What's Keeping You Up at Night?  
2016 Hot Topics in Non-Profit Governance

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This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.
As in life, when running a tax-exempt organization, S-H-#-@ happens. The key is to avoid as many of the problems as possible, or, if they do occur, limit their negative impact. Another goal should be to make sure, if something goes wrong, that you have done what is feasible and legally required to have avoided any foreseeable problems.
More Background

- **What to address and when?**
- **Know what is required of management and the board (i.e., satisfying fiduciary duties).**
- **Identify high-risk areas.**
  - For example, if your organization regularly holds highly sensitive personal data, then invest in cyber security technology and insurance.
  - In allocating resources, address high risk, highly likely events first, and then work your way down the continuum.
- **Other potential priorities:**
  - Low risk problems that constantly pop up.
  - Significant disruptors/organization killers which are not highly likely but would be devastating if they occurred.
- **Put necessary policies in place and follow them.**
Fiduciary Duties: You Know the Basics

- Officers and directors owe a fiduciary duty to the nonprofit organization.
- The fiduciary duties are: the duty of care, the duty of loyalty and the duty of obedience.
- In fulfilling their duties, officers and directors must act in the best interests of the Organization (e.g., work to fulfill the Organization’s tax-exempt purposes and maintain its tax-exempt status).
  - The Board is ultimately in charge and is responsible for the overall financial health and mission of the Organization, while avoiding micro-managing the staff.
  - Management is responsible for day-to-day operations, ensuring the Organization furthers its exempt purposes and making the Board aware of significant risks (financial, programmatic, reputational) and working with the Board to address such risks.
Fiduciary Duties: Duties of Obedience and Care

- **Obedience**
  - Officers and directors must not engage in *ultra vires* acts – acts that the corporation, under its charter and applicable law, cannot perform because such acts are prohibited or beyond the scope of the corporation’s powers.

- **Care**
  - Devote time, exercise ordinary diligence, and use reasonable judgment to ensure the organization is run prudently and with due regard for its tax-exempt purposes.
Fiduciary Duties: Duty of Care and Financial Management Obligations

- **Oversight.** In the vast majority of cases in which nonprofit directors have incurred liability relate to investments, it is **not** because the investments made simply underperformed, but rather, it is because the directors delegated investment responsibility to an investment advisor, a board/staff member, or committee, and then failed to oversee or supervise that person/entity.
  - “Hey, we just put this great investment advisor in charge of all our money. His name is Bernie Madoff.”

- **Delegating or Abdicating Authority.** While it is not unusual for a nonprofit board to delegate investment responsibility (e.g., to a committee or individual director, or outside advisor), boards should document such a delegation, be clear as to the scope of the delegation, and clearly delineate investment criteria and goals.
  - Board must still monitor investment activities to make sure the delegated authority is being exercised in a prudent and reasonable way.
  - Review overall performance, balance/asset allocation, risk allocation, and perhaps link to mission.
Fiduciary Duties: Duty of Loyalty

- The duty of loyalty requires a director to act *solely* in the best interests of the organization rather than in his or her own interests, or those of his or her associates.
- One important aspect of the duty of loyalty is to retain the confidentiality of information that is explicitly deemed confidential by the organization, as well as information that appears to be confidential from its nature or matter.
- The duty of loyalty also encompasses a director’s obligation to avoid conflicts of interest.
  - For a director, a violation of this duty may result in personal liability for a breach of fiduciary duty.
- For the organization, such a breach may allow a court to void the corporate transaction in which a conflict was present.
Fiduciary Duties:
Duty of Loyalty and Conflicts of Interest

- In general, a conflict of interest exists when the organization does business with:
  - a director of the organization;
  - another entity in which a director of the organization is also a trustee, director, officer, employee, consultant, or agent; or
  - another entity in which a director has a financial interest (a “financial interest” can generally be defined to include an ownership or investment interest in the entity with which the organization is contracting, or a compensation arrangement with such entity).

