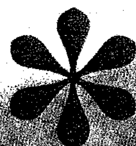
Taxation of

September/October 2



Special Compensation Issue

Deferred Compensation for Executives, Continued

Split-Dollar vs. 457(f) Plans

Gainsharing Arrangements and Exemption

THE NEW AGE OF CORPORATE GOVERNANCE FOR NONPROFIT ORGANIZATIONS

The governance scandals of the past few years—for-profit and nonprofit—have caused a tightening in a complicated system that those involved must master.

AVI Z. KESTENBAUM

With the abundance of corporate governance scandals and abuses in recent years, and the remedial measures and penalties imposed by the legislature and judiciary at both the federal and state levels to address them, both the for-profit and nonprofit sectors are experiencing a new age of corporate governance.[1] Most people are aware of Sarbanes-Oxley, as well as the numerous court cases involving fraud and wrongdoing in once prominent corporations (e.g., Enron, Tyco, Worldcom, Adelphi Communications), which have raised the bar of corporate governance requirements in the for-profit world.

There may have been even more changes, however, in the nonprofit arena, though many of them are subtle. They involve diverse areas ranging from charitable solicitations and contributions to charity tax shelters and excessive compensation for directors and insiders. These changes effectively may have increased the duties and liabilities of nonprofit directors and officers even more so than those of their for-profit counterparts. Moreover, these changes have dramatically affected the way that nonprofit organizations are required to operate. Advisors to nonprofit organizations must be sensitive to and aware of these changes to ensure that well-intentioned organizations and their directors and officers do not run afoul of their increased legal obligations. Failure to do so risks penalties to both the organizations and their directors and officers, and, in the worse case scenario, jeopardizes the organizations' federal and state tax exemptions.

Fiduciary duties

The starting point for discussing the governance standards of nonprofit organizations is with their directors and officers. It is generally understood that nonprofit directors and officers owe two primary fiduciary duties: the duty of care and the duty of loyalty.[2] Directors and officers owe these duties to their organizations, to fellow directors and officers, and, in limited circumstances, to third parties and donors.

AVI Z. KESTENBAUM *is an attorney with Meltzer, Lippe, Goldstein & Breitstone, LLP of Mineola, NY, where he specializes in estate planning, taxation, and nonprofit organizations.*

THE STARTING POINT FOR DISCUSSING GOVERNANCE IS THE DIRECTORS AND OFFICERS.

The duty of care is defined in many state statues, as well as in the Revised Model Nonprofit Corporation Act (RMCA), as the execution by a director or officer of his or her duties (1) in good faith, (2) with the care an ordinarily prudent person would exercise in a like position under similar circumstances, and (3) in a manner the director or officer reasonably believes to be in the best interest of the organization.[3] The duty of care, which mandates that directors and officers be informed and act in good faith, encompasses the "manner in which the directors exercise their responsibilities, rather than a decision's correctness or benefit to the organization."[4] Accordingly, the general requirements of the duty of care include—but are not limited to—being informed, attending board and committee meetings, having access to all organization information, and making informed decisions.[5]

The duty of loyalty is the second primary fiduciary duty. This duty requires the director's and officer's faithful pursuit of the organization's interest rather than the financial or other interest of the director or officer, or of another organization or person.[6] The director and officer must avoid self-dealing activities and interested-party transactions under the duty of loyalty.

Though directors and officers must act in the best interests of their organizations and avoid self-dealing activities, they are not prohibited from all acts of self-dealing as long as (1) there is adequate disclosure to the board of directors regarding all the facts and circumstances of the self-dealing activity, (2) the activity is fair and reasonable and similar to the activity that a for-profit entity would be conducting with non-interested persons in pursuit of its goals, and (3) the activity is authorized in the organization's certificate of incorporation, bylaws, or other governing instrument, and is approved by an independent board of directors who have no direct or indirect interest in the transaction.[7] Nevertheless, there are rigid and complex rules and requirements in the Code that must be followed to avoid penalties and, in the worst-case scenario, loss of exempt status. In addition, there are state laws on the subject. California's was strengthened recently (see below) and other states are contemplating similar changes.

