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10 Years Later

**UCC case changed fundraising contracts**

By Mark Hrywna

There are some things that simply evoke a visceral reaction from people. When it comes to fundraising, two phrases seem to do the trick: United Cancer Council and Watson & Hughey.

It's been probably 10 years -- or more -- since you might have thought about those phrases. It was February 1999 when a federal appellate court reversed an Internal Revenue Service (IRS) decision to revoke the tax-exemption of United Cancer Council (UCC) in Indianapolis, Ind., essentially a reprieve from a charity death penalty. By that spring, the case was settled for good after almost a decade tied up in litigation. It started with the IRS's revocation in 1990, continued into Tax Court, and set in motion a series of changes all around the charitable and fundraising world while raising the question of just how far government would go in regulating charity.

Many said the case of UCC directly led to the creation of intermediate sanctions and excess benefit transaction regulations. Section 4958 of the Tax Code, adopted during the summer of 1996, offered a middle ground for the IRS rather than an all-or-nothing approach of revoking a charity's tax-exempt status. As a result of UCC and other cases during the 1980s and 1990s, states began requiring more disclosure and transparency while cooperative mailing rules redefined relationships between charities and professional fundraisers.

A lockbox that sent fundraising appeal revenue directly to a charity, and not the fundraiser, was one of the provisions in the great debate on cooperative mailing rules, according to Neal Denton. He was executive director of the Alliance of Nonprofit Mailers in 2003 at the time the U.S. Postal Service enacted the rules. "An important ingredient is where the check goes to," Denton said.

The cooperative mailing rules helped to ensure that the mail piece really was the product of the nonprofit and not the commercial entity raising money and hiding behind a nonprofit mission, he said.

"We were always advocating for even more stringent rules to ensure that only nonprofits had access to that preferred postal rate, and they could still have a commercial agent relationship with a printer or professional fundraisers," said Denton, who today is senior vice president, government relations and strategic partnerships, for the American Red Cross.

Similar issues resurfaced in early 2008 when Congressman Henry Waxman, chairman of the House Oversight and Government Reform Committee at the time, took aim at several nonprofits that served veterans but came under accusations of self-dealing and questionable spending practices.

"It's an issue that's still around," Denton said, whether a commercial entity has created a separate nonprofit, built a fundraising business around it, or even usurped the mission of an existing organization, and ends up taking advantage of the nonprofit.

Darryll Jones, a professor at the Stetson University College of Law in St. Petersburg, Fla., said there has been little effect on the "cottage industry of raising money using a nonprofit's name" since the UCC case, with some fundraisers still getting as much as 90 percent of the money raised. "The status quo is the same these days, just not on such a conspicuous level," he said. Perhaps fledgling nonprofits have no choice but to rely on professional fundraisers, Jones said, however it has resulted in some "erosion of the nonprofit halo" because of an "almost prostituting of a nonprofit's name."

The story starts in 1983, when UCC, then an umbrella organization of former American Cancer Society (ACS) chapters that was created 20 years earlier, was struggling financially. The UCC board, made up of about two-dozen people including doctors, judges and accountants, agreed to an exclusive, no-risk, five-year contract with the fundraising company Watson & Hughey.
Under the contract, the firm would be responsible for any outstanding debt if the mailings failed to raise enough money to cover costs. Watson & Hughey had access to UCC's prospect list while the charity agreed to not sell or lease the list. No direct mail fundraising solicitations could be mailed without UCC's prior approval and, according to court records, UCC refused to mail some solicitations or changed some of the proposals.

Watson & Hughey mailed some 80 million pieces for UCC in a campaign that featured educational materials and sweepstakes offerings during the next five years. While nearly $29 million was raised, fundraising expenses accounted for more than $26 million.

UCC applied more than $12 million to program services, netted slightly more than $2 million in cash, and was left with a donor list of more than 1.1 million names. Meanwhile, Watson & Hughey collected $4 million in fees and $4 million went to its list broker division, Washington Lists. Another $7.5 million was spent on postage.

After the Watson & Hughey contract expired in 1989, UCC took its 1.1 million names and retained another fundraising firm. By June 1990, however, the charity filed for Chapter 7 bankruptcy. Later that year, the IRS revoked UCC's tax-exemption retroactive to June 11, 1984 -- the start of the Watson & Hughey contract -- and ordered it to repay $175,000 in retroactive taxes. The decision was challenged in Tax Court and a trial ensued during the early 1990s before the court backed the IRS in 1997.

