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CHAPTER 1

SETTING THE STAGE: SOME PRELIMINARIES

Send lawyers, guns, and money, Dad, get me out of this.

WARREN ZEVON[1]

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You may be passionate about addressing literacy problems in your community, or perhaps the senior partner in your advertising agency or law firm has told you that you will be serving on the board of directors of a business association that sponsors an annual street festival. Then again, a friend who is chairman of an inner-city hospital might have tapped you for service on the hospital's board—or your generous contributions to the local opera company may have been noticed, causing the company's development director to ask you to serve as a board member.

There are many routes to service as a director or officer of a nonprofit. Whatever your route to service, you need guidance. This is true even if you are an attorney or accountant because like it or not, the other board members will assume you are an expert in nonprofit law, regulation, and taxation. That will be true even if you limit your practice to divorce or admiralty law, or to auditing Fortune 500 companies.

This *Guide* is designed to help you fulfill your responsibilities by providing you some needed information. It covers a wide range of topics, including (1) how nonprofits are legally organized, (2) the roles, responsibilities, and duties of directors and officers, (3) the basic tax rules affecting nonprofits and donors to charities, (4) the laws regulating fundraising, (5) organizational risks, and

1. *Lawyers, Guns and Money,* on EXCITABLE BOY (Asylum 1976).

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(6) steps that you can take to protect yourself from liability as a volunteer director or officer. To spur discussion within your own organization, the *Guide* concludes with an organizational self-evaluation that summarizes the many issues it covers.

The challenges facing those who run nonprofits are daunting. The primary mission of nonprofits is to educate students, treat the sick, feed the hungry, provide legal services to the disadvantaged, display art and perform music to enlighten, and serve the community in any number of other ways. Yet, nonprofit directors, officers, and employees must seek contributions and grants, comply with complicated tax laws, report to a variety of governmental agencies, protect assets, maintain records, manage multiple risks, and stand accountable to various constituencies.

The only way those running nonprofits can succeed in achieving their primary missions is to act in concert with each other in developing systems and controls to successfully complete all secondary tasks. This means that the board and the executive director must be partners, exhibiting mutual respect for each other. In many instances, the organization is the brainchild of the executive director who saw a need, nurtured an idea to meet that need, found the funding to build an organization to implement the vision, and selected the directors. In other words, the executive director is often a very strong-willed person. The natural tendency will be for the board to defer to the executive director.

That deference can be a fatal mistake, although few realize this until it is too late. As visionaries, executive directors tend to be mission focused, viewing much of what we will consider in this *Guide* as burdensome detail, red tape, and administration that interferes with the mission. One has only to reflect on the many scandals that have plagued the nonprofit sector during the last decade to realize that the headlines are rooted in failure to pay attention to secondary aspects of running an organization: risk management, control, red tape, and administration. There were no conflict-of-interest or gift-acceptance policies in place. Financial controls were inadequate. The organization operated without budgets or acceptable financial reports. There were no procedures to ensure compliance with restrictions in gifts. Investment policies and procedures were either nonexistent or poorly conceived. In almost every instance, one question, often unstated, lurks: Where was the board of directors?

The law clearly assigns duties to directors. Based on the belief that only so much can be asked of what are often volunteers, the law has regrettably gone too far in relieving directors of liability for breach of those duties. This does not mean that volunteers must live up to the law's low expectations by shirking their legal duties. As should be evident, board members should be actively engaged in the organization's governance, asking tough questions, and demanding that controls be put in place and adhered to. That does not mean that the directors and the executive director need be locked into a never-ending battle. Quite the contrary: By ensuring that adequate controls and reporting are in place, the board is actually freeing the executive director to focus on mission.

Are Nonprofit Directors Really Afraid of Liability? The Trustees of the Tampa Museum of Art Paint a Different Picture

* * *

Want to improve nonprofit governance? Lots of people do, and they prove it by making all sorts of proposals, but holding directors responsible is on absolutely nobody's agenda. Directors can ignore the financial statements. They can miss all of the meetings. They can approve transactions evidencing blatant conflicts of interest while ignoring statutorily mandated validation procedures. They can refuse to even acknowledge internal controls. While not universally true, a likely regulatory response will be removal rather than accountability through monetary liability, and even removal is relatively rare.

Why the resistance to mandating that directors act responsibly? "Everybody knows that if there is any possibility that a director will be held liable, nobody will serve as a volunteer director." That is the gospel. Nobody is willing to question something that is so obvious. But is it so obvious?

Consider the trustees of the Tampa Museum of Art. When the museum wanted to expand, it sought funding from the city of Tampa to the tune of $29.8 million.[2] The museum had raised $31 million as part of a capital campaign and hoped to raise another $20 million.[3] Tampa Mayor Pam Iorio was not satisfied, however, with the adequacy of the funding package. She literally asked the museum's trustees to guarantee their decision process as a condition to financial participation by the city. Specifically, the mayor asked the trustees to *personally* cover operating losses through 2015 with a $9 million guarantee.[4]

Given the old saw about directors refusing to serve if they are held to *any* level of accountability, the entire board of trustees would have been expected to resign on the spot, but that did not happen. You might assume, therefore, that the trustees engaged in a lengthy debate that went on for days, if not months. That did not happen. Did they spend hours in their lawyers' offices discussing asset protection trusts? Apparently not. Rather surprisingly, they quickly agreed to the guarantees.

