

LAW OFFICES
ANDREW T. MIRSKY

TEL: (202) 339-0303 • FAX: (202) 339-0302
EMAIL: ANDY@MIRSKYLEGAL.COM
INTERNET: WWW.MIRSKYLEGAL.COM

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Part I of this article discusses five topics in nonprofit governance:

1. Audit and Compensation Committees; Auditors and Non-Audit Services
2. Annual Review Process for Board
3. Compensation Issues Generally
4. Conflicts and Interested Transactions, Staff Codes of Conduct
5. Disclosure Requirements

My focus is three-fold: (1) How developments in these areas are affecting – and will affect – nonprofit organizations, and what organizations are doing responsively and proactively, (2) the interplay of some of these areas, for example the relevance of standards for audit and compensation committees and implementation of conflicts policies and restrictions on excess compensation and (3) how state laws, and ideas on federal preemption through contemplated action in Congress, are impacting corporate governance for nonprofits.

Part II follows with a brief discussion of recent hearings and action taken in Congress, and state legislation in California and New York. In many respects, legislative and political action at the federal and state levels brings these governance topics into a cohesive whole. In Part I, I note the relevance and significance of various and state and federal proposals on the various governance topics discussed.

These topics are being addressed extensively in the press, in academia, in industry and accreditation organization pronouncements and elsewhere. As of this writing, for example, the U.S. Senate Finance Committee is imminently expected to draft a bill touching on numerous issues, although focusing on donor abuses. Independent Sector, a consortium of many organizations in the nonprofit sector, issued a report responding to various subjects addressed by Senate Finance in hearings last summer. The Independent Sector report dovetails with many of the recommendations made by accreditation groups and new or proposed state laws in New York and California. I discuss some of these recommendations here as well.

The impetus for governance reforms has been the legal and political environment illustrated and captured most prominently by the federal Sarbanes-Oxley law, although (a) the federal law applies, generally, to for-profit public companies only and (b) much energy for these developments has been generated from within the industry itself and from a litany of other federal and state government sources, including the IRS, Senate Finance and House Ways and Means Committees, the Independent Sector consortium, accreditation programs such as the Better Business Bureau's Wise Giving Alliance and various state charity bureaus.

This article is intended to be a survey, and I will discuss each of these topics in more depth in one or more articles to follow. Two important governance topics I do not discuss are Section 404 controls and the USA Patriot Act. I do not discuss here requirements under Section 404 of Sarbanes-Oxley, addressing financial controls. I also do not discuss here the impact on nonprofits of the USA Patriot Act, specifically the Patriot Act's provisions regarding terrorist financing. Much has

been written recently about the Patriot Act's chilling effect on nonprofit fundraising and grant-making, some of it overstated but some of it on the mark. The Treasury Department is expected to issue regulations (including safe harbors, possibly) addressing concerns for nonprofits about their sources and recipients of funds, including particularly reference to "watch" lists. Depending on client interest and feedback, I may write more extensively about this topic in the coming months.

An additional important topic to my nonprofit clients is the impact of these matters on small organizations. Most obviously, for example, are requirements for outside audits, which for many small organizations are not budgetarily practical. I will discuss in a separate article how small organizations can manage the impact of corporate governance reforms and best practices.

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If you have any questions about these developments and how they may impact your organization, please contact me at (202) 339-0303 or by email at andy@mirskylegal.com. Thank you.

Andrew Mirsky

Part I: Five Topics in Nonprofit Governance

1. *Audit and Compensation Committees; Auditors and Non-Audit Services*
2. *Annual Review Process for Board*
3. *Compensation Issues Generally*
4. *Conflicts and Interested Transactions, Staff Codes of Conduct*
5. *Disclosure Requirements*

1. Audit and Compensation Committees; Auditors and Non-Audit Services

Audits

Many nonprofits, although not just small nonprofits, are not independently audited by outside firms. It is an expense that is often considered unnecessary, or even a luxury beyond the book preparing and advisory services typically provided to smaller organizations by small- and medium-sized accounting firms. The trend here, not surprisingly, is toward more rigorous and formal engagement of independent auditors. Under federal law, nonprofits that receive federal grants of \$500,000 or more each year must have audits performed on their federal funds as well as the related programs supported by the funds (OMB Circular No. A-133). Various states require audits on nonprofits meeting specified financial thresholds, as do California and New York as discussed below.