UCC appealed again, this time to the 7th Circuit Court of Appeals in Chicago, which covers Indiana. In a ruling in early 1999, a three-judge panel found Watson & Hughey not to be an insider of the charity and thus, there was no private inurement. The 7th Circuit remanded the case back to the Tax Court, which had not considered the IRS argument about private benefit. Within several months, however, a settlement was reached, with the UCC paying an undisclosed sum to the IRS and donating its remaining assets to other health charities with no relationship to Watson & Hughey.

Today, Watson & Hughey is known as Direct Response Consulting Services. The McLean, Va.-based fundraising firm changed its name in 1992, something principal Jerry Watson said was because "it sounds more like what we do," and not because of numerous lawsuits and settlements during the early 1990s.

Watson insists that new charities that don't have any money still will have a difficult time getting started, adding that, like any business, charities need repeat customers, or in their case donors, to survive. "You have to advertise, you have to get them in the door. If people could raise money easily for charities, you would have them (charities) popping up on every corner," he said. It makes it difficult to get new organizations off the ground, Watson said, and adding to that is that mailing is expensive, even at nonprofit rates.

Watson estimates there are only a certain number of people who will regularly donate to charities while others won't, at least not without some incentive. "The reason people do sweepstakes, is those people are totally different, they're not day-to-day givers. It's a way for charities to reach out, get their message out" to new donors.

"None of the regulators like the high cost, but you have to spend money to make money," said Watson, especially when these smaller nonprofits are competing against larger, well-established charities. For large organizations, like the American Cancer Society, Watson believes gifts from wills and estates dilute fundraising expenses. "Young charities will be way out of whack until they're established," he said.

It was not uncommon for state regulators to take aim at Watson & Hughey during the late 1980s and into the 90s for high fundraising expenses or alleged unfair business practices. The firm settled a dispute about its sweepstakes mailings with attorney generals around the country.

Watson said it was common for nonprofits to have no-risk contracts back then, having adopted the model from political campaigns. The contracts were among the evolutions from the UCC litigation, along with joint list ownership between charities and fundraisers. "It's just not worth it. It's too expensive worrying about that, the time and mental resources," Watson said of no-risk contracts. "If that's what IRS wanted to do, to stop those no-risks contracts, you could say they succeeded," he said.

After the UCC case, regulators "kind of threw in the towel around that point on trying to regulate the fees that fundraisers can charge," said Cynthia Rowland, an attorney with Coblentz, Patch, Duffy & Bass in San Francisco. The Internet has allowed attorneys general, especially in larger states, to provide the public information about how much commercial fundraisers are paid. That's led to a shift from the IRS trying to enforce limitations, she said, to state charity officials using the marketplace to educate the public about charitable solicitations.
States have become more assertive in requiring registration by commercial fundraisers, requiring annual reports and monitoring. “There’s more oversight of who’s in the state fundraising but it’s not a backlash on the amount, or percentage, of the charitable funds raised kept by fundraiser,” Rowland said.

Belinda Johns, senior assistant attorney general for charitable trusts, California attorney general’s office, said the UCC case was big for the IRS, but regulators already knew they could not shut down an organization based solely on fundraising expenses after the 1988 U.S. Supreme Court decision in Riley v. National Federation of the Blind. That case helped deal with constitutionality issues, framing complaints toward fraud and unfair business practices about solicitations that mislead or had a tendency to mislead consumers/donors. “People were told their money would be used for a cancer institute, or whatever, and so much of the money was going to the fundraisers that they couldn’t possibly do what they say they were doing,” Johns said. “It’s still the basis for cases today, and we still see it,” she said.

Mark Fitzgibbons, vice president of corporate and legal affairs at American Target Marketing in Manassas, Va., is a frequent critic of state regulators. Using fundraising costs as a gauge can be misleading, he said, especially when comparing charities that get funding from government or foundations. “States focus on how much money it costs to raise a dollar, but they’re not focusing on the federal taxpayer money that goes to charities, or the foundation money that goes to charities,” said Fitzgibbons. The standards that states use are not only misleading, he added, but harmful for donors because a charity that does not accept taxpayer money will have higher costs to raise a dollar.

States have not only prompted more disclosure, Fitzgibbons said, but they’re regulating terms of contracts. That’s a problem for nonprofits trying to raise money nationally because if 41 states regulate the professional fundraising relationship with charities, he said, and decide to regulate contracts, it can add conflicting terms.