There will be some who argue that the museum's directors were just a bunch of rich people who would have donated that sort of money to the museum over the next ten years. The recent fundraising experience of New York City's Museum of Modern Art (MoMA) suggests that there is some truth in that perception.[5] At the same time, it is one thing to give money to build a building. It is quite different to agree to underwrite a decision if it turns out to be a bad one in hindsight. If the operating deficits materialize, does the museum then dig a $9 million hole in the museum's lobby and name it after the trustees? People like to fund successes. They do not like to fund disasters, but that is exactly what the museum's trustees agreed to do should losses materialize.

Would a smaller pool of volunteer directors necessarily be a bad thing? Not if it forced a consolidation of charities providing duplicative and inefficient services. Board sizes presumably would also shrink, eliminating 50-person boards that prove to be inefficient and unwieldy.

* * *

2. M. Manning, *Museum Trustees Take It Personally*, Tampa Bay Bus. J., Feb. 27, 2005.
3. *Id.*
4. *Id.*
5. H. Eakin, *A Very Modern Art, Indeed*, N.Y. Times, Nov. 7, 2004.

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So we come to our first major case. Surprisingly, the origins of this story are not in some state attorney general's efforts to identify and correct board misdeeds but in the New York Office of Parks, Recreation, and Historic Preservation (OPRHP). Back in 1969, the Saratoga Performing Arts Center (SPAC), a Section 501(c)(3) organization that sponsored an annual performance series at an amphitheatre located in Saratoga, New York,[6] entered into a 50-year rent-free lease (with a 50-year renewal option) with OPRHP.[7] The New York City Ballet was one of the two principal resident companies participating in the series. On February 12, 2004, SPAC's board of directors decided to terminate the ballet's summer residency following the 2005 season. OPRHP recognized that the board's decision was contrary to the entire rationale underlying the lease; consequently, it wanted some explanations. As regulator and funder, OPRHP sent in a team of auditors to assess the decision process. What the auditors found was a very poorly run nonprofit with major control and governance failures at virtually every level of the organization.[8] Specifically, the team found that:

- Corporate minutes were incomplete, lacked detail, and did not record vote tallies.[9]
- Executive compensation was too high as measured against a comprehensive benchmark study of 55 similar organizations.

6. New York State Office of Parks, Recreation, and Historic Preservation, with the support of the Bonadio Group, Preliminary Audit Report—Saratoga Performing Arts Center, Inc. (Nov. 22, 2004). SPAC issued a formal response to the Preliminary Audit. *See* Letter from Stephen M. Serlin, Chairman of the Board of Directors of Saratoga Performing Arts Center to Paul Laudato, Chief Counsel, New York State Office of Parks, Recreation, and Historic Preservation (Dec. 20, 2004). OPRHP issued a final audit report in 2005. See New York State Office of Parks, Recreation, and Historic Preservation, Final Audit, Saratoga Performing Arts Center (Mar. 16, 2005). In its formal response to the Preliminary Audit, SPAC's board of directors stated:

   > The Board sees no advantage in engaging in a protracted audit process or debate to question or confirm a set of findings with which the Board essentially agrees.

   The board did take some issue with the Preliminary Audit's conclusions regarding the reasons behind the termination of the New York City Ballet, as well as with the conclusion that the president's compensation was excessive. In the case of the termination, the board contended that whatever methodology is used, it believed that the New York City Ballet required significant underwriting. The board's response also addressed a number of other issues in the Preliminary Audit, seeming to express some disagreement over more minor points. The Final Audit took issue with both the board's assessments regarding the financial analysis and the president's salary.
7. Saratoga Performing Arts Center, Inc. and National Museum of Dance, Combined Financial Statements for the Years Ending December 31, 2004 and 2003, Note 4.
8. OPRHP, Preliminary Report, *supra* note 6. *See also* R. Pogrebin, *Saratoga Center Cited for Mismanagement*, N. Y. Times, Nov. 23, 2004.
9. The wording in the OPRHP, Preliminary Report *supra* note 6, was ambigious. The comment did seem to be general in nature, but placed specific emphasis on the minutes for the meeting where the decision regarding the ballet was made.

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- Reimbursement policies were sloppy, with some of the records apparently incomplete.[10]
- The president's wife, functioning as the development officer, was the second highest paid employee despite documented evidence of inadequate fundraising plans, efforts, and results.[11]
- SPAC fell short on building its endowment, relying too heavily on ticket sales. The auditors found no evidence of a planned giving program.
- SPAC had no investment or spending policy with respect to its endowment, limited as it was.
- There was no evidence of a long-term business plan despite the president's pledge to create one after his responsibilities had been significantly reduced, leaving him additional time for developing a plan.[12]
- There may have been internal control deficiencies with respect to how large cash payments to some performers were made.
- The decision to terminate the New York City Ballet was based on incomplete financial data, which, had the analysis been complete, might have actually shown that the New York City Ballet carried its weight or at least have come much closer than SPAC had suggested—it is hard to say because the audit report is unclear on the various revenue sources that the auditors apparently viewed as closing a perceived gap in funding.[13]
- Board members did not receive advance notice that the decision involving the New York City Ballet was on the agenda. Not even half of the board members attended the meeting at which the decision was made to drop the ballet.

