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Combating Charitable Fraud: An Overview of State and Federal Law

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Summary

In the wake of the September 11 attacks and the more recent Hurricane Katrina disaster, major charitable organizations such as the American Red Cross and the United Way began raising money for the victims and the victims' families. A number of smaller, lesser known organizations were also formed to respond to the needs of victims. There is concern that some of these organizations may not be legitimate charitable organizations, and that professional fundraisers for other organizations may be engaging in unfair or deceptive activities. Reports indicate that some organizations claiming to represent relief workers, including police and fire departments, were not engaged in legitimate fundraising activities. Other organizations allegedly failed to use contributions to aid the victims' families.

This report will provide a brief overview of the regulation of charitable fundraising and federal and state government efforts to combat charity fraud, including state statutes requiring the registration of charities and professional fundraisers and statutes addressing fraudulent solicitations. This report will also discuss a relevant Supreme Court case and Federal Trade Commission actions against fundraisers under the Federal Trade Commission Act. The report will be updated as developments warrant.

Regulation of Charitable Fundraising

While the federal government does not directly regulate fundraising for charitable purposes, actions may be taken against those who engage in deceptive practices or attempt to defraud consumers through telephone solicitations or prize promotions. Fundraising activities by charitable organizations may also be regulated at the state level, usually by the state attorney general.

In addition to governmental regulation, many organizations in the private sector, working with charitable organizations and consumers, seek to prevent charitable fraud. Organizations such as the Better Business Bureau's Wise Giving Alliance collect information on charitable organizations and develop standards to promote ethical practices by philanthropic organizations.¹ The Council of Better Business Bureaus promulgated these standards in an effort to "inspire public confidence, further the growth of public participation in philanthropy, and advance the objectives of responsible private initiative and self-regulation."² These standards include the voluntary disclosure of an organization's activities, finances, fund raising practices, and governance.³

Federal Action and Laws Aimed at Preventing Charitable Fraud

Several provisions of Title 18 can be used to take action against individuals who use the U.S. mail, interstate telephone or wire communications, or credit card schemes to defraud charitable donors.⁴ Penalties for these deceptive practices include imprisonment for up to 30 years.⁵ Title 18 further provides that it is a federal felony for an individual to falsely or fraudulently represent himself to be a member or agent of the American Red Cross for the purpose of soliciting or collecting money.⁶ Punishment under this provision can lead to a five year prison term.⁷

Additionally, Congress enacted antiterrorism legislation (P.L. 107-56) in 2001 that included a provision targeting fraudulent charitable solicitations. This provision, entitled Crimes Against Charitable Americans, requires telephone solicitors' to "promptly and clearly disclose" that the purpose of the call is to solicit donations.⁸ Solicitors' must also reveal the name and address of the charitable organization on behalf of which the solicitation is being made.⁹

In the aftermath of Hurricane Katrina, Attorney General Alberto Gonzales took action to combat charitable fraud by establishing the Hurricane Katrina Fraud Task Force.¹⁰ The purpose of the Task Force is to deter, investigate and prosecute crimes aimed at defrauding

¹ See [<http://www.give.org>]. Other organizations that collect information on charitable organizations include the Philanthropic Advisory Service, National Charities Information Bureau, and the American Institute of Philanthropy.

² The standards promulgated by the Council of Better Business Bureaus can be found at [<http://www.give.org/standards.cbbbstds.asp>].

³ *Id.*

⁴ 18 U.S.C. §§ 1341, 1343 and 1029.

⁵ *Id.*

⁶ 18 U.S.C. § 917.

⁷ *Id.* This section was amended by P.L. 107-56 § 1011 to carry a five year prison term instead of the original one year.

⁸ P.L. 107-56 § 1011. This section amended the Telemarketing and Consumer Fraud and Abuse Prevention Act (15 U.S.C. § 6101) to include fraudulent charitable solicitations.