- To avoid even the appearance of a conflict of interest, a director may want to treat as a conflict any transaction between the organization and (i) the director’s spouse or domestic partner, or the director’s siblings, descendants, or ascendants (as well as the spouse or domestic partner of any spouse, descendant or ascendant), (ii) any entity in which such a relative is a trustee, director, officer, employee, consultant, or agent, or (iii) any entity in which such a relative has a financial interest.
Fiduciary Duties:
Duty of Loyalty and Conflicts of Interest

- In addition, the organization should have its own conflict of interest policy that must be followed.
  - Indeed, on the federal tax return (Form 990), tax-exempt organizations are now required to disclose whether they have a written conflict of interest policy; report whether officers, directors or trustees, and key employees are required to disclose annually any interests that could give rise to conflicts; and describe how the organization monitors and enforces compliance with the conflict of interest policy.

- If a conflict of interest is or may be present, the director must:
  - Disclose to the board of directors or relevant committee of the board the material facts as to his or her relationship or interest.
  - Not participate in any board discussion or vote, unless the organization’s board determines that the director may participate in such discussion or vote.

- If a director follows these disclosure and recusal procedures, a party challenging a transaction on the grounds of a conflict of interest/breach of fiduciary duty will face a heightened burden.
Governance Issues Keeping Me Up At Night

1. Charity Rating Organizations
   - Unique Issues for NFPs
2. Executive Comp/Board Compensation
3. Board Independence/CEO Dominance
4. General misconduct
Charity Rating Organizations

- For some nonprofits, especially those who rely heavily on donations from the general public, charity rating agencies play an important oversight role and obtaining and keeping that seal of approval is vital.
- Better Business Bureau Wise Giving Alliance and Charity Navigator are the two main accrediting/monitoring groups.
- BBB/Wise Giving Alliance has 20 standards covering Governance and Oversight, Measuring Effectiveness, Finances, and Fund Raising and Informational Materials.
- Charity Navigator evaluates Financial Health and Accountability and Transparency.
Charity Rating Organizations

- A slightly different model is used by Charity Watch, which does deep dives into the financial reporting of charities and provides a grade (A to F) based on the percentage of total expenses a charity spends on programing vs. total expenses and how much it costs the charity to raise $100.
  - Ideally, Charity Watch wants to see a program percentage of 75% or higher and “cost to raise” ratio of 25% or less (it costs $25 or less to raise $100).
  - Very limited focus

- Focus on fund-raising percentages and programmatic ratios is controversial; considered by some to be too narrow a focus.
Charity Rating Organizations

- The one-size-fits-all approach of rating standards may not work for all organizations.
- However, tracking performance against criteria of rating agencies, and using standards as a general guide, can be very effective tool in monitoring governance, even if rigid adherence to requirements is not possible or appropriate.
- Review standards offer a general list of best practices and an independent set of guidelines to point to if board, president or others resist imposition of governance standards.
Charity Rating Organizations

- Even if you disagree with the formulaic approach of the rating agencies, there are useful **lessons** to be gleaned from the rating agency standards.

- Guidance on the oversight authority of the board
  - Formal review of CEO at least every other year
  - Approves annual budget
  - Carefully monitors outside fund-raisers
  - Oversees finances, including by reviewing annual Form 990, audited financial statements, management letters (if any)
  - At least 5 board members and 3 evenly spaced meetings per year
  - Monitor conflicts of interest
  - Have approved method for monitoring and measuring effectiveness of organization’s programs
Charity Rating Organizations

- Financial oversight is key
  - Carefully monitor program spending (recommended ratio from 65-75% at minimum)
  - Have board-approved budget that is tracked throughout the year
  - Annual audits for larger organizations

- Ensure that the organization’s fund-raising activities follow legal requirements and best practices
  - All appeals should be accurate, complete and truthful
  - Have clear donor privacy policy and follow it
Executive and Board Compensation