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10. OPRHP, PRELIMINARY REPORT, *supra* note 6, at 3 (Executive Summary—Findings and Recommendations 3 and 7).
11. OPRHP, PRELIMINARY REPORT, *supra* note 6 (Executive Summary—Findings and Recommendations 1 and 3), and (Findings and Recommendations 3 and 5).
12. OPRHP, PRELIMINARY REPORT, *supra* note 6, at 11 (Executive Summary—Findings and Recommendation 8).
13. OPRHP, PRELIMINARY REPORT, *supra* note 6, at 3 (Executive Summary—Findings and Recommendation 2), provides:

> SPAC's decision to eliminate the residency of the New York City Ballet after the 2005 season was based on financial information which was inaccurately and incompletely presented. The $900,000 "accounting gap" between ticket sale revenues and production costs did not portray the complete financial condition of the ballet program as it did not include directed gifts in support of the ballet program (as identified in SPAC's own financial records) nor were nearly identical balance sheet gaps by the Philadelphia Orchestra, the other principle summer tenant, disclosed to the public. Moreover, the audit found that the NYCB's commitment to its Saratoga residency included a $700,000 subsidy of its own (made up from NYCB's own development efforts) and that the average attendance at a ballet performance at SPAC was higher than per-performance attendance at the NYCB's Lincoln Center home (excluding "The Nutcracker").

For additional background information, see R. Pogrebin, *City Ballet's Summers in Saratoga Springs Are Dancing on the Edge*, N.Y. TIMES, Aug. 16, 2004.

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- SPAC's decision to drop the ballet was a fundamental change in mission, yet the board and officers never sought the input of a number of SPAC's constituencies, including its landlord (New York State).
- Some fundraising events and balls lost money—although this is often characteristic of these sorts of events.
- Board members provided significant services to SPAC on a fee basis, raising conflict-of-interest questions.[14]
- There was no evidence of job descriptions for SPAC employees.

Something clearly was wrong with SPAC. The report focused on the board's lack of independence and involvement.

Other boards that do not want to make the same mistakes should take the time to read the OPRHP preliminary report, asking whether their organization would receive a clean bill of health if subjected to such close scrutiny. Those boards that are feeling sheepish or even embarrassed when faced with that question might want to start with the checklist in Chapter 13, but they would be better served by first reviewing the entire *Guide*. By no means does this *Guide* provide all of the answers, particularly because personalities run organizations and interact with each other while doing so, generating competition, goodwill, conflict, humor, envy, admiration, bitterness, and a whole host of other emotions. This *Guide* does, however, address virtually every fault raised in that truly amazing report.

1.1 THE NEED FOR ACTION

Many of the covered topics are ones that people, particularly some executive directors of nonprofit organizations, do not like to discuss. As a businessperson, lawyer, accountant, or other professional, you are probably accustomed to asking tough questions in your day-to-day professional life. If you are like many professionals, you probably view your participation as a volunteer director or officer as an opportunity to "kick back" and do some good. Don't!! William Bowen, the president of the Andrew W. Mellon Foundation, makes a strong case in his 1994 book, *Inside the Boardroom: Governance by Directors and Trustees*, that the most important input from a volunteer director is his tough-mindedness.[15]

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14. OPRHP, PRELIMINARY REPORT, *supra* note 6 at 13 (Executive Summary—Findings and Recommendations 6 and 12).
15. William G. BOWEN, INSIDE THE BOARDROOM, GOVERNANCE BY DIRECTORS AND TRUSTEES 131–33 (John Wiley & Sons,1994). Mr. Bowen actually poses a paradox, noting that many individuals agree with his basic proposition that business executives often check their analytical apparatus and toughness at the boardroom door. At the same time, Mr. Bowen is quick to second the observation of one commentator, who said "[business] CEOs tend to be the best board members; they are more likely than others to understand how complex organizations function."

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United Way of America and William Aramony, the Granddaddy of Scandals

* * *

Probably the most publicized example of nonprofit mismanagement in recent years involved United Way of America (UWA) and its executive director, William Aramony. UWA is the national umbrella organization that supports nearly 1,400 independent local United Ways across the country.[16] According to its Web site, UWA provides these member organizations with advertising, training, corporate relations, research, networks, and government relations. The member organizations support UWA by providing voluntary funding equal to less than 1 percent of the funds the members raise.[17] In 1992, stories of excessive compensation paid to Mr. Aramony began to appear in the popular press, resulting in an uproar.[18] People were surprised to learn that the president of a nonprofit organization received a salary of $390,000 per year, plus $73,000 in additional compensation. The stories in the press reported trips on the Concorde, local travel in chauffeured limousines, and stays while visiting New York City in a $430,000 condominium purchased by a UWA subsidiary.[19]

In 1994, Mr. Aramony was indicted, charged with diverting hundreds of thousands of dollars in funds for his personal use. The jury convicted Mr. Aramony on 25 counts, and he was sent to prison. The Fourth Circuit Court of Appeals subsequently affirmed most of the convictions, although it vacated two of them.[20]

In an editorial, *The Washington Post* asked the pertinent question: "Where was [the United Way of America's] board while its staff was flying the Concorde to Europe? The board has traditionally been composed largely of leading figures from the corporate world—people who brought prestige to it, but put little time into it."[21]

