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Nonprofit *Alert*®

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

Inside This Issue:

Foundation Declares Bankruptcy Amid Investigation

The Baptist Foundation of Arizona, the fundraising and endowment branch of the Arizona Southern Baptist Convention, filed for bankruptcy last month after state regulators found that it lacked money to cover its debts to investors. The foundation owes nearly $600 million to over 13,000 investors, to whom it promised lucrative financial returns. Its current assets are estimated between $160 and $200 million. The foundation acknowledges that its officials concealed money-losing investments, engaged in costly insider transactions, and maintained overhead "at excess levels." As reported in **Nonprofit *Alert*®** last month, the Arizona Attorney General's office is investigating foundation officials who allegedly committed fraud and self-dealing.

The foundation has already dismissed its top three officials and laid off 72 of its 127 employees. It has offered a plan allowing investors to receive either 20% of their original investments or the equivalent shares in a new, for-profit corporation that will hold the foundation's remaining assets.

15 years of the surgery center's operation. The contract was then renewable at the for-profit's sole discretion for two additional five-year periods.

The Tax Court agreed with the IRS, finding a number of reasons to deny exempt status to RSS: nothing obligated the for-profit partners to put charitable purposes ahead of profit-making; RSS lacked voting control over the partnership and held insufficient control to guarantee achievement of charitable purposes; and the management contract gave the for-profit control over daily operations and provided incentive to maximize income rather than serve charitable purposes. *Redlands Surgical Services, Inc. v. Commr.*, 113 T.C. No. 3 (7/19/99). The foundation is the primary fundraising subsidiary of the Arizona Southern Baptist Convention. It sells investment products primarily to Southern Baptist members, but also operates dozens of subsidiaries that engage in everything from real estate to insurance.

Because of the dollars involved, this latest investment scandal is potentially more devastating than the Ponzi scheme of the early 1990's that involved the Foundation for New Era Philanthropy. The New Era scandal resulted in the loss of some $350 million taken from hundreds of investors, mostly charities. These cases underscore the need for all investors—both individuals and charities alike—to look carefully and critically before making any significant investments.

> *"There are thousands and thousands of people in our communities who have lost their saving or what they counted on for monthly income."*
> — C. Truett Baker, former president of Arizona Baptist Children's Services, referring to what will likely be the largest nonprofit bankruptcy in history.

