

# Nonprofit *Alert*®

Alerting nonprofit leaders to key legal developments and responsive risk management steps.



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## Supreme Court Hears Arguments in Charity Free Speech, Solicitation Case

The Supreme Court heard arguments last month in the first charity fundraising case to come before the Court in more than a decade. *Madigan v. Telemarketing Associates* (formerly known as *Ryan v. Telemarketing Associates*) pits state charity regulators against a telemarketing firm that collected more than \$8 million on behalf of a charity called VietNow. (See *NPA*, Dec. '02).

### 85% Went to Solicitor

Donors to VietNow were told their money would be used to purchase food and provide training for needy veterans. But Telemarketing Associates, Inc., the professional firm that conducted the solicitation, took 85% of the donations as payment for its services, pursuant to its fundraising contract with VietNow.

Donors were not told how much of their contributions would actually go to VietNow. The Illinois Attorney General objected to the lack of disclosure and the high fees Telemarketing Associates charged, but the state's highest court dismissed the case on free speech grounds. Illinois then appealed to the Supreme Court, and 40 other states, plus the District of Columbia and Puerto Rico joined in support of Illinois' position.

### Fraud v. Free Speech

Charity regulators say the case provides the Supreme Court a perfect opportunity to give states greater flexibility in fighting fraud and abuse. Charity fraud has been on the rise in recent decades, they argue, and without a legal mandate to enforce disclosure requirements and other restrictions against telemarketers, consumers will be hurt. Charities argue the issue is really free speech. More

than 200 charitable and nonprofit groups filed briefs in support of Telemarketing Associates urging the Court to uphold constitutional principles and avoid what they claim would amount to a "chilling" of protected speech.

During last month's argument before the High Court, the justices intently questioned both sides, revealing little about what the Court's final ruling might be. Justice David Souter asked if the argument would be any different had Telemarketing Associates only claimed a 60% fee.

*... claiming an 85% fundraising fee is probably excessive, but exactly where should the line be drawn?*

He noted that it's one thing to say a firm is out of bounds by claiming an 85% fee, but exactly where the line should be drawn is not altogether clear. Justice Antonin Scalia joined in the exchange by noting that an attempt to set percentage limits would surely trigger additional problems.

The court is expected to rule on the case this summer. Legal briefs from all parties participating in the case are available on line at:

<http://www.charity-reg.org>.

**The Supreme Court's decision in this case will likely have a significant effect on all state solicitation regulations, particularly those states that require solicitors to disclose the percentage of contributions used for charitable purposes.**

For a brief summary of state charitable solicitation requirements, e-mail Gammon & Grange ([npa@gandglaw.com](mailto:npa@gandglaw.com)) and request a free copy of *Charitable Solicitation Registration: What you Need to Know Before Raising Funds*.

For a more detailed review, order *Nonprofit Alert® Memo, Charitable Solicitation Laws: A Multi-State Summary*. See back page to order.

## Liability & Risk Management

### *Court Protects Nonprofits From Bankruptcy*

Creditors can't force a church and its nonprofit child care center into involuntary bankruptcy, a Pennsylvania court has ruled, because the entities aren't "moneyed, business[es], or commercial corporation[s]." The case involved Grace Christian Ministries and its Noah's Ark Child Care Center. When the center was constructed in 1998, the church still owed \$269,000 in payments for its building. Shortly thereafter, the church's pastor was accused of swindling funds, and a trustee was appointed to oversee the child care center. It operated without incident until 2002 when the builder and three other creditors petitioned a court to force the church and child care center into Chapter 11 bankruptcy because their loans made to construct the child care center were long overdue. Pennsylvania law prohibits filing involuntary bankruptcy proceedings against any "corporation

that is not a moneyed, business, or commercial corporation," generally interpreted as schools, churches, charities and foundations. In this case, the court said it was enough that the church was a nonprofit corporation. That alone qualified it for the exemption. The creditors then argued that the child care center didn't qualify for the exemption because it charged fees for its services. But the court rejected this argument, saying if such a conclusion were true, then many nonprofit corporations would be in jeopardy of bankruptcy. Instead, the court said the exemption depends, "at the very least, on what [a nonprofit] does with any surplus revenue" it receives. Here, the child care center recognized "no 'profit' as the term is used in ordinary parlance," the court concluded. *In Re Grace Christian ministries*, No. 02-30028-BM (W.D. PA, Bankruptcy, 2002).

