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READY REFERENCE PAGE

NO. 92
FOR YOUR FILE

What Do We Mean When We Say "Nonprofit"?

Terminology obscures distinctions that are critical to understanding the rules that apply to organizations

We often start our lectures by quizzing the participants on their understanding of "nonprofits."

By show of hands, how many think the following organizations are nonprofits?

The Bill Gates Foundation; your church, synagogue, or mosque; the local United Way; the local community foundation; a major local university such as Harvard; a local social service organization; the Sierra Club; the local private golf club; the National Football league; the New York Stock Exchange.

A whole lot of people do not raise their hands very often. The hands particularly start to drop after the United Way or the community foundation. Yet all of these organizations are nonprofits except the New York Stock Exchange. And even the New York Stock Exchange was a nonprofit until 2006.

We all think we know what we mean when we say "nonprofit." But the key to understanding nonprofits is to understand that there are many different types of nonprofits. Different rules apply, depending upon the type of organization. An understanding of the difference is critical to understanding the world of nonprofit organizations.

Nonprofit

"Nonprofit is a concept of state law, which means that an organization may not pay dividends or otherwise pass any surplus revenue, or "profits," from the enterprise on to shareholders, members, or other individuals. Although a nonprofit may pay reasonable compensation for services actually rendered to it, in general, any surplus generated by the organization must stay within the organization and be used for its stated purposes.

(New York Attorney General Eliot Spitzer's suit against Richard Grasso, former President of the New York Stock Exchange, was based on the provision of the New York Not-for-Profit Corporation Law which, like most nonprofit corporation laws, permits payment of reasonable compensation only. There is no corresponding limitation in the business corporation law. (See Ready Reference Page: "Spitzer Challenges Grasso Salary as 'Objectively Unreasonable'.")

A nonprofit corporation is not "owned" by anyone. It may be controlled by individuals or other entities, but those who control the nonprofit do not have an ownership interest in the organization. (See Ready Reference Page: "The Key Question: Whose Organization Is It?")

Tax Exempt

When we say "nonprofit" we are usually thinking of an organization that is exempt from taxation. Most, but not all, nonprofit organizations are exempt from paying *federal* income tax on their earnings.

Section 501(c) of the Tax Code now spells out 29 separate categories of exempt organizations. These categories include:

Section 501(c)(2) title holding companies (See Ready Reference Page: "Title Holding Companies Have Limited Uses."); Section 501(c)(4) social welfare and advocacy organizations like the Sierra Club; Section 501(c)(5) agricultural or labor organizations; Section 501(c)(6) business leagues, professional and trade associations, like the National Football League; Section 501(c)(7) social clubs; Section 501(c)(8) and (10) fraternal organizations; cemetery organizations ((c)(13)); veterans organizations ((c)(19)) and so on down to (c)(28).

Charities

The largest category, and the one most people usually think of when they think of "nonprofit" or "tax exempt," is Section 501(c)(3) "charitable" organizations. Virtually all charities are nonprofits; but not all nonprofits are charities.

Under the Tax Code definition, a Section 501(c)(3) charitable organization is one which is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."

In addition, no part of the net earnings may inure to the benefit of any private shareholder or individual, no substantial part of the activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation, ("lobbying"), and the organization may not participate in any political campaign for or against any candidate for public office ("electioneering"). (See Ready Reference Pages on Requirements for Federal Tax Exemption, and on Lobbying and Electioneering.)

When the U.S. Supreme Court decided in the *Citizens United* case in 2010 that corporations could spend unlimited amounts on "uncoordinated" political campaign advertising, many existing and newly created 501(c)(4) advocacy groups and 501(c)(6) trade associations significantly increased their electioneering activity, as they are permitted to do under the law. Unfortunately, in much of the media discussion of the expenditures, the media referred to spending by "nonprofits," without distinguishing between those allowed to participate in elections and charities that are not so permitted. While the media was not wrong in calling these organizations nonprofits, the use of the term was hugely confusing because many people equate nonprofit" with "charitable" and charities cannot participate in election campaigns.

The other critical distinguishing feature of charities, as opposed to almost all other types of federally exempt organizations, is that individuals and corporations may make charitable contributions to charitable organizations and claim a charitable contribution deduction on their own federal income tax returns.

Public charities and private foundations

Section 501(c)(3) charities are further subdivided under Section 509(a) of the Tax code between "public charities" which receive broad public support and "private foundations" which receive the great

bulk of their income from a very limited number of contributors and investment income. All charities are deemed to be private foundations unless they show the Internal Revenue Service that they qualify as public charities. (See Ready Reference Page: "Calculating Public Support.")

Section 509(a)(1) describes publicly supported organizations such as churches, hospitals, and schools, which are considered publicly supported by virtue of what they do, and also organizations that receive a specified percentage of their revenue from a broad range of contributions such as the United Way, or a community foundation.

Section 509(a)(2) describes those that are deemed publicly supported because they receive a broad range of public support from contributions and fees for service, such as many social service organizations or a nursing home.