* * *

There are many reasons that directors check their good judgment at the boardroom door. Here are three possible explanations: First, too many directors take what might be called the "books-on-tape" approach to board membership, showing up once a month to hear the executive director tell a nice story about all of the good things the organization is doing. These meetings tend to be very relaxing with lots of carbohydrates consumed in the form of morning buns, scones, and doughnuts. If the directors are really lucky, they will receive a plate of

16. United Way of America *available at* http://national.unitedway.org/aboutuw/mission.cfm (last viewed Mar. 18, 2005).
17. The "less than 1 percent" claim was originally made on a Web page that is no longer available. The United Way of America's 2003 IRS Form 990 shows approximately $22 million in membership dues. This is less than 1 percent of the $3.59 billion that United Way indicates was raised by member organizations through the annual campaign, gifts, corporate sponsorships, and government grants in 2003-04.
18. C. Shepard, *United Way Head Resigns Over Spending Habits*, Wash. Post, Feb. 28, 1992; and *Aramony Convicted of Using Charity Money to Support Playboy Lifestyle,* Wash. Post, Apr. 4, 1995.
19. C. Shepard, *Perks, Privileges and Power in a Nonprofit World*, Wash. Post, Feb. 16, 1992.
20. United States v. Aramony, 88 F3d 1369 (4th Cir. 1996); and United Way of America, Vacco v. Aramony, N.Y.L.J., Aug. 7, 1998 (Sup. Ct. N.Y. County July 13, 1998).
21. S.J. Vitell and D. L. Davis, *United Way's Breach of Trust*, Wash. Post, Apr. 7, 1992.

scrambled eggs and bacon[22] or a catered lunch of oversized sandwiches and fancy chips, but eating is not what governance is about, nor is passively watching a slick PowerPoint presentation.

Second, too many board members equate governance and fundraising, assuming that they have discharged their duties if they raise enough money. While the lifeblood of many organizations is money, fundraising is not governance. Those who are good at fundraising would do everybody a favor by not demanding positions on boards unless they are willing to read financial statements, think about personnel issues, allocate resources, review budgets, and take on the other difficult decisions that come with governing an organization.

Third and finally, some executive directors can be power hungry, carefully guarding their prerogatives and fiefdoms. The board may want information that is not forthcoming from the executive director. With only limited time to devote to the organization, few board members are willing to rock the boat, particularly if the executive director uses food and PowerPoint as part of the pacification process.

Does this mean that the board should be at war with the executive director? Absolutely not, but there should be some institutional tension. The board does not exist to rubber-stamp every proposal that the executive director makes. No executive director is infallible. The truly good ones recognize this, causing them to seek input and advice from their boards. One nonprofit recently was reported to be in dire financial straits.[23] Its former chairman functioned as the de facto executive director. Not surprisingly, one board member reported that "[he] screamed and hollered, and there were certain things he wanted done, and he was a powerful guy."[24] According to a newspaper account, "[he] drove out the treasurer, fired the development director and wound up the only person allowed to write the league's checks."[25] This organization was the victim of a kickback scandal, resulting in the indictment of the former chairman and the attorney he had handpicked as counsel to the organization.[26] The attorney subsequently pled guilty, and the former chairman pled guilty to a charge involving a similar scheme, but a different organization.[27] The other board members had a problem that was readily apparent based on the quotes given to the newspaper. They should have either governed or resigned, but it is fairly apparent that at least

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22. One board had a chairman who was a leading heart surgeon. The board meeting was held at a local club. Eggs were available on the menu, but everyone ordered fruit after the surgeon gave the cue when he ordered oatmeal.
23. C. Spivak and D. Bice, *Debts Threaten Athletic League: Facing Bankruptcy, PAL May Have to Sell Building*, MILWAUKEE J.-SENTINEL, Feb. 9, 2005.
24. J. McBride, *With George at Helm, Athletic League's Financial Health Deteriorated*, MILWAUKEE J.-SENTINEL, Dec. 2, 2003.
25. *Id.*
26. G. Zielinski, *Sostarich Pleads Guilty in George Scandal: He Admits to Kicking Back Legal Fees to Ex-Senator*, MILWAUKEE J.-SENTINEL, Jan. 30, 2004.
27. G. Zielinski, *George Pleads Guilty to Fraud: Four Other Counts Dismissed; Ex-Senator to Cooperate*, MILWAUKEE J.-SENTINEL, Jan. 22, 2004.

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some of the other members were too passive, apparently failing to provide the tension that was clearly required under the circumstances.

The explanations for lackluster board performance should not be taken as excuses or justifications. Put plainly, if you are a member of a board, it is your duty to either actively involve yourself in the governance of the organization or submit your resignation. Not only are you opening yourself up to embarrassment and potential liability if you do not take your position seriously, but more importantly, you are wasting resources that others have entrusted you to protect, and you are diminishing the value of the independent sector in the eyes of the public.

THE MUSEUM OF MODERN ART: A FUNDRAISING JUGGERNAUT. BUT WOULD LESS HAVE BEEN MORE?

* * *

In anticipation of the reopening of the Museum of Modern Art in November 2004, The *New York Times* ran a lengthy article entitled "MoMA's Funding: A Very Modern Art, Indeed,"[28] focusing on how MoMA financed the $858 million construction of its new facilities. A significant portion of the financing for this project came from a large board of trustees with members who made seven- and eight-figure pledges. Total contributions from the trustees exceeded $500 million, averaging more than $7 million per trustee. Every museum hopes that its permanent collections and curatorial staffs make it the envy of other museums throughout the world, but there is little doubt that most executive directors who read this article were even more envious of MoMA's fundraising capacity. Like a California wildfire, the news leapt from the museum world to other nonprofits, also making MoMA the envy of social service agencies, universities, hospitals, and countless other equally worthy nonprofits.