 **Federal bankruptcy law is generally interpreted to prohibit involuntary bankruptcy proceedings against charitable organizations, but all state laws do not include that same prohibition. This ruling clarifies Pennsylvania bankruptcy law and protects nonprofits operating on marginal incomes. It may also serve as an example for other jurisdictions.**

**War's Impact on Charities:  
Between Iraq and a Hard Place**

For charities, the most immediate fallout from war with Iraq will be felt in fundraising, experts predict. Charitable giving has been in the doldrums for the last three years, starting with 2001 when giving decreased 2.3% from the prior year—the lowest growth rate since 1959.

Fundraising statistics from the Gulf War and post-9/11 periods show that donors reduce giving during times of national crisis. How a charity handles donor communications are critical to fundraising after the crisis. Experts offer these tips:

- show sympathy with donor's fears and uncertainties while you focus on hope and confidence.
- make fundraising campaigns flexible so dates or messages can change if current events intervene.
- articulate your mission in a way that respects the national sentiment.
- identify your best donors in case you need to craft a fundraising campaign targeting those most supportive of your mission.

### *Board Isn't Separately Liable From Nonprofit*

A nonprofit's board of directors can't be sued apart from the corporation, says an Ohio appellate court, because the board is not a separate entity. The ruling grew out of an employment dispute between a hospital employee and the hospital's board of directors. The employee filed suit against the hospital and the board for breach of contract. The hospital then filed for bankruptcy and the employee petitioned the court to allow his case to proceed solely against the board. The trial court dismissed the case, however, finding the board could not be sued separately. An appeals court upheld the ruling, saying a board cannot sue or be sued in its own name. The court said it would be "pointless" to hold a board liable as a collective entity since boards can't hold property in their own name. Therefore, "any judgment against [the board] could not be recovered..." The board had purchased insurance to cover its liabilities, but the court the board's decision to protect itself with insurance did not create a right for others to sue the board. *Flarey v. Youngstown Ostopathic Hospital*, No. 01 CA 53 (OH Ct.App., 7<sup>th</sup> App.Dist., 2002).

 **Although the board cannot be sued separately, individual board members may be sued personally. Here, the employee failed to name the board members as parties to his lawsuit so they escaped liability. Don't count on that oversight to save your board. Most states provide some immunity to volunteer board members, but immunity is not absolute. Board members may be personally liable for corporate wrongdoing in which they participate.**

### ***Bonnie & Clyde: Bookkeeper & Boyfriend Indicted for Stealing Foundation's Checks***

A former bookkeeper employed by the Memphis Leadership Foundation, a nonprofit Christian group, was indicted last month for allegedly cashing some \$78,500 in stolen checks. The bookkeeper worked at Neighborhood Housing Opportunities Management Co., Inc., a subsidiary of the foundation. The grand jury indictment alleges she conspired with her boyfriend to steal checks made out to the organization, then forged signatures to cash the checks. The two allegedly deposited the cash into their personal accounts. Both individuals were charged with conspiracy and 24 counts of aiding and abetting bank fraud, punishable with up to 30 years in prison.

**According to the foundation's web site, it operates 14 ministries with a combined budget of \$7 million. Nevertheless, the foundation and its subsidiaries were not immune to fraud. If it could happen there, it could happen in your organization. Consider adopting controls described in Nonprofit Alert® Memo, *Accounting & Fiduciary Guidelines*. See back page to order.**

According to a Johns Hopkins University study, more than 19 million people are employed in the nonprofit sector in the 22 leading countries of the world.

### ***Americorp "Volunteer" Can't Claim Worker's Comp***

A Kentucky court has denied workers compensation to a Habitat for Humanity "volunteer" who was injured while helping build a Habitat home. The "volunteer" was actually a former construction worker who had signed a member participation agreement with Americorps, the national service volunteer program. His Americorps service assignment was with the Homeless and Housing Coalition of Kentucky, which directed his volunteer work with Habitat. The Coalition paid him \$8340 annually in living allowances and \$4725 in educational awards. He also received health/accident insurance, mileage, expenses, child care allowances and unemployment insurance from the Coalition. The Kentucky appellate court

upheld earlier decisions by an administrative court and the Worker's Compensation Board, denying workers comp because federal and state law specifically stated that individuals participating in Americorps are not to be considered employees. This meant the worker was not eligible to receive workers comp for his injury.

