

Nonprofit *Alert*®

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



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Supreme Court Upholds State Fraud Charges Against Charity

State charity regulators may sue charities for misleading fundraising statements without violating First Amendment guarantees of free speech, the Supreme Court has ruled. The Court's unanimous decision marked a departure from its usual position of extending First Amendment protection to fundraisers and solicitation speech.

In this case, the Court found that the First Amendment protection did not apply because the fundraiser used fraudulent and misleading solicitations to lure donors. The state's interest in eliminating fraud and protecting unwary donors was sufficiently compelling to justify its lawsuit against the charity, the Court ruled.

Madigan v. Telemarketing Associates (formerly known as *Ryan v. Telemarketing Associates*) pitted Illinois state charity regulators against two telemarketing firms that collected \$7.1 million on behalf of a charity called VietNow. (See *NPA*, April '03). Over the course of their eight-year relationship with the charity, the telemarketing firms kept 85% of the donations to cover their own expenses, which eventually totaled \$6 million.

The soaring overhead expenses were never disclosed to donors, nor were donors told how much of their contributions actually went to VietNow. Instead, the telemarketers told donors their contributions would

be used to purchase food and provide training for needy veterans. Some donors were told the charity incurred no "labor costs" because everything was "done by volunteers" and that more than 90% of the money raised would go directly to help veterans.

The Illinois Attorney General brought suit against the telemarketing firms for making
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Gospel Missions Challenges Solicitation Ordinance on Constitutional Grounds

In another charitable solicitation case with constitutional implications, Gospel Missions of America (GMA), a religious charity that serves the homeless, continues to pursue its challenge to a Los Angeles' charitable solicitation law. The law requires anyone conducting charitable solicitations to first obtain an "information card" by submitting details about the solicitation to the city police department.

The police investigate the information and then decide whether to issue the card. The law also authorizes police to require "any additional information which in the opinion of the [police] department will be of assistance to the public in determining the nature of the solicitation..." No individual or organization may conduct solicitations in the city unless an information card has been issued to them.

Among the claims argued, GMA challenged the information card requirement as vague, overbroad, and in violation of constitutional Equal Protection provisions. A lower court rejected that claim, but the 9th Circuit remanded the issue to determine whether the information card was the "functional equivalent" of a license.

If so, then the lower court must decide if the law violates the Equal Protection clause by authorizing the city to unfairly single out groups such as GMA for stricter treatment. *Gospel Missions v. City of Los Angeles*, No. 00-55993 (9th Cir., 5/5/03).

Liability & Risk Management

Did Failure to Supervise Cause Volunteer's Fall?

Once a volunteer for your organization completes her duties and leaves for home, your responsibility to supervise her ends, right? A Louisiana appeals court suggests otherwise. The case involved a food bank volunteer who, after completing her duties for the day, waited on the loading dock to load spoiled food into her truck. This was a routine chore; the food bank often gave spoiled food to volunteers for disposal or to feed animals. For accountability, the food bank always weighed the food before giving it away. In this instance, an employee loaded the food on a forklift, but a barrel resting on a hydraulic pallet jack blocked his passage-way. In the process of trying to move the jack, the volunteer fell off the loading dock, broke her arm, and suffered other injuries. She later sued the food bank, claiming the driver failed to properly supervise her, which led to her injuries. A lower court dismissed the case, but on appeal, the court said there was a genuine question of fact about whether the volunteer acted on her own or at the direction of the fork lift driver. The appeals court remanded the case for further inquiry, noting that if the driver actually witnessed the volunteer operating the pallet jack, he might have had a duty to supervise her. *Wesley v. Food Bank of NE Louisiana*, No. 36-588-CA, (LA Ct.App.2nd Cir., 1/7/03).

 **Did the driver and food bank have a duty to supervise the volunteer under these circumstances? Did the food bank take adequate measures to prevent her injuries? The same or similar issues could complicate your charity's volunteer program if you don't adequately delineate the where, when, and how of what volunteers may do or not do on your organization's premises. Nonprofit Alert® Memo, *Managing Volunteers*, provides more practical tips for limiting liability. See back page to order.**

Employee Copyright Infringement: What They Download Could Hurt You

Illegal downloading, copying, or transmission of copyrighted materials subjects an employee *and his/her employer* to potential liability. Since Internet access is so common on workplace computers, employers should take deliberate steps to limit their liability risk.