Always ask to see at least the last two annual certified audits, a list of the current board of directors, and the most recent SEC filing. If the investment company doesn't provide this informa-tion or promises extra-ordinary returns, don't part with your money. Much of this information can be obtained online. As a further step, either email or call the state attorney general's office where the organization is headquartered to inquire about the organization's status.

~~~ The Ascent of Charitable Giving ~~~

America's top charities raised 16% more in 1998 than in the previous year, according to a survey published by *The Chronicle of Philanthropy*. For the seventh year in a row, the Salvation Army was the biggest fundraiser among charities, totaling $1.2 billion. It was followed by the YMCA at $629 million, Fidelity Investments Charitable Gift Fund at $572 million, the American Cancer Society at $556 million, and the American Red Cross at $543 million. Charitable giving will likely continue its dramatic ascent, according to researchers at Boston College who predict that charities will gain between $6 trillion and $25 trillion over the next 50 years, far more than previous studies have estimated.

Liability & Risk Management

Scripture May Be Authority Over Contract Disputes

State law is not inconsistent with a contractual provision requiring that scripture be the supreme authority by which disputes between the parties are settled, according to a Colorado court. The case involved the Promise Keepers ("PK") organization, which entered an agreement with Encore Productions, Inc. Encore was to provide production and consulting services at PK's conferences. When PK terminated the relationship, Encore sued for violation of the agreement. PK invoked an arbitration clause in the agreement that required the parties to enter conciliation under the Rules of Procedure for Christian Conciliation, published by the Institute of Christian Conciliation ("ICC"). Encore argued that the Christian conciliation provision was unenforceable because it elevated scripture over state law. The court disagreed, citing an ICC rule that state or federal law will apply if any such law is inconsistent with ICC rules. The court rebuffed Encore's argument that courts cannot make a "theological conclusion" to enforce a Christian conciliation provision, stating that "courts have the power to enforce secular contract rights, despite the fact that one of the contracting parties may base their rights on religious affiliation." *Encore Productions v. Promise Keepers*, No. 99-B-14, 1999 U.S. Dist. Lexis 10024 (D. Col. 1999).

Nonprofits can minimize costly litigation by including conciliation clauses in all appropriate contracts. Nonprofit *Alert*® Memo 9101-6, *Christian Conciliation: Conciliate, Don't Litigate* explains how. For non-religious organizations, Nonprofit *Alert*® Memo 9510-1, *Alternative Dispute Resolution: Arbitrate, Don't Litigate*, provides helpful guidance in establishing conciliation policies and processes. See back page to order.

Fraud and Abuse Alleged in Child Food Program

The U.S. Department of Agriculture alleges that nonprofit organizations participating in the Department's Child and Adult Care Food Program are responsible for millions of dollars in fraud and abuse. Forty-nine nonprofit organization "sponsors" in 23 states receive and dispense program funds to child care providers for snacks and meals. The Department has accused 37 sponsors of abuses ranging from submission of false information to failure to submit program fund expense records. The Department has already dismissed 16 of the 37 sponsors, and launched investigations of several others. So far, 28 individuals have ben convicted or pleaded guilty to fraud and must pay $4.2 million in restitution. The Department also places blame on its Food and Nutrition Service, which failed to take action when evidence of fraud first came to light. The program was seriously deficient in training and monitoring sponsors, requiring strict record keeping and detailed reimbursement procedures, and communicating with parents of child recipients, a Department report concluded.

A nonprofit should maintain ongoing discretion and control over its assets to ensure they're used exclusively in furtherance of charitable purposes and in compliance with the organization's policies. Before accepting government funds, nonprofits should count the costs of administration, paperwork, and potential loss of some autonomy and control of funded programs.

Presidential Seal of Approval Backfires on Charity

A New York charity has discovered the hard way that misusing the Presidential seal will negate a clever fundraiser. When President and Mrs. Clinton announced they would buy a home in Chappaqua, New York, the Horace Greenley Scholarship Fund printed and sold t-shirts bearing the Presidential seal and the words, "Secret Service, Chappaqua Bureau, Presidential Detail." After producing over 500 shirts, the Fund was disappointed to learn that Executive Order #11649 does not permit sales of products bearing the presidential seal, even by charities. The White House has ordered the Fund to stop selling the t-shirts but is permitting them to be given away free.

Besides the presidential seal, nonprofits should not use copyrighted or trademarked material without obtaining the owner's permission, which may require a license agreement. For more information, order Nonprofit *Alert*® Memo 9301-2, *Trademark Law for Nonprofits*. See back page to order your copy.

Employees & Volunteers

Silence Beats Half Truth in Employee Job Referral

A detention center in New Mexico was held liable for negligence in failing to describe, in an employment reference letter, a former employee's acts of sexual harassment. The detention center had investigated several allegations that the employee sexually harassed female inmates and found evidence substantiating the allegations. It reprimanded the employee, then placed him on administrative leave after he continued to sexually harass inmates. Yet, the employee's supervisor gave him a letter of recommendation for future employment, which led to his employment at a hospital. A female patient at the hospital sued the center after the employee sexually harassed and assaulted her. A New Mexico appeals court recognized that an employer has the

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right to remain silent and not give a job reference for a former employee. Once the employer elects to give a reference, however, the employer must not make any misrepresentations or mislead the prospective employer, particularly when doing so would create a risk of injury to others.

If you must make a negative employment reference, make doubly sure every assertion is factual and verified. Check whether your state provides qualified immunity against defamation for good faith disclosures about former employees' performance. Nonprofit *Alert*® Memo 9402-1, *Minimizing Liability in the Employment Process*, describes reference checks and other elements of comprehensive risk management in your employment process. See back page to order.

Waffle House Can't Mix ADR Into EEOC Batter

The Equal Employment Opportunity Commission ("EEOC") cannot be bound by an alternative dispute resolution ("ADR") clause in an agreement between an employee and an employer, says the Fourth Circuit Court of Appeals. Waffle House entered an employment agreement with a grill operator that required the parties to arbitrate any claims arising from the employment. After the employee suffered a seizure on the job, Waffle House discharged him on the grounds that it was unsafe for him to continue employment. The employee filed a complaint with the EEOC, claiming that Waffle House violated the Americans With Disabilities Act. The EEOC then filed suit against Waffle House. Although the court considered federal policy favoring arbitration, it concluded that the EEOC was not bound to arbitration since it was not a party to the agreement.

