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Nonprofit Alert®

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

Inside This Issue:

White House Announces New Faith-Based Funding & Regs

The White House Office of Faith-Based and Community Initiatives announced proposed regulatory changes last month that would give faith-based groups greater access to federal funding. The office and its federal agency affiliates also finalized several federal regulations relating to faith-based groups and awarded more than $30 million in Compassion Capital Funds.

The announcement marks positive developments on faith-based issues, despite failed legislative efforts earlier this year. Here's a summary of this latest action:

Proposed Regs

The Department of Justice (DOJ) and Department of Education (DOE) proposed regulations designed to prohibit discrimination against religious organizations seeking federal funding for social service programs. The proposals mirror federal regulations already in place at certain government agencies. DOE's proposed regulations would apply to all its federally and state-administered grant programs, including community technology grants and mentoring programs. DOJ's proposal would affect its asset forfeiture program under which forfeited assets of $50,000 or less are given to community social service providers. The new policy treats religious and non-religious charities equally.

> More than $30 million in Compassion Capital Funds awarded to faith-based charities...

The Veterans Administration's proposed regulatory changes would eliminate the requirements that religious organizations must forfeit their rights to make employment decisions on the basis of religion and to certify that they "exert no religious influence" when serving homeless veterans.

Regs Finalized

The Department of Health & Human Services (HHS) finalized regulations that implement charitable choice laws for the Substance Abuse and Mental Health Services Administration and the Community Services Block Grant programs, among others. Some of these regulations had existed since 1996, but HHS's action now makes the policies permanent, resulting in access to nearly $20 billion in social service grants for faith-based organizations.

Read more about the Compassion Capital Fund.

Faith-Based Funding & Regs . . . . . continued from p. 1

The Department of Housing & Urban Development (HUD) also finalized similar regulations that make $8 billion in HUD grants available to faith-based groups. The regulations specify that such grants cannot be used for the acquisition, construction, or rehabilitation of a religious organization's principal place of worship, but they allow grants to be applied toward non-religious facilities operated by faith-based groups such as homeless shelters and rescue missions.

$30 Million Awarded

HHS awarded $8.1 million in 60 new grants to help build the capacity of faith-based organizations in serving low-income populations. HHS also announced the continuation of 21 other grants totaling $24 million. Grant recipients serve a wide spectrum of clients, from at-risk youth to incarcerated adults.

All the grants came from the Compassion Capital Fund, which was established in 2001.

Liability & Risk Management

Make sure you justify executive salaries with legitimate compensation comparisons and reviews. Find more tips in Nonprofit Alert® Memo, *Compensation Policies & Legal Guidelines* .

Reasonable Compensation Media Story Sparks Legal Inquiries by State Regulators

Last month, the *Boston Globe* ran a story detailing a study it conducted of private foundation tax returns, which revealed numerous examples of potential excesses paid to foundation executives. The story sparked controversy in foundation circles, and precipitated investigations by attorneys general in three states.

Attorneys General in three states investigate potential excess.

A spokesperson for California's Attorney General says they take the allegations "very seriously" because "charitable foundations are supposed to be just that: charitable...not cash cows for private individuals." The *Globe* story cited the Hocker Foundation of Rancho Sante Fe, CA, which compensated its sole trustee $580,000 over a three year period while at the same time making only three charitable grants totaling $265,000.

The Massachusetts Attorney General is "determining what actions are appropriate" following the story's allegations that the Paul & Virginia Cabot Charitable Trust paid trustee Paul Cabot, Jr. some $5 million over four years. Cabot allegedly admitted to the *Globe* that he gave himself a $200,000 raise to help cover his daughter's wedding expenses. During this same period, the trust made annual donations averaging $400,000.

New York's Attorney General says he's reviewing the records of the William T. Morris Foundation and the Gerda Lissner Foundation to determine if they paid excessive compensation to trustees. The *Globe* article alleged that the Morris Foundation tripled its president's compensation over a three year period to $900,000.

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Nonprofit executives are "fiduciaries" who have a duty of care and loyalty to their organizations.

Read a similar story about a nonprofit ordered to disband after its profiteering exec was caught in our NPA Feb'03 archives.

Songs of a Brazen Bull: Court Reprimands Executive for Breach of Duty

When his nonprofit publishing company wouldn't print his own book of poetry, *Songs of a Brazen Bull*, the president sidestepped the nonprofit's normal editorial process and published the book without informing the board of directors. He quietly applied to the Library of Congress for a catalog number using the nonprofit's International Standard Book Number (ISBN) prefix. He then reassigned executive duties to make himself the sole contact for all ISBN communications within the nonprofit. Claiming he represented the nonprofit publisher, he also contacted Amazon.com and Books in Print to arrange marketing and distribution of his book.

Did *Songs of a Brazen Bull* foreshadow such brazen actions?

When the board discovered the president's unauthorized actions, they fired him and brought suit for breach of fiduciary duty, trademark infringement, and deceptive trade practices. A federal district court in Minnesota ruled for the nonprofit on all claims, finding the president's actions were so contrary to the interests of the nonprofit that they could not have been caused by an honest intent. Those actions represented a clear violation of the president's fiduciary duties of care and loyalty.

The court also found the president's use of the nonprofit's trademarks in publishing and promoting his book constituted false designation and deceptive trade practices. Using the nonprofit's trademark and ISBN number to falsely designate the origin of his book caused public confusion and deception, the court wrote. As a result, the court ordered him to destroy all copies of his poetry book that carried the nonprofit's trademark and ISBN number and cease any further use of the nonprofit's trademark or ISBN number. *Mid-List Press v. Nora*, CV-No. 02-68 (U.S.Dist. Ct., MN 7/31/03).

