**BOUNDARIES CONVERSATION**

ABOUT OUR

CHARITABLE ORGANIZATIONS

Panel and Audience Discussion with

Harriet Moss

Chair

 West Marin Fund

Catherine J. Porter

Executive Director

West Marin Fund

Tom Silk

Legal Counsel

Wednesday October 16 3:30-5:30 Dance Palace Point Reyes Station

**Preface**

For 50 years now, I have been practicing law, mostly nonprofit law, advising funders, managers, and directors, mainly of charitable organizations, about legal issues that may arise in the formation, operation, and termination of charitable organizations.

The missions of those organizations are enormously varied and include

educational, religious, cultural, human rights, animal rights, and environmental causes.

However diverse their missions and activities, I have become aware that a common theme, present in all charitable organizations, is to make the world a better place.

This common idealistic goal carries with it a spiritual dimension, including a consciousness and gratitude for being of service that becomes, for many, the central benefit of their involvement with the charitable organization.

Today we will address some of the practical legal issues that may arise in the life-cycle of a charitable organization, to better enable you to succeed in your involvement with your charitable organization and to provide you with this guide for your future reference.

Aware that the notion of making the world a better place is not confined to the charitable sector and is embraced also by individuals, businesses, and other organizations beyond the charitable sector, our larger hope is that our joint efforts today will expand its reach even further and deeper.

Tom Silk

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**Fiduciary Duty Boundaries**

Traditionally, the phrase “fiduciary duties”, taken from trust law, refers to the two customary duties of a trustee: the duty of loyalty and the duty of care.

In California, Section 5231(a) of California’s Nonprofit Corporation Law sets forth the duty of loyalty (the duty of a director to perform his duties in a manner the director believes to be in the best interest of the corporation) and the duty of care (the duty of a director to act in good faith, in a manner the director believes to be in the best interest of the corporation, with such care including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances).

Section 5231(b) describes circumstances under which a director may rely on the advice of qualified individuals, and Section 5231(c) provides that the director shall not be liable if the director acted in accordance with subsections (a) and (b).

As used in the field of charitable law today, the concept of fiduciary duties has a much broader reach that the duties of loyalty and care and may refer to any of the obligations, including emerging principles as well as best practices, of directors of charitable organizations.

Here are ten emerging principles for boards of directors, drawn both from charitable and corporate worlds, that we recommend each charitable organization consider implementing.

1. The board of directors should engage in active, independent, and informed oversight of the activities of the charity, particularly those of senior management.

2. Directors with information and analysis relevant to the board’s decision

making and oversight responsibilities are obligated to disclose that

information and analysis to the board and not sit passively.

3. Every board should have a nominating/governance committee composed entirely of directors who are independent in the sense that they are not part of the management team and they are not compensated by the corporation for services rendered to it, although they may receive reasonable fees as a director. The committee is responsible for nominating qualified candidates to stand for election to the board, monitoring all matters involving corporate governance, overseeing compliance with ethical standards, and making recommendations to the full board for action in governance matters.

4. Every charitable organization with substantial assets or annual revenues

should develop and implement a three-tier annual board evaluation

process whereby the performance of the board as a whole, each board

committee, and each director are evaluated annually. The board should

also develop and implement a process for review and evaluation of the

chief executive officer on an annual basis.

5. The board of directors should be mindful of setting a “tone at the top”, and overseeing ethical conduct, including the adoption of a conflict of interest policy requiring an annual review and signature by each director.

6. Every charitable organization with annual revenues of $2 million or more must be audited annually by an independent auditing firm.

7. The chief executive officer and the chief financial officer should review, prior to filing, Form 990, the annual tax return filed by the charitable organization with the IRS.

8. Any attorney providing legal services to a nonprofit corporation who learns of evidence that the attorney reasonably believes indicates a material breach of fiduciary duty or similar violation shall report that evidence to the chief executive officer of the nonprofit corporation and, if warranted by the seriousness of the matter, to the board of directors.