Legal standards of liability and standing to sue

Today it is generally thought that there is little difference between the standards of liability of for-profit directors and officers and their nonprofit counterparts. For many years, directors and officers of nonprofits were held to the higher fiduciary standard of trustees. Trustees, unlike corporate directors and officers, generally are liable for ordinary negligence, even if they exert good-faith efforts and reasonably believe that their actions are appropriate.[8] Good-faith reliance on the advice and representations of others is no defense to the high fiduciary standard of trustees.[9] On the other hand, for-profit corporate directors and officers generally will not be held liable for "ordinary negligence," and will be held liable only for "gross negligence" or "recklessness."[10] Additionally, as will be explained later, corporate directors and officers are protected by the "business judgment rule" (sometimes known as the "best judgment rule" when applied to nonprofits) if they reasonably rely on the advice and representations of others.

The recent trend has been to apply the more lenient for-profit standards of liability to non-

[1] This article is a significant expansion and update of Kestenbaum, "Duties and Liabilities of Nonprofit Directors and Officers," 31 Est. Plan. 218 (May 2004).

[2] Some also include a "duty of obedience." This third duty is cited in Rigney, *Nonprofit Governance and Management* (ABA, 2002), page 87. The Corporate Laws Committee of the ABA Section of Business Law, however, does not recognize the "duty of obedience" as a separate duty, but instead sees it as a subset of the "duty of loyalty."

[3] Revised Model Nonprofit Corporation Act (RMCA) section 8.30 (1987).

[4] Fishman, "Improving Charitable Accountability," 62 Md. L. Rev. 232.

[5] Kestenbaum and Shin, *Exempt Organizations and Charitable Activities in New Jersey* (National Business Institute, 2003).

[6] Kurtz, "Board Liability: Guide for Nonprofit Directors." (Moyer Bell Ltd., 1988)

[7] See e.g., New Jersey Statutes Annotated (N.J. Stat. Ann.), § § 15A:6-11 through 15A6-14.

[8] See Eurich v. Korean Foundation, 31 Ill. App. 2d 474 (Ill., 1961).

[9] Scott, "The Law of Trusts," § 201 at p. 221 (Aspen, 1988).

[10] Block, et al., *The Business Rule: Fiduciary Duties of Corporate Directors* (Aspen, 1988).

profit directors and officers as well.[11] The RMCA adopted this change, as did numerous court rulings beginning approximately 35 years ago.[12] According to the RMCA: "A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property."[13] It should be noted, however, that with all the recent corporate governance abuses, there has been a shift to imposing higher fiduciary duties on directors and officers of both for-profit and nonprofit organizations, so the gap between the fiduciary duties owed by trustees, and those owed by corporate directors and officers, may have narrowed.

In light of the many recent corporate governance abuses by nonprofits and/or their directors and officers (e.g., the United Way, Hale House, the New York Stock Exchange, the James Beard Foundation), two important questions arise—who has standing to sue nonprofit directors and officers for breach of fiduciary duties, and what legal protections are available for nonprofit directors and officers?

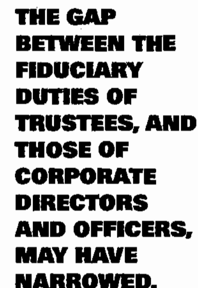
In the past, there have been four recognized potential classes of plaintiffs who have standing to sue nonprofit directors and officers for breaches of their fiduciary duties—state attorneys general, beneficiaries with a "special interest," fellow directors, and members. Recently, however, courts have recognized a new, fifth class of potential plaintiffs—donors to the organization who are seeking to impose the terms of their charitable gifts.[14] As will be explained below, this additional class should create a heightened degree of care by the nonprofits in fulfilling the requests of donors.

The authority of state attorneys general to oversee the affairs of nonprofits and bring suits against nonprofit directors and officers has long been recognized by common law and is codified into many state statutes.[15] In fact, this is the primary class that enforces the duties and obligations of nonprofit organizations and their directors and officers.