- A common form of inurement or excessive private benefit is salaries or fees for service.
- Rather than revoke section 501(c)(3) (or 501(c)(4)) exempt status for paying excessive compensation, Congress introduced an “intermediate sanction” in 1996:
  - Previously, the IRS was hesitant to revoke exemption for isolated instances of improper benefits.
- Section 4958 imposes excise taxes on an “excess benefit transactions” between exempt organizations and “disqualified persons”:
  - Imposes excise tax penalties on directors, officer or senior management who receive excess benefits, and on directors and officers who approve such transactions knowing them to be excessive.
  - Can be imposed in lieu of – or in addition to – loss of tax exempt status!
Executive and Board Compensation

- An “excess benefit transaction” is any transaction in which the organization provides an economic benefit directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for the benefit.

- A “disqualified person” is any person who, at any time during the five-year period ending on the date of the excess benefit transaction, is “in a position to exercise substantial influence over the affairs” of the organization, as well as the family members of such a person and any entity at least 35% controlled by such a person or family member.
Executive and Board Compensation

- Excess benefit transactions must be “corrected” (i.e., the excess benefit amount repaid to the organization, plus interest)
- Must also pay excise taxes on the excess benefit transaction:
  - On the “disqualified person” who engages in an excess benefit transaction, 25% of the excess benefit amount;
  - On the disqualified person, 200% of the excess benefit amount, if the excess benefit transaction is not corrected; and
  - On any “organization manager” who knowingly participates in an excess benefit transaction, such as a member of a board of directors that approves the payment of an excess benefit, 10% of the excess benefit amount, subject to the limitation that the aggregate tax imposed on all organization managers for any one excess benefit transaction may not exceed $20,000
Beware of “automatic excess benefits!” If the organization did not clearly demonstrate contemporaneously in writing that it intended to treat the benefit as compensation for services, penalty taxes apply even if the payment (standing alone or in addition to other compensation) is reasonable.

- How to demonstrate intent: organization reports payment on tax return (Form 990, Form W-2, Form 1099), individual reports payment on return (Form 1040), approval by decision-making body (employment contract, Board meeting minutes, etc.)
- Common excess benefit transactions: paying for spousal travel for Board members, failing to include taxable fringe benefits on W-2s
- **Lesson:** For anything you pay for and provide to an employee or Board member (or family member of either), confirm its tax status.
Executive and Board Compensation

- Rebuttable presumption of reasonableness: a payment is assumed to be reasonable where the following conditions are satisfied
  - Compensation approved by a governing body composed of individuals without a conflict of interest (e.g., unrelated to and not subject to the control of the disqualified person)
  - Governing body obtains and relies upon appropriate comparability data in making decision
    - Ideally, data regarding similar benefits provided by comparable organizations compiled by a qualified, independent professional – though type of data may vary with size, sophistication of organization
  - Governing body documents the basis for its determination concurrently with the decision
- The IRS may rebut this presumption only if it develops contrary evidence regarding the comparability data the governing body relied upon
- **Lesson**: Have your Board approve compensation, using appropriate comparability data and documented in meeting minutes
While failed governance comes in many forms, one common form is the case of the dominant CEO. Usually, this CEO is, at least initially, very effective, but it then becomes all about him or her, and not about the organization. The dominant CEO frequently hand-picks board members who are friends or otherwise loyal to him or her. This type of CEO believes that the board reports to him or her, as opposed to the other way around. Staffers are frequently prevented or limited in their access to the board. Loyalty to CEO is valued above all else and that is reflected in advancement, compensation, access, etc.
Dominant CEO

- Remembering that the board is ultimately in charge of the Organization and should set “big picture” goals and parameters for the Organization, the CEO tries to marginalize the board, rather than keeping the board informed, working with the board to define the “big picture” and working with the staff to achieve this vision.

- Board members who challenge CEO or try to instill appropriate processes are also pushed out or isolated.

