

**THE CHANGING ACCOUNTABILITY CLIMATE AND
RESULTING DEMANDS FOR IMPROVED “FIDUCIARY
CAPACITY” AFFECTING THE WORLD OF PUBLIC
CHARITIES**

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I. INTRODUCTION

Nonprofit tax-exempt organizations, particularly those accorded Internal Revenue Code (I.R.C.) § 501(c)(3) tax-exempt status (commonly referred to as “charities”¹) or that undertake

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1. I.R.C. § 501(c)(3) of the 1986 Internal Revenue Code, as amended, defines a category of exemption from income taxation, with attendant other

community benefit efforts beyond their membership as described in I.R.C. § 501(c)(4)² have faced increasing demands for public accountability for most of the last decade. For example, copies of filed Annual Returns of Exempt Organizations (Form 990 series), which disclose a plethora of financial and other information on each year's operations, must be provided to anyone who asks for them within a three-year period.³ In addition, most charities' Forms 990 are posted on the Internet and readily accessible to the public.⁴ Public charities and other so-called "public benefit"

benefits beyond tax exemption. (The same numbering was found in the Internal Revenue Code of 1954.) I.R.C. § 501(c)(3) enumerates as qualified for income-tax exemption entities operated for one or more of eight specific purposes, including in its list religious, educational, or charitable purposes. Entities holding such status, regardless of which purpose(s) they serve, are commonly referred to as "charities" or "charitable organizations." As a further complication to the lexicon, entities that are described as exempt under § 501(c)(3) are further classified under I.R.C. §§ 508 and 509 as either private foundations or non-private foundations, and the colloquial expression long-accepted for the latter classification is the term "public charity." Unless otherwise indicated, all references and citations in this article to the Internal Revenue Code (I.R.C.) refer to the Internal Revenue Code of 1986, as amended, currently located at 26 U.S.C.A. (West 2004).

2. Entities that are "not organized for profit but operated exclusively for the promotion of social welfare . . . and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes." I.R.C. § 501(c)(4)(a).

3. I.R.C. § 6104(e), added in 1987, imposed a "public inspection" (as opposed to hardcopy dissemination) requirement on both exempt organizations' exemption applications and annual returns (except for private foundations' annual returns, which were already subject to certain public availability requirements). Nine years later, the *Taxpayer's Bill of Rights II* expanded the requirements to include hardcopy dissemination of those same filings, but postponed the effective date until sixty days after the issuance of Final Income Tax Regulations. Pub. L. No. 104-68, 110 Stat. 1452 (1996) (amending I.R.C. § 1313(a)). Legislation in 1998 brought private foundations' annual returns into the scheme and deleted I.R.C. § 6104(e), moving these requirements to I.R.C. § 6104(d). Pub. L. No. 105-277, 112 Stat. 2681 (1998). Hard copy dissemination of Forms 990 (or the alternative, Forms 990-EZ) was required as of June 8, 1999, while hard copy dissemination of Forms 990-PF (required for private foundations) was effective on March 13, 2000.

4. This is largely the result of the advent of the Internet site Guidestar.org. <http://www.guidestar.org>. Anyone with access to the Internet can use the site to search the Internal Revenue Service's (IRS) database of 501(c)(3)-registered organizations and to retrieve information on the organization including Forms 990 on the tax years begun in 1997 and in successive years for those in the IRS database or those that have been added at their own initiative (as imperfections exist in the IRS database). The IRS provides the forms themselves to the web site sponsor, Philanthropic Research, Inc. (PRI), under a process that was initially undertaken as a collaboration between the IRS, PRI, and the National Center for

nonprofits that are accorded 501(c)(4) tax-exempt status are subject to a tax scheme that imposes an excise tax if transactions undertaken with certain parties fail to be at arm's length. That regulatory scheme taxes both the individual receiving the "excess benefit" and directors who approved the payment.⁵ Furthermore, IRS regulations state aspirational standards for boards of directors to document precisely the process by which compensation decisions are made for individuals who exercise substantial influence over their organizations.⁶ In the wake of the scandals at major corporations such as Enron and WorldCom, attorneys general of several states are proposing additional legislative reforms to ensure financial accountability of nonprofit organizations, and both the Senate Finance Committee and House Ways and Means Committee have recently held hearings on proposed reforms for exempt organizations.

These increasing demands for accountability have, in turn, amplified the pressure on boards of directors of all nonprofit organizations to govern effectively. But what is effective governance in this new climate of accountability, particularly for organizations holding exalted status under I.R.C. § 501(c)(3) and concomitant "public charity" status under 509(a)? This article will review current developments in the area of fiduciary duty of boards

Charitable Statistics. At present the site posts Forms 990 of approximately 290,000 charitable organizations, redacting only donors' identifying information, as well as signatures. Some charities post their own Form 990 filings to a web address of their own choice as a mechanism to satisfy I.R.C. § 6104(d) with respect to the requirement that they otherwise provide copies of returns upon written or in-person request. See *supra*, note 3 (explaining I.R.C. § 6104(d)).

5. I.R.C. § 4958, added in 1996 via enactment of the *Taxpayer's Bill of Rights II*, actually was given retroactive effect, covering transactions back to September 14, 1995. Pub. L. No. 104-68, 110 Stat. 1452 (1996). However, the need for regulatory address of the statute's definitions, application, and minutiae resulted in three Treasury Department pronouncements and resultant delay in enforcement of the statute. Proposed regulations were initially issued on August 4, 1998, followed by temporary regulations on January 10, 2001 and final regulations on January 23, 2002. 63 Fed. Reg. 41,486 (proposed Aug. 4, 1998); 66 Fed. Reg. 2144 (proposed Jan. 10, 2001); 67 Fed. Reg. 3076 (proposed Jan. 23, 2002) (to be codified at I.R.C. § 4958). I.R.C. § 4958 applies to all 501(c)(3) organizations *except* those holding private foundation classification, and also reaches organizations described in 501(c)(4) (in the latter instance, regardless of whether exemption has been applied for, if the organization holds itself out as so exempt). Given its scheme of applying to transactions with certain insiders for a period of sixty months following their loss of such relationship or status, I.R.C. § 4958 also covers revoked 501(c)(3)s and 501(c)(4)s for a sixty-month period following their loss of exemption.

6. Treas. Reg. § 53.4958-6(a) (2002).

of directors of nonprofit tax-exempt organizations, to suggest what current trends indicate may be enhanced definitions of directors' fiduciary duties in the post-Enron environment.