Independent Sector noted in its interim report to Senate Finance that there is currently no IRS requirement for financial audits for nonprofits. Sarbanes-Oxley, as not specifically applicable to nonprofits, does not require outside audits for nonprofits. Independent Sector recommended to Senate Finance a requirement for financial audits similar to California's new requirement. Specifically, organizations with annual revenues of \$2 million or more should be required to have an independent audit performed, and organizations with revenues between \$500,000 to \$2 million should be required to have independent reviews performed. (Senate Finance staff issued a "Discussion Draft" last summer proposing a \$250,000 revenues threshold for audits and \$100,000 for reviews.) Independent Sector based its financial criteria on results of its survey of accreditation groups with audit threshold requirements for their member organizations, citing the identical revenue thresholds established by the Evangelical Council for Financial Accountability. The National Health Council, in its "Standards of Excellence: Good Operating Practices for Voluntary Health Agencies", requires an audit for accredited members, together with an annual report on financial operations prepared in conformity with generally accepted accounting principles (GAAP).

For organizations that do use outside auditors, recent government action (Sarbanes-Oxley) and industry best practices suggest some of the following: Periodic but regular rotation of outside auditors or auditing firms (required by Sarbanes-Oxley every 5 years); barring auditing firms from providing non-auditing services (including financial information systems, management and HR services, and legal services) or review of each case of proposed non-auditing services by outside auditors; requiring disclosure by the auditor of accounting policies and practices; prohibiting (or strictly curtailing) "revolving door" staff exchanges between the company and outside auditing firms.

For various reasons many organizations do not maintain financial and accounting records in accordance with GAAP, while the influence of private accreditation programs and other best practice advocates is pushing the industry toward consistent GAAP accounting.

Committees

Revenue thresholds reflect practical concerns about the costs of outside audits for large and small organizations alike. These services can be beyond budgetary practicality for small organizations. I will discuss this issue separately in a forthcoming article, including generally how smaller organizations can get ahead of corporate governance reforms. The problem for smaller nonprofits is tied to the role of an audit committee and questions of “independence” and conflicts of interest review in financial practices (the purview of the audit committee), summed up as this: Does the organization have mechanisms to properly vet conflict situations to the satisfaction and perception of outside stakeholders, including the public? Here, I note the following: Depending on size, organizations will or will not have outside audits conducted, and may or may not have separate audit committees of their boards. Nonprofit boards routinely use established financial committees, including audit but also investment, compensation and finance. A separate audit committee is strongly recommended as a governance mechanism to regulate the company’s external and internal audit processes, including receiving and investigating whistle-blower complaints about auditing or accounting matters.

Setting up an audit committee generally requires a revision to an organization’s charter to establish the committee and its responsibilities and authority. In a separate article, I will write more about the audit committee’s responsibilities. Under Sarbanes-Oxley rules for public companies, applicable by analogy, each member of a company’s audit committee must be a member of the board of directors and independent. For example, under Sarbanes-Oxley at least one member of the audit committee must meet a standard of “financial expert”, the definition of which is currently left to individual board discretion pending an expected SEC statement. (I discuss elsewhere company-instituted requirements of “financial literacy” for board members as part of newly implemented review processes for directors.) Sarbanes-Oxley defines “independence” of committee members in a commonsense way, but also in a way meant to be flexible, and includes barring separate compensation for audit committee service. A recent *Wall Street Journal* editorial lampooned what it deemed hyper-sensitivity to board member “independence” by the California Public Employees’ Retirement System (Calpers), regarding the companies in which it invests. Calpers evidently objected to former Senator Sam Nunn’s membership on the Coca Cola board because Senator Nunn formerly worked at a law firm that does business with Coke. The *Journal* warned against turning a “fetish” about independence into a threat to the availability to companies of willing and knowledgeable directors.