For beneficiaries to have standing to bring suit against nonprofits, they must have a "special interest," which can be loosely defined as being a member of a small, identifiable class that the charity was designed to benefit.[16] A mere potential beneficiary of a nonprofit organization does not have standing to sue.

Fellow directors, officers, and members may actually have a duty to sue one another in a "derivative action" on behalf of the nonprofit organization in circumstances of breach of duty or fraud, and the failure to sue one another may actually be a breach of duty by the non-breaching directors and officers. Typically, however, directors, officers, and members have little incentive to sue each other because (1) this would cause internal strife within the organization and (2) any and all damages would be awarded to the nonprofit organization.

The standing of donors to sue was addressed in *Smithers v. St. Luke's Roosevelt Hospital Center*, 723 N.Y.S. 2d 426 (1st Dept., 2001). The New York Appellate Division decided that a legal representative of the donor of funds used to establish the Smithers Alcoholism Center had common law standing to enforce certain terms with respect to the charitable gift. It will be interesting to see over time whether other courts will also enforce the standing of this new class and create additional oversight over the actions of charitable organizations and their directors and officers with respect to enforcing the terms of charitable gifts.



THE GAP BETWEEN THE FIDUCIARY DUTIES OF TRUSTEES, AND THOSE OF CORPORATE DIRECTORS AND OFFICERS, MAY HAVE NARROWED.

Business judgment rule and statutory and voluntary protections

Nonprofit officers and directors, like their for-profit counterparts generally are protected by the "business judgment rule." This rule provides that, even if the decisions of nonprofits' officers and directors turn out to be in error, the officers and directors will not be held liable as long as informed and reasonable decisions were made at the time the decisions were rendered.[17] This protection is

[11] See Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, et. al., 381 F. Supp. 1003 (DC D.C., 1974). *See also*, Denckla v. Independence Foundation, 193 A. 2d 538 (Del. Ch., 1963).

[12] *Id.*

[13] RMCA section 8.30(e).

[14] See Smithers v. St. Luke's Roosevelt Hospital Center, 723 N.Y.S. 2d 426 (1st Dept., 2001).

[15] See e.g., N.J.S.A. § 45:17A-18 et. seq. See also Lopez v. Medford Community Center, 424 N.E. 2d 229 (Mass., 1981).

[16] See Blasko, Crossley, and Lloyd, "Standing to Sue in the Charitable Sector," 28 U.S.F.L. Rev. 37 (1993).

[17] See Boston Children's Heart Foundation, Inc. v. Nadel-Ginard, 73 F.3d 429 (CA-1, 1996). See also Parish, et. al. v. Md. and Va. Milk Producers Ass'n, Inc., 277 A.2d 19 (Md., 1971).

especially crucial in the area of investments and management of assets, which merely requires that directors and officers show reasonable and informed judgment.[18] The "business judgment rule" is found in both the RMCA and case law to protect nonprofit directors and officers.[19] The business judgment rule, however, will not protect directors and officers for decisions made dishonestly or in bad faith, or for intentional misconduct, knowing violation of the law, or receipt of improper personal benefits.[20]

The laws of many states provide that a nonprofit may voluntarily adopt a provision in its bylaws eliminating or limiting the personal liability of a nonprofit director or officer for breach of fiduciary duty.[21] Moreover, many state statues limit the liability, at least to some degree, of directors and officers serving without compensation.[22] It is also common to find provisions regarding liability protection and indemnification in the articles of incorporation and bylaws of nonprofits. Without these protections, many directors and officers would not be willing to serve their organizations, especially those serving without compensation.

COURTS HAVE RECOGNIZED A NEW, FIFTH CLASS OF POTENTIAL PLAINTIFFS—DONORS.

Recent developments

Many developments over the past few years have significantly affected the now-heightened legal standards for nonprofits and their directors and officers. The following discussion will not cover all of them, but instead will provide an overview of the areas on which nonprofits and their advisors must focus in order to understand the more stringent requirements covering them. It is critical that nonprofits that are remiss in their obligations to quickly take corrective measures in light of these developments.