9. Every nonprofit corporation should adopt a written policy setting forth standards for document integrity, retention, and destruction. Section

1102 of the Sarbanes-Oxley Act provides that whoever alters or destroys any document with the intent to obstruct the investigation or proper administration of any matter within the jurisdiction of any federal agency or department is guilty of a felony. This provision applies to individuals within nonprofit corporations as well as business corporations.

10. Every nonprofit corporation should adopt a written policy to permit and

encourage employees to alert management and the board to ethical

issues and potential violations of law without fear of retribution. This is based on Section 1107 of the Sarbanes-Oxley Act which treats as a felony any discharge, demotion, or harassment of any employee who provides to a law enforcement official true information about the potential commission of a federal offense. This provision also applies to individuals within nonprofit corporations as well as business corporations.

**Charitable Purpose Boundaries**

The activities of a charitable organization must occur within boundaries consistent with its charitable purposes, as set forth in its charter (its trust, articles of incorporation, or similar founding document).

California law does not permit a charitable organization to engage in activities beyond the scope of its charitable purpose.

This rule is called the charitable trust doctrine, and it is enforced by California’s Attorney General who is responsible for regulating charities in California.

The charitable trust doctrine is not a law enacted by the legislature, it is court made law. Conceptually, the doctrine is based on the trust notion that funds contributed to a trust by the trustor or donor must be held and used in accordance with the intent of the donor, and the intent of the donor may be inferred from the charitable purpose specified in the trust or articles of incorporation of the donee.

Two examples: (1) the assets of an organization whose articles provided that its charitable purpose was the operation of a hospital could not abandon that activity to operate medical clinics instead, and (2) on the dissolution of a Baptist church, its assets must be distributed to another Baptist church rather than to a church of a different denomination.

The charity is free to change its charitable purposes by amending its charter, but the change will apply only to assets acquired after the change. Assets acquired prior to the change must continue to be used for the purposes in effect at that time.

The charity may also change its existing us of assets only by a court judgment in a *cy pres* action brought by the charity which succeeds in proving that its specific charitable use has become illegal, impossible or impracticable.

**Lobbying Boundaries**

Federal tax law does not permit a section 501(c)(3) organization (“charitable organization”) to engage in unlimited lobbying (attempts to influence legislation).

For most charitable organizations, lobbying boundaries are described by either of two rules.

**The first rule** is the substantiality rule, enacted in 1934. It provides that attempts to influence legislation may not constitute a substantial part of the overall activities of a charitable organization.

Exactly what constitutes “substantial” is measured in terms of time and money devoted to lobbying and is determined on a case by case basis.

Crossing the substantiality border, however indistinct it may be, may result in the loss of the tax exemption, resulting in all of the income of the previously exempt organization being subject to tax. Moreover a tax of 5% of the lobbying expenditures may be imposed against the directors and officers who made the expenditures.

**The second rule** is the expenditure test, enacted in 1976 in response to the vagaries of the substantiality test. It is available to exempt organizations other than churches and private foundations.

This test is also unavailable to any charitable organization that exceeds the annual maximum lobbying nontaxable amount expenditures of $225,000 plus 5% of the exempt purpose expenditures over $1,500,000. Under his test, the maximum amount any charitable organization may spend on lobbing is $1,000,000.

The expenditure test permits a precise dollar amount of expenditures to be made for lobbying measured as a percentage of the amount of exempt purpose expenditures. For example, if the exempt organization spends $500,000 or less on its exempt purpose expenditures, it may spend on lobbying up to 20% of that amount.

**Charitable organizations eager to benefit from the clarity of the expenditure test must elect to use it by filing Form 5768 with the IRS**. The election may be made at any time during the year, and it remains in effect for succeeding years.

We recommend that all charitable organizations with any significant lobbying activities file Form 5768 if they qualify, so they may benefit from the clarity of the expenditure test.