Lessons from extreme definitions of “independence” notwithstanding, good business practice and Sarbanes-Oxley do behoove nonprofits to ensure the independence of the members of board financial committees and, particularly, audit committees. Likely legislative recommendations of the Senate Finance Committee, various state charity laws and, most progressively, accreditation group best practice recommendations are moving the sector to act the same way.

A separate compensation committee is important in cases of highly compensated staff. As discussed separately below, IRS excessive compensation rules require that compensation have a “reasonable” relation to services provided. The *Chronicle of Philanthropy* recently called attention to new IRS automatic calls for justification to exempt organizations paying compensation of \$1 million and higher. An important factor in substantiating “reasonableness” in compensation decisions is approval of the compensation by a committee of disinterested members – in other words, a compensation committee. A related approach taken by many public companies has been implementation of regularly scheduled executive sessions of non-management directors which, as the *Wall Street Journal* recently profiled, “allow[s] frank discussions of such issues as chief executive performance and pay.”

Excessive compensation and benefits regulation is not necessarily an outgrowth of the Sarbanes-Oxley environment, but obviously raises a complimentary set of issues for nonprofit organizations that can be addressed in the same series of steps. I will discuss in greater detail the practical meaning of these developments in a separate article.

2. Annual Review Process for Board

A recent *Law.com* article noted that, in response to Sarbanes-Oxley recommendations for public companies, numerous high-profile nonprofits have adopted codes of ethics for board members. In addition to addressing relatively mundane matters including attendance requirements, these codes increasingly reflect the more progressive corporate governance philosophies post-Sarbanes-Oxley, namely: stricter conflicts-of-interest rules; limitations (or outright prohibitions) on director loans; obligations to refer corporate opportunities; and generally, formal adoption of common and state law fiduciary and loyalty duties, independence standards and, most interestingly, “financial literacy” requirements for directors. Many public companies have self-instituted financial literacy requirements for directors, ranging from required attendance at company-sponsored training sessions to outside continuing education requirements and mandated financial education certifications.

I will discuss these codes of ethics at greater length in a separate article. I will also include a sample code of ethics.

The Senate Finance Committee’s Staff Discussion Draft proposed its own statement of board duties, including standards of care and establishment of federal liability based on breaches of these duties. These duties are consistent with those under most states’ corporation laws, and mimic proposals for hiring and supervision requirements for independent auditors (discussed above). Three interesting proposals made by the Finance Committee staff are board duties to establish conflicts of interest policies, regulatory and liability compliance programs, and whistleblower procedures – each of which would be required to be confirmed on the 990. The staff also proposed granting the IRS authority to remove board members and any officer or employee of an exempt organization violating self-dealing, conflict-of-interest, excess benefits or private inurement rules, or charitable solicitation laws.

One of the practical problems for board committees (highlighted by the Calpers example cited above) is inability to recruit qualified members. At a recent meeting of the Nonprofit Coordinating Committee of New York (NPCC), a story was told of a partner at a New York law firm resigning from the board of a nonprofit. His concern was that his particular professional expertise would impose on him a higher duty of care in his board and committee activities than others not so qualified. In other words, he felt he would be penalized for his expertise. In a sense, this may be similar to common law debates over the “reasonable man” standard, where perhaps a NASCAR driver would be held to a higher standard of care on the road. Discussion that followed at NPCC raised the public policy counterweight in the corporate and particularly nonprofit environment, where evidently there is interest both at the federal and state levels in making director liability equal across the board. However, the Senate Finance Committee staff report suggests otherwise.

3. Compensation Issues Generally

Compensation issues have been among the most notorious highlights of recent corporate governance scandals, with public companies and in the nonprofit sector.

Compensation can be “excessive” when it involves compensation paid to a disqualified person, meaning someone in a position to exercise substantial influence over a nonprofit

organization. The compensation is not “reasonable”, usually described in terms of the value of compensation paid for like services by like organizations (i.e. other nonprofits and reasonably comparable for-profits). IRS regulations recognize a 3-part safe harbor to protect against “excess benefit” determinations in nonprofit compensation arrangements, essentially: (1) that compensation be approved by non-conflicted board members or a separate compensation committee, (2) that compensation be demonstrably researched and shown to be based on market comparability data including (but not only) compensation paid by other tax-exempt organizations, and (3) documenting the basis of compensation awards, including terms, participating decision makers from board and management, the comparability data used and any conflicts-of-interest. This would include disclosure on Form 990 or an amendment to a previously filed 990.