Sarbanes-Oxley. The Sarbanes-Oxley Act ("the Act") was enacted in direct response to the corporate and accounting scandals.[23] The purpose of the Act was "to protect investors by improving the accuracy and reliability of corporate disclosures."[24] The Act primarily applies to publicly traded corporations and requires the implementation of new and heightened corporate governance requirements. These include, but are not limited to, establishment of independent audit committees; increased duties and rules for company auditors; certification of financial statements by the chief executive officer and chief financial officer; prohibitions on insider transactions, including loans to directors and management; increased disclosures and duties to correct past financial statements; whistleblower protection; and prohibitions on destruction of documents. While the Act, on its face, does not apply to nonprofits (except for the whistleblower protection and prohibitions on destruction of documents) it has tremendously affected the heightened scrutiny and regulation in the nonprofit sector.

In response to the Act, many nonprofits have taken the initiative to voluntarily adopt its provisions. These nonprofits have undergone significant time, energy, and expense to adopt changes to their corporate governance structure. For example, Drexel University voluntarily adopted much of Sarbanes-Oxley in 2003. Among other things, Drexel decided to maintain an independent audit committee, implement whistleblower protections, prohibit loans to directors and insiders, get certification of annual financial reports, and establish a code of conduct for university employees.[25] In the wake of the Act, other nonprofits have followed Drexel's lead and have also implemented significant changes to their corporate governance structures.[26]

Some states, including California and New York, have considered or are considering applying portions of the Act to nonprofits. In January 2003, New York Attorney General Eliot Spitzer proposed amendments to the New York Not-for-Profit Corporation Law. These proposed amendments would apply certain provisions of the Act to New York nonprofit corporations. Included would be requirements for certifying annual reports, establishing executive and audit committees, limiting the scope of indemnification for directors and officers, and increasing regulation on interested-party transactions and compensation of directors and

---

[18] See Kestenbaum and Shin, *supra* note 5.

[19] See RMCA § 8.30, comment 3. See also Oberly v. Kirby, 592 A.2d 445 (Del., 1991).

[20] See Smith v. Van Gorkum, 488 A.2d 858 (Del., 1985), Scheuer Family Foundation, Inc. v. 61 Associates, 582 N.Y.S. 2d 662 (1st Dept., 1992). See also North Carolina v. Ila Corp., 132 N.C. App. 587, 513 S.E.2d 812 (N.C. Ct. App., 1999).

[21] See e.g., Del. General Corp. Law, § 102.

[22] See e.g., N.Y. Not-for-Profit Corp. Law § 720-A.

[23] P.L. 107-204 (7/30/02).

[24] *Id.*, 116 Stat. at 745.

[25] See Jones, "With Charity for All," Corporate Counsel, 1/18/05.

[26] *Id.*

officers. While these proposed amendments have not yet been adopted by the New York legislature, they have certainly still made a significant impact on the current trend of heightened regulation in the nonprofit sector.

In California, the Nonprofit Integrity Act of 2004 took effect in January 2005. It applies increased reporting, disclosure, and other requirements on charitable organizations with gross revenue of $2 million or more, and in particular requires mandatory audit committees for charitable corporations. Additionally, charitable organizations regardless of size are subject to increased requirements regarding financial statements, officer compensation, state registration, and contracts with commercial fundraisers and fundraising counsel. There are also increased requirements on commercial fundraisers and fundraising counsel themselves. The penalties for non-compliance may result in late fees and civil penalties, as well as the potential for fundraisers to be barred from raising funds in California.