⁹ *Id.*

¹⁰ See [http://www.usdoj.gov/opa/pr/2005/September/05_ag_462.htm].

would-be donors to charitable causes.¹¹ The Task Force includes members from the FBI, the Federal Trade Commission, the Postal Inspector's Office and the Executive Office of the United States Attorneys.¹² The Task Force works with state and local officials to identify and track fraudulent charities.¹³

State Laws Aimed at Preventing Charitable Fraud

Many states require charitable organizations and professional fundraisers soliciting within the state to register with the state attorney general's office or the secretary of state's office.¹⁴ Registration of charitable organizations may involve providing such information as the name of the organization; the purpose for which it was organized; the principal address of the organization and the address of offices in the state; the names and addresses of the chief executive officer, chief financial officer, directors, trustees, officers, and board members; the names and addresses of chapters, branches, or affiliates in the state; evidence of the organization's tax-exempt status; and the general purpose for which the solicited contributions are to be used.¹⁵ Professional fundraisers may be required to provide such additional information as whether the professional will at any time have custody or control of the contributions, a statement of professional fees and how fees are to be calculated, and information concerning the contract between the organization and the professional fundraiser.¹⁶ In general, states prohibit unregistered organizations from soliciting in the state.¹⁷

Some states broadly define charitable fraud as a deceptive trade practice, and fraudulent solicitations are sanctioned under the state's general consumer protection or deceptive trade practices law.¹⁸ Other states have enacted statutes specifically addressing fraudulent charitable solicitations. In general, state statutes prohibit a solicitor from engaging in "any fraudulent or illegal act, device, scheme, artifice to defraud or for obtaining money or property by means of a false pretense, representation or promise."¹⁹ Solicitors are generally required to identify themselves and the organization for which the solicitation is being made.²⁰ Solicitors may also be required to disclose how the funds

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *See, e.g.,* Colorado, C.R.S. 6-16-104; South Carolina, S.C. Code Ann. § 33-56-30; Illinois, 225 ILCS 460/2.

¹⁵ *See, e.g.,* S.C. Code Ann. § 33-56-30; 225 ILCS 460/2.

¹⁶ *See, e.g.,* C.R.S. 6-16-104.3.

¹⁷ *See, e.g.,* New Jersey, N.J. Stat. § 45:17A-23; New York, NY CLS Exec § 174.

¹⁸ *See, e.g.,* Arkansas, A.C.A. § 4-88-108.

¹⁹ NY CLS Exec § 172-d(2). *See also* North Dakota, N.D. Cent. Code, § 50-22-04.3; West Virginia, W. Va. Code § 29-19-13; Delaware, 6 Del. C. § 2595.

²⁰ *See, e.g.,* Delaware, 6 Del. C. §2595(b).

being solicited will be used,²¹ and in cases where a professional fundraiser is being used, what percentage of the proceeds will actually go to the charitable organization itself.²² It may also be a violation of law for a solicitor to use a charitable organization's name without the consent of the organization.²³

Penalties for charitable fraud vary by state, with some states prosecuting fraudulent activities as criminal cases and others imposing civil fines. For example, California criminally prosecutes cases of fraudulent solicitation, and violations are considered a misdemeanor "punishable by imprisonment in the county jail for not more than one year, by a fine not exceeding five thousand dollars, or by both that imprisonment and fine."²⁴ In New Jersey, violations of the charitable fraud statute are subject to civil penalties of up to \$15,000, while penalties for violating administrative orders enforcing the statute can reach \$25,000.²⁵ Using a hybrid approach, Colorado imposes both civil and criminal penalties for violations of its Charitable Solicitations Act depending on the nature of the violation.²⁶

Recently, states have begun to enact new legislation to impose tighter restrictions on public charities.²⁷ Some recently enacted measures include requiring charities to register annually with the Department of Consumer Protection, rather than just once.²⁸ In addition, many states are requiring charities with annual revenues in excess of a certain amount to form an audit committee and require the chief executive officer to certify the financial statements.²⁹ Other states are increasing oversight and accountability by requiring charities to spend a certain percentage of their budget on the charitable purpose that is the basis of their Internal Revenue Code Section 501(c)(3) tax-exempt status.³⁰

Supreme Court Decision on First Amendment Issue

In *Illinois ex rel. Madigan, Attorney General of Illinois v Telemarketing Associates, Inc.*, the Supreme Court considered a state Attorney General's ability to sue a for-profit fundraising corporation for affirmatively misrepresenting the amount of each dollar that

²¹ See, e.g., West Virginia, W. Va. Code § 29-19-13(c).

²² See, e.g., Pennsylvania, 10 P.S. 162.15(A)(9).

²³ See, e.g., Georgia, O.C.G.A. § 43-17-12(c)(7).

²⁴ Cal Pen Code § 532d(a).

²⁵ N.J. Stat. § 45:17A-33(k).

²⁶ C.R.S. 6-16-111.

²⁷ See *As States Attempt to Ramp up Oversight of Public Charities, Some Look to Sarbanes-Oxley as Model for Audit Requirement, September 13, 2005, available at* [<http://www.ippubs.bna.com/NWSSTND/IP/BNA/dtr.nsf>] [BNA article].