In fact, on the same day that the article appeared, Independent Sector, a nonprofit trade association, began its annual conference in Chicago. During a discussion of the ideal board size, one gentleman from the audience (a very corporate-looking lawyer: no weekend-casual dress for this prosperous fellow), took the mike, extolling MoMA's fundraising capacity. He essentially argued that no nonprofit should limit its board size if it can find directors who can raise the sort of money described in the *Times* article. Word had spread. Audible gasps were heard from many of the 125-plus attendees when the tanned lawyer repeated the numbers. The undercurrent from many in the audience was, "Hear, hear. This gentleman is absolutely right. The staff of the Senate Finance Committee[29] has no business telling us to limit our board size to 15 members. One size does not fit all."

Unfortunately, the dark-suited messenger failed to report the article's subtext. The *Times* article included the following facts: There is now a "powerful new emphasis on net worth." To raise the money that it did, MoMA added a number of celebrity business executives to its board who are not recognized as traditional collectors and may not fully understand MoMA's historical context or mission. There has also been an apparent shift in power with

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28. H. Eakin, *A Very Modern Art, Indeed*, N.Y. Times, Nov. 7, 2004, *supra* note 5.
29. Staff of the S. Fin. Comm., DISCUSSION DRAFT ON PROPOSED REFORMS FOR EXEMPT ORGANIZATIONS (2004).

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the movement in the direction of professional managers and away from curators. There was also discussion of cost overruns. One person was quoted in the article as having said, "[The new building] ran away with the budget." The logical question: Is fundraising capacity skewing MoMA's mission?

No one will know the answer to that question for several years, but there certainly was a lot of speculation over the size of the gift shops and restaurants. Many were questioning MoMA's jaw-dropping $20 admission price before the reopening. While MoMA was successful in tapping the pocketbooks of its trustees, it also incurred over $235 million in additional debt to finance the project, bringing its total outstanding debt to over $398 million.[30] That debt and the staff needed to run a larger facility have to be funded somehow. Will this mean more blockbuster shows of big-named artists at the expense of smaller, more intimate shows highlighting the works of newer and lesser known artists? The *Times* article suggest the answer is "No." In fact, the article suggests that there may be fewer blockbusters if desired attendance levels can be reached without resort them. But will there be room for many lesser-known contemporary artists, or will MOMA's collection be frozen in the Twentieth Century? Striking the proper balances is what defining, fostering, and protecting mission are about.

Let's return to our corporate lawyer and many of those at the session on governance. Governance and fundraising are not the same things. As a couple of people in the audience pointed out, large boards are unwieldy, and their members lose a sense of responsibility. Those observations are fact, not opinion. Large boards also tend to shift power to the executive director, which can actually weaken the institution by eliminating an important check on the executive director. In other words, a large board may be good for fundraising but not for governing. There are plenty of ways to reward big donors, including granting naming rights and appointing major benefactors to donor-advisory committees. Those in the room who argued against smaller boards were confusing fundraising with governance.

* * *

1.2 PART OF THE BIGGER SCHEME

You may view yourself as "just a minor player on the scene." Nothing could be further from the truth. Assuming your organization is a tax-exempt entity, it is just one of over 1.54 million tax-exempt organizations that were on the Master File of Tax-Exempt Organizations of the Internal Revenue Service (IRS) at the end of Fiscal Year 2004.[31] There are undoubtedly additional organizations that are nonprofits but these have not obtained tax-exempt status for one reason or another. The nonprofit sector's share of national 1998 income was 6.1 percent, or just over $440 billion. The total number of paid employees in this sector of the economy that year was 10.9 million.[32] The point: You might be a volunteer, but nonprofits play a vital role in our society. Your efforts are important.

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30. H. Eakin, *supra* note 5.
31. *See* Internal Revenue Service, *Table 22—Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2001–2004*, reprinted in PUBLICATION 55B, IRS DATA BOOK (FY 2004).
32. URBAN INSTITUTE, THE NEW NONPROFIT ALMANAC & DESK REFERENCE (2002).

1.3 ASSUMPTION

The title to this *Guide* includes a reference to executive directors and advisors but the *Guide*'s real focus is on "volunteer" or pro bono service, with special focuses on the role of directors and the partnership between the board and the executive director. The *Guide*'s typical reader will be a director—sometimes referred to as a trustee. If the organization does not have a professional staff, the typical user may also be serving as an officer who carries out the board's directives. As a consequence of this focus on "volunteer" service, the *Guide* will not always draw the sharp distinction that the law draws between directors and officers. Having just described the intended audience, let's be clear: This *Guide* will prove to be invaluable to lawyers, accountants, and advisors to nonprofits. Even those who are already knowledgeable about certain topics covered in the *Guide* will undoubtedly have gaps in their knowledge that other parts of the *Guide* can fill.

1.4 GENERALITY OF COVERAGE

Although the discussion of the federal income tax aspects of nonprofits will be applicable to nonprofits throughout the United States, the discussion regarding director and officer duties, corporate governance, operational risks, fundraising, and other matters governed by state law should be viewed as a general discussion with the understanding that the specific rules will vary from state to state.