II. DEVELOPMENT OF LAW GOVERNING FIDUCIARY DUTIES OF OFFICERS AND DIRECTORS OF NONPROFIT TAX-EXEMPT ORGANIZATIONS

Legal duties of officers and directors to the corporations they govern have developed from the same principles as those applicable to trustees. In early cases, directors of all corporations were found to owe a duty to the corporation similar to that which a trustee owes to a beneficiary.⁷ Later cases questioned the strictness of that standard, and courts began to define the duties that nonprofit directors owed to their organizations more in line with the fiduciary standards that directors of business organizations owed to their organizations.⁸ For example, the Federal District Court for the District of Columbia notes in *Stern v. Lucy Webb Hayes National Training School for Deaconesses & Missionaries* that the "modern trend is to apply corporate rather than trust principles in determining the liability of directors of charitable corporations."⁹

A. *Duty of Care*

In 1987, the American Bar Association promulgated the Revised Model Nonprofit Corporation Act (the "Revised Model Act"), which also included the corporate standard for the duty of care. Minnesota, among other states, adopted a version of the Revised Model Act in 1988 as Minnesota Statutes chapter 317A.¹⁰ Chapter 317A replaced the former chapter 317 in 1989.¹¹

Minnesota Statutes section 317A.251 sets out the standard of care for directors that comports to the Revised Model Act, requiring a director to discharge his or her duties "in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the

7. *People v. Larkin*, 413 F. Supp. 978, 982 (N.D. Cal. 1976); *Burden v. Burden*, 54 N.E. 17, 23 (N.Y. 1899); MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* 199-200 (2004).

8. *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

9. *Id.*

10. MINN. STAT. § 317A (2004).

11. *See id.* § 317A.

director reasonably believes to be in the best interests of the corporation.”¹² A parallel provision applies to nonprofit corporate officers.¹³ The duty of care embodied in these statutes generally requires directors to carry out their responsibilities by staying informed about the organization’s activities and acting to ensure that directors’ decisions are made in good faith and with the intent to further the organization’s purposes.¹⁴

In an effort to limit the personal liability exposure of nonprofit directors, several states have adopted statutory protections, providing that a director is not liable to the corporation for an act or omission unless that director’s actions are clearly self-interested, in bad faith, or grossly negligent.¹⁵ As of January 1, 2003, a total of thirty-one states had adopted such statutes, “although sixteen of the statutes apply only if the director serves without compensation.”¹⁶

Minnesota expanded the protections available to nonprofit directors in 2003, when the Minnesota Supreme Court, in a case of first impression, found that the “business judgment rule” applies to shield nonprofit boards of directors from liability for decisions made in good faith, where the director is disinterested, reasonably informed, and honestly acting in a manner he or she believes to be in the best interest of the corporation.¹⁷ In *Janssen v. Best & Flanagan*, the court found that several states explicitly apply the business judgment rule to decisions made by nonprofit boards of directors, while no other states deny application of the rule to nonprofit board decisions.¹⁸ The court reasoned as follows:

In addition to finding support in other jurisdictions for giving judicial deference to nonprofit corporate decisions, the primary rationales for applying the business judgment

12. *Id.* § 317A.251.

13. *Id.* § 317A.361.

14. *See generally id.* § 317A (2004). As noted below, these statutes are read to embody duties of loyalty and obedience. *See infra* parts II.B, II.C.

15. *See, e.g.*, CAL. CORP. CODE § 5239(a) (West 2004); FLA. STAT. ch. 617.0834(1)(b)(3) (2004); MICH. COMP. LAWS § 450.2209(c) (2004).

16. FREMONT-SMITH, *supra* note 7, at 226. *See* MINN. STAT. §317A.257, subd. 1 (2004) (providing that generally a person who serves without compensation as a director, officer, trustee, member or agent of an organization exempt from state income taxation under Minnesota Statutes section 290.05, subdivision 2, is not civilly liable for an act or omission by that person if the act or omission was in good faith, was within the scope of the person’s responsibilities as a director, officer, trustee, member, etc., and did not constitute willful or reckless misconduct).

17. *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003).

18. *Id.* at 883.

rule in the for-profit context apply in the nonprofit context as well. Organizations are autonomous agents that should control their own destiny. Directors of nonprofits may take fewer risks than would be optimal if they were overly concerned about liability for well-meaning decisions. Additionally, courts are not well-equipped to scrutinize the decisions of a corporation; judges should not be caught in the middle of fighting factions of nonprofits any more than they should be thrust between dissatisfied shareholders and profit-seeking boards. Therefore, we conclude that the boards of nonprofit corporations may receive the protection of the business judgment rule.¹⁹

B. Duty of Loyalty

Generally, the duty of loyalty requires that corporate directors and officers act in good faith and in a manner reasonably believed to be in accordance with the best interests of the corporation.²⁰ As with the duty of care, Minnesota applies the duty of loyalty to directors through the reach of Minnesota Statutes section 317A.251,²¹ and to officers through Minnesota Statutes section 317A.361.²² Minnesota Statutes section 317A.255 speaks to and expands aspirationally the duty of loyalty for directors, providing a procedure for boards of directors to follow when conflicts of interest arise that applies a higher level of scrutiny for transactions with directors and parties to whom they are related.²³ To such end, Minnesota Statutes section 317A.255, subdivision 1 defines the situations in which a “conflict of interest” exists with respect to the corporation entering into contracts or transactions and then provides for a “safe harbor” directors’ procedure that renders such corporate actions not void or voidable.²⁴ The situations in which contracts or transactions would otherwise be void or voidable are:

A contract or other transaction between a corporation

19. *Id.* (citations omitted).

20. *See, e.g.* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998) (quoting DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NON-PROFIT DIRECTORS 21 (1988)).

21. MINN. STAT. § 317A.251 (2004).

22. *Id.* § 317A.361.

23. *Id.* § 317A.255.

24. *Id.* *See infra* note 27 and accompanying text.

and: (1) its director or a member of the family of its director; (2) a director of a related organization, or a member of the family of a director of a related organization; or (3) an organization in or of which the corporation's director, or a member of the family of its director, is a director, officer or legal representative or has a material financial interest.²⁵

Minnesota Statutes section 317A.255, subdivision 2 fails to give a substantive definition of what constitutes a "material financial interest," but sets out that:

(1) [A] director does *not* have a material financial interest in a resolution fixing the compensation of the director or fixing the compensation of another director as a director, officer, employee, or agent of the corporation, even though the first director is also receiving compensation from the corporation; and

(2) [A] director *has* a material financial interest in an organization in which the director, or a member of the family of the director, has a material financial interest.²⁶

In spite of the lack of statutory definition, "material financial interests" are commonly understood to be those in which a remunerative or exchange return is expected. Thus, it would be a "material financial interest" for an individual to have rights (whether or not yet vested) to be paid compensation, employee or retiree benefits, dividends, or profit-sharing, or to have their expenses reimbursed or obligations or other liabilities repaid, etc. Similarly, exchange transactions (for example a sale of property) would give rise to the participant's "material financial interest."

By specifically addressing what procedures, if followed by directors (or others) would render such a "conflict of interest" contract or transaction *not* voidable, the statute touches on only one aspect of directors' duty of loyalty.²⁷ Also encompassed within

25. MINN. STAT. § 317A.255 (2004).

26. *Id.* (emphasis added).

27. Minnesota Statutes section 317A.255 sets out the specific scenarios in which a director's conflict(s) of interest will cause a transaction to be void or voidable, and outlines procedures that may be undertaken by the board of directors to refute that consequence:

Subdivision 1. Conflict; procedure when conflict arises.

