OPERATION(S)
5 THINGS THAT ARE MAKING REGULATORS BUZZ

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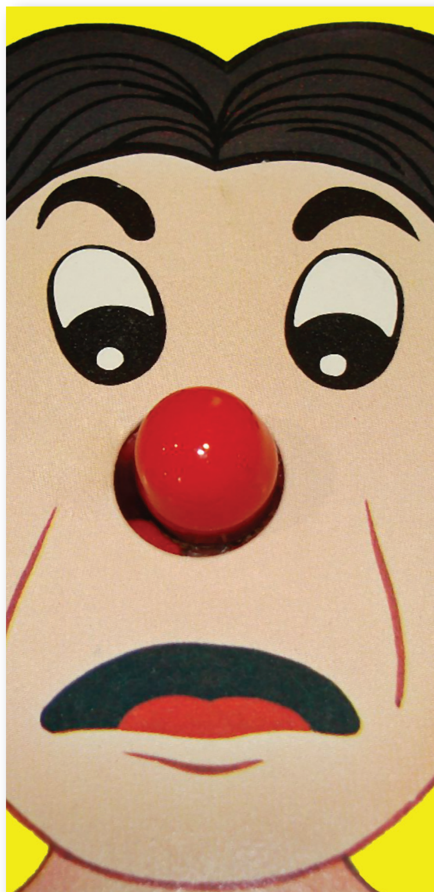
Changes in the way nonprofits operate alter the face of many discussions. But, a number of the underlying legal issues and compliance considerations seem to be perpetual. Internal operational issues are of great interest to regulators.

Among them are five hot-button areas -- everything from governance to finances to online activity.

GOVERNANCE & COMPLIANCE: POLICY VS. PRACTICE

One of the longstanding legal problems that nonprofits continue to face is failure by boards to properly implement adopted governance and compliance policies. For example, with respect to conflicts of interest, is the board properly considering alternatives when a proposed financial transaction will benefit an insider? Are only the independent directors reviewing and approving such transactions based on the best interests of the organization?

Failure to observe these key protocols can lead to improper excess benefit to insiders, and scrutiny of insider transactions by the Internal Revenue Service (IRS) and charity regulators. Similarly, failure to ensure that internal financial control policies and procedures are actually being implemented on a day-to-day basis can lead to fraud and embezzlement, with serious consequences to the organization to both finances and reputation.



Certain best practices in board governance, such as requiring a minimum number of board meetings to be in-person meetings, help ensure that boards have robust discussions before making important decisions on issues that involve serious organizational risk.

Boards that treat governance as a mere rubber stamp of the executive staff's decisions do not provide the checks and balances that are critical to their function as fiduciaries of the organization.

To ensure effective governance and compliance, nonprofit board members should regularly review policies in light of applicable laws and best practices, but also take time to ensure that they are being properly implemented.

SCRUTINY OF FUNDRAISING AND OVERHEAD COSTS

State charity regulators are increasingly seeking ways -- whether through legislation or enforcement actions -- to prosecute charities and their fundraisers for charitable solicitation fraud by scrutinizing charities' fundraising and overhead costs.

The Supreme Court of the United States confirmed in 2003 that charitable solicitation speech is fully protected under the First Amendment. As such, it is unconstitutional for state charity regulators to take action against charities and their fundraisers for fraud based solely on the basis of high fundraising or overhead costs.

Nevertheless, state regulators have persisted in their scrutiny of such costs -- stating that they are a preliminary indicator of fraud (which is a permissible basis for an enforcement action).

The typical fact patterns that lead to an investigation of a charity with high fundraising costs involve a charity that hires a professional fundraiser to solicit charitable contributions from the public, receives a minimal percent (usually in the range of 10 to 15 percent) of the total funds raised, and spends little or no funds on its charitable programs.