Again, I will write separately about processes, documentation, market comparisons, decision-maker non-conflicts and excess benefits generally. I will also write separately about IRS “intermediate sanctions”, applicable to 501(c)(3) and 501(c)(4) organizations, which penalize both individual compensation recipients and organization management for excessive compensation, as an intermediate remedy (hence the name) short of revocation of the organization’s tax-exempt status. Compensation that is deemed excessive can subject the receiving individual to an excise tax of 25% of the amount of the excess benefit, plus interest (or a tax of 200% of the excess benefit), plus a separate excise tax of 10% imposed personally on the organization’s managers who approved the excess benefit compensation. The *Chronicle of Philanthropy* reported last summer that the IRS is requiring organizations that pay any executives more than \$1 million in annual compensation, based on disclosure in Series 990 filings, to justify that compensation. The IRS is contacting such organizations and conducting “soft audits” (desk audits or non-site audits) seeking information to justify compensation determinations.

Congress’ Joint Committee on Taxation (JCT) in January issued its own recommendations for nonprofit sector reform, among which it targeted changes to the intermediate sanctions rules. The JCT proposed eliminating the rebuttable presumption of reasonableness in the safe harbor, proposing that the elements of the safe harbor instead be deemed to establish a minimum standard of due diligence. While the extent of this reform seems unlikely to come to pass at the federal level, it is worth noting that legislation proposed in New York State would grant power to the attorney general to challenge interested party transactions it deems objectionable. Presumably, the history of a compensation decision would be relevant, if not conclusive.

The Senate Finance Committee’s Staff Discussion Draft proposed extending most existing self-dealing rules to public charities (currently applicable to private foundations), and expanding the definition of “disqualified persons” covered by the rules. Disqualified persons would include an organization “with respect to which a disqualified person is a person of substantial influence.”

Already discussed was the importance of establishing audit and compensation committees, and their processes and functions. Companies, particularly in the public sector, have made more regular use of outside compensation consultants to structure compensation arrangements and/or audit compensation packages approved by compensation committees. An interesting example of a control on this: To avoid the obvious but notorious conflicts of consultants with ties both to management and to compensation committees, the New York Stock Exchange amended its listing requirements in 2003 to require that compensation committees retain sole hiring and firing authority with respect to such compensation consultants.

Like anything else, however, use of outside compensation consultants can be expensive and prohibitive for smaller organizations.

As a true governance matter, there is more to this for non-profits than simply the establishment of compensation committees or the engagement of outside consultants. There is the issue of making things actually work and matter. The methods of deliberation, comparison to industry standards, and other innovative attempts to tie compensation to mission achievement relate compensation issues to fundamental corporate governance concerns for nonprofits. The *Wall Street Journal* recently reported on Bristol-Myers Squibb's institution of "clawback" provisions in compensation packages for senior executives, mechanisms which penalize executives acting "in a [financial] manner detrimental to the company's interests." For nonprofits, here is a potentially powerful tool to tie executive pay to metrics like program establishment goals, fundraising, membership increases, and staff retention and satisfaction. This and similar tools likewise permit use of financial incentives to hold executives accountable for such matters as regulatory fines, accounting irregularities and improprieties, and undisclosed conflict transactions.

4. Conflicts, Interested Transactions Staff Codes of Conduct

Conflicts and Interested Transactions

Sarbanes-Oxley's rules against insider transactions and conflicts, generally, touch on existing laws and regulations on these subjects. Prominent among existing rules are application of IRS intermediate sanctions rules to compensation and transactions with board members and staff (discussed above). Included among reforms recommended by industry groups, possible forthcoming legislation and accreditation organizations: Prohibitions on personal loans to directors and executives (already prohibited under the District of Columbia's nonprofit corporation law, for example) or establishment of policies for formal board approval of such loans with appropriate documentation; full public disclosure (typically in current 990 filings, please see the discussion below on "Disclosure"); and disinterested board member approval.