(a) A contract or other transaction between a corporation and: (1) its director or a member of the family of its director; (2) a director of a

the duty of loyalty that directors (and, under Minnesota law, officers) hold is the requirement that the corporation's information be kept confidential to the extent that the information is privileged or that its release would compromise the corporation's opportunities; and that directors (and officers) refrain from actions that are detrimental to the corporation's interests (including "taking" an opportunity of the corporation).

Recent cases interpreting the duty of loyalty addressed the latter point and held that a corporate officer breached his fiduciary duty of loyalty to a Minnesota nonprofit corporation. In *Shepherd of the Valley Lutheran Church of Hastings v. Hope Lutheran Church of Hastings*,²⁸ the Minnesota Court of Appeals held that a vice-president of a congregation breached his fiduciary duty when he purposefully withheld material information from other officers and members of the congregation of Shepherd of the Valley Lutheran

related organization, or a member of the family of a director of a related organization; or (3) an organization in or of which the corporation's director, or a member of the family of its director, is a director, officer, or legal representative or has a material financial interest; *is not void or voidable because the director or the other individual or organization are parties or because the director is present at the meeting of the members or the board or a committee at which the contract or transaction is authorized, approved, or ratified, if a requirement of paragraph (b) is satisfied.*

(b) A contract or transaction described in paragraph (a) is not void or voidable if:

(1) the contract or transaction was, and the person asserting the validity of the contract or transaction has the burden of establishing that the contract or transaction was, fair and reasonable as to the corporation when it was authorized, approved, or ratified;

(2) the material facts as to the contract or transaction and as to the director's interest are fully disclosed or known to the members and the contract or transaction is approved in good faith by two-thirds of the members entitled to vote, not counting any vote that the interested director might otherwise have, or the unanimous affirmative vote of all members, whether or not entitled to vote;

(3) *the material facts as to the contract or transaction and as to the director's interest are fully disclosed or known to the board or a committee, and the board or committee authorizes, approves, or ratifies the contract or transaction in good faith by a majority of the board or committee, not counting any vote that the interested director might otherwise have, and not counting the director in determining the presence of a quorum.*

MINN. STAT. § 317A.255 (emphasis added).

28. 626 N.W.2d 436 (Minn. Ct. App. 2001), *cert. denied*, 534 U.S. 1082 (2002).

Church in an attempt to create a competing congregation.²⁹ The court noted that, in order to establish a breach of fiduciary duty claim, a plaintiff must show that “the action attacked is so far opposed to the true interests of the corporation as to lead to the clear inference that no officer thus acting could have been influenced by an honest desire to secure such interests.”³⁰ The court pointed out that the fiduciary duty of the officer extended to all members of the congregation, not just to those who were allied with him.³¹ In *Mid-List Press v. Nora*,³² the Federal District Court for the District of Minnesota, applying Minnesota law, held that the corporation’s founder and president violated his fiduciary duty when he misappropriated the corporation’s trade name and International Standard Book Numbers to publish his own book of poetry.³³

C. *Duty of Obedience*

While the duty of obedience is not specifically identified in statutory definitions of fiduciary duties applicable to nonprofit boards and officers, this duty has become more accepted as a stand-alone requirement with which directors and officers must comply. In its publication, “Fiduciary Duties of Directors of Charitable Organizations,” the Minnesota Attorney General’s Office lists the duty of obedience separately from the duties of care and loyalty, and includes the following as specific obligations under it:

1. State and Federal Statutes. Directors should be familiar with state and federal statutes and laws relating to nonprofit corporations, charitable solicitations, sales and use taxes, FICA and income tax withholding, and unemployment and workers’ compensation obligations. They should also be familiar with the requirements of the Internal Revenue Service. Directors should see to it that their organization’s status with state and federal agencies is protected.

29. *Id.* at 442-43.

30. *Id.* at 442 (citing *Westgor v. Grimm*, 318 N.W.2d 56, 59 (Minn. 1982), quoting *Warner v. E.C. Warner Co.*, 226 Minn. 565, 573, 33 N.W.2d 721, 726 (1948)).

31. *Id.* See also *Wenzel v. Mathies*, 542 N.W.2d 634, 641 (Minn. Ct. App. 1996) (holding that a fiduciary duty is owed to all persons who have equal interests and concerns in the corporation and are subject to harm).

32. 275 F. Supp. 2d 997 (D. Minn. 2003).

33. *Id.* at 1003-04.

2. Filing Requirements. Directors must comply with deadlines for tax and financial reporting, for registering with the Attorney General, for making social security payments, for income tax withholding, and so on. Additionally, if an organization is incorporated under the Minnesota Nonprofit Corporation Act, its directors have a duty to maintain its corporate status by submitting timely filings to the Secretary of State's Office.

3. Governing Documents. Directors should be familiar with their organization's governing documents and should follow the provisions of those documents. Directors should be sure proper notice is given for meetings, that regular meetings are held, that directors are properly appointed and that the organization's mission is being accomplished.

4. Outside Help. Where appropriate, directors should obtain opinions of legal counsel or accountants.³⁴

D. State Attorney General Enforcement

Recent enforcement efforts by state attorneys general have made it clear that nonprofit boards of directors will need to pay more than lip service to fiduciary duties set out in state statutes.³⁵ Developments in the nonprofit, tax-exempt healthcare community

34. MINN. ATT'Y GEN., FIDUCIARY DUTIES OF DIRECTORS OF CHARITABLE ORGANIZATIONS: A GUIDE FOR BOARD MEMBERS (2003), *available at* <http://www.ag.state.mn.us/charities/charDuties.html> (last visited Oct. 1, 2004).

35. While this article focuses primarily on the enforcement efforts of the Minnesota Attorney General's office, it should be noted that other attorneys general have stepped up enforcement efforts as well. A July 19, 2004 ABA position paper prepared for the U.S. Senate Finance Committee hearing on July 22, 2004, notes the following developments:

[I]n California the Attorney General has proposed the "Charity Integrity Bill" and the "Nonprofit Integrity Act of 2004, CA Senate Bill 1262" was introduced; . . . in Hawaii, the Attorney General proposes legislation that would give the Attorney General the authority to remove directors; in Massachusetts, the Attorney General is proposing the "Act to Promote the Financial Integrity of Public Charities;" and in New York, the Attorney General has proposed the "Nonprofit Accountability Act" and the legislature has introduced S. 4836 on behalf of the Attorney General [requiring that the president or chief executive officer, or treasurer or chief financial officer of each nonprofit corporation shall verify the corporation's annual report].