²⁸ BNA article; see, e.g., Connecticut, S.B. 946.

²⁹ BNA article; see, e.g., Connecticut S.B. 946; New Jersey, S.B. 204; New York, H.B. 7825.

³⁰ BNA article; see, e.g., North Carolina, H.B. 119.

would be donated to the charitable nonprofit.³¹ In *Telemarketing Associates*, a for-profit fundraising corporation (Telemarketing Associates) contracted with VietNow National Headquarters to solicit donations to aid Vietnam veterans.³² The contract provided that the fundraisers would retain 85% of the proceeds from the donors.³³ The Illinois Attorney General brought a fraud action in state court alleging that the fundraisers knowingly misrepresented to donors that a significant amount of each dollar donated would be paid over to VietNow.³⁴ Telemarketing Associates responded with a motion to dismiss, asserting that the First Amendment’s prior restraint principle barred any attempts to restrain charitable solicitation based on the percentage of donations the fundraisers would retain.³⁵

The Supreme Court held that states can maintain fraud actions when fundraisers “make false or misleading representations designed to deceive donors about how their donations will be used.”³⁶ For example, affidavits attached to the complaint revealed that Telemarketing Associates deliberately misled potential donors into believing that 90% or more of their contributions would go to the veterans.³⁷ The Court noted that the First Amendment protects against attempts to ban charitable solicitations based solely on high fundraising costs.³⁸ However, the First Amendment does not shield fraud.³⁹ The Court concluded that the state can maintain a fraud action as long as the complaint emphasizes a false or misleading representation and not just a failure to disclose information or an action based entirely on the amount of the solicitors’ fees.⁴⁰

Federal Trade Commission Actions

The Federal Trade Commission (FTC) enforces the Federal Trade Commission Act, which declares unlawful “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce.”⁴¹ While the FTC does not generally regulate charitable organizations,⁴² the Commission has used the unfair and

³¹ 538 U.S. 600 (2003).

³² 538 U.S. at 605.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 609.

³⁶ *Id.* at 624.

³⁷ *Id.* at 608.

³⁸ *Id.* at 624.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ 15 U.S.C. § 45(a)(1).

⁴² The FTC Act applies to “persons, partnerships, or corporations” that may use unfair or deceptive practices, with corporation being defined by statute as an entity “which is organized to carry on business for its own profit or that of its members.” 15 U.S.C. § 44. Thus, on its face, the FTC Act does not appear to apply to non-profit organizations. However, the FTC may assert

deceptive trade practices provisions of the act against solicitors who engage in deceptive or fraudulent solicitations on behalf of charitable organizations.

The FTC's jurisdiction over those making solicitations on behalf of charities and the activity of charitable fundraising itself were challenged in *Federal Trade Commission v. Saja*.⁴³ In *Saja*, the FTC brought an action against the defendants for violations of section 5 of the FTC Act in connection with solicitations on behalf of a non-profit organization. The FTC alleged that the defendants "repeatedly and deliberately acted outside the scope of the contractual authority delegated to them by the non-profit organization, failed to correct problems occasioned by their unapproved solicitations, deliberately deceived consumers, and allowed such deception to flourish unchecked in their subcontractors' phone rooms."⁴⁴ The defendants responded with a motion to dismiss challenging the FTC's jurisdiction over them and their fundraising activities.

The court denied the defendants' motion to dismiss, rejecting the jurisdictional challenges. In response to the argument that the FTC has no jurisdiction over non-profit organizations, the court noted that the defendants themselves were a for-profit organization. The court held that the defendants' status as fundraisers for a non-profit organization did not create a non-profit status for them, thus the FTC's exercise of jurisdiction was proper.⁴⁵ The defendants also argued that the FTC had no jurisdiction over charitable fundraising activities because such activity is not "in or affecting commerce" as required under the FTC Act. The FTC argued that the defendants' activities did affect commerce because donations were solicited throughout the country over interstate telephone lines and pledges were collected through interstate channels. The court found these interstate connections were sufficient to grant FTC jurisdiction over the defendants' fundraising activities.

⁴² (...continued)

jurisdiction over charitable organizations if the organization's activities resemble the activities of a business. See Nicholas Barborak, *Saving the World, One Cadillac at a Time: What Can be Done When a Religious or Charitable Organizations Commits Solicitation Fraud?*, 33 Akron L. Rev. 577, 589 (2000).

⁴³ 1997 U.S. Dist. LEXIS 17225 (1997).

⁴⁴ *Id.* at 2.

⁴⁵ *Id.* at 4.