Section 509(a)(3) describes those organizations that are deemed publicly supported because they are "operated, supervised, or controlled by or in connection with" a publicly supported charity or governmental unit. (See Ready Reference Page: "Supporting Organizations Are Public Charities.")

Charities that don't meet the criteria of Section 509(a) are considered private foundations. Like the Gates Foundation, essentially all of their income has come form a single or limited number of individuals, families, or corporations and income on their investments. Private foundations are subject to more stringent regulation. (See Ready Reference Pages on Private Foundations.)

Nonexempt nonprofits

Although rare, there are nonprofit organizations that are not tax-exempt, like the New York Stock Exchange immediately before it converted to a for-profit so that it could sell stock to provide an ownership interest to investors. A "nonprofit" organization partakes of some of the "halo effect" of the term, even though most people do not understand that the term is not completely descriptive.

Some state nonprofit corporation laws make distinctions between charitable, mutual benefit, religious and other types of nonprofit corporations, and apply different rules for each, but many nonprofit corporation laws have only a single classification that includes all nonprofits.

State tax exemption

State tax exemption in most states is an entirely separate matter. Although most are likely to be exempt from state corporate income taxes, if any, many states have separate criteria, often more stringent than the federal 501(c)(3) criteria, for real estate or state sales tax exemption.

If you can't identify the category in which a nonprofit fits, you can't know the rules by which it is regulated.

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Pa. Supreme Court To Consider Attorney-Charity Confidentiality

Party claims charity's lawyer may report suspicious activity to Attorney General without regard to current Rules

The Supreme Court of Pennsylvania has agreed to consider whether an attorney for a public charity who believes that charitable assets are being unlawfully diverted for private purposes may notify the Attorney General.

Since the party claiming such a right does not base the action on Rule 1.6 of the Rules of Professional Conduct that permits breach of confidentiality in limited situations, presumably the disclosure is in violation of the Rule. The petitioner claims that counsel owes a fiduciary to the Attorney General as representative of the ultimate beneficiary of the charity, the general public. The petitioner argues that by structuring itself as a public charity supported by tax exemptions, the entity has foregone any right to have its lawyer "hide its activities from the Commonwealth," and presumably has waived its rights as a client under Rule 1.6. (Redacted v. Redacted, No. 173 MM 2014, 12/30/14.)

The specific question the Court will consider, as framed by the petitioner, is this: "When counsel for a nonprofit corporation believes that charitable assets are being unlawfully diverted, may counsel disclose this information to the Attorney General's office, as parens patriae for the public to whom the charity and its counsel owe a fiduciary duty?"

The case itself is totally under seal. Neither the parties, the other issues, nor the identity of the attorneys is available to the public. Although the order allowing the consideration of the attorney-client confidentiality question was filed on December 30, it was not made public until March 2.

The case was originally commenced in the Commonwealth Court, primarily a mid level appellate court that has original jurisdiction in a few types of cases, including certain actions against the Commonwealth or its officers. The statement of jurisdiction says the question involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of the mat-

ter. The Supreme Court proceeding is an appeal from a Commonwealth Court order that refused to say that the disclosure was permissible.

Rule 1.6 allows, but does not require, an attorney to breach client confidentiality in limited circumstances, including when the lawyer reasonably believes it is necessary to prevent reasonably certain death or substantial bodily harm, or to prevent the client from committing a criminal act that is likely to result in substantial injury to the financial interests or property of another. Apparently the attorney in this case released information to the Attorney General that did not fit within the limited exceptions.

The petition argues that attorneys for private trusts have duties to the beneficiary "that transcend those that a lawyer normally owes to a client" and that the same rule should apply to the relationship that exists among a public charity, its attorney, and the Attorney General. The brief supporting the request for consideration says: "[Redacted], as a public charity, owed a fiduciary duty to the public; thus, when [redacted] lawyer had reason to believe that the corporation was diverting public charitable resources into private pockets, she was at least permitted, if not obliged, to disclose that information to the Attorney General."

No response to the petition and no copy of the Commonwealth Court order has been disclosed. According to published reports, the appellee's brief is due March 23 but the Court has not decided whether to hold oral argument.

YOU NEED TO KNOW

It is always risky to comment on a case when it is impossible to know the facts or the issues. But the Rules of Professional Conduct have been honed over generations, perhaps even centuries, of jurisprudence, and the concept of attorney-client confidentiality is one of the bedrocks of our legal system. We want people to consult with lawyers so that they can get legal advice to comply with the law. A client's willingness to consult with a lawyer on anything would be seriously chilled if the client thought that the lawyer could run off and tell the Attorney General of anything the lawyer had "reason to believe" was improper. Confidentiality can be breached only in egregious situations.

The Rules also provide in Rule 1.13 a series of steps an attorney may take within the organization to try to rectify a problem, including asking for reconsideration, or taking the issue to higher levels of authority within the organization. Any measures the attorney takes must be designed to minimize the risk of revealing information to persons outside the organization. If the attorney is not satisfied that the situation has been corrected, the attorney may resign the representation. This Rule does not authorize disclosure to third parties, and even on withdrawal, the attorney must take reasonable steps to protect the client's interests.

