlight both the core nonprofit governance principles attorneys general frequently seek to vindicate and their willingness to police controversial areas of nonprofit law.

Let's look at how states regulate nonprofit operations.

Nonprofit corporations — like all corporations — are creatures of state law. Yet by their nature, nonprofits are subject to greater state supervision to ensure their assets are not wasted or misused, given many solicit funds from the public and generally enjoy substantial tax benefits.

Nonprofits come in various forms, and their federal tax-exempt status is determined by the activities they conduct. Those operating pursuant to Section 501(c)(3) of the Internal Revenue Code must operate for charitable, religious, educational or other specifically enumerated purposes. Although they may engage in some lobbying, these organizations are prohibited from engaging in political campaign activity.

A Section 501(c)(4) organization operates for the promotion of social welfare or a local association of employees. These organizations may engage in political activity as long as it does not constitute the organization's primary activity.

Both 501(c)(3) and 501(c)(4) organizations are also regulated at the state level and must satisfy initial registration requirements and annual filing obligations. Many states also require nonprofits to separately register to fundraise within the state.

And certain events can trigger filing or even regulatory permission requirements, such as

governance reforms, mergers and sales of substantial assets. These filings are made to, and permissions sought from, the state nonprofit regulator — in most states, the attorney general.

AG actions highlight core principles of nonprofit regulation and governance.

New York and D.C.'s respective lawsuits against the NRA, New York's successful dissolution of the Trump Foundation, and D.C.'s pending action against the Trump inaugural committee all demonstrate the basic regulatory requirements that can later bedevil inattentive nonprofits, as well as the fundamental governance principles that underlie many AG regulatory actions.

First, seemingly minor oversights, such as failure to properly register with the state or make annual filings, can create significant issues for a nonprofit, particularly where an initial investigation yields evidence of broader mismanagement.

For example, two years prior to filing its enforcement action, the New York attorney general issued a cease-and-desist order to the Donald J. Trump Foundation for soliciting contributions in New York without registering. The order effectively barred the entity from operating and presaged a broader review that uncovered evidence Trump used charitable assets for personal, business and political purposes. Armed with this evidence, the attorney general then filed a broader lawsuit, seeking to dissolve the foundation.

Second, state attorneys general often focus on rooting out private inurement — the term used when individuals who run a charity co-opt its resources for their own benefit. To guard against such activity, state law often requires nonprofits to undertake specific steps when engaging in transactions with those affiliated with the organization; such transactions must also comply with federal tax law requirements. Failure to abide by these rules can yield serious consequences.

For example, Racine's lawsuit against the 58th Presidential Inaugural Committee, a D.C.-based nonprofit, alleges that it abused nonprofit funds for the benefit of its trustees' private interests, including by paying above-market rates to rent event space in the Trump International Hotel and diverting funds for private receptions for the president's children. The NRA lawsuits are replete with allegations of self-dealing, including James' claim that NRA Executive Vice President Wayne LaPierre bestowed upon himself a $17 million post-employment contract with the organization, without board approval.

AGs are willing to address controversial legal issues regarding nonprofit activities.

Beyond these fundamental issues of nonprofit regulation and governance, recent actions by state attorneys general demonstrate their increasing willingness to tackle controversial issues of nonprofit law, including by reviewing how nonprofits fulfill their charitable missions and policing the line between permissible charitable activity and impermissible political activity.

State AGs can investigate whether a nonprofit is properly fulfilling its charitable mission.

Nonprofit corporations are governed by boards and managed by officers, who are ordinarily granted discretion in the fulfillment of their duties similar to what for-profit directors and managers are entitled under the business judgment rule. This rule presumes that these individuals act on an informed basis and in good faith.

It does not, however, grant blanket immunity. For example, as New York's Trump Foundation lawsuit showed, a board that never meets and has no policies cannot expect business judgment rule deference.

Yet the analysis becomes more complex where a functioning board takes actions that would be entirely reasonable for a for-profit institution, though can be viewed as counter to a nonprofit's charitable mission.

For example, Pennsylvania Attorney General Josh Shapiro initiated litigation against the University of Pittsburgh Medical Center, a nonprofit health care provider that had failed to renew a consent agreement with Highmark Inc., a for-profit insurer, that allowed Highmark insureds to access UPMC services.

Shapiro claimed UPMC was violating its charitable obligations by limiting the ability of patients insured by Highmark to access UPMC doctors and refusing to negotiate payment terms with self-insured employers. Although UPMC vigorously disputed this claim, Shapiro's lawsuit led UPMC and Highmark to enter into a 10-year consent decree ensuring Highmark subscribers' access to UPMC services and doctors.

State AGs are increasingly willing to investigate charities for engaging in political activity.