Organizations that do not have formal conflicts-of-interest policies should very quickly adopt such policies, and just as importantly, ensure board endorsement and full, fair and consistent enforcement of policies by senior management. This too, will include effective use of audit committees to review actual transactions and enforce policies once implemented, and the services of independent directors in ensuring effective application and enforcement. Financial pressures can test the teeth of these sorts of controls, such as a down funding or grant-making environment and drop in dues revenue, or the influence of important board members and constituencies.

Conflicts policies seem relatively noncontroversial. Implementation, however, can be a classic case of good intentions causing unintended consequences. The *Washington Post* recently reported on ethics rules at the National Institutes of Health causing consternation at NIH itself and also across the science and business communities. NIH, like many federal government agencies, applies "gift" and similar rules prohibiting the acceptance of awards or prizes of more than \$200. In February, NIH issued new rules in response to a Congressional inquiry finding undisclosed outside consulting deals by 120 NIH scientists. Under the new rules, NIH scientists have felt compelled to resign from or refuse board positions with industry organizations, including unpaid advisory positions and posts with professional associations. The *Post* article reported that the policy has adversely impacted NIH's recruiting efforts, forced long-time researchers to disassociate from NIH, and chilled relationships between the agency and industry to the detriment of scientific and technological advancement.

As noted, the problem that elicited the NIH policy revision was a finding of undisclosed outside consulting deals by NIH scientists, where disclosure was the problem. The *Post* story also pointed out that the M.D. Anderson Cancer Center in Houston permits researchers to earn an

additional 50 percent of their Anderson salaries in outside consulting deals, perhaps highlighting the science community's interest in fostering relationships with industry.

I have examples of good conflicts policies which I will include in a separate article, covering conflicts and related issues. There, I will also discuss examples of typical trouble areas in conflicts-of-interests affecting nonprofits, which have acquired increased significance in light of recent regulatory scrutiny. I also discuss this subject further below in the context of recent state-level activity in New York and California.

Codes of Conduct for Nonprofit Staff

Broader ethical policies bring up the related issue of staff conduct and Codes of Conduct for nonprofit staff. Many exempt organizations have adopted (or updated if not previously adopted) Codes of Conduct for all organization staff. This is a governance practice that was not widely observed in the nonprofit community before the Sarbanes-Oxley era. Codes of Conduct elevate organizational conduct of staff to a level commensurate with that for judging board members and leadership, above expected ethical criteria to an equally important focus of attention for the public constituencies and other stakeholders in nonprofit organizations.

A Code of Conduct is more than a personnel policy for employees. It is a combination mission statement, acknowledgment of public purpose, code of ethical conduct and statement of fiduciary trust in charitable assets. While there is no reason the same philosophy cannot prevail in the for-profit world, a Code of Conduct would perhaps distinguish the nonprofit organization's governance standards from those of for-profit companies (private and public) responding to the same corporate governance pressures, at least as much as any other governance tool.

I will write more specifically about what a Code of Conduct should include in a separate article. I will also offer one or more examples of actual Codes for reference.

5. Disclosure Requirements

Under current law, annual filings of Form 990 must be made freely available to anyone requesting them. The nonprofit sector is famous for inconsistencies in accuracy, completeness, and timeliness of required filings – as well as public accessibility.

Penalties – sometimes severe penalties – are provided under current law, but seldom imposed and generally first among the casualties of under-budgeted IRS and state regulatory enforcement. This situation may be changing with increased scrutiny of the industry and the complimentary stepped-up nonprofit audit arm of IRS (though still under-appropriated). Electronic filing is one obvious improvement for the industry that should be adopted as part of best practices. Other important steps include making 990s electronically available for download via an organization's website and/or participating in aggregator-type databases such as Guidestar. Independent Sector, in its interim report to the Senate Finance Committee, recommended that the IRS mandate electronic filing of all 990s, with appropriate changes to eliminate certain information requirements that make electronic filing particularly burdensome for smaller organizations. Independent Sector also recommended parallel requirements for the 1023 application for recognition of tax exemption. Independent Sector has recommended against increasing penalties for noncompliance, instead advocating broader use of the IRS' power to suspend tax-exempt status for noncomplying organizations, including for example an organization that has failed to file two consecutive years.