The Rule on confidentiality starts with the requirement for confidentiality for all clients — individuals, for-profit businesses, and charities alike. It allows, but never requires, a breach in a few circumstances where the interest of protecting another party overrides the interests of the client. As a society, we are properly concerned about wrongdoing by any client, but we have made a judgment that having a client seek legal advice will more likely prevent more wrongdoing in the long run than dissuading the client from talking to a lawyer for fear that the lawyer will run to authorities if he or she has "reason to believe" that something is wrong. Wrongdoers are subject to sanctions for their actions, but we have not made our lawyers the first source of complaint. Charities play an important role in our society and our economy. There is no reason to apply a different rule to them than we apply to others.

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Attorney Confidentiality Question Changes in PA Supreme Court

Released briefs suggest Attorney General used improperly disclosed information to start investigation

Recently released portions of briefs in the sealed case involving the question whether an attorney for a public charity may disclose confidential information to the Attorney General without regard to the usual standards of the Rules of Professional Conduct have cast a slightly different light on the case before the Pennsylvania Supreme Court. (See *Nonprofit Issues*, February, 2015) The briefs suggest that the ultimate issue before the Court is whether the Attorney General may utilize improperly disclosed information as the basis on which to start an investigation.

The case known as Redacted v. Redacted, (*Redacted v. Redacted*, 145 MAP 2014) because the parties, the issues, and the lawyers involved are all undisclosed took on a somewhat different appearance when the Court unsealed about 8 pages of the 36-page brief for the party supporting the attorney's disclosure (apparently the Attorney General) and about 21 pages of the 58-page brief for the party objecting to the disclosure (apparently the charity being investigated). Significant arguments on other questions and a clear statement of the facts have not been made public.

The party arguing that disclosure is appropriate does not argue, at least in the material made public, that the disclosure was permissible under the Rules of Professional Conduct. It argues instead that counsel for a nonprofit corporation who "believes a public charities' [sic] board of directors are unlawfully diverting charitable assets may disclose this information to the Attorney General as parens patriae for the public to whom the directors owe a fiduciary obligation."

While acknowledging that no Pennsylvania court has ever so ruled, the party says "this narrow rule is well-grounded in existing Pennsylvania law governing fiduciaries and beneficiaries." Citing a county Orphans' Court decision, the party argues that the attorney has a duty to a beneficiary of a private trust to provide complete information concerning the administration of the trust.

“We submit that the same rule that applies to private trusts should apply as well to public charities,” the party argues. “Public charities, like private trusts, exist not to serve their directors but to serve their beneficiary: the general public.”

“Thus, where charitable assets are being diverted, by the very fiduciary obligated to protect those assets, the beneficiary — the public — has a right to know it and the charity’s attorney has a right to disclose it. The proper recipient of such a disclosure is the Attorney General, to who [sic] has been delegated the Commonwealth’s parens patriae function of protecting the public interest in the administration of public charities.” The party goes on to argue that “by electing to structure itself as a public charity supported by tax exemptions, [redacted] has forgone any right to have its lawyer, who has fiduciary obligations of her own, to hide its activities from the Commonwealth.”

The party opposing the disclosure states in its summary of argument that “there is no duty more sacred than the duty of confidentiality that a lawyer owes to his or her client…. These confidentiality rules lie at the heart of the attorney-client relationship because they give clients, such as nonprofit corporations, certainty that they can deal freely and openly with their lawyer; whatever information is provided to the lawyer will be kept in trust by the attorney absent a very narrow, clear set of circumstances, spelled out in detail in the ethics rules.”

It then goes on to argue a previously undisclosed line of argument. “Because confidentiality is fundamental to the attorney-client relationship, violations of the confidentiality rules are treated by courts with the utmost seriousness. When courts confront cases like this one — built upon flagrant violations of the confidentiality rules — they have uniformly deprived the party seeking to exploit the confidential information of any possibility of doing so…. As a result of this uniform body of law, most law enforcement bodies around the country have developed protective measures for handling cases that potentially involve attorney-client information… Not so here.”

The party says: “The record is undisputed that when the Companies’ then-current counsel, [redacted], approached [redacted] to discuss information she had expressly learned during the scope of her representation, [redacted] failed to proceed with care. Nor did it have any policies for doing so. Instead, it barreled forward without any deliberation, securing as much information as it could from [redacted] about her clients [redacted]. [Redacted] then proceeded to negotiate with [redacted] as the opposing counsel on behalf of the targets on whom she had purported to blow the whistle. And then, when informed that [redacted] unethical conduct and their facilitation of it warranted dismissal and disqualification under a uniform body of case law, [redacted] responded by [redacted] creating post-hoc justifications for their conduct and [redacted] conduct.”

The party opposing disclosure argues that the comparison to private trusts is not justified and that “traditional attorney-client relationships would be fundamentally altered, if not destroyed, by the extension of the exception to the nonprofit corporation context.”

“No other prosecutorial body at the state or federal level has ever sought such power to our knowledge,” the opponents argue. Since the Attorney General is the chief prosecutor of charity fraud in the state, the language of the argument suggests that the party seeking the benefit of the disclosure may be the Attorney General herself.