Nevertheless, the discussion will alert you to the basic issues that will arise in whatever legal jurisdictions your organization is organized and operates. In many cases, there are far more similarities than differences among state laws. When appropriate, differences in state law will be noted, but when it comes to particular issues affecting your organization, you will still need to consult with qualified legal counsel.

1.5 USING QUALIFIED PROFESSIONALS

This *Guide* will provide you with practical insights into the issues facing volunteer directors and officers, but it is not meant as a substitute for the advice of a qualified attorney, accountant, or other professional. Many of the rules that are discussed have exceptions, complex definitions, subparts, and subtle nuances. If each rule were discussed in detail, this *Guide* would quickly become a treatise. The objective is to alert you to issues that you need to know about to better manage your nonprofit's operations and assets while keeping everyone out of trouble.

Unfortunately, many nonprofits try to cut corners when it comes to legal, accounting, and other professional services. Often this is a case of being "penny-wise and pound-foolish." The argument goes something like this: "We are a social services agency. Every dollar we spend on lawyers and accountants is a dollar less that we can spend on the needs of those we serve." The problem

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with this argument is that others have entrusted the board and officers with making sure that the money from contributions and grants is not wasted or stolen. Like it or not, that means the organization must tolerate some level of expenditures on lawyers, accountants, and administrative overhead. There will still be those who disagree. The simple retort: "Fire those in charge of disbursing the money—just leave the money in a bag and tell needy people to help themselves." In the long run, truly qualified advisors save organizations money and protect assets.

1.6 BEFORE STARTING A NEW ORGANIZATION

Throughout this *Guide*, the examples assume that the organization in question is an established one with staff, financial resources, and a clearly articulated mission. However, there will undoubtedly be people who review this *Guide* as they contemplate starting a new organization. The organization in question will mostly likely be charitable in nature. With that in mind, let's now briefly address the considerations in starting a charity.

(a) START BY LOOKING FOR AN EXISTING CHARITY. Organizing and operating any organization takes time, effort, and money. Simply building the organizational architecture does not provide any benefit to the needy or the sick. These organizational efforts do not improve the school system or bring art to a new or wider audience. So before starting a charity, be sure that there is a need. If you google a phrase such as "medical research," "contemporary dance," or "food bank for the homeless," you will discover that there are existing organizations already providing the services in question. While everyone likes to be the big kahuna, you may actually be far more effective by teaming up with an existing organization. The downside: You may have to establish credibility by performing menial tasks assigned to new volunteers before you can make policy. Those tasks may entail stuffing envelopes, updating mailing lists, packing cartons of food, or pounding nails and sawing two-by-fours. Do not forget, however, that those tasks await you as the organizer of a new organization unless you have a long list of volunteers.

By working with an existing charity, your time and money are much more likely to impact mission. A good case can be made that we have too many charities with many providing duplicative services. Each one of these charities develops a fundraising program, assembles a board and staff, implements a system of internal controls, and pays outside advisors. For the most part, all of these expenditures represent overhead that is necessary but that siphons dollars away from the mission. Consider taking advantage of the economies of scale offered by an existing charity.

There is a clear lesson here for people who want to start a charity: Think long and hard before building a new wheel.

A NEW TREND TOWARD CONSOLIDATION

* * *

Over the last several years, there have been a number of widely reported stories of fraud perpetrated against charities with "marquee" names. One fraud that comes to mind involved the American Cancer Society's Ohio Division and the embezzlement of nearly $6.9 million dollars through wire transfers to a Swiss bank account.[33] Fortunately for the society, the fraud was quickly discovered and the bulk of the money was recovered. During the spring of 2004, an executive with the St. Clair Goodwill in Port Huron, Michigan pled guilty to two counts of embezzlement, admitting to stealing $750,000 from the charity over a 20-year period.[34]

Here is a hypothesis about these frauds. When people think about the Goodwill Industries or the American Cancer Society, a large, national organization comes immediately to mind. However, many reported frauds involve local chapters of nationally known organizations. The appeal of local chapters is understandable because the chapter structure permits the national organization to add an influential banker, attorney, accountant, union leader, and other prominent members of the local community to its fundraising efforts through the allure of board membership. Those local faces are good for fundraising. Face-to-face appeals are undoubtedly more effective than phone calls from telemarketers located in the charity's office in Washington, D.C. or India.

There is a cost to the resulting decentralized structure, however. While the national organization may be a large one, the local chapters are relatively small, particularly if the branches go deeper than the state level. Each of these organizations must implement a system of internal controls. That should mean checks and balances in the accounting system. Structurally, such a system requires at least two "finance or accounting" types so that someone is always watching the person who has custody or expenditure authority over the organization's assets. Three people would be preferable so that the recordkeeping function is kept separate from the custody and expenditure functions.[35] As the St. Clair Goodwill incident at least suggests, however, these chapters simply may not be large enough in terms of financial resources to be able to support a large administrative staff. None of the newspaper accounts indicate whether the St. Clair chapter had more than one accountant, but one has to be suspicious about whether there were "deep" financial controls. From a practical standpoint, small organizations simply do not generate the volume of financial transactions that are often necessary to make a solid system of financial controls economically viable.