Letter from Richard A. Shaw, Chair, Section of Taxation, American Bar Association, to Sen. Charles E. Grassley, Chairman, Senate Committee on Finance, App. F, n.4 (July 19, 2004) [hereinafter ABA LETTER].

that both predate and are eerily parallel to the Enron debacle of 2001 are generally credited with generating this attention. The Coalition for Nonprofit Healthcare published a “Corporate Responsibility Guidebook” in November 2002, which tracks the “corporate responsibility environment” as one informed by actions of Minnesota Attorney General Mike Hatch in pursuing the Allina organization in 2000-2001, but credits even before that (and outside of Minnesota):

[T]he long-running saga of the bankruptcy and related litigation involving AHERF [Allegheny Health Education and Research Foundation], which began in 1998. At its core, this controversy involved alleged failures of oversight by corporate governance and lapses in the monitoring of the financial integrity of the health system and the actions of certain members of senior management. The bankruptcy, and ultimate settlement of ongoing litigation in 2002, result in the return of over \$75 million to existing endowment funds The high-profile AHERF failure (and resulting dissipation of charitable assets) has made state attorneys general increasingly sensitive to their obligation to monitor the degree of stewardship of charitable assets by governing boards.³⁶

Not only has the current Minnesota Attorney General been one of the country’s most proactive in pursuing organizations perceived to have lax board oversight and insider self-dealing,³⁷ but his predecessor, Hubert H. Humphrey III, in office through the year 2000, led an investigation in 1998 which resulted in an agreement with one of Minnesota’s most beloved charitable institutions, Minnesota Public Radio, to the end of ensuring the board’s appropriate independent oversight in setting management

36. COALITION FOR NONPROFIT HEALTH CARE, CORPORATE RESPONSIBILITY GUIDEBOOK 2 (2002), *available at* http://www.healthlawyers.org/pg/tax/docs/tax_guidebook_0212.pdf (last visited Oct. 1, 2004).

37. In addition to Allina, Attorney General Mike Hatch pursued HealthPartners for alleged fiduciary lapses, with similar publicity of his staff’s investigative findings. His office also asserted breach of fiduciary responsibility against the Board of Directors of Minnesota Partnership for Action Against Tobacco. *See* Memorandum from Plaintiff State of Minnesota to Ramsey County District Court File C1-94-8565 (arguing by the Attorney General that the Board had a duty to act as a fiduciary for the State and the public in administering State funds received in settlement of tobacco litigation brought by the State of Minnesota against R.J. Reynolds and others, and failed to do so) (citing *Shepherd of the Valley Lutheran Church of Hastings v. Hope Lutheran Church of Hastings*, 626 N.W.2d 436 (Minn. Ct. App. 2001), *cert. denied*, 534 U.S. 1082 (2002)).

compensation.³⁸

Drawing on the statutory definitions of duties of directors of nonprofit organizations in Minnesota Statutes sections 317A.251 and 317A.255, the Minnesota Attorney General's website displays a series of policies for nonprofits to consider when developing standards to govern their operations and the conduct of board members, officers, directors, and employees.³⁹ According to the Attorney General's Office, its policies are offered as guides, and are based in part upon the policies adopted by Allina in connection with the Attorney General's recent compliance investigation of that organization.

With respect to conflicts of interest, the Minnesota Attorney General's sample policy emphasizes that board members, officers and management employees owe the public a fiduciary duty, "which carries with it a broad and unbending duty of loyalty and fidelity."⁴⁰ The board, officers, and management employees have the responsibility to administer the affairs of the nonprofit tax-exempt organization they govern "honestly and prudently, and [to exercise] their best care, skill, and judgment for the sole benefit of" their organization.⁴¹ Directors, officers, and management employees "shall exercise the utmost good faith in all transactions involved in their duties, and they shall not use their positions with [the organization] or knowledge gained therefrom for their personal benefit. The interests of the organization must be the first priority in all decisions and actions."⁴²

E. Internal Revenue Code

A charitable organization must serve a public, rather than a private interest, in order to meet the "operational test" of I.R.C. § 501(c)(3).⁴³ A charitable organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole

38. Letter from Sheila S. Fishman, Manager, Charities Division, Minnesota Attorney General's Office, to John E. Harris, Attorney, Faegre & Benson LLP (Jan. 27, 1998) (on file with author).

39. See Minn. Att'y Gen. website, at <http://www.ag.state.mn.us/charities/Default.htm> (last visited Oct. 1, 2004).

40. MINN. ATT'Y GEN., SAMPLE CONFLICT OF INTEREST POLICY 1 (2004), at <http://www.ag.state.mn.us/pdf/charities/ConflictInterestPolicy.pdf> (last visited Oct. 1, 2004).

41. *Id.*

42. *Id.*

43. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) (as amended in 1990).

or in part to the benefit of private shareholders or individuals having a personal and private interest in the activities of the organization.⁴⁴ These limitations have historically established an IRS counterpart, at least from a qualification perspective, that requires both charitable organizations and 501(c)(4) tax-exempt entities⁴⁵ to ensure that directors adhere to the fiduciary duty of loyalty that is imposed on a state basis as set out in statutory and/or case law.

Until 1996, the IRS was largely restricted in enforcing the prohibition on private inurement as the only action available to that agency was the revocation of exempt status from charitable organizations that had engaged in such transactions with directors or officers (or their family members). While this penalty may have been effective to prevent the charitable organizations from engaging in these activities in the future, it did nothing to recoup improper payments of compensation or issuance of other benefits to the individuals who had received them, and perhaps served a countervailing purpose in ultimately causing the loss of programs when revocation signaled loss of gift or grant income.

Congress added § 4958 to the I.R.C. in 1996.⁴⁶ Through enactment of this section and its attendant regulations, the IRS gained new and far-reaching power shy of revocation, to assess excise taxes against certain individuals who receive unearned or excessive compensation or other benefits from a charitable organization (or other entities subject to the statute), and potentially upon even other fiduciaries of the charitable organization who approved the transaction, knowing it to convey “excess benefit.”⁴⁷ Section 4958 and its regulatory implementation

44. Treas. Reg. §1.501(c)(3)-1(c)(2) (as amended in 1990). The term “private shareholder or individual” in § 501 refers to persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c) (as amended in 1982).

45. The Code was amended in 1996 to include a “no private inurement” proscription for 501(c)(4) exemption. *See* Taxpayers Bill of Rights 2, H.R. 2337, 104th Cong. § 1311 (1996).

46. *Id.* (effective for transactions occurring on or after September 14, 1995). *See supra* note 5.

47. *Id.* I.R.C. § 4958 applies to all 501(c)(3) organizations except those classified as private foundations, to organizations described in 501(c)(4) (in the latter instance, regardless of whether exemption has been applied for, if the organization holds itself out as so exempt), and to entities who were revoked from 501(c)(3) status while holding non-private foundation status or from 501(c)(4) status in the last 60 months. *See supra* note 5.

are known as “intermediate sanctions,” as they represents an arsenal of sanctions available to the IRS short of revocation of the organization’s tax-exempt status.

In general, § 4958 sanctions apply when a subject entity has engaged in an “excess benefit transaction”⁴⁸ with one of its “disqualified persons.” A “disqualified person” is a natural person or organization who was in a position of “substantial influence”⁴⁹ over the affairs of the organization at any time during the five-year period ending on the date of the transaction, as well as their family members and parties in certain relationships to one or more disqualified persons.⁵⁰ An “excess benefit transaction” is one where an economic benefit is provided by an applicable organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing such benefit.⁵¹ For purposes of the intermediate sanctions regulations, the term “compensation” is broad, and includes all forms of cash and non-cash compensation, or benefits including salary, bonuses, deferred compensation which is earned and vested, premiums for liability, or any other insurance coverage and other types of benefits (whether or not includable in taxable income).⁵²

It is important to note that Congress provided what is in essence a “safe-harbor” for boards of directors to use in order to switch the burden of proof away from the taxpayer (and, accordingly, to the IRS) to show that a transaction with a disqualified person has not conveyed any “excess benefit.”⁵³ The

48. See Treas. Reg. § 53.4958-4(a) (2002) (defining an excess benefit transaction as one in which “an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.”).