The identity of the party seems to become even clearer in the opponents’ next argument. “The main irony of this case is that [redacted] with its expansive parens patriae powers, has no need for any ‘fiduciary’

exception and no explanation for why it cannot follow the typical rules jurisdictions such as the federal government have in place for investigations into for-profit corporations."

The brief goes on to cite a series of whistleblower cases in which prosecutorial agencies have been unable to use tainted information in prosecutions. "[Redacted] does not and cannot explain why it could not abide by the same rules," it argues. "Instead it seeks a rule that would encourage disgruntled in-house attorneys for nonprofit corporations, [redacted] to use [redacted] as a pawn in their employment disputes with their employers. The Commonwealth Court recognized the folly of such an approach, and this Court should as well."

The brief concludes by stating that "[redacted] is inviting this Court to remedy its lack of prudence in dealing with [redacted] by adopting an unnecessary rule that would fundamentally undermine the attorney-client relationship for every nonprofit organization in Pennsylvania. The Court should respectfully decline the invitation, just as the court below did."

YOU NEED TO KNOW

Although the context of the argument has changed with the release of the significantly more extensive arguments, the crux of the issue is still the same. Should charitable organizations have the benefit of the same rules of confidentiality that are the bedrock of our legal system that apply to other clients? The party arguing to change the rule, apparently the Attorney General, has argued that organizations give up such rights by becoming charities, but certainly has not justified the argument.

If the rule were to be extended to charities, where else might it be extended? Would it also be extended to public officials, for example? To paraphrase the proponent's argument: where governmental assets are being diverted, by the very fiduciary obligated to protect those assets, the beneficiary — the public — has a right to know it and the official's attorney has a right to disclose it. The proper recipient of such a disclosure is the Attorney General or the District Attorney, to whom have been delegated the Commonwealth's function of protecting the public interest in the administration of governmental affairs. By electing to run for office, the official has forgone any right to have his or her lawyer, who has fiduciary obligations of her own, hide such activities from the Commonwealth.

And why limit disclosure to a law enforcement officer? Why shouldn't the lawyer just go directly to the beneficiary public, through leaks to the newspaper or postings on social media?

Do we really want a system where clients cannot feel safe in asking lawyers for legal advice?

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IRS updates private foundation rules on MRIs and equivalency determinations

The Internal Revenue Service has given new approval to mission related investments by private foundations and spelled out specific requirements for making "good faith determinations" that grants to foreign organizations are qualifying distributions that don't require expenditure responsibility.

The Tax Code, in Section 4944, imposes an excise tax on private foundation investments that "jeopardize the carrying out of any of its exempt purposes," but specifically excepts from the limitation "program related investments" where the primary purpose is to accomplish its charitable purpose and "no significant purpose" is the production of income or the appreciation of property. (See Ready Reference Page: "Foundations May Be Source of Venture Capital") PRIs are not only permitted, but are counted toward the minimum distribution requirement of the foundation.

The exception applies, however, only where there is "no significant purpose" to generate income. Some foundation managers have been concerned that they might be liable if they invested portions of their endowments in "mission related investments" or "socially responsible investments" which are aligned with their charitable goals but still provide — and are expected to provide — a return on investment, although not necessarily the highest return. Investing in alternate energy sources rather than fossil fuels might be an example.

In IRS Notice 2015-62, the Service says an investment will not be considered a jeopardizing investment "if, in making the investment, the foundation managers exercise ordinary business care and prudence (under the circumstances prevailing at the time the investment is made) in providing for the long-term and short-term financial needs of the foundation to carry out its charitable purposes. … foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence … and do not jeopardize the private foundation's charitable purposes."

The IRS says the standard "is consistent with investment standards under state laws," citing the Uniform Prudent Management of Institutional Funds Act. The relatively new UPMIFA allows managers to consider the asset's special relationship or special value, if any, to the charitable purposes of the organization. (See Ready Reference Page: "New UPMIFA Sets Rules for Management of Charitable Funds")

The IRS has also issued final regulations on standards for a private foundation to make a "good faith determination" that a foreign grantee is a charitable organization that is not equivalent to a private foundation. Grants to such organization may be qualifying distributions and not taxable expenditures. A private foundation is permitted to make a grant to a foreign organization that meets the definition of a U.S. public charity (including a supporting organization other than a non-functionally integrated Type III supporting organization) or a private operating foundation. To make grants for charitable purposes to other organizations, the foundation must exercise expenditure responsibility. The final regulation slightly modifies proposed regulations issued in 2012 and is effective as of September 25, 2015.

The final regs under Section 53.4942(a) attempt to balance two important considerations, the IRS said, —removing barriers to international grantmaking and ensuring that foundations' good faith determinations are informed by a sufficient understanding of applicable law, are based on all relevant facts, and are likely to be correct.

The final regs expand the class of advisors who may provide written advice on which a foundation may rely to include "qualified tax practitioners," including CPAs and enrolled agents. Attorneys may be in-house counsel or outside counsel. All must be licensed in their disciplines and authorized to practice in a state or as an enrolled agent at the IRS. Foundations will not be able to rely on an opinion of grantee's counsel unless that counsel meets the qualifications for a qualified tax practitioner. Opinions by foreign lawyers or CPAs not licensed in the U.S., therefore, will not be sufficient.