The "fraud" arises from a claim of misrep-

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resentation based upon solicitation materials which state that funds raised are spent on specific programs when in fact, little or no funds are spent on such programs, or that the charity is a "sham" charity (i.e., it exists to benefit a non-charitable purpose, such as to generate profits for the fundraiser).

Though not alone in its enforcement activity, the New York and California attorneys general have been particularly aggressive in bringing these cases, and their actions are not limited to charities and their fundraisers. Individual directors and officers, and even organizations' external CPAs, have been the subject of such actions.

The recent 50-state plus Federal Trade Commission (FTC) action against four cancer organizations is a wake-up call for charities and their fundraisers to carefully review fundraising practices, including their contracts, registration filings, and solicitation disclosures and materials, to ensure that they are in compliance with all regulatory requirements. Charities should also solicit bids from multiple fundraisers to ensure that the fees charged are reasonable in light of the services to be provided.

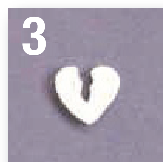
The State of Oregon recently began enforcing its law, which effectively penalizes charities that do not spend a statutory minimum percent of funds on programs. Failure to meet such program spending ratios results in the loss of donors' ability to deduct their contribution from their Oregon income tax.

Charities that fail to meet these program ratios must affirmatively advise prospective donors that they are not permitted to take a tax deduction against Oregon income taxes until the charity is able to meet its program expenditure requirement. Efforts to challenge the constitutionality of this law have, thus far, been unsuccessful.

Regulators are joined by watchdog agencies that have long highlighted fundraising and overhead costs in their reports to the public. While watchdog ratings are worth considering as one of many factors when deciding whether to donate to a charity, reliance on such ratings becomes problematic when watchdog agencies issue failing grades based solely on expense allocations, and without regard for the charity's effectiveness or impact.

Even more problematic is when the failing grades are based on an artificial manipulation of a charity's audited financial reports, such as by re-allocating program expenses to fundraising, contrary to Generally Accepted Accounting Principles. Though charity watchdogs are protected by their right to state their opinions, negative ratings that arise from flawed methodologies can have a devastating impact on charities, through loss of critical funding and other partnerships.

Some watchdogs have acknowledged that a charity's effectiveness should not be judged solely on their fundraising and overhead percentages, and are beginning to take steps to better incorporate or facilitate charities' reporting on their impact and effectiveness.



SOLICITATION AND USE OF DONOR-RESTRICTED GIFTS

The strong desire to communicate to potential donors the specific impact of their donations might lead to unintentionally creating donor restrictions on the gifts being solicited -- or creating such restrictions without understanding the consequences of doing so. A gift restriction can arise explicitly through a donor's specific instructions, as well as implicitly, such as when a donor responds to a specific solicitation request which states or implies that funds raised will be used for a specified purpose.

Once restricted, charities must either obtain the donor's consent to alter the restrictions, or follow strict statutory procedures for modifying gift restrictions, which may involve notice to the attorney general, as well as court approval.

This issue arises frequently in disaster relief fundraising, but it can happen anytime a charity requests a gift for a specific purpose. State charity regulators are increasingly holding charities accountable for the proper expenditure of donor-restricted gifts.

Soliciting funds for one purpose while using them for a different purpose, even a charitable one, is a possible basis for a claim of fraudulent solicitation. Charities that desire to maintain flexibility to expend funds where they are needed most should carefully review their solicitation materials to verify that they have properly communicated how funds raised will be used, and ensure that any donor-restricted gifts are properly recorded and expended.

ONLINE FUNDRAISING & TECHNOLOGY

With technology driving so much of today's social innovations, it should come as no surprise that nonprofits are increasingly harnessing its power to propel fundraising and communication efforts. New technologies are being used to communicate with donors and members in an increasingly interactive, data-driven, and customized way.

However, as new fundraising platforms are developed, a variety of legal issues must be considered to ensure that these fundraising and communications tools are safe as well as in compliance with applicable laws.