49. See Treas. Reg. § 53.4958-3(c) (2002) (classifying voting members of the governing body; presidents, chief executive officers, or chief operating officers; treasurers and chief financial officers; and persons with a material financial interest in a provider-sponsored organization as automatically having “substantial influence,” and providing a “facts and circumstances” test for others).

50. *Id.*

51. *Id.* § 53.4958-4(a).

52. *Id.* § 53.4958-4(b)(ii)(B)(1).

53. H.R. REP. NO. 104-506, 104th Cong. 2d Sess. (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143; Treas. Reg. §53.4958- 6 (2002) (providing a rebuttable presumption that a transaction is not an excess benefit transaction).

so-called “safe harbor” is no more than an aspirational standard for appropriate due diligence when a conflict is noticed between the organization and parties who themselves hold, or have a relationship with someone who holds (or has been in the last sixty months able to exert), substantial influence over the organization. If the following procedures are undertaken, the amount of compensation paid to a “disqualified person” is presumed to be reasonable and/or a transfer of property between an exempt organization and a “disqualified person” is presumed to be at fair market value:

- 1) The compensation arrangement or terms of the transfer are approved by the organization’s board of directors, or committee of the board or a properly authorized body independent of the disqualified person;⁵⁴
- 2) the decision-making board obtained and relied on appropriate data regarding comparability before making its determination;⁵⁵ and 3) the decision-making body adequately documented the basis for its determination by the later of the next meeting of the decision-making body,⁵⁶ or sixty days after final approval of the transaction by the decision-making body.⁵⁷

For organizations with less than \$1 million of annual gross receipts, the authorized body will be deemed to have considered appropriate data on comparability of compensation if it has reviewed data on compensation paid by three similar groups for similar services.⁵⁸

In accord with the enactment of I.R.C. § 4958, Form 990 was modified to reflect the application of the statute. Line 89b of Form 990 asks 501(c)(3) and 501(c)(4) filers whether the reporting organization engaged in any “excess benefit transactions” during the reporting year, or whether it became aware of any “excess benefit transaction” from a prior year during the reporting year. In addition to the specific reference to that excise tax scheme, it has long been the case that Part III of Schedule A⁵⁹ of Form 990 asks

54. Treas. Reg. § 53.4958-6(c)(1) (2002).

55. *Id.* § 53.4958-6(c)(2).

56. *Id.* § 53.4958-6(c)(3)(i).

57. *Id.* § 53.4958-6(c)(3)(ii).

58. *Id.* § 53.4958-6(c)(2)(ii).

59. The Schedule A is a required, six-page add-on to the annual return that is required of all 501(c)(3) organizations holding public charity classification. Schedule A (I.R.S. Form 990 or Form 990 E-Z) (2003), *available at* <http://www.irs.gov/pub/irs-pdf/f990sa.pdf> (last visited Oct. 1, 2004).

whether the organization has directly or indirectly engaged in certain described transactions, such as furnishing goods or services, during the reporting year, with a laundry list of individuals including directors and officers, substantial contributors, family members of those parties, etc.⁶⁰

Enforcement of intermediate sanctions by the IRS has begun in earnest. IRS Commissioner Everson submitted written testimony to the U.S. Senate Finance Committee in connection with a hearing on exempt organization reform on June 22, 2004.⁶¹ Commissioner Everson's testimony makes clear that the IRS has begun a new series of initiatives (including so-called "soft contacts" and limited audits), which are anticipated to touch at least 1,000 charities in 2004. The IRS intends to ask these charities for clarification about errors in their Form 990 filings or for information on how executive compensation and/or terms for transactions with insiders was set. While the Commissioner makes clear that the IRS's focus will be aimed at transactions and organizations who willfully flaunt the tax rules, most of the IRS's initiatives are designed to reach—and will touch—the more common and pedestrian charities, whose errors, if that, are inadvertent or sloppy, but certainly not malevolent. Not announced at the hearing, but well-communicated by IRS officials in other ways these last few months, is that these 1,000 limited contacts or audits represent the tip of the iceberg, as the IRS expects to make a total of 11,000 contacts this year in total with exempt organizations. This *modus operandi* is undoubtedly designed not only to show that "the sheriff is back in town" but also to educate and motivate those who have been sloppy or imperfect in complying with charity mandates (including management of compensation and insider transactions). The goal of these efforts is to have errant charities undertake reforms and move faster to adopt best practices.

60. Schedule A, Part III, q. 2 asks if any enumerated transactions take place by asking "[d]uring the year, has the organization, either directly or indirectly, engaged in any of the following acts with any substantial contributors, trustees, directors, officers, creators, key employees, substantial contributors, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee or majority owner, or principal beneficiary?" *Id.*

61. The IRS released the Commissioner's testimony as a written document on June 21, 2004. Available at <http://www.irs.gov/newsroom/article/0,,id=124186,00.html> (last visited Oct. 1, 2004). See also *infra* part II.F (discussing the impact of the Senate Finance Committee hearing).

As Lois Lerner, Director of the Exempt Organization Rulings and Agreements section of the IRS' office for tax-exempt organizations, noted in comments made at the American Bar Association's Tax Section Exempt Organization Committee meeting on May 7, 2004:

We're going to be targeting some high-risk areas—loans to employees, deals between employees and organizations, compensation as compared to assets. We will be following up with organizations that have checked the box saying they've been involved in excess benefit transactions. We're also going to be following up on folks who haven't checked any box with regard to excess benefit transactions.⁶² There are, I think, over 4,000 of the returns that we've looked at that don't have anything checked. And we thought, now, some of these people might have forgotten or made a mistake, but that's an awful lot of them. So we want to look behind why aren't people checking the box.⁶³

As discussed earlier, IRS Commissioner Everson described several efforts that the IRS is undertaking, including an initiative to “explore the seemingly high compensation paid to individuals associated with some exempt organizations.” He said that the initiative would be “aggressive,” would include both traditional examinations and compliance checks, and would aim to create “positive tension for organizations as they decide on compensation arrangements.” He also reported on a market segment initiative, involving approximately 400 examinations, designed to provide the IRS with more accurate information of the degree of compliance by private foundations. And, explaining that audit levels have fallen to historically low levels, he proposed to increase spending on audits of tax-exempt and government entities by seventeen percent by next year.

62. The question on Line 89b of the Form 990, to which Ms. Lerner refers in her comment, has two alternative check boxes: one for “yes” and one for “no.” When neither is checked, the filing organization is considered to not have made a “complete” return and the accuracy of its reporting (failure to check equals a “maybe”?) will be subject to IRS review, at least for those who find themselves the subject of one of the announced initiatives to review such filers. *Available at* <http://www.irs.gov/pub/irs-pdf/f990.pdf> (last visited Oct. 1, 2004).