The Recording Industry Association of America (RIAA) and the Motion Picture Association of America (MPAA) recently published a free guide to help employers educate employees about avoiding copyright infringements. The publication follows a well-publicized case that netted a \$1 million settlement. RIAA announced last year against Integrated Information Systems, which allegedly failed to prevent its employees from accessing and distributing thousands of music files over the company's network. The guide recommends to:

- establish a clear policy against downloading copyrighted materials;
- monitor employee workstations and Internet traffic;
- take immediate action when violations are suspected;
- delete copies of copyrighted material saved on company networks;
- implement security precautions to prevent further infringements.

 **The free guide, *A Corporate Policy Guide to Copyright Use and Security on the Internet*, is available at <http://www.riaa.com> or <http://www.mpaa.org>.**

Computers At Work

Nearly 70% of all public sector employees use computers at work, and more than half also use the Internet, according to Department of Labor statistics. The numbers were slightly lower for private sector employees: 51.2% use computers and 35.6% use the Internet. The figures are derived from a recently released 2001 survey, the latest year for which statistics are available.

Nonprofit's Trustees Escape Joint Liability for Bad Investments

Trustees of a nonprofit association are not jointly liable for the failed investments of the association, made by one trustee and his brokerage firm, says a New York appeals court. When the Scalp & Blade Scholarship Association's investment portfolio suffered continuing losses, the association sued its investment advisor (who was a member of the association's board of trustees) and his firm for \$330,000, claiming their poor advice caused the association's losses. A trial court ruled in the association's favor. Seeking to share liability, the advisor/trustee then petitioned the appeals court to hold *all* the association's trustees jointly liable for breaching their fiduciary duty. The appeals court rejected his claim. It held that the trustees complied with the state's Prudent Investor Act, which permitted the association's trustees to delegate their investment responsibilities to professionals if the trustees exercised reasonable judgment in their selection and oversight. The advisor/trustee was solely liable for the association's losses because he was "the one who benefitted from the investment activity," and was "substantially more at fault," the court concluded. *Scalp & Blade v. Advest*, CA 02-01241 (NY App.Div. 4th Dept., 12/30/02).

 **The lesson here is fundamental to nonprofit governance: nonprofit boards should seek maximum benefit for the nonprofit without showing favoritism to insiders. The board should follow a conflicts of interest procedure to ensure that any transaction with an insider is fair and reasonable, without generating excess benefits to the insider. Consult Nonprofit Alert® Memos, *Conflicts of Interest Policy and Intermediate Sanctions Law* for help in avoiding these problems.**

Tax Exempt Issues

7th Circuit: State Funding to Religious Halfway House Passes Constitutional Review

In a ruling that bodes well for faith-based initiatives, the 7th U.S. Circuit Court of Appeals held that state funding to a religiously-affiliated halfway house does not violate the Establishment Clause. The Wisconsin Department of Development granted about \$600,000 to Faith Works, a Christian agency based in Milwaukee that provides substance abuse treatment and job training for prison parolees. The program incorporates religious ideas and teachings. As an alternative to remaining in prison, qualified parolees could attend one of

... no religious coercion occurred since secular options were presented along with Faith Works . . .

several treatment programs, including Faith Works. Parolees were given a choice about which treatment program they could attend. The state reimbursed a portion of the treatment costs to whichever halfway house each parolee chose. Because Faith Works operated a nine month program, while most of the secular programs were only three months, many correctional officers favored the longer program.

The state waived its normal bidding requirements for the Faith Works program as a result of the correctional department's confidence in the program. A group of Wisconsin citizens brought suit, claiming this favoritism constituted a violation of the Establishment Clause. A lower court dismissed the case, and the 7th Circuit upheld the dismissal, holding that state funding to Faith Works was legal because inmates only went to the program by choice. There was no religious coercion, as correctional officers were required to present secular program options to each inmate. The court also found no constitutional problems with the bidding waiver because the state granted the waiver based on the length of Faith Works' program and its attractiveness to correctional officers, not on the program's religious nature. The court's ruling effectively puts Faith Works back in business. The organization had suspended its operations in December 2002 because the state stopped funding Faith Works' program, pending the outcome of this case. *Freedom From Religion Foundation, Inc., et. al. v. Scott McCallum, et. al.*, No. 02-3102 (7th Cir, 4/2/02).