Foundations will also be unable to rely solely on an affidavit from the foreign grantee. Although the IRS recognized that some affidavits could be reliable because the person understood the requirements of U.S. law, it said that some of them would be unreliable because the grantee did not understand U.S. law. Therefore, reliance solely on the grantee's affidavit would not be considered a good faith determination. The IRS said, however, that a qualified tax practitioner could rely on foreign counsel for questions of foreign law or other matters within such counsel's experience.

Some private foundations who make grants to the same foreign organizations have wondered whether U.S. grantmakers may share their determinations and still meet the good faith determination standard. The IRS again said that some determinations could be good, while others would be invalid because they are not made by people familiar with U.S. law. The final regulations do not prohibit the sharing of information and determinations, but each foundation must rely on advice given to it by a qualified tax practitioner, not by another foundation.

The IRS said that these new guidelines can be used by sponsors of donor advised funds in making grants abroad "until further guidance is issued."

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IRS may offer alternate substantiation form

The Internal Revenue Service has proposed a new tax form to provide an alternative means for donors to substantiate gifts of $250 or more to charities. (See Ready Reference Page: IRS Requires Substantiation of Contributions") It has proposed to allow charities to file a new form listing the name and address of the donor, the donor's taxpayer identification number, the amount of cash or a description of other property donated, whether any goods or services were given in return, and if so, a good faith estimate of the value thereof.

The form would give donors the ability to claim the gift if they lost their contemporaneous substantiation record or did not receive one. On an audit, they could ask the IRS to check its own records to confirm their gift.

The Tax Code currently allows an exception to the general requirement for a taxpayer to obtain a contemporaneous written acknowledgement of the gift from the recipient organization. It allows the IRS to establish a form for the charity to file with the IRS, but it has never done so since the law was changed in 1993. In its notice of the proposed rule, the IRS says it "has received few requests" for such a form.

Nevertheless, some taxpayers have argued that the gifts can be deducted if the donee organization amends its Form 990 to include reference to the gift. The IRS has never accepted that argument and says it has concluded that the Form 990 would not be appropriate for such reporting. But it is now proposing a specific form as authorized in the Code.

The donee organization would be permitted, but would not be required, to file the form (the design of which has not been released) by February 28 of the year following the year of the receipt of the gift. If the organization did file the form, it would be required to provide a copy to the taxpayer by the same date.

The proposed change in Regulations was released September 16. The IRS has called for comments or requests for a public hearing by December 16.

You Need to Know….This sounds like a lot more paperwork to protect donors who don't keep very good records for their tax returns and who have the misfortune to be among the very few who are audited.

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DOJ finds no criminality in Tea Party "Scandal"

The Department of Justice found evidence of mismanagement, poor judgment and institutional inertia in the Internal Revenue Service's handling of applications for 501(c)(4) tax-exemption by Tea Party and other politically oriented organizations but no evidence that any IRS official acted based on political, discriminatory, corrupt or other inappropriate motives that would support a criminal prosecution. The conclusion was recently set forth in a letter dated October 23 from the DOJ to the Chair and ranking member of the House Ways and Means Committee.

The Department said it had conducted "an exhaustive probe," interviewing more than 100 witnesses, collecting more than a million pages of IRS documents, and analyzing almost 500 tax-exemption applications. It said it found no evidence of criminality or obstruction of justice and was closing its investigation.

It said its findings confirmed "the core factual findings" of the report of the Treasury Inspector General for Tax Administration in 2013 that had found "heightened scrutiny" including burdensome questions and significant processing delays, but found no criminal intent by any IRS official. The report specifically found no criminal intent by Lois Lerner, who was then director of the exempt organizations group.

"Not a single IRS employee reported any allegation, concern, or suspicion that the handling of tax-exemption applications — or any other IRS function — was motivated by political bias, discriminatory intent, or corruption," the letter said.

To bring a criminal charge, the letter said, the DOJ "must have evidence of criminal intent." Although it "searched exhaustively" for evidence that any IRS employee deliberately targeted an applicant or group of applicants for scrutiny, delay, denial, or other adverse treatment because of their viewpoint, it found none. "Proof that an IRS employee acted in good faith would be a complete defense to a criminal charge; and proof that an IRS employee acted because of mistake, bad judgment, ignorance, inertia, or even negligence would be insufficient to support a criminal charge," it said.

It said the IRS was motivated by "the desire to treat similar applications consistently and avoid making incorrect decisions." It found

that "their plans to treat applications consistently were poorly implemented, due to a combination of ignorance about how to apply section 501(c)(4)'s requirements to organizations engaged in political activity, lack of guidance from subject matter experts about how to make decisions in an area most witnesses described as difficult, and repeated communication and management issues."

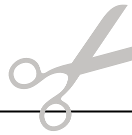
It concluded, however, that "ineffective management is not a crime."

The letter drew distain from various Republican Congressional leaders and claims of I-told-you-so from Democratic leaders.