Proposed legislation in New York would exempt organizations from having to provide copies of annual reports to the public if such reports are “widely available” pursuant to the applicable Internal Revenue Code rules, and the fact of that wide availability is stated in solicitation documents.

The Senate Finance Committee’s Staff Discussion Draft (to which Independent Sector’s proposals referred to above were responding) last summer proposed doubling penalties for failure to file the Form 990, tripling penalties for organizations with annual gross receipts over \$2 million and threatening loss of exemption (or other penalties, such as loss of eligibility for deductible contributions) for such failure for two consecutive years. These penalties would be in addition to increased penalties for failure to include required information on a Form 990. The Senate Finance staff also proposed increased requirements for 990 disclosure of relationships with taxable subsidiaries and other nonexempt organizations, and disclosure of the exempt organization’s financial statements (currently not required disclosure). The staff also recommended that unrelated business tax income returns (990-T) be made public.

While the IRS has stated since at least 2002 its goal of comprehensive and, ultimately, mandated electronic filings, electronic filing for Form 990 and Form 990-EZ is now available through a free service offered by the Urban Institute’s National Center for Charitable Statistics (NCCS), at www.efile.form990.org. Guidestar offers free software for a similar capability through its website, www.guidestar.org. The Senate Finance Committee’s staff proposed requiring the IRS to have electronic filing capability in place by January 1, 2006.

Corporate governance improvements, public policy and greater public accountability are addressed not just through implementation of conflict-of-interest policies and re-chartered (or chartered) audit committees. In addition, the concept of effective enforcement calls on nonprofits to publicly and adequately disclose the results of these policies. I will discuss these disclosure issues at greater length in a separate article.

Part II: Legislative Action in Congress and the States

1. U.S. House and Senate Committee Action

The Staff of the Senate Finance Committee issued a “Staff Discussion Draft” following the Committee’s hearings on nonprofits last summer. The Discussion Draft made a number of proposals consistent with reforms advocated elsewhere inside and outside of government, plus uniquely noteworthy reforms such as a five-year review of tax-exempt status by the IRS for all exempt organizations. Much of the Senate Finance thrust (including follow-up hearings this spring) has been the donor and contribution side of exempt organizations, advocating extensive reforms for donor advised funds, supporting organizations and credit counseling organizations. There has also been suggestion, for example of restricting Section 170 deductions for charitable contributions to operating uses and program purposes, and not for, say, endowment building. These donor side subjects are quite philosophical and the focus of much discussion in many arenas, but not my focus here. In Part I above, however, I note the Discussion Draft’s proposals touching on the various topics addressed by this article.

The House and Ways and Means Committee held its own hearings on the nonprofit sector in April. Ways and Means is nowhere near the stage of any pending legislation or even proposals, however, and the hearings evidently served more to raise issues and set context. That said, the hearings did raise some tantalizing philosophical issues of core concern to the world of exempt organizations. For example:

- Exploration of removing the exempt organization category entirely, and response from Douglas Holtz-Eakin, director of the Congressional Budget Office, suggesting that moves to tax the nonprofit sector might not generate nearly as much revenue as might otherwise be thought. To support his argument, the CBO director cited evidence that exempt organizations are just as adept as their taxable counterparts in eliminating tax liabilities from unrelated business taxable income.
- A University of Illinois law professor suggesting that exemption should be limited to organizations relying on contributions for their support rather than the private market or government, and as opposed to endowment-supported organizations. In this view, the latter category of organizations are not necessarily in need of the exemption from income tax.
- A University of Miami law professor suggesting that exemption should be determined by positive definitions of public benefit, rather than an absence of private inurement or private benefit.

As of this writing, however, the Ways and Means Committee has taken no action on these or other ideas or proposals.

The Joint Committee on Taxation (JCT) in January issued its own recommendations for nonprofit sector reform, with emphasis on compensation issues. I discussed the JCT's recommendations earlier in this article.