- **Lesson:** Put protective processes in place on Day One
  - Make sure that you have a process to elect independent and qualified board members
  - Have executive sessions *without* CEO at every board meeting, whether you need it or not, will give directors a chance to raise concerns when it is needed, without raising red flags.
Lessons cont’d:

– In these cases, it is vital for key staffers (GCs and CFOs in particular) to have independent access to the board (either Chair or Chair of Audit Committee or Finance Committee).

– Have a strong Audit Chair who oversees audit and have audit focus on areas that are high risk with CEOs like this (travel expenses, personal expense reimbursement, etc).

– Make sure CEO is reviewed by board each year, with a 360 review being done. Do not just include the usual suspects in the 360 review. Have a lower-level person from accounting, for examples, those closed out of the inner circle, et cetera.

– If whistleblower policies are in place and publicized, this is one way problems come to board’s attention, despite CEO’s control of the flow of communications from staff to board.
Management of General Misconduct

- Ensure that appropriate controls are in place, including regular and updated harassment, diversity and other employee-related trainings
- Evaluate effectiveness of financial reimbursement mechanisms and consider whether updates are appropriate
- Consider how the organization will manage public relations related to misconduct, i.e., internal investigation, media exposure, and reputational risks
- What happens and what do you do when the misconduct or general incompetence is at the board level?
  - Can you really go to the state Attorney General and turn your own board in?
  - What are the other options? Encouraging board turn over or expansion of the board?
Management of General Misconduct

- **Lessons:**
  - Identify and report to management and the board on key areas of risk and risk mitigation efforts
  - See prior lesson on Whistleblower Policy (have one and follow-up on complaints)
  - Take care in electing and training board members
  - Have crisis response plan in place so you are not searching for a PR firm or trying to figure out who to call when the New York Times calls for a comment on scandal/misconduct/etc.
  - Identify and monitor high risk areas (just a few common ones are use of organization credit cards, reimbursement policies and travel/entertainment)
  - May want to have developed good relations with key members of the press, AG’s office, rating agencies and others who can help in a moment of crisis
Speaker Biographies

James P. Joseph (Partner) is head of Arnold & Porter’s Tax practice. He represents clients on tax planning and litigation matters. Mr. Joseph represents tax-exempt organizations (including public charities, private foundations, and international nongovernmental organizations) in structuring and implementing complex charitable programs and business ventures. He provides advice to corporations and individual donors on charitable, advocacy-related, and political giving. On tax controversy matters, he has represented corporations, partnerships, tax-exempt organizations, and individuals in IRS audits, proceedings before the IRS Appeals Office, state-level audits and administrative hearings, and litigations in the US Tax Court and in federal district and appellate courts. Mr. Joseph is Co-Chair of the Lawyers’ Committee for Civil Rights Under Law.

Tamara Jack (Vice President, General Counsel & Corporate Secretary) is responsible for the legal affairs of IRD and its sister company, Blumont, Inc. IRD and Blumont are U.S. and foreign government contractors delivering innovative, evidenced-based, locally driven solutions that advance the aspirations of people, communities and institutional partners worldwide. Ms. Jack serves on the membership committee of the Association for Corporate Growth National Capital. She served on the Board of Directors of the National Capital Region chapter of ACC. She was an adjunct instructor at American University’s Washington College of Law, and has spoken at numerous conferences and written articles on various government contracting, M&A, governance, ethics and compliance, and international trade compliance issues. Ms. Jack has a Bachelor of Arts degree from American University and a Juris Doctor degree from American University’s Washington College of Law.

Robert Aronson (Senior Vice President and General Counsel) is responsible for providing and coordinating all legal services for National Rural Utilities Cooperative Finance Corporation, including governance and corporate matters, lending and capital markets transactions, and litigation. Ms. Aronson earned her B.A. degree (with high distinction) from The Pennsylvania State University and received her J.D. degree from The George Washington University School of Law. Aronson is a member of the District of Columbia and Maryland bars, and is a Corporate Counsel in the Commonwealth of Virginia. She is a member of the Non-Profit Forum for the National Capital Region Corporate Counsel Association.