63. Lois Lerner, *Edited Transcript of the May 7, 2004 ABA Tax Section EO Committee Meeting*, 45 EXEMPT ORG. TAX. REV. 27 (2004).

F. Recent Congressional Action

Spurred in part by the significant changes brought about in the oversight of publicly traded entities by the Sarbanes-Oxley Act,⁶⁴ Congress has continued to investigate charitable organizations' practices, particularly with respect to excessive compensation and private inurement. In 2003, two well-publicized reports harshly critical of how charity managers fail to guard against insider benefit, both in the private foundation and public charity communities, were published.⁶⁵ Those reports, alongside the House of Representatives' passage of H.R. 7,⁶⁶ suggest that big changes are in the works for the charitable sector.

Indications of the further regulation that Congress is

64. American Competitiveness and Corporate Accountability (Sarbanes-Oxley) Act of 2002, 15 U.S.C.A. §§ 7501-7266 (West Supp. 2004). While most of the provisions of the Sarbanes-Oxley Act do not directly apply to nonprofit charitable organizations, many commentators have discussed the implications of the Act for the charitable sector. See, e.g., Suzanne Ross McDowell, *Should Nonprofit Organizations Adopt the Rules of Sarbanes-Oxley?*, 16 TAX'N OF EXEMPTS 1, July/Aug. 2004; BOARDSOURCE & INDEPENDENT SECTOR, *THE SARBANES-OXLEY ACT AND IMPLICATIONS FOR NONPROFIT ORGANIZATIONS* (2003), at <http://independentsector.org/PDFs/sarbanesoxley.pdf> (last visited Aug. 1, 2004) [hereinafter BOARDSOURCE]; Patrice A. Heinz, *The Financial Reporting Practices of Nonprofits*, ALLIANCE FOR CHILD. AND FAM'S SARBANES-OXLEY REP., Aug. 2003, at http://www.alliance1.org/Home/SOX_final_8-03.pdf; Thomas A. McLaughlin, *For-Profit Spillover: New Regulation and Independence*, NONPROFIT TIMES, Feb. 1, 2003, at <http://static.highbeam.com/t/thenonprofittimes/february012003/forprofitspillovernewregulationofindependencetree/>; Martin Michaelson, *A New Era of Corporate Governance Bears Down on Higher Education*, 11 TRUSTEESHIP 37 Jan./Feb. 2003; Thomas Silk, *Ten Emerging Principles of Governance of Nonprofit Corporations*, 43 EXEMPT ORG. TAX REV. 35 (2004).

65. CHRISTINE AHN ET AL., GEORGETOWN PUB. POLICY INST., FOUNDATION TRUSTEE FEES: USE AND ABUSE (2003), available at http://cpnl.georgetown.edu/doc_pool/TrusteeFees.pdf (last visited Oct. 1, 2004). Starting in October 2003 and continuing into 2004, the *Boston Globe* ran a series of articles spotlighting private foundation abuses. See, e.g., Beth Healey, *Foundation's Sale of Nonprofit Hospital a Windfall for Administrator*, BOSTON GLOBE, Oct. 9, 2003, at A42; Beth Healey et al., *Charity Money Funding Perks*, BOSTON GLOBE, Nov. 9, 2003, at A1; Beth Healey et al., *Foundation Lawyers Enjoy Privileged Position*, BOSTON GLOBE, Dec. 17, 2003, at A1; Beth Healey et al., *Some Officers of Charities Steer Assets to Selves*, BOSTON GLOBE, Oct. 9, 2003, at A1.

66. H.R. 7, 108th Cong. (2003). The initial version of H.R. 7 would have strongly limited the administrative expenses of the private foundation community; in its passed version it did so more modestly, excluding from characterization as "qualifying distributions" (which in general must be paid out at a rate of 5% of all investment assets) three categories of administrative expenses: "indirect" administrative expenses, compensation exceeding \$100,000 for specific categories of individuals, and certain air travel expenses. *Id.*

contemplating emerged in testimony and preliminary legislative proposals that were discussed at a hearing held on June 22, 2004 before the U.S. Senate Finance Committee.⁶⁷ While many who testified at that hearing were more muted in their call for Congressional reforms,⁶⁸ a bipartisan “Staff Draft,” issued jointly by the Chairman of the Senate Finance Committee, Senator Charles Grassley (R-IA) and the ranking Member, Senator Max Baucus (D-MT), harshly criticized current nonprofit practices in three areas: tax evasion, governance, and operations.⁶⁹

With respect to the first arena – tax evasion – concern was expressed that tax shelter practices of an abusive nature have spread significantly to the charitable community. Chairman Grassley said that there are “a growing number of individuals who knowingly set up a charity to evade taxes.”⁷⁰ Senator Baucus criticized “charities engaging in abusive tax shelters.”⁷¹ IRS Commissioner Everson said that, if the abuses were not checked, “there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised.”⁷² The practices of concern fell into two main categories: outright tax fraud and sophisticated shelters. It should be noted that included in the “tax fraud” category were reports of overvaluation (by donating taxpayers) of donated cars and other assets. Any charity taking

67. *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing before the S. Fin. Comm.*, 108th Cong. (2004), <http://finance.senate.gov/sitepages/hearing062204.htm> (last visited on Aug. 10, 2004) [hereinafter *Hearings*].

68. In addition to the Commissioner of the IRS, Mark Everson, other key witnesses included William Josephson, Assistant Attorney General of New York (Charities Bureau); Diana Aviv, President and CEO, Independent Sector; Derek Bok, President Emeritus, Harvard University; and Mark Macella, on behalf of the National Association of State Charity Officials. *Id.* There also were other witnesses, including those whose identity was concealed, testifying about various types of fraud that they had participated in or witnessed. *Id.*

69. The third problem described at the hearing, related to operations, addressed whether charities were devoting sufficient efforts towards achieving their charitable purpose. *Id.* As those underlying issues were not emphasized by the Committee’s Chair or Ranking member, nor the state witnesses, they are omitted from discussion here.

70. *Id.* at <http://finance.senate.gov/hearings/statements/062204cg.pdf> (last visited Oct. 4, 2004).

71. *Id.* at <http://finance.senate.gov/hearings/statements/062204mb.pdf> (last visited Oct. 1, 2004).

72. *Id.* at <http://finance.senate.gov/hearings/testimony/2004test/062204me-test.pdf> (last visited Oct. 1, 2004).

donations of non-cash property (including intellectual property) will be well served to apply due diligence to the organization's practices in this area.