2. State Laws: New York and California

Sarbanes-Oxley, IRS regulations, state laws and reforms proposed by the Senate Finance Committee are prominent drivers of nonprofit governance reforms. At least as importantly, industry groups and other private organizations have created accreditation standards that parallel and usually exceed actual legal requirements. These groups advocate governance responsibility for their industry members as a way of reassuring a restive philanthropic community, and being out in front of government regulatory reform. Much has been written about these accreditation programs. The *Wall Street Journal* last summer profiled the Maryland Association of Nonprofit Organizations, the Better Business Bureau's Wise Giving Alliance and other programs which require members to demonstrate compliance with standards such as administrative expense to program budget ratios, compliance with criteria for contract relationships and conflict of interest policies. I will not write here at length on these programs, but if more information about their activities is desired please contact me.

I do note here that the Senate Finance Committee's Staff Discussion Draft suggested that private nonoperating foundations with administrative expenses in excess of 10 percent of total expenses should be required to submit additional supporting material with the IRS, to determine whether expenses were reasonable and necessary as qualifying distributions under payout rules. The Discussion Draft also suggested capping qualifying distributions for private nonoperating foundations at 35 percent of total expenses.

As is well known, the states have been active participants in the recent government attention paid to nonprofits. Arguably, states like California and New York have been more aggressive and more progressive than Congress or the IRS. New York Attorney General Eliot Spitzer has pushed New York to play a prominent role. California has also been actively engaged in recent legislative activity in this area.

New York

The current version of proposed New York legislation (still pending in the New York State Senate) reflects considerable modification after its initial introduction by the Charities Bureau of the AG's office. Still, for organizations based and/or operating in New York, the responsibilities are more extensive than current law or even current recommended practices described elsewhere in this article. These obligations include establishment of an audit committee and defined obligations of the audit committee – specifically, obligations to meet with and supervise outside auditors and supervise the financial audit process generally. Nonprofits may choose to not have a separate audit committee by amending their bylaws and causing the full board to act as audit committee.

New York's proposed bill makes persistent failure to file complete and accurate reports a breach of the directors' and officers' duty to the corporation, subjecting them to removal. New York's law would also require creation of an executive committee of the board for boards of more than 25 members, reflecting a legislative policy of having a manageable management group for day-to-day operations and non-extraordinary decisions.

New York's law would also closely follow IRS intermediate sanctions rules for interested party transactions, although granting power to the AG to challenge interested party transactions it deems objectionable. More than conceivably, as proposed, even if a transaction is adequately vetted by non-conflicted directors, it still could be ordered disallowed. It is important to point out that the law as proposed applies not just to transactions between the corporation and a director or officer, but also between the corporation and another entity in which a director or officer has an interest. The bill refers to "substantial financial interest", although the vagueness of this standard becomes apparent in the context of a situation, for example, where a director is actively involved in another charity but without an actual financial stake. That issue aside, the standards for these transactions remain "fair and reasonable" and full disclosure.

New York's legislation would require financial officers of organizations with revenues of \$1,000,000 or less to provide a simple "verification" of the accuracy of financial information presented to a board. More extensive certifications would be required of organizations above a \$1,000,000 revenues threshold (revised up from an initially proposed revenues threshold of \$250,000), although lobbying by nonprofits industry groups such as the Nonprofit Coordinating Committee of New York (NPCC) was successful in lowering the certification requirement to one of "knowledge".

The New York Charities Bureau also proposed strengthening existing New York restrictions on indemnification of officers and directors by the nonprofits they serve. A potentially controversial (and confusing) change here involves the advancement of legal costs to indemnified persons by an organization. The proposed bill would amend current law to provide that, in most cases, an indemnified director or officer would need only to make a written commitment to repay the advanced expenses, with no bonding requirement. The exception, requiring the posting of a bond, would be situations where the organization is legally barred from indemnifying the director or officer – typically the case in claims against an officer or director for misconduct or not acting with interests aligned with the organization. Much of the bill's original proposal regarding further restrictions has not survived, although the law in New York (as in many states) is still restrictive on a nonprofit's ability to indemnify officers and directors. Since this is a multi-state and important current topic in nonprofit management – impacting officer and director recruiting and retention, among other obvious implications – I will write more on this separately. A comment in a recent meeting of the NPCC pointed out that an overwhelming majority of claims against directors and officers arose in personnel matters, suggesting that some of the debate about the fee advance for non-aligned actions is academic.