YOU NEED TO KNOW

If ineffective management were a crime, there are a lot of Congressional leaders who would be ripe for prosecution.

Unfortunately, the IRS has still failed to establish criteria for the type and amount of political activity that is permissible for a 501(c)(4) organization. Some in Congress don't seem to want a real answer to that question. (See Ready Reference Page: "IRS Proposes New Regulations for 501(c)(4) Social Welfare Organizations")



READY REFERENCE PAGE NO. 127 FOR YOUR FILE

IRS Proposes New Regulations For 501(c)(4) Social Welfare Organizations

Attempt to define "candidate-related political activity" leaves key issues unresolved, draws fire from left and right

Responding to the lack of definition of the type and amount of political activity permitted by 501(c)(4) social welfare organizations and last year's "scandal" over the extra scrutiny given to Tea Party and other organizations applying for (c)(4) status, the Internal Revenue Service has proposed a new set of regulations to clarify some of the issues and ask for public comment.

The outpouring has been substantial, from both the right and left sides of the political spectrum. The left has criticized the proposals as curbing civic engagement. The right has criticized them as a power grab. A record number of comments has been received during the comment period that expires February 27.

Social welfare organizations obtained renewed prominence immediately after the U.S. Supreme Court held in the *Citizens United* case in 2010 that corporations could spend money to endorse or oppose candidates for election so long as the expenditures were not coordinated with the candidates. Political parties and political action committees, of course, have always been able to spend money on elections and their political income is not subject to tax. But candidates, parties, and PACs are required to disclose their donors. (c)(4) organizations, unlike 501(c)(3) charities, have been allowed to participate in election campaigns so long as their "primary" activity is promotion of social welfare. The big difference between political organizations and (c)(4)s, however, is that (c)(4) organizations are not required to disclose their donors. The underlying controversy, therefore, is largely about disclosure, although it takes the form of a debate about tax law definitions.

Comparison of 501(c)(3) and 501(c)(4).

The statutory language of Sections 501(c)(3) and 501(c)(4) are basically the same. Each must operate "exclusively" for charitable or social welfare purposes. The IRS adopted regulations that say in each case that "exclusively" means "primarily." The (c)(4) regs say that the promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. No such provision was required for (c)(3) organizations because the statute itself provides that an organization may not be classified as a charity if it engages in such political activity.

The regs for charities further state that an organization will not qualify for (c)(3) status if "more than an insubstantial part of its activities" are not charitable. Apparently because it was recognized that (c)(4) organizations were permitted to participate in political activity, no such limitation was placed in the (c)(4) regs. As a result, many commentators, including some at the IRS, believe it is permissible for a (c)(4) organization to spend up to 49% of its activity on political activity. (See Ready Reference Page Commentary: "Is IRS Caving In On Standard for Political Campaign Activity by (c)(4) Groups?")

But where to draw the line for the permitted amount of campaign activity is one of the issues that the IRS did not attempt to resolve in its current proposed regulations. It is probably the most significant is-

sue on which it has requested comments. If the IRS were to pass regulations providing that no substantial part of a (c)(4)'s activities could be political activities (election activities rather than lobbying and legislative activities), it wouldn't make much difference how political activity is defined. The mad rush to create and use (c)(4)s for partisan election activity would immediately abate. The new ones are not focused primarily on legislative activity. They are focused on supporting or opposing candidates.

New regs limited to 501(c)(4) organizations

Nevertheless, the IRS has attempted to create a new definition of "candidate-related political activity." The proposed regs are designed only for (c)(4) organizations and do not apply to (c)(5) labor unions and agricultural organizations or (c)(6) trade associations, which were also liberated by the *Citizens United* case to participate more directly in political campaigns. The IRS has asked for comment on whether the rules should be extended to other 501(c) organizations.

In developing its proposals, the IRS has drawn heavily on the rules developed for 501(c)(3) charities, for 527 political organizations and for federal election law. (For rules applicable to charities see Ready Reference Pages: "Charities May Not Participate in Elections" and "IRS Issues New Guidance on Electioneering") In the preamble to the proposed regulations, the IRS says that the rules overlap but are not synonymous.

The 501(c)(3) rules depend heavily on a "facts and circumstances" analysis and are used for 501(c)(4) organizations. The proposed regs are intended to "more readily identify activities that constitute candidate-related political activity and, therefore, do not promote social welfare." They do not attempt to define the promotion of social welfare. The IRS acknowledges that its attempt to make things clearer could be both more restrictive and more permissive than the current approach but says it is justified by the need to provide greater certainty to reduce the need for fact-intensive determinations.

Consistent with the scope of Section 527, a candidate is defined as "an individual who publicly identifies himself, or is proposed by another, for selection, nomination, election, or appointment to any federal, state, or local public office or office in a political organization, or to be a Presidential or Vice-Presidential elector," and any officeholder who is subject to a recall election. This definition is broader than the (c)(3) definition and includes candidates for executive branch offices and appointed judicial nominees.

New definition of "candidate-related political activity."