The duty of care requires a nonprofit executive to oversee the organization with scrupulous good faith, candor, and care. The duty of loyalty requires an executive to act in the organization's best interests and not his or her own personal interests. Directors and officers who act in their own interest could be subject to excise taxes under the Intermediate Sanctions Law. Learn more by reading Nonprofit Alert®Memos, *Directors' Nonprofit Legal Duties,* and *Intermediate Sanctions* available from Gammon & Grange, P.C.

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Nonprofit & Tax Exempt Issues

Court Says No Undue Influence With $1M Gift

Four years before she died, Eva Aamodt hired an attorney recommended by a friend to prepare her will. Aamodt told the attorney she planned to leave her estate to the Salvation Army. The attorney, who had served on the Salvation Army advisory board for ten years, informed Aamodt of this connection and suggested she seek a more impartial attorney.

Aamodt declined to seek other representation and hired the attorney anyway. The attorney then drafted Aamodt's will and several codicils over the course of years, but the Salvation Army remained the primary beneficiary throughout this time.

Upon her death, Aamodt's heirs challenged the will, claiming the attorney exercised undue influence over Aamodt in naming the Salvation Army as beneficiary. The heirs argued that Aamodt had never favored social service charities. However, other evidence showed that Aamodt also volunteered and periodically contributed to the Salvation Army and other charities throughout her life.

The presumption of undue influence can be overcome with substantial evidence -- as was presented in this case -- to show the donor's clear intent.

An earlier will named Aamodt's sons as beneficiaries, but after they both died she removed them from the will. The court decided the heirs failed to produce any evidence of undue influence. Any presumption that might have arisen from the attorney's involvement on the Salvation Army board was overcome by "substantial evidence" of Aamodt's intent, the court said. *Estate of Aamodt*, No. 28460-0-II (WA Ct.App., 7/15/03).

If your organization is asked to assist in the preparation of a donor's will, then refer the donor to an impartial, qualified attorney with no legal relationship to your organization. Ask the attorney to secure all necessary waivers. These measures could help stave off later challenges.

Most attorneys insist clients sign a waiver if the possibility of a conflict like this one occurs.

Exempt Status Not Jeopardized by Scholarship to Relatives

A scholarship awarded to a relative of a director or officer of a community foundation will not necessarily result in an excess benefit transaction if the director or officer is removed from the scholarship selection process, the IRS has determined in a letter ruling.

The foundation's volunteers helped identify deserving students for scholarships, then maintained contact with scholarship recipients after graduation to help assess the value of the scholarship program. The volunteers voiced concern that the excess benefit prohibitions of IRC §4958 could disqualify their children or grandchildren from consideration for the scholarships. In response, the foundation restructured its scholarship program. It formed a supporting organization that nominated scholarship recipients to the foundation's board of directors, which made final selections of scholarship recipients. If a volunteer's relative were included among the nominees, then the volunteer would be recused from the entire scholarship process to maintain the relative's eligibility for the scholarship. The IRS said a scholarship awarded under these guidelines would not result in private inurement or benefit, nor would it endanger the exempt status of the foundation. IRS LTR 200332018.

Could a recipient exclude the scholarship from taxable income? Find out in Nonprofit Alert® Memo, *Scholarship and Tuition Reduction Programs*.

Highlight of the Month

Insurance: Know What You've Got Before You Need It

Your nonprofit carries a hefty insurance policy to shield it from liability. That should be adequate, right? Not necessarily. Adequate protection depends on the type of coverage as well as the *amount* of coverage, as one California church discovered.

A female employee at the Amanda Church of Self-Realization sued the church after experiencing a series of discriminatory and harassing remarks by two pastors with whom she worked. The church's insurance carrier refused to cover the claim, forcing the church to defend the lawsuit. A jury awarded the employee $300,000 in damages, and the church filed for bankruptcy. The church then sued the insurance company for failure to defend, but lost because the church's policy was only a "claims-made" policy, which limited coverage to claims made against the church during the policy period. Because the church's policy expired eight months before the employee filed her lawsuit, the court ruled that the policy did not cover the claim.

The church argued the claim should've been covered because the employee complained to her supervisor about the harassment before the policy expired. The court found, however, that the employee's complaint fell far short of a claim, which is "an assertion of a legal right" rather than a mere "expression of dissatisfaction, disappointment or grievance."

Clearly, church leaders did not fully understand the parameters of their insurance coverage– a common, but costly, mistake in both profit and nonprofit organizations. "Claims-made" policies cover only liabilities for which claims are made during the policy period for *damage that occurs after* the policy's retroactive date (usually the date of the policy's inception).

If a nonprofit changes insurance carriers and begins a new policy, the new carrier will likely advance the retroactive date forward to the time the new policy begins. This means the nonprofit is left with no coverage for any claims arising from liabilities that occurred during the prior period (i.e. the time between the inception date of its first policy and the inception date of its new policy) because the old policy is no longer in effect.

➥ **To avoid this risk when obtaining new insurance coverage, negotiate a policy with "full prior acts" coverage, which means a retroactive date would not apply to limit coverage. Otherwise, never agree to advance the retroactive date on a policy. If converting a claims-made policy to another type of insurance, always clarify coverage start/stop dates and what coverage may be lost in the conversion. If necessary, consider adding an extended reporting period clause or some other suitable provision that will generate the protection your organization needs throughout the period in question.**

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