Issues that arose during the initial UCC trial led to the IRS “needing other tools to deal with some of the other compensation issues,” said Kelly Browning, executive vice president and chief operating officer at the American Institute for Cancer Research (AICR) in Washington, D.C., and volunteer chair of the Direct Marketing Association. Intermediate sanctions established in 1996, giving the IRS other avenues rather than revocation of exempt status, “by and large have been pretty effective,” he added. Some credit could also be given to the UCC case for revisions to the IRS Form 990, Browning said, which had been a work in progress for many years.

Watson said he founded the AICR in 1982 but relinquished all relationships with the nonprofit a few months later. Today, the charity spends upward of half a million dollars annually with the firm. AICR has never had a no-risk contract with Direct Response or Watson & Hughey, Browning said, adding that its contract has been held up as a model for charities and fundraising firms.

Everything the IRS lost in court, it practically won on because the UCC case became the genesis, in part, for intermediate sanctions, said Errol Copilevitz, a partner with Copilevitz and Canter in Kansas City, Mo. When the government lost, “it created a heightened awareness in institutionalizing some of the positions the government wanted to take while UCC only will be remembered for their case,” he said.

“The irony is that the IRS thought by revoking their exemption there wouldn’t be pushback because UCC was in bankruptcy,” said MacKenzie Canter III, who represented the charity in Appellate Court. It set a precedent of sorts, he added, with a legal defense fund established that gave UCC the resources to contest the revocation.

“Really, it was pretty isolated on the facts of that case, I don't think it had broad implications other than one point: it's an arm's length negotiation, not tainted by private inurement or private benefit, if both parties believe they were negotiating in their best interest,” Canter said.

Marc Owens, an attorney with the Washington, D.C. office of Caplin and Drysdale, was director of the Exempt Organizations Division of the IRS from 1990 to 2000. Though the private inurement issue was addressed by Congress, Owens said the UCC case never moved the issue of private benefit forward. The case “reflects the continuing difficulties of the IRS in dealing with the private benefit concept,” he said, which has not been addressed in any regulations by Congress, Treasury, or the IRS. “The fact that the case never got to the private benefit analysis, either in Tax Court or the 7th circuit, before it was ultimately dealt with, reflects longstanding problems with the way the IRS defines private benefit in the context of charity,” he said.

"It's an example of the sort of fundraising contract that states and the FTC (Federal Trade Commission) had been struggling with for years and continues up until now," Owens said.
Bruce Hopkins, a partner with Kansas City-based Polsinelli Shalton Flanigan Suelthaus, contends that the decision is essentially pointless these days. He's been a critic of the 7th Circuit decision over the years, labeling it "a disaster."

"It really is one of the worst court opinions in my opinion that has ever been issued," said Hopkins. "Ten years later, it's of no consequence," he said because intermediate sanctions have superceded it.

In the initial Tax Court decision, the judge found Watson & Hughey to be an insider and that the fees paid were excessive, Hopkins said, so there was alleged to be private inurement. Hopkins says he believes UCC and Watson & Hughey was a "classic private inurement, excess benefit transactions situation," creating charities and then making them their clients and charging high fees.

Once the Tax Court ruled the fundraising company to be in control of the charity - which was pretty radical in its day - Hopkins said it then only had to show that the fees were excessive. "The 7th Circuit didn't see it that way and that's where the 7th was completely wrong," Hopkins said.

Judge Richard Posner, who wrote the 17th circuit decision on behalf of the three-judge panel, said that he did not recall details of the case when contacted by The NonProfit Times.

It's rare that one party could be deemed in control of a charity today, Hopkins said, but it can happen and when it does, it would be covered by the intermediate sanctions rules.

Indianapolis-based attorney James Curtis Jr. started representing UCC in 1986, one of several attorneys for the organization. "In the latter part of the '80s, all nonprofits were being scrutinized more about cost versus program dollars," he said. The changes that were coming about, in terms of more scrutiny, led to more disclosure requirements on Form 990, according to Curtis.

"One of the allegations of the government was that we were just an alter ego for Watson & Hughey, and there couldn't have been anything further from the truth," Curtis said, adding that UCC had constant fights with the firm over what it wanted, how it wanted mailings done and the cost.

Whether the issue began with UCC or even earlier, Denton said, it's been debated back and forth over the years: the balance between the role of the commercial entity working with a nonprofit using their direct marketing expertise to help, versus the point at which it becomes the commercial entity's campaign instead of the nonprofit's. NPT