The proposed regs specify the activities that constitute "candidate-related political activity." They are:

(1) Any communication expressing a view on, whether for or against, the selection, nomination, election or appointment of one or more clearly identified candidates, or of candidates of a political party, that contains words of express advocacy, such as "vote," "oppose," "support," "elect," "defeat," or "reject" or is susceptible of no reasonable interpretation other than a call for or against the selection of such a candidate.

A communication is defined as any communication by whatever means, including written, printed, electronic (including Internet), video or oral.

(2) Any public communication within 30 days of a primary election or 60 days of a general election that refers to one or more clearly identified candidates in that election, or in a general election, to candidates of a political party. A "public communication" is one made by broadcast, cable or satellite, on an Internet website, by newspaper, magazine or other periodical, as paid advertising, or that other-

wise reaches or is intended to reach more than 500 persons.

(3) Expenditures that have to be reported to the Federal Election Commission.

(4) A contribution (including a gift, grant, subscription, loan, advance or deposit) of money, or anything of value to, or the solicitation of contributions on behalf of (a) any person if the transfer is reportable under any federal, state or local campaign finance law, (b) any 527 political organization, or (c) any organization described in Section 501(c) that engages in candidate-related political activity. Anything of value includes both in-kind donations and other support such as volunteer hours and free or discounted rentals of facilities or mailing lists. A transfer to a 501(c) organization will be considered for candidate-related political activity unless the receiving organization provides a written representation that it does not engage in such activity and the contribution is subject to a written restriction that it may not be so used.

(5) Conduct of a voter registration drive or a "get-out-the-vote" drive. (Public charities are permitted to engage in these activities so long as they are nonpartisan, but these proposed regs would include them within the definition of political activity whether or not nonpartisan.)

(6) Distribution of any material prepared by or on behalf of a candidate or a 527 political organization.

(7) Preparation or distribution of a voter guide that refers to one or more clearly identified candidates, or in a general election, to one or more political parties. (Broad-based and non-partisan guides are permitted by pubic charities while narrow-issue guides are deemed to constitute an intervention because the audience will know what the "right" answer from a candidate should be.)

(8) Hosting or conducting an event within 30 days of a primary election or 60 days of a general election at which one or more candidates in such election appear as part of the program. (Candidate debates involving all recognized candidates for a specific office are frequently held by 501(c)(3), (c)(4) and (c)(6) organizations under the current rules.)

The proposed regs also include an "attribution" rule. Activities will be attributed to a 501(c)(4) organization if they are paid for by the organization or conducted by an officer, director, or employee acting in such capacity, or by volunteers acting under the organization's direction or supervision. Communications include those that are paid for by the organization or that are made in an official publication or at an official function of the organization.

Candidate-related political activity is not prohibited

Although some of the commentary on the proposed regs seems to assume that these activities that constitute candidate-related political activity are prohibited, that is not the case. Like lobbying for public charities, they are permitted, but they are counted towards the limit of whatever is ultimately deemed to be "too much."

Most commentators believe that it will be a long while before the IRS finalizes these regulations, if ever. The political stakes are extraordinarily high, and once again, the Tax Code is being asked to regulate conduct rather than collect or exempt from tax. Before *Citizens United*, few people cared what a 501(c)(4) organization could do in political activity. And if it weren't for the secrecy of donors, probably few people would care now. But once again our political system has put the IRS in the middle, where it isn't very comfortable, and where it doesn't have very clear direction.

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Court denies exemption to group home provider

The Pennsylvania Commonwealth Court has reversed a trial court decision and denied charitable real estate tax exemption to a group home provider. It has held that the provider, which was funded primarily by Medicaid payments from the state, did not prove that it donated gratuitously a substantial part of its services.

Fayette Resources, a 501(c)(3) nonprofit corporation, operates group homes and provides services for intellectually disabled individuals in western Pennsylvania. It operates about 80 homes and has over 700 employees with a budget of about $24 million a year. In 2012, it applied for exemption on 15 properties, all group homes except one training center where it trains its clients and its staff.

The county Board of Assessment denied the applications. The Court of Common Pleas reversed and granted the exemptions, but the Commonwealth Court has reversed again.

Pennsylvania law allows the state legislature to exempt institutions of purely public charity from real estate taxes. The state Supreme Court in 1985 established five criteria for qualification. The organization has to (1) advance a charitable purpose; (2) donate or render gratuitously a substantial part of its services; (3) benefit a substantial and indefinite class of persons who are legitimate subjects of charity; (4) relieve the government of some of its burden; and (5) operate entirely free from private profit motive.

The Court agreed with the trial court that Resources advanced a charitable purpose by providing group homes for intellectually disabled persons and that the intellectually disabled are a legitimate class of subjects of charity. The fact that it received payment from the government or others does not negate its charitable purpose or its benefit to persons who are legitimate subjects of charity, the Court said.

It also agreed that Resources relieved the government of a statutory duty to care for intellectually disabled individuals and that it operated without a private profit motive. The Board argued that Resources could not meet the no private profit requirement because it showed an $820,000 surplus for its 2010 fiscal year. The Court dis-

agreed, saying the requirement could be met by reinvesting the surplus in the charitable activities and not directly or indirectly to benefit private individuals.

But the Court said that the trial court's finding that Resources donated gratuitously a substantial part of its services was not supported by "any evidence in the record."