Large organizations that utilize local chapters need to take at least one of two basic courses of action to ensure the adequacy of internal controls. The first course is the obvious one: Consider consolidating local chapters into state or regional chapters. If the national organization believes this will hurt fundraising, it should appoint the lawyer, accountant, and community leader to an advisory board to keep them involved.

A second course of action is to adopt a "lockbox" approach with the local chapters left in place but the national organization adopting and enforcing a system of internal controls covering local operations. This system could include a staff of internal auditors who periodically

33. M. Gallagher and V. Radcliffe, *Internal Controls in Nonprofit Organizations: The Case of the American Cancer Society, Ohio Division*, 12 NONPROFIT MGMT. & LEADERSHIP 313 (Spring 2002).
34. A. Mullins, *Ex-Goodwill Executive Admits Stealing $750,000*, TIMES HERALD.COM, Apr. 30, 2004; and A. Mullins, *Ex-Goodwill Worker Stole 'Substantially'* TIMES HERALD.COM, Dec. 18, 2003.
35. We consider all three functions in Chapter 5.

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review local accounting controls, a standardized system of internal controls, a uniform chart of accounts, prepackaged accounting and reporting systems, and centralized investment of funds. With the lockbox in place, money is collected at the local level but remitted into segregated accounts maintained by the parent organization.

Obviously, much thought and planning must go into determining the particular features for a given organization. Overall, the lockbox approach is designed to leave the local fundraising structure in place while imposing a cost-effective control system from above. The national organization will have to develop a system to ensure that locally raised money is returned to the local community. In achieving that result, the umbrella organization should resist the temptation to impose a "handling" fee that exceeds the actual cost of the control system.

As just one example, the United Way of Chicago and the United Way of Suburban Chicago recognized the potential cost savings that could be achieved through a consolidation of their operations, resulting in a decision to merge. The following is an excerpt from a press release[36] issued by United Way of Metro Chicago:

> On January 1, 2004, United Way entities throughout the Chicago area become United Way of Metropolitan Chicago. This restructuring, a full-scale effort to impact more lives in the community, has succeeded in lowering costs and increasing operational efficiency, so more donor dollars are available to fund community health and human service programs. The consolidation centralizes all support staff functions, but does not change the fundamental activities of United Way in each community it serves—that is raising funds and distributing them locally.
>
> "The consolidation will eliminate duplication and dramatically increase efficiencies and effectiveness so we can direct more donor dollars to improving peoples' lives," said R. Eden Martin, Board Chairman of United Way of Metropolitan Chicago. He said the consolidation has already put in place changes that will yield an annual savings of nearly $3.0 million in administrative costs, which means an 18% reduction in expenses. As a result, more donor dollars can go to United Way-funded programs. "We're extremely pleased with these immediate results of our efforts, and expect to see more positive results as time goes on," he said.

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(b) CONSIDER PARTNERING OPPORTUNITIES. There may be a reason that there is not a contemporary dance company or a school of medieval art in your community. There may be no need or demand for the services in question. To quickly assess whether the need exists, try identifying a successful entity that is in close geographic proximity to your community. Give the executive director a call, and see whether he has ever considered extending the organization's service area. This organization may already have a detailed study that outlines why expansion to your community is not warranted or feasible. These insights could save you wasted time and resources. That contact could also expose "partnering" opportunities. For example, suppose you are located in rural Connecticut, 75 miles outside New York City. You are interested in classical music but are tired of making the trek into New York City. You and friends consider starting a symphony

36. Press Release, United Way Metro Chicago, "Chicago Area United Way System Completes Its Transformation" (Dec. 19, 2003).

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orchestra. That is going to require a lot of money. Instead of almost certain failure, why not contact an institution located in New York City to see whether it has ever considered an "outreach" program? You can offer organizational skills, a new source of funds, and a possible venue for a two-or-three concert summer series. The series probably will not include performances by the New York Philharmonic, but you might be able to find students from Juilliard or other schools who are looking for a venue. That's an opening that you may be able to build into a more substantial series.

(c) IDENTIFY FUNDERS. All too often, people interested in starting a charity begin the process by asking the attorney to "draw up the papers." That is the wrong place to start. After identifying an unfilled need, begin by determining how much financial support there is for your idea. If you and several like-minded friends have only a few thousand dollars to contribute, you will not get very far. Unless you can obtain legal and accounting services pro bono, you are probably looking at a minimum cost of $2,500 to $5,000 in professional fees to shepherd a new organization through the formation and tax-exemption process.

That cost will be much higher if you do not have a business plan—yes, a business plan—for the charity. Even though the charity may be a nonprofit, if it is to succeed, it must be run like a business. At a minimum, you should have the following information before contacting a professional to help with the organizational process:

- A clearly defined mission and the specific activities that will fulfill that mission.
- A detailed assessment of need in the contemplated service area (e.g., identify the number of children with the life-threatening disease or who cannot read at grade level).
- A detailed assessment of how the community is likely to react to the organization and its activities, particularly if the activities will be controversial (e.g., a halfway house for sex offenders or drug addicts).
- A list of individuals and organizations already providing similar services in the contemplated service area with as much detail about these existing service providers as is available (e.g., clinics that treat AIDS patients and the number of persons served).
- A list of directors and officers as well as their qualifications.
- A five-year budget with a very detailed one-year budget.
- A list of any required government approvals or licenses with necessary contacts and approval and license applications.
- A list of potential and committed funders and sponsors. If grants are contemplated, you should have a full understanding of what information must be provided to each potential funder and of the application and funding processes.