Highlight of the Month

Senate Offers CARE for Charities

Last month, the Senate passed the Charity Aid, Recovery, and Empowerment (CARE) Bill of 2003 (S. 476) in an overwhelming 95-5 vote. We briefly covered the high points of the bill in the May issue of Nonprofit Alert®, but this month, we take a closer look at other provisions in the bill that would impact the charitable community at large, if it were to become law:

Non-itemizer Deductions - The bill would permit taxpayers who don't itemize on their tax returns to deduct up to \$500 for any charitable contributions they make over \$250 in any single year (or up to \$1,000 deduction for contributions over \$500 on a joint return). This long-sought amendment to the tax code will likely have the greatest impact on charities.

IRA Distributions - Under the CARE legislation, distributions from a traditional or Roth IRA would be tax-free if they are "qualified charitable distributions" to a church, charity, charitable remainder trust (CRT), pooled income fund (PIF), or charitable gift annuity (CGA). Donors couldn't take advantage of this benefit, however, until they reach age 70 ½ for distributions to a church or charity, or age 59 ½ for distributions to a CRT, PIF, or CGA.

Charitable IRS Mileage Rate - The bill would bring the charitable mileage rate in line with the standard IRS business mileage rate, currently at .36 cents per mile. This means charities could reimburse volunteers for mileage they incur in their private vehicles, during service to the charity, at the .36 cent rate. Charities would be required to maintain the same records as required for documenting the business mileage rate.

Form 990 - Charities with annual incomes less than \$25,000, which are normally exempt from filing informational Forms 990 with the IRS, would have to file an annual "notice" instead. The notice would provide general information to the IRS about the charity's continued operations, though far less information than that required on Form 990. Failure to file the notice for three consecutive years could result in revocation of exempt status. Churches would be exempt from this new requirement.

The CARE measure now goes to the House for consideration, where members are expected to take up a companion bill soon. Some House members reportedly oppose the Senate's version of the bill because it does not contain any of President Bush's faith-based initiative provisions. Those provisions were deleted from the CARE bill after facing opposition in the Senate. Stay tuned as Nonprofit Alert® follows this legislation throughout the coming months.

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State Fraud Charges . . . (continued from page 1)

knowingly deceptive and materially false representations, committing fraud, and for seeking private gain from the fraudulent actions. The state's supreme court rejected the claim on free speech grounds, but the state then appealed to the Supreme Court. Forty other states, plus the District of Columbia and Puerto Rico, joined the appeal in support of Illinois' position.

In overturning the lower court's decision, the U.S. Supreme Court drew a distinction between this case and previous fundraising cases that raised constitutional issues over allegedly excessive fees charged by telemarketers. The court held in those cases that setting limits on telemarketers' fees violates the First Amendment because such limits indirectly restrict solicitation speech.

In this case, however, the Illinois Attorney General objected to the telemarketers' fees, but she also sought to enforce the state's antifraud laws for specific instances of deliberate deception committed by the telemarketers against Illinois citizens. The difference, simply put, was fraud.

"Like other forms of public deception, fraudulent charitable solicitation is unprotected speech," Justice Ruth Bader Ginsberg wrote for the Court, but added, "Fraud may not be inferred simply from the percentage of charitable donations absorbed by the fundraising costs..."

This case clearly showed fraud in solicitation, which placed it outside the realm of First Amendment protection. "States may maintain fraud actions when fundraisers make false or misleading representations designed to deceive donors about how their donations will be used," the Court said.

"What the First Amendment and our case law emphatically do not require...is a blanket exemption from fraud liability for a

fundraiser who intentionally misleads in calls for donations," the court concluded.

The ruling gives states greater flexibility in fighting charity fraud and abuse, which has risen sharply in recent decades. With this ruling, state regulators now have a legal mandate to enforce disclosure requirements and other restrictions against telemarketers for the protection of donors.

The ruling also preserves existing free speech protections for telemarketers because the Court drew clear distinctions between the right of solicitors to engage in free speech and the acts of fraud present in this case. *Madigan v. Telemarketing Associates*, No. 01-1806 (5/5/03).



For a brief summary of state charitable solicitation requirements, email Gammon & Grange (npa@gg-law.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.

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