The negative outcome of this case should not discouragethe use of ADR or conciliation provisions in contracts, since in the large majority of cases, courts will honor ADR provisions. ADR provisions serve a helpful corrective role in directing potential disputes into friendlier forums for settlements.

Odometer Alert: IRS Raises Business Mileage Rate

The IRS has increased the standard business mileage rate for the business use of an automobile to 32.5 cents, effective January 1, 2000. The rate for charitable use of an automobile remains at 14 cents per mile. Employees and self-employed individuals who own or lease an auto can use these mileage rates in computing deductible costs for operating the automobile, in lieu of deducting all of the actual fixed and operating expenses incurred in using the vehicle.

Tax-Exempt Issues

Law and Disorder: Experts Question IRS Activities

Nonprofit experts are questioning the ability of the IRS to regulate charities in the face of several recent developments and news reports, including the following:

- The IRS says it misplaced 114 files related to audits of tax-exempt organizations.

NPA Highlight of the Month

New Web Sites Serve Nonprofits

As we approach Y2K, an increasing number of new web sites are serving nonprofits. In the November 1999 issue of the **Nonprofit *Alert*®,** we reported on a new web site run by the AOL Foundation, **Helping.org**, which will provide information on more than 600,000 charities. In addition, the following newly-created web sites are offering services to nonprofit organizations, donors, and beneficiaries:

- **GrantMatch.com** (www.grantmatch.com) will give charities an opportunity to describe their specific activities and projects and will facilitate donors' contributions designated for those projects. The site will also contain charities' grant proposals and donors' "requests for proposals." Registration is free for nonprofits and donors until December 31, 1999.
- **The Quality 990** site (www.qual990.org) provides information on the Form 990 and on projects that educate charities about the Form 990. It also provides articles on charity disclosure rules and other legal issues affecting nonprofits.
- **NonProfit Pathfinder** (www.independentsector.org/pathfinder), run by the Independent Sector, profiles charitable programs in the areas of arts and culture, economic development, housing, and technology, and provides links to web sites that evaluate nonprofit programs. It also contains links to research centers studying nonprofits and other on-line resources on philanthropy.
- **SeeUthere.com** (www.seeuthere.com) will enable nonprofits to send invitations and sell tickets to events both on-line and off-line; both by email (a free service) and, for individuals without access to the Internet, by fax, postcards, or letters (for a fee). SeeUthere.com will create a free web site for each event to facilitate communication between the charity and individuals.
- **ResourceLink** (www.resourcelink.org) will match manufacturers who have surplus food with charities that can deliver the food to the needy. It also plans to link surplus clothing and building materials for affordable housing with those in need.
- **Raffa and Associates** (www.raffa.com/interior/charsolic.html) has developed an on-line compendium of charitable solicitation registration requirements for all 50 states, and contact information for each state agency that regulates fundraising.

- The IRS has been sued for allegedly shredding documents to conceal efforts by politicians to have certain groups audited, and the IRS claims that a secretary taped over a recording sought as evidence in the lawsuit.
- The Treasury Department's inspector general for tax affairs plans to investigate 4,000 IRS workers in the 2000 fiscal year, a 50% increase over the number audited in 1999.
- The IRS Exempt Organization Division's director, Marcus Owens, and his executive assistant, Jay Rotz, have announced they are leaving the agency.
- The IRS has announced a plan to reorganize its bureaucracy into four separate units. One of these units, the Tax-Exempt and Government Entities Division, will be headed by three officials who do not specialize in tax-exempt issues.

Despite these developments, the IRS continues to monitor nonprofits. The IRS recently released its fiscal year 2000 work plan for exempt organizations, calling for examination of split-dollar life insurance arrangements, donor directed or donor advised funds, tax-exempt bond financing, and §403(b) plans.

Are IRS Tax-Exempt Audits Politically Motivated?

The White House and members of Congress have triggered hundreds of audits of tax-exempt organizations by filing complaints with the IRS, according to a report by the Associated Press. The White House forwards about 1,300 constituent letters each year to the IRS, many of which register complaints against nonprofits. The IRS computer tracking system indicates the names of politicians who referred nonprofits to the IRS for investigation. Several of these referral letters are marked with "hot politically" or "sensitive." The IRS claims that less than one percent of its audits originate with complaints from the White House or members of Congress, and that its decisions are guided by the facts.

Tax-exempt organizations should take proactive steps to prepare for potential IRS audits. See Nonprofit *Alert*® Memos 9109-1, *Converting Your Annual Audit Into Vital Risk Management,* and 9102-3, *Preparing the Nonprofit for an IRS Visit*.

IRS Develops A Greater Affinity for Credit Cards

The IRS has finally relented from pursuing unrelated business income tax ("UBIT") from affinity credit card programs, in which nonprofits are paid by banks for the right to place their names on credit cards marketed to their donors. After crushing defeats in *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), and more recently in *Oregon State University Alumni Association v. Commissioner*, No. 96-70565 (9th Cir. Oct. 4, 1999), IRS Exempt Organizations Director Marcus Owens said the IRS does not plan any further litigation. Courts have held that income from such programs does not generate UBIT, so long as the nonprofit is not actively involved in managing or operating such programs.

State Rules & Regs

Nonprofits Are Invited to Boston "Fee" Party

Boston is aggressively soliciting voluntary contributions from charities for city services such as trash removal and police protection. Over half the city's property is owned by tax-exempts. Some (including Harvard University) have entered payment agreements with the city to pay a percentage (*e.g.,* 25%) of what they would otherwise pay in property tax if they were not exempt. The city expects to take in $20 million from 40 nonprofits in 2000.

Private School Program for the Poor Prevails in AZ

The U.S. Supreme Court won't review the Arizona Supreme Court's decision to uphold a state law allowing residents to claim a tax credit for donations to nonprofit scholarship organizations that help poor families pay for private school tuition. The Arizona court said the program was a legitimate attempt by the state to "keep pace with changing economic conditions and societal goals."

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