Congressional hearings. In June 2004, and again in April 2005, the Senate Finance Committee heard testimony relating to abuses in the charitable sector. The purpose of these hearings was to address recent abuses by charities and donors and focus on implementing changes to curtail them. Changes discussed at the June 2004 hearings included limiting compensation for trustees of private foundations; requiring organizations to refile with the IRS every five years to determine whether they should retain exempt status; improving the quality, extending the disclosures, and increasing the requirements on the Form 990 informational returns; increasing the penalties for inaccurate Forms 990; establishing strict rules for exempt organization boards of directors; more stringent disclosure and other requirements for charitable gifts; and increased scrutiny and regulations on donor advised funds and certain supporting organizations.

At the April 2005 hearings, IRS Commissioner Mark Everson testified that abuses by nonprofits and donors are costing the government approximately $15 billion a year in lost revenue.[27] In May 2005, Senate Finance Committee Chair Charles Grassley (R-Iowa) and ranking minority member Max Baucus (D-Mont.) introduced a bill to curtail certain abuses involving nonprofits and life insurance.[28] In June 2005, the Panel on the Nonprofit Sector, a group of leaders from the nation's charities and nonprofits, presented a comprehensive report to the Senate Finance Committee regarding actions that organizations, the IRS, and Congress need to take to strengthen the sector's governance and accountability.[29] There likely will be many further developments from Capitol Hill regarding increased scrutiny and regulation on the charitable sector in the near future.

Increased IRS requirements and scrutiny

The IRS, too, has added to the governance requirements placed on charitable organizations in response to abuses in the nonprofit sector. These include:

1. Increased scrutiny on compensation of officers and other insiders in nonprofit organizations, including an announcement by the IRS that it would contact nearly 2,000 organizations regarding their compensation practices and procedures.[30]
2. Changes to the rules regarding vehicle donations to charities.[31]
3. A revision of Form 1023, "Application to IRS for Exemption Under Section 501(c)(3) of the Internal Revenue Code," published in October 2004 and mandatory for organizations filing for exemption after April 2005. The revised Form 1023 significantly increases reporting and disclosure requirements.
4. Numerous attacks in recent years on charitable tax shelters.[32]
5. Numerous attacks in recent years on impermissible charitable deductions.[33]
6. Establishing teams dedicated to curtailing abusive conservation easements.[34]
7. Examination of credit counseling organizations.[35]

[27] See "Official Cites Tax Abuses with Charities," N.Y. Times, 4/6/05.

[28] S. 993 IS, 109th Cong., 1st Sess.

[29] "Charity Panel Urges Oversight and Accountability Increase," N.Y. Times, 6/23/05.

[30] IR-2004-106, 8/10/04.

[31] See IRS Pub 4302, "A Charity's Guide to Car Donations;" Section 170(f)(12).

[32] See e.g., IR-2005-19, 2/28/05. See also Notice 2004-22, 2004-12 IRB 632.

[33] See e.g., Notice 2004-7, 2004-3 IRB 310; Rev. Rul. 2003-28, 2003-1 CB 594.

[34] "IRS Starts Team on Easement Abuses," Wash. Post, 6/9/05, page A6.

[35] guidestar.org/news/articles.

8. Changes to the rules regarding the donation of intellectual property.[36]

Charitable solicitation

Most states require charities that solicit contributions from the public, and paid fundraisers, to register. Many states recently have tightened these requirements. *Madigan v. Telemarketing Associates, Inc., et al,* 538 U.S. 600 (2003), illustrates this.

Madigan involved a paid telemarketing fundraiser that solicited funds for a tax-exempt organization in Illinois without telling potential donors that 85% of the gross collections would be paid to the fundraiser. The Illinois State Attorney General sued and the case ultimately ended up in the U.S. Supreme Court after working its way up through the Illinois state court system. The Supreme Court held that the misleading charitable solicitation was not protected by the First Amendment right to free speech, and that Illinois could bring a claim for common law fraud and breach of fiduciary duty and fraud under its state statutes. In three earlier Supreme Court cases, the Court took the position more favorable for fundraisers and charities—that state regulations of charitable solicitations, barring fees in excess of a prescribed level, imposed restraints on fundraising that were in violation of the First Amendment.[37] Therefore, *Madigan* is a significant development.