As discussed above, nonprofits operating pursuant to Section 501(c)(3) of the Internal Revenue Code are expressly disallowed from engaging in activity directly or indirectly related to political campaigning on behalf of — or in opposition to — a candidate for elected public office. Violating this prohibition can theoretically lead to severe consequences, including federal excise tax liability and revocation of exempt status.

Yet the IRS and the Federal Elections Commission have substantially scaled back their enforcement regarding nonprofits engaging in political activity. State attorneys general, which have broad authority to ensure that entities they regulate abide by all applicable laws, have stepped forward.

For example, Hawaii Attorney General Claire Connors is investigating KAHEA: The Hawaiian Environmental Alliance.[3] The attorney general subpoenaed the organization's bank records on the grounds that the organization failed to transmit a copy of its Form 990 to the attorneys general's office as required by state law.

The attorney general is also reportedly investigating the nonprofit's alleged use of donor funds to support activities of civil disobedience in a manner that may violate federal tax laws. This aspect of the investigation has drawn criticism, as some have asserted the attorney general should not investigate potential violations of federal tax law,[4] and the Hawaii Legislature has introduced a bill — S.B. No. 42 — that would prohibit the attorney general's office from investigating nonprofits for exercising rights by nonviolent civil disobedience.[5]

In addition, when it filed its lawsuit against the Trump Foundation in 2018, then-New York Attorney General Barbara Underwood referred the foundation to the IRS and Federal Elections Commission for potential violations of federal tax and elections law; those regulators have not taken any public enforcement action.

Although Underwood did not allege violations of federal law, her complaint led the state

court to examine Trump's 2016 Iowa fundraiser, an event in support of veterans. The court found that Trump had breached his fiduciary duty by using the fundraiser, and the funds it raised, to further his political campaign, and ordered him to pay $2 million to bona fide charities.

What nonprofits should learn from AG lawsuits.

The lawsuits the New York and D.C. attorneys general filed against the NRA and the Trump entities garner attention for their politics, but they should put all nonprofits on notice of the important governance principles they seek to vindicate. Against this backdrop of aggressive state attorney general enforcement, nonprofit boards and management should continuously consider key issues.

The basics matter.

Nonprofits must abide by registration and filing requirements in all relevant states.

Some states' regulations — such as New York's — are stricter than others. Both when incorporating and while operating, nonprofit fiduciaries must educate themselves on the laws of the states in which they are chartered, operate and fundraise to ensure compliance.

Proper board governance is essential.

Nonprofit boards should meet regularly, recording and preserving their meeting minutes. They should be particularly aware of the risks of related-party transactions, which can give rise to private inurement claims. In order to avoid these consequences and satisfy fiduciary duties, nonprofits should:

- Adopt a conflict of interest policy that defines conflicts, requires directors and officers to affirmatively disclose such conflicts, and outlines preventative and remedial measures.
- Mandate that conflicted parties recuse themselves from voting.
- Record minutes, noting the voting members and the actions taken to prevent conflicts of interest.
- Research fundraising, investments and contracts for potential bias and ensure that market rates are adhered to.
- Ensure that board composition is varied, including independent members and restricting a high percentage of related board members.
- Determine whether any state-specific procedural requirements exist concerning approval of related-party transactions. Prior to engaging in such transactions, it is important to review these requirements to ensure compliance.

Act in furtherance of the nonprofit's purpose.

A nonprofit's purpose — particularly a charity's purpose — is not mere words in a charter. In order to enjoy the discretion the business judgment rule or similar state statutory rules provide, trustees and officers must act in furtherance of that purpose. If a nonprofit's

activities expand from its stated charitable purpose or if the nonprofit's charitable purpose changes, the organization must ensure that the purpose for which it solicited charitable donations is consistent with their intended use.

Be mindful of the limits on political activity.

The Internal Revenue Code sets limits on political activity by nonprofit organizations. State attorneys general can indirectly enforce federal tax and election law using their powers as the primary regulators of nonprofits. Nonprofits should therefore remain mindful of these strictures even though federal enforcement has ebbed.

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[1] Lloyd Hitoshi Mayer, "The Better Part of Valour Is Discretion": Should the IRS Change or Surrender Its Oversight of Tax-Exempt Organizations? Columbia Journal of Tax Law, 7(1), 80, 82 (2016), https://journals.library.columbia.edu/index.php/taxlaw/article/view/2836.

[2] Brice McKeever, The Nonprofit Sector in Brief, National Center for Charitable Institutes (2019), https://nccs.urban.org/project/nonprofit-sector-brief#overview.

[3] http://www.kahea.org/e-holomua-kakou-update-on-ag-subpoena-of-kaheas-bank-records.

[4] https://www.civilbeat.org/2020/01/hawaii-ag-wrong-to-subpoena-protest-groups-records.

[5] https://www.capitol.hawaii.gov/measure_indiv.aspx?billtype=SB&billnumber=42&year=2020.