Governance reforms also occupy much attention in the Staff Draft. Chairman Grassley spoke of the various failings witnessed (or awaiting disclosure) at charities where "poor governance or failure to abide [by] best practices" occurs.⁷³ Senator Baucus criticized "inflated salaries" and "insider deals."⁷⁴ IRS Commissioner Everson (speaking for the current White House) started his testimony by addressing "the need for enhanced governance."⁷⁵ Invoking recent problems in the corporate sector, he said:

In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a corporation, its executives, its accountants and auditors, and its legal counsel. *Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. . . . All these reflect potential issues of ethics, internal oversight, and conflicts of interest.*⁷⁶

Everson went on to specifically criticize "the governing boards of tax-exempt organizations [that] are not, in all cases, exercising sufficient diligence as they set compensation for the leadership of the organizations."⁷⁷

The Staff Draft includes the following proposed regulatory changes related to exempt organization governance. While these proposals have not been made law at this time,⁷⁸ they provide

73. *Id.* at <http://finance.senate.gov/hearings/statements/062204cg.pdf> (last visited Oct. 1, 2004).

74. *Id.* at <http://finance.senate.gov/hearings/statements/062204mb.pdf> (last visited Oct. 1, 2004).

75. *Id.* at <http://finance.senate.gov/hearings/testimony/2004test/062204me-test.pdf> (last visited Oct. 1, 2004).

76. *Id.* (emphasis added).

77. *Id.*

78. An invitation-only, closed-door hearing was scheduled by the U.S. Senate

insight into the breadth of the changes that are being contemplated. In fact, they reveal that Congress is considering the need to extend the authority of the IRS into areas of nonprofit governance that have only been subject to State oversight in the past. Some of the proposals would:

(a) Change governance practices—these will have to be adopted and maintained *in order for 501(c)(3) status to be granted and/or continued*:

- Size of boards—would require boards to consist of between three and fifteen members.
- Boards would have to establish and oversee—basic organizational and management policies; program objectives and performance measures; the conduct of business, including approving significant transactions; accounting and auditing practices (including retaining of an independent auditor); review and approval of budgets.
- Boards would be *required* to have conflict of interest policies and would be required to report annually on Form 990 a summary of determinations made under the policy.
- Boards would have to establish and maintain a compliance program, and include in same procedures for reviewing complaints against the organization.

(b) Increase transparency of board's decision-making in general and specifically with respect to overseeing key staff and managing compensation:

- Organizations would be required to report how often the Board of Directors met, including how often the meeting occurred without the CEO (or equivalent) present.
- New safe harbors and ceilings for compensation to certain individuals would be created (in some cases mandatory IRS review would be required); in addition, annual review by the board and public disclosure of supporting materials considered in setting

Finance Committee on July 22, 2004 as a follow-up. The American Bar Association prepared comments on the Staff Draft for that hearing, many of which urged Congressional restraint. See ABA LETTER, *supra* note 35.

compensation would be required.

(c) Require every tax-exempt organization to undergo a review, every five years, to determine “whether the organization continues to be organized and operated exclusively for an exempt purpose.”⁷⁹

(d) Permit IRS to share confidential taxpayer information with state regulators.

(e) Create new rights of action, allowing states, directors, or private individuals to bring an action against a charitable organization for violating federal tax and other requirements.

(f) Require an organization’s Form 990 to be reviewed by a so-called “independent auditor”; increase penalties for failing to file timely and create new penalties for errors in reporting on the form.

(g) Require the CEO of an exempt organization to sign a statement that the CEO had put procedures in place that would ensure that the organization’s filings with the IRS complied with the tax laws.

(h) For all charities, limit expenses for travel, meals, and accommodation to the applicable federal governmental rate.

(i) Establish a new series of federal standards or “best practices” for the governance of tax-exempt organizations. The basic standard is akin to the standard already enunciated in Minnesota law for nonprofit corporations, but breach of the new standards would bring federal liability:

In performing duties, a Board member has to perform his or her duties in good faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the

79. It is interesting that the President/CEO of Independent Sector, Diana Aviv, seemed to support some version of this proposal, noting that “there is an interest by some in a more thorough examination of a sampling of public charities from time to time to ascertain whether the organizations continue to meet the requirements for recognition as charitable tax-exempt organizations.” *Hearings, supra* note 67.

mission, goals, and purposes of the corporation. An individual who has special skills or expertise has a duty to use such skills or expertise.⁸⁰

III. WHAT THE DEVELOPMENTS PORTEND REGARDING “DEMANDS FOR INCREASED CAPACITY”

Nonprofit board governance has always been subject to oversight by a combination of state and federal laws and regulations. In the wake of some abuses of nonprofit organizations by key staff and governors in both the for-profit and nonprofit worlds, oversight by governmental authorities is stepping up. In addition, public awareness of and interest in issues of nonprofit governance has increased. Lois Lerner, in her remarks to the ABA Tax Section Exempt Organization Committee in May 2004, noted that the increased availability of information about charitable organizations to state and federal regulators and to the public will act to discourage organization managers from abusing their positions as insiders of their organizations:

I mean [there is] more and better information out there about the organizations. If the information is out there and available to the IRS, to the public, to state regulating organizations, we think that that's going to provide for broader oversight and, again, a little bit more focused thinking on the part of those people who run the organizations and those of you who deal with the organizations. We think it will actually help you in your job to explain to the folks who are coming in to talk to you that what you're doing is going to be out there, it's going to be available, you're going to be reading about yourself in the paper, and you want it to be positive rather than negative.⁸¹

The June 2004 hearing before the U.S. Senate Finance Committee and new initiatives undertaken by the IRS indicate that board governance will remain a key focus of interest and increased regulation. The trend on both the state and federal levels appears to be two-pronged: providing more and better information to charitable organizations on existing law and best practices for

80. SENATE FINANCE COMMITTEE, STAFF DISCUSSION DRAFT (2004), *available at* <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf> (last visited Oct. 1, 2004).

81. Lerner, *supra* note 63.

governance; and, particularly with the federal developments that have been discussed above, increased enforcement efforts to emphasize how serious a matter the responsible fiduciary control of charitable funds is.

A. *Duty of Care Recommendations*

Nonprofit charitable organizations would do well to review their governance practices to ensure that they are compliant with whatever new regulatory arrangements result from the current concerns over accountability.⁸² Several commentators have recommended specific steps in this area.⁸³ In particular, in the area of compliance with the fiduciary duty of care, the authors recommend that charitable organizations should:

(a) Recruit knowledgeable board members with skills in financial, programmatic and other substantive areas relevant to the applicable organization;

(b) Educate board members regarding their duties and encourage them to actively question management and outside advisors on any “red flags” they see;

(c) Ensure that board members know and follow written policies and procedures of the organization, and that they ensure that management complies with these as well;

(d) Educate potential board members about the commitment and responsibilities that their service will entail;

(e) Develop internal controls that require management to report significant events to the board, and

82. See, e.g., MINN. ATT’Y GEN., FIDUCIARY DUTIES OF DIRECTORS OF CHARITABLE ORGANIZATIONS (2003), available at <http://www.ag.state.mn.us/charities/charDuties.html> (last visited Oct. 1, 2004) (providing information that is relevant to board members’ fiduciary duties).