**While this case arose under the expressed statutory exception for Americorp volunteers, it has equal adaptability to all volunteers who are generally exempt from worker's comp. The significance of this case is that worker's comp is a safety net that not only provides a resource for employees injured on the job, but it also serves as a shield for the employer by prohibiting most employee lawsuits in such circumstances. Obviously, where an employee is injured in a job-related accident, and is not covered by worker's comp, then lawsuits against the employer are more likely. Check with your insurance carrier to make sure your general liability coverage would extend to claims by volunteers in those circumstances.**

## **Employees & Volunteers**

### ***Divorce Ends Marriage, But Not COBRA Coverage***

As if divorces aren't complicated enough, the IRS has now added another wrinkle. In recently released guidance, the IRS says that if, in preparation for divorce, an employee eliminates a spouse's health care coverage under a group health plan, COBRA coverage must still be provided for the spouse as of the date of divorce. Generally, an employee can notify his/her group health plan to eliminate coverage for his/her spouse, which then usually takes effect at the end of the month. As of the date of divorce, the spouse then loses all eligibility for coverage under the employee's group health plan. However, the IRS says the divorce itself is a "qualifying event" and the spouse is a "qualified beneficiary," which triggers COBRA. This means the employee's health plan is required to offer COBRA continuation coverage to the former spouse as of the date of divorce, assuming the spouse was not previously disqualified for health care coverage or COBRA coverage for some other reason.

**Normally, a plan administrator must provide specific notice of COBRA coverage within 14 days of a qualifying event. For more detailed guidance on COBRA's somewhat intricate rules, see Nonprofit Alert® Memo, *COBRA Compliance for Nonprofits*. To order, see instructions on back page.**

## **Tax Exempt Issues**

### ***Web-Based Job Placement Compliments Exemption***

A nonprofit's operation of a web-based health care provider information and job opportunity database will not affect the nonprofit's exempt status, the IRS has ruled. The nonprofit was founded to promote health education. As part of that mission, the nonprofit developed a professional placement service for healthcare workers that became very successful in several states. The program expanded to include a web-accessible database. Later, the nonprofit launched a separate web-based program designed to aid physician recruitment in rural areas. Both programs generated membership fees paid by health care entities and nonprofit organizations representing the participating communities. No other fees, such as placement fees or user fees were imposed. Access to the web-based (*continued on p. 4*)

(continued from p. 3) services was free to potential job candidates. No headhunters or professional recruiters were permitted to use the services. Although the rural database charged a membership fee, it routinely operated at a loss. The nonprofit subsidized its operation with funds from its other services. The IRS said that both databases furthered the nonprofit's exempt purposes and helped improve the health conditions of numerous participating communities. As such, the programs would not endanger the nonprofit's tax-exempt status nor create unrelated business income for the nonprofit.

 **Designing programs that relate to your charity's mission is essential to maintaining exempt status. Here, the IRS was persuaded by statistics from the Department of Health and Human Services, showing how the nonprofit's service communities had been designated as medically under-served areas. Those statistics bolstered the nonprofit's claim that a job placement database served those communities, and only secondarily benefitted the healthcare professionals registered in the database. Having contemporaneous documentation demonstrating the exempt-function relatedness of activities that have for-profit counterparts is essential to avoiding unintended UBIT and, in the extreme case, preserving exemption.**

**To Order Memos:** Memos referenced in the *Nonprofit Alert* can be purchased for \$20 each (\$10 for clients) from Gammon & Grange, P.C. Five or more copies of the same memo are bulk priced at \$5 each. Call, write, or email us at the address below.

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***New York A.G. Proposes Stiffer Corporate Accountability on Nonprofits***

As *Nonprofit Alert*® reported last September, corporate scandals at Enron, Tyco, Worldcom, etc. have prompted Congress to pass the Sarbanes-Oxley bill, which imposes corporate governance reforms on publicly traded companies. Now, the New York Attorney General has proposed similar legislation that would apply to nonprofits as well. If enacted, New York nonprofits would be subject to audit committee standards, certification requirements related to financial statements and internal control procedures. Stricter procedures for approving interested director transactions would also be imposed, along with the potential removal of directors and officers for willful or persistent failure to file required reports. Highly public corporate scandals in both the for-profit and nonprofit sectors have created increasing pressure for legislative reform.

**Corporate scandals in both the for-profit and nonprofit sectors have created increasing pressure.**

 **Nonprofit Alert® will monitor the status of this and similar proposals in other states that may follow New York's lead. To take proactive steps in implementing prudent financial practices, order the recently revised *Nonprofit Alert® Memo, Annual Audits: Vital Risk Management*, which includes an analysis of the historic Sarbanes-Oxley law's impact on nonprofits. Refer to ordering instructions in the box at left.**

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