**Electioneering Boundaries**

Federal tax law is clear. Section 501(c)(3) organizations (“charitable organizations”) are not permitted to support or oppose a candidate for election to public office.

That section denies exemption to organizations that “participate in, or intervene in (including the publishing or distribution of statements) on behalf of (or in opposition to) any candidate for public office”. Because the prohibition against election campaign intervention is expressed in absolute terms, even an infraction may result in loss of exemption.

There is, not surprisingly, a tension between political campaign activities (prohibited) and voter education activities (permitted). The IRS has ruled that a charitable organization may properly prepare and disseminate the voting records of candidates for public office, so long as there is no editorial comment and no approval or disapproval of the voting records is implied.

How then may issues driven charitable organizations speak out in elections where the issues they support or oppose may be impacted by the results of those elections?

The answer is what has come to be known as the sibling options. If a charitable organization wants to get involved in electioneering or is chafing against the restrictions on lobbying one option might be to form a Section 501(c)(4) social welfare organization which is free to lobby without limit so long as it furthers social welfare and to engage in electioneering so long as that is not its sole purpose. Another option might be a Section 527 PAC or political action committee to carry out election related activities, so long as no funding comes from the related (c)(3).

**Commercial Activities Boundaries**

On the boundary between charity and business, a charitable organization may encounter the question of how much business or commercial activity it may engage in without risking the loss of its exemption or the puzzle of what amount of UBIT (unrelated business income tax) must it pay.

Consider the following patterns of commercial activities of a charitable organizations: (1) commercial activities are non-existent or do not rise to the level of a trade or business, (2) commercial activities are so extensive that they amount to a trade or business, but the trade or business is related, (3) the trade or business is unrelated but insubstantial compared with its exempt activity, or (4) the trade or business remains unrelated but now it is substantial compared with its exempt activity.

In the first two examples, there are no income tax consequences because there are no commercial activities, the activities are not sufficient to constitute a trade or business, or because the trade or business is related. Examples include the fees charged by universities and museums and other educational and cultural organizations.

In the last example, the organization fails to qualify for a federal exemption from income tax. If a substantial portion of a charitable organization’s income is from unrelated sources, it cannot qualify for tax exemption. The IRS may deny or revoke the exempt status of an organization where it regularly derives over one-half of its annual revenue from unrelated activities.

In the third example, the organization will retain its exemption but it must pay income tax on the net income from its unrelated activities unless they come within on of the many modifications (examples: income, rent, dividends, and other so-called passive income are not taxable) or multiple exceptions (examples: a business in which substantially all of the work is performed by volunteers or where substantially all of the merchandise sold is contributed to the business)

**Insurance Boundaries**

Insurance coverage for charitable organizations usually takes the form of a number of policies with separate insurers including general liability, volunteer accident coverage, property, directors and officers insurance.

Despite its misleading name, general liability insurance does not cover all forms of potential liability. Typically, a general liability policy covers bodily injury, damage to property, personal injury and claims arising from advertising.

General liability policies often exclude accident coverage for volunteers. Charitable organizations that make significant use of volunteers may want to consider obtaining separate coverage for accidents of volunteers.

Insurance for the real estate owned by a charitable organization will usually be covered by a separate property insurance policy, including related claims such as fire or flood.

Directors and officers (D&O) insurance is designed to cover actions and decisions of the board of directors and to protect the directors from liability.

Among the items a directors and officers policy should include is broad coverage for all types of employment related actions, including wrongful termination, harassment, discrimination, failure to hire, etc. It should also pay defense costs as they are incurred, not on a reimbursement basis.

For small charitable organizations the premium cost for $1 million of D&O coverage will usually range between $600 to $1,000 annually.

The insurance industry tells us that the most frequent claims made under a D&O policy – over 90% nationwide – are those filed by former employees for wrongful termination.