83. See, e.g., Silk, *supra* note 64; BOARDSOURCE, *supra* note 64. In addition, the authors would like to acknowledge the benefit of the recommendations made by Nancy Evert, in Best Practices for Governance and Management of Charitable Organizations in a Post-Enron Environment, Address at the Minnesota Council of Nonprofits Annual Conference (Oct. 2, 2003).

that specifies size or kinds of transactions that require board approval;

(f) Develop board self-evaluation mechanism (with the opportunity for input from staff and management) to ensure effective operation of the board, its committees and its individual directors;

(g) For larger organizations, consider the appropriateness of an outside “independent” audit committee: “independent” meaning composed of directors who are without ties to management or the auditor, without conflicts of interest, and who are not compensated. This committee would be charged with reviewing the audit in detail, hiring and supervising the auditor’s work with the organization, and ensuring that complaint procedures are in place for issues related to financial management of the corporation. They may also be responsible for risk management oversight.

B. Duty of Loyalty Recommendations

To comply with the fiduciary duty of loyalty, charitable organizations should identify meaningful ways to encourage board members, officers and staff to embrace the variety of resources they bring to the organization, but acknowledge at the same time that these connections inevitably lead to divided loyalties or “conflicts of interest.” In the authors’ experience, the title “conflict of interest” in the heading of Minnesota Statutes section 317A.255⁸⁴ and analogous other state statutes is too often read as defining the only situations in which a director must provide notice of a “conflict of interest.” A director’s withholding of information concerning a real, or even potential “conflict of interest” that falls outside of the statute’s narrow list of voidable transactions, may still comprise a breach of fiduciary duty to the extent that it prevents the corporation from evaluating whether an undertaking is in the best interest of the corporation.

The statute correctly underscores that transactions between the corporation and directors, their family members, or organizations that are related to directors, as well as between

84. See *supra* note 27 and accompanying text.

organizations related to the corporation and directors, their family and related organizations, are the *most* susceptible of conflict.⁸⁵ However, our experience has shown that those are not the only scenarios in which a director may have other interests that could be at odds with the charge to serve the corporation's "best interests" (in accord with the overarching standard of care from which the three duties being discussed in this part emanate). Loyalty with respect to serving the corporation and its best interests encompasses ongoing obligations well beyond managing the conflict scenarios with respect to whether the corporation meets one's own (or other so-called "insiders") interests.

We recommend the following specific steps in this regard:

(a) Adopt a substantive conflict of interest policy that addresses at minimum three types of transactions:

(1) Direct and

(2) indirect related-party transactions with officers and/or directors, including in this tier as 'indirect-related party transactions' those that occur with "close family members" of officers and/or directors, other individuals or with non-501(c)(3) organizations with which officers and/or directors or their "close family members" are affiliated.

(3) Perceived conflict of interest transactions.⁸⁶

(b) Document, with respect to any such related-party transactions, the pool of others who have been given consideration for the same opportunity, along with relevant features of their offers, reasons for choosing related party, and have the fact of a related-party's involvement, along with full facts thereof disclosed along with the other

85. MINN. STAT. § 317A.255 (2004).

86. See SAMPLE CONFLICT OF INTEREST POLICY, *supra* note 40. A different sample conflict of interest policy that encompasses the three tiers of transactions noted here, direct and indirect related-party transactions and a broader group of situations in which board members, officers and staff may have dual allegiances to the nonprofit organization they serve and to personal interests may be found on the authors' website, http://www.bamlawoffice.com/pdf/sample_coi_policy.pdf. Note that neither policy, however, sets out the procedures that are necessary to avail the corporation of the so-called "intermediate sanctions safe-harbors" for direct and indirect related-party transactions reached by I.R.C. § 4958.

information here in advance of the meeting in which the decision is to be made. (Note that in the case of tier-1 transactions, it may be necessary for the Board to procure independent comparability data to evaluate as part of setting the transaction's terms, to avoid excise tax liability under I.R.C. § 4958.)⁸⁷

(c) Set a higher threshold for approving the transaction (for example, requiring same to be approved by 2/3 of the uninterested directors, rather than the majority that would typically be required for an act of the Board), and document all votes ye or nay on the transaction.

(d) Have Board members regularly review the organizations with which they have a "material financial interest," and the pool of connections their "close family members" (as the corporation's policy has defined those individuals) have with other individuals and/or organizations in which they hold a "material financial interest."

(e) Document, with respect to any compensation issues with insiders, that compensation is reasonable based on objective data; that only uninterested directors considered the data and how the Board arrived at a decision about it; and who was at the meeting approving the compensation.

C. Duty of Obedience Recommendations

To ensure that the organization complies with the duty of obedience, charitable organizations should develop a method by which directors are educated regarding the governmental filings that are required, and understand what mechanisms are in place each year to ensure that same are timely and accurately filed. Of particular importance for fiduciaries in the current climate is planning to bring appropriate review to the organization's completed Annual Return of Exempt Organization (i.e., Forms 990, 990-EZ and 990-PF). The authors anticipate from the clear trend of the law in this area, as well as likely calls for increased

87. See *supra* note 53 and accompanying text.

disclosure of charity's governance capacity on such filings⁸⁸, that fiduciaries of charitable organizations will be expected to know what information is disclosed about the organization's activities and undertakings (including transactions with insiders) on these filings. Undertaking educational initiatives⁸⁹ now with boards, as well as with internal reviewers and/or paid preparers of Form 990 series filings, would be a valuable proactive step, particularly given that these filings are now, as discussed above, the focus of both increased IRS enforcement review and public scrutiny.

88. For example, the July 19, 2004 ABA submission to the Senate Finance Committee hearing supported in large part the recommendation in the Committee's Staff Draft that additional governance focus be advanced through the addition of new Form 990 series questions. ABA LETTER, *supra* note 35. The ABA letter states that the "concept in the Discussion Draft that the Form 990 could be used as a vehicle to promote strong governance and best practices is appealing for a number of reasons. . . . including a governance section on the Form 990 would allow the IRS to educate charities on the importance of this issue" *Id.* The same submission also made the *suggestion* that "Form 990 might also include a check-box affirmation that copies of Form 990 were provided to each member of the EO's governing body." *Id.* at 5.

89. Over the course of the last several years, various initiatives have developed to encourage improved education of board members and officers on the Form 990 filing that is required for almost all exempt organizations (the chief exception from the filing requirement is for churches) whose gross receipts average more than \$25,000 a year. For example, in 2001 a group of representatives of the Minnesota Attorney General's office, the private bar (including the authors), the CPA community, and finance officers of Minnesota charities began working together as the Minnesota Nonprofit Accountability Collaborative ("NAC"). The group designed workshops and publications on the theme "Making Your Form 990 Work for You." That effort, which culminated in 2003, yielded eight workshop presentations to date and produced two technical assistance publications for lay readers, including "Tips for Telling the Truth—a Form 990 Tool," *available at* <http://www.crcmn.org/npresources/truthtips.pdf>. This publication addresses the four priority areas that the NAC found that 990 preparers were in need of the most education: explicating program service accomplishments; documenting and disclosing expenses appropriately under the Statement of Functional Expenses; understanding what comprises reportable fundraising expenses; and disclosing insider transactions and compensation. *Id.*