California

California, effective January 1, 2005, enacted a sweeping reform of its charitable organization oversight through its Supervision of Trustees and Fundraisers for Charitable Purposes Act. The Act affects more than just fundraisers, broadly governing nonprofit activity in California. Organizations are subject to the Act if “doing business” in California, meaning (among other things) soliciting donations in California from inside or outside the state by any means; maintaining an office in California; and conducting programs in California, although specifically not including discretionary grant-making activity in California where that activity is the only California contact. “Doing business” includes internet and therefore, conceivably includes solicitations not targeted to California donors.

The California law applies not just to charitable organizations, but also to commercial fundraisers and consultants that support their client organizations’ fundraising efforts in California. The law requires commercial fundraisers to file notice with the state attorney general’s office regarding each campaign with which they are involved.

California now requires that covered charitable organizations institute board (or compensation committee) review of compensation for senior executives, specifically: president, chief executive officer, treasurer and chief financial officer, using a “just and reasonable” standard. The review has to be made upon hiring and upon subsequent changes to compensation and renewal of employment term.

Financial statements, if prepared by outside accountants, must be made available for review by the state AG, as well as to be made publicly available in accordance with IRS procedures for Form 990 filings (IRC Section 6401(d)). California has instituted its own enforcement scheme and penalty package for failures of disclosure, on top of penalties that the IRS might impose.

California has also instituted its own version for nonprofits of Sarbanes-Oxley’s rules dealing with engagement of outside auditors for non-audit services and requirements for an independent audit committee. The specificity of California’s law on audit committee requirements (e.g. no staff members on the audit committee, no separate compensation for audit committee service, etc.) is likely to be more important than, say, general best practices in response to Sarbanes-Oxley, due to the express application of California’s law to nonprofits. (Again, the federal Sarbanes-Oxley law expressly applies to public companies only.) In effect, California (and, soon, New York) has legislatively mandated much of the nonprofit industry’s non-binding guidelines promulgated by organizations like Independent Sector, National Health Council, the Better Business Bureau’s Wise Giving Alliance and many others.

One other provision of note from California is a requirement for written contracts with commercial fundraisers and fundraising advisers. The written contract requirements are extensive and specific, particularly with regard to fee arrangements and other compensation issues. As noted above, industry and accreditation groups have long advocated requirements for written contracts under accreditation or best practices guidelines. California’s law codifies this practice for certain core fundraising relationships. New York’s bill would require that contracts between professional fundraisers (or fundraising counsel) and charitable organizations expressly provide that the charity exclusively owns any contributor lists or mailing lists, whether compiled by the charity or by the fundraisers or fundraising counsel. A provision in New York’s bill stirring up some controversy would also provide charitable organizations with a 5-day right to cancel contracts with commercial co-venturers, a “cooling off period”.

California has enacted extensive anti-fraud and misrepresentation rules for organizations and their fundraising partners and advisers. New York's law would provide similar rules. I will discuss these and other states' anti-fraud provisions in a separate article.

Bruce Collins, corporate vice president and general counsel of C-SPAN, wrote in the March 2005 *Corporate Legal Times* that by virtue of its jurisdictional breadth coupled with the physical reach of its economy, California had effectively enacted "a de facto national law governing the corporate governance, fundraising, executive compensation, audit requirements, accounting standards and more of the non-profit sector." Whether Collins' view is an exaggeration is fast becoming moot, because (a) New York and other states are already jumping into the fray with their own "me too" laws, (b) the industry (led by Independent Sector, and other consortia and industry organizations) has already stepped up calls for self-improvement and advocacy at the federal level on this subject, and (c) the federal government has already announced its intention to get involved, both at IRS and in Congress.

I will cover these and other state law developments at fuller length in a separate article.

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If you have any questions about these developments and how they may impact your business, please contact me at (202) 339-0303 or by email at andy@mirskylegal.com. Thank you.

Andrew Mirsky