We strongly recommend that every charitable organization obtain an insurance broker, preferably one that specializes in working with nonprofits. Such a specialist will probably obtain your organization’s insurance through NIAC, Nonprofit’ Insurance Alliance of California, enabling you to benefit from NIAC’s extensive employment law resources.

**OUR CHARITABLE ORGANIZATION**

 Conflict of Interest Policy

Article I

Purpose

The purpose of the conflict of interest policy is to protect the interest of OUR CHARITABLE ORGANIZATION (OCO) when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer director of OCO or might result in a possible excess benefit transaction.

Article II

Definitions

1. Interested Person

Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

2. Financial Interest

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

a. An ownership or investment interest in any entity with which OCO has a transaction or arrangement,

b. A compensation arrangement with OCO or with any entity or individual with which OCO has a transaction or arrangement, or

c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which OCO is negotiating a transaction or arrangement. Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial. A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

Article III

Procedures

1. Duty to Disclose

In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

a. An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.

b. The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

c. After exercising due diligence, the governing board or committee shall determine whether OCO can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.

d. If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in OCO’s best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination it shall make its decision as to whether to enter into the transaction or arrangement.

e. Alternatively, the transaction may be approved by a committee or person authorized by the Board so long as (1) the committee or person approves the transaction in a manner consistent with a through e, (2) it was not reasonably practicable to obtain Board approval of the transaction prior to entering into the transaction, and (3) the Board also determines that the transaction is fair and reasonable to OCO at the time it was entered into and OCO entered into the transaction for its own benefit, and the Board, at its next meeting, ratifies the approval of the transaction by the committee or authorized person. by a vote of a majority of directors then in office without counting the vote of any interested director.

4. Violations of the Conflicts of Interest Policy

a. If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

b. If, after hearing the member’s response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

Article IV

Records of Proceedings

The minutes of the governing board and all committees with board delegated powers shall contain:

a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board’s or committee’s decision as to whether a conflict of interest in fact existed.

b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

Article V

Compensation

a. A voting member of the governing board who receives compensation, directly or indirectly, from OCO for services is precluded from voting on matters pertaining to that member’s compensation.

b. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from OCO for services is precluded from voting on matters pertaining to that member’s compensation.

c. No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from OCO, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

Article VI

Annual Statements

Each director, principal officer and member of a committee with governing board delegated powers shall annually sign a statement which affirms such person:

a. Has received a copy of the conflicts of interest policy,

b. Has read and understands the policy,

c. Has agreed to comply with the policy, and

d. Understands OCO is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

Article VII

Periodic Reviews

To ensure OCO operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

a. Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm’s length bargaining.

b. Whether partnerships, joint ventures, and arrangements with management OCOs conform to OCO’s written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes and do not result in inurement, impermissible private benefit or in an excess benefit transaction.

Article VIII

Use of Outside Experts

When conducting the periodic reviews as provided for in Article VII, OCO may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

**OUR CHARITABLE ORGANIZATION**

**Annual Affirmation Statement**

The Conflict of Interest Policy of OUR CHARITABLE ORGANIZATION (OCO) requires an annual affirmation that each director, principal officer, and member of any committee with governing board delegated powers (1) has received a copy of the Conflict of Interest Policy, (2) has read and understands the Policy, (3) has agreed to comply with the Policy, and (4) understands OCO is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes. Also, the Policy requires that you annually disclose (5) your affiliations with any organization with which OCO may have a financial relationship, and (6) persons with whom you have a close relationship (such as a family member or close companion) who are affiliated with any organization with which OCO may have a financial relationship.

Please sign this Statement indicating your affirmation as described above. Please disclose, in addition, any applicable affiliations known to you.

Please complete and return this Statement to the Executive Director of OCO prior to the first Board meeting in the following calendar year.

 Your name: Date:

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| --- | --- | --- |
| Business/Organization | Nature of Relationship | Dates of Relationship |

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Please use another piece of paper if your answer requires more space.

Reviewed for OCO by: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Date: \_\_\_\_\_\_\_\_\_\_\_\_\_