Here are five notable issues to consider in this area:

• First, for donations to be tax-deductible, donations must be made to 501(c)(3) tax-exempt organizations, which must have authorized the collection of donations on their behalf. Donations made through platforms in which campaigns are being conducted to raise funds for a charitable organization without the charity's authorization might not be tax-deductible, and such campaigns could raise other issues relating to unauthorized solicitation activity, and violation of the charity's trademark rights;

• Second, some platforms operate by receiving all donations through a tax-exempt public charity operating a donor-advised fund (DAF). The charity operating the DAF is the legal recipient of all donations, and issues donation tax receipts to the donor. Organizations with this model must clearly disclose the flow of funds, including notably, that the charity operating the DAF has exclusive legal control and discretion over the funds, but makes grants to other charities pursuant to donor recommendations;

• Third, with so much donor data being

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collected through third-party platforms, data security is a major issue. Before signing up with any new fundraising platform, take time to confirm that the platform has proper data security protocols in place, and carefully review and negotiate contract provisions to ensure that appropriate protections exist in the event of a security breach;

• Fourth, a major concern expressed by state charity regulators is the risk of fraud happening through online fundraising platforms. The National Association of State Charity Officials (NASCO) posted a set of "Wise Giving Tips" at the end of 2013, advising charities selecting fundraising platforms to use to examine whether the platform takes steps to prevent solicitation fraud. NASCO similarly advised fundraising platforms to develop and follow policies and procedures to detect more sophisticated attempts at fraud; and,

• Fifth, at the heart of state charity regulators' compliance and enforcement regime are state charitable solicitation registration requirements applicable to charities as well as certain types of fundraisers, namely, professional fundraisers, fundraising counsels, and commercial co-venturers. Regulators are closely examining new and existing fundraising platforms to determine whether their activities fall into any of the regulated categories, and thus require the entity to register and comply with related applicable laws.

New platforms should evaluate their registration obligations at the outset, and understand their compliance obligations to minimize potentially costly penalties later. Charities should similarly understand whether they are contracting with a platform that would require the platform to register.

NEW LEGAL STRUCTURES FOR ACHIEVING SOCIAL IMPACT

Many nonprofits are taking a more commercial or free market approach to tackling some of these deepest social challenges, such as combating poverty or fighting human trafficking. One basic example is by selling goods or services rather than just soliciting contributions. Such sales lead to questions as to whether the activities generating the income are substantially related to the organization's tax-exempt mission, or whether they are subject to unrelated business income tax (UBIT).

When such revenue-generating activities create risk to the organization, some have established wholly-owned limited liability companies to further shield the organization and its assets from such risks.

If ownership in the LLC is shared with other investors or partners, issues of private benefit need to be considered. Any such joint ownership should be carefully structured to avoid jeopardizing the nonprofit's tax-exempt status.

If the income generated is from activities that are mission-related, but may not meet the "substantially related" standard to avoid being subject to UBIT, some organizations are establishing affiliated for-profit entities, such as benefit corporations to reduce tax risk.

A benefit corporation is a legal form that provides protections for boards seeking to balance financial as well as non-financial (e.g., social, environmental) interests in their decision-making.

Many in the newer generation of "changemakers" are not even using traditional vehicles (i.e., nonprofits) as part of their philanthropic strategy, and are instead simply establishing standalone socially responsible businesses. Their philanthropic goals are achieved through the production of products or services that are necessary or beneficial to society, and/or through a close examination of their business practices through a social/environmental impact lens.

This new direction for achieving social impact is attracting the attention of legislators, including new legislative proposals that create tax incentives for socially responsible businesses. These businesses are also attracting the attention of state charity regulators, because of their explicit commitment to positive social goals.

Interestingly, four out of the past five NASCO conferences have emphasized the "evolving" or "changing" nature of the charitable sector, and robust discussions have taken place regarding the extent to which regulations developed for charitable organizations should extend to these new business vehicles, if at all.

The evolution in legal structures for achieving social impact continues to be a "hot" issue to monitor for the foreseeable future. **E**

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