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- If the organization will require ongoing funding, a detailed plan describing fundraising plans and assessing associated costs.
- An assessment of what resources the organization will need to fulfill its mission (e.g., music teachers, special needs facilities for handicapped clients). If physical facilities are required, identify the cost, lease terms, and availability. If specialized personnel are required, identify their availability and cost.
- An assessment of insurance costs and needs.

You can certainly pay a consultant to assist you in assembling this information, particularly when it comes to fundraising and obtaining grants. Much of the legwork can and should be undertaken, however, by the organizers.

(d) RETAIN A QUALIFIED ATTORNEY. You should contact a qualified attorney once the business plan is in place and the organization and its activities appear to be viable. At that point, you and the attorney can begin the organizational process, which should include the following steps:

- Form a nonprofit corporation (or other appropriate entity) by filing articles of incorporation with the appropriate state agency (most likely the secretary of state). Do not let the attorney handle this process alone. Be sure to review all documents, focusing on governance and the organization's needs.
- Name or elect an initial board of directors.
- Hold an organizational meeting with the initial board of directors appointing officers and adopting organizational bylaws
- Obtain a taxpayer or employer identification number.
- Prepare and file an application for tax-exempt status with the IRS. The attorney will help you with this process, but if you have taken the preliminary steps already suggested, you should be able to prepare many of the required schedules yourself.
- If required, file an initial registration with the charity regulator in the states in which the organization is organized, soliciting funds, or doing business.
- If required, obtain workers' compensation coverage.
- File all necessary applications, registrations, exemptions from or permits required by sales and use tax, employment tax, and property tax laws.
- File and obtain any special licenses (e.g., for a day care center or charter school).
- If contracting with paid fundraisers, make sure that the fundraisers and related contracts comply with applicable state and federal laws.

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- Schedule and provide notices for regular board meetings and, if a membership organization, necessary membership meetings.
- Begin working with a qualified accountant to set up an accounting system, including a system of financial and internal controls.

To reiterate, do not call an attorney until you have completed the initial steps just described. Every attorney who works with tax-exempt organizations has horror stories to tell about the client who called before the business plan was in place. Good attorneys will tell this client that either the attorney can do the legwork or the client can, but if the attorney does the legwork, the client will receive an exorbitant legal bill. All too often, the inexperienced client pushes forward, asking the attorney to write descriptive material that the client could just as easily have written. Despite the warnings and carefully crafted engagement letter, this client is almost always shocked when the bill arrives.

(e) ADVICE TO THE WEALTHY. Every advisor who specializes in charitable organizations has had a wealthy person ask about setting up a foundation. The inquiry often occurs in conjunction with the sale of a closely-held business, an IPO, or thoughts about the person's legacy. Many people like the sound of their surname followed by the phrase "Family Foundation." Granted, this discussion will not discourage most people who have the glimmer of a family foundation in their eyes from forming a foundation, particularly when the person is worth hundreds of millions of dollars and has very specific charitable missions firmly in mind. However, the wealthy need to recognize that family foundations are very expensive from an administrative standpoint. These foundations are subject to complex and unforgiving federal tax rules that forbid self-dealing, political activity, certain business holdings, and certain expenditures. The foundation will require regular legal advice to avoid the pitfalls posed by these and other rules.

With that in mind, wealthy individuals and families should at least consider alternatives to the family foundation, particularly when the contemplated gift or bequest will not exceed $10 million. The following alternatives should be considered:

- Making restricted gifts to a public charity or charities that carry out programs that are of interest to the donor.
- Making a gift to or creating a fund administered by a community foundation.
- Setting up a donor-advised fund with a commercial entity such as Fidelity Investments or the Vanguard Group.
- Establishing a supporting organization.[37]

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37. Forming a supporting organization may become more difficult because the Senate Finance Committee has considered proposed legislation that would prevent charitable organizations that look like family foundations from availing themselves of "supporting organization" status as a means to avoid private foundation status. At the May 20, 2005 meeting of the Exempt Organizations Subcommittee of the American Bar Association

Each of these alternatives provides the tax advantages associated with charitable giving, creates a legacy, provides younger family members with the opportunity to participate in the family's philanthropic endeavors, and, in many cases, offers more flexibility than a family foundation. We will consider several of these alternatives in more detail in the section of Chapter 7 that pertains to private foundations and in Chapter 10.

1.7 CONCLUDING THE PRELIMINARIES

William Bowen's sentiments are worth keeping in mind. Volunteering as a nonprofit director or officer permits you to devote your energies to a cause you believe in while providing what should be a pleasant diversion from your day-to-day professional activities. While you might be tempted to check your professional judgment at the nonprofit boardroom door, don't.

Your contribution to a nonprofit organization will be greatly enhanced by relying on your hard-hitting business judgment. This *Guide* will provide you an overview of the legal, accounting, and regulatory issues that confront nonprofits, permitting you to better focus that judgment.

Tax Section, one government official indicated that the IRS had centralized the processing of applications for those organizations trying to take advantage of what are now apparently suspect categories of supporting organizations. This official indicated that processing of these applications had all but ground to a halt as the IRS considered how to deal with the "supporting organization" issue in the wake of congressional concerns.