Practical steps to limiting liability

While there are many practical steps that will assist nonprofit organizations and their directors and officers in limiting their liabilities while fulfilling their duties, the list below will serve as a brief guide to particular areas to which attention must be paid:

1. Be aware of the structure and operations of the organization. This includes its legal structure as well as the organization's current and past activities.
2. Pay careful attention to any specific liability risks of directors and officers.
3. Incorporate provisions in the organization's governing documents that will help limit the liability of directors and officers. State law must also be addressed.
4. Procedural safeguards must be put into place under the duty of care, such as regular board meetings, oversight committees, committee reports, and reports from legal and financial advisors.
5. Be aware of particular tax and legal issues affecting the organization and stay current on changes to federal and state law.
6. Pay particular attention to special circumstances that may trigger either specific liability concerns or any state law requirements for actions or notices. These include dispositions of property, mergers, and sales.
7. Define the mission of the organization and constantly review the activities it takes in furtherance of its mission. The organization should also consider adopting a "mission statement."
8. Adopt a conflict of interest policy that will provide guidelines and procedures regarding self-dealing activities and ensure compliance with the duty of loyalty.
9. Consult periodically with legal advisors regarding any changes in the law that may affect the organization.
10. Be sure to hire accountants, attorneys, and financial professionals who are specialists in the nonprofit field.
11. When making overseas grants, be sure to consult with a legal advisor regarding the many complex legal issues involved. Comply as best as possible with the "Voluntary Best Practices" issued by the Treasury Department regarding terrorist organizations.
12. Develop independent audit committees to review periodically the structure, finances, director and officer compensation, and general compliance of the organization.
13. Limit the terms of directors and officers to ensure independence and proper oversight. Many state statutes already provide for mandatory term limits.
14. Periodically evaluate the performance and compensation of directors and officers.

---

[36] Notice 2005-41, 2005-23 IRB 1203.

[37] See Schaumberg v. Citizens for a Better Environment, 444 U.S. 620 (1980); Secretary of State of Md. v. Joseph H. Munson Co., 467 U.S. 947 (1984); Riley v. Nat'l Federation of Blind of N.C., Inc., et. al., 487 U.S. 781 (1988),

15. Understand the delegation of authority and chain of command within the organization.
16. Be mindful of any political and lobbying activities of the organization, which in the worst-case scenario could cause the organization to lose its tax-exempt status.
17. Ensure that the organization is in compliance with the strict federal and state law requirements regarding charitable solicitation and contributions.
18. Understand to whom legal duties and obligations are owed.
19. Know the organization's employees; their roles and duties. A director and officer may be responsible for an employee's act or failure to act.
20. Before accepting the role of a director or officer within a nonprofit organization, understand that there are many complicated legal issues and requirements and consult with an attorney.
21. Consider purchasing director and officer (D&O) insurance policies.
22. The organization should consider adopting a "code of conduct" for directors and officers, and for employees in general.
23. The organization should adopt a "gift acceptance policy" to help comply with legal obligations, as well as to deal with donors.

Conclusion

The corporate governance landscape for nonprofit organizations has undergone significant changes in recent times. These organizations, as well as their directors and officers, are burdened with many increased duties and obligations at both the federal and state level. Moreover, in the wake of the many scandals in both the for-profit and nonprofit sectors, directors and officers are faced with heightened standards of care and loyalty. In light of these numerous changes, many of which are outlined in this article, the argument can be made that nonprofit corporate governance has undergone more significant changes than its for-profit counterpart.

Regardless of whether this hypothesis is true, nonprofit directors and officers, and their organizations, must be extremely diligent in complying with all of their burdensome legal obligations. They should consider an immediate review of their corporate structures and operations to ensure that they are meeting their requirements.

Additionally, one who is serving as a director or officer, or one who is considering doing so, should understand all the legal duties and responsibilities in order to better perform his or her role and limit his or her liability. Consulting with outside attorneys and advisors in the nonprofit field is always good practice, and critical is this time of heightened scrutiny and regulation from many different angles. ■