Resources did not show that the payments it received did not cover the costs of its services. The Court said Resources also failed to show that it provided its services "at cost or less," which would meet the qualification requirements. Resources had not shown that it received charitable contributions or donations of property or services. Nor did it show that it purchased and renovated group homes with funds other than those it received for services. It had not introduced financial statements or Form 990 tax returns that showed it paid for its services from any source other than "fully adequate payments" for its services. (*Fayette Resources v. Fayette County Board of Assessment,* Commonwealth Ct., PA, No. 405 CD 2014, 12/23/14.)

YOU NEED TO KNOW

It is not clear whether this case is merely one in which the applicant failed to prove sufficient subsidy for its services or one in which it could not prove a subsidy because it was fully paid for its work. If the latter, it was consistent with a long line of cases in Pennsylvania, primarily in the subsidized housing field, in which the courts have said essentially that if a governmental source is willing to pay the full cost of services, the state will disallow a real estate tax exemption and allow the governmental payor to, in effect, pay the local real estate taxes as part of its payment. That would be a wonderful idea if the governmental payor could just increase the payment to the provider and the provider could continue to provide the same level and amount of services. Unfortunately the payor's funds are usually limited. The result is that costs go up and fewer legitimate subjects of charity can be benefited by the payments. With legislatures so much less likely to increase funding for legitimate needs, it means that fewer people get services, or less complete services.

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Penn State Trustees May Review Source Material of Freeh Report

Court orders release of information despite board's vote not to look at background data

A group of trustees elected by Penn State alumni has the right to review the background data developed by Louis B. Freeh and his staff in connection with their controversial report on the University's handling of the sexual misconduct charges against former assistant football coach Jerry Sandusky. A trial court judge sitting specially in Centre County has ordered the University to produce the materials for review, even though the full board had voted against reviewing the background material. (*In Re: Application by Nonprofit Corporation Trustees to Compel Inspection of Corporate Information*, No. 1593 of 2015, Centre Co., PA, 11/19/15.)

The alumni trustees have expressed concerns about the Freeh Report and asked to see copies of the interview summaries and other information developed by the investigators. They argued that the information was important to their fiduciary duty to oversee the University's operations, and particularly on how to deal with a variety of court cases currently facing the University stemming from the Sandusky situation. The University had refused to give them access to the information. In part, the University claimed that a majority of the board had voted against authorizing a special committee, including several of the alumni trustees, to review the data and had instead voted not to further investigate.

The trustees sued under section 5512 of the Pennsylvania Nonprofit Corporation Law. The law provides that provides a director shall have the right, "to the extent reasonably related to the performance of the duties of the director," to inspect and copy corporate records and documents. The section also provides that if the corporation refuses, the court "shall" summarily order disclosure of the information unless the corporation proves that the information is not reasonably related to the director's duties or that the director is "likely to use the information in a manner that would violate the duty of the director to the corporation."

Tracing the history of the provision, the Court started with a 1912 decision of the Pennsylvania Supreme Court taking a broad view of a director's rights. "The duty to manage the corporation rests alike

upon each and every one of the directors," the Supreme Court had written, "and, therefore, it is the right of each director to inspect its books and documents. There doubtless may be differences of opinion among directors as to the management of the affairs of the corporation, but while the majority will control, they have not the authority, and cannot be permitted to deprive the minority, by refusing an inspection of the books and papers, of the right to obtain information as to the affairs of the company."

In 1939, dealing with a director of a business corporation, the state Supreme Court had again permitted review so that a director could "perform his duties to the corporation," but placed a restriction that the director must act in good faith and refrain from using the information for purposes in conflict with his fiduciary obligation.

The 1988 provision in the Nonprofit Corporation Law adopted both of the limitations, the trial court said, but "the burden of establishing either of these restrictions is on the corporation." If the corporation fails to prove either restriction, "the statute provides the Court shall summarily order that the information be provided to a director."

In applying the rules to this case, the Court said the trustees had set out the reasons they believe the requested information is related to their duty in managing the affairs of the University, including a number of pending lawsuits involving the Freeh Report. The statute was not intended to "place a high bar" on access to information, the Court wrote, and the determination that the information is fairly and reasonably related to the director's duties "is one to be made solely by the court." The Court said it was "satisfied that a reasonable relationship exists."

It also reviewed the University's claims, filed under seal in August, that the trustees were likely to use the information in a manner that would violate their duties as directors. It said that the information was not "of such import as to warrant a conclusion" that the directors would violate their fiduciary duties.

The University had argued that release of information disclosing which witnesses had made what specific statements would make witnesses less likely to come forward and be forthright in future investigations. It also argued that the information could be used against some of the employees. While the Court expressed some sympathy with the arguments, it concluded that no promise of confidentiality was expressly made to those interviewed. The Court nevertheless limited the use of the information.

The Court ordered that all of the source material that the University did not claim to be protected from disclosure by privilege or confidentiality or that is in the public domain be made available to the trustees within 20 days. It also ordered the University to make information it claimed is subject to privilege or confidentiality available within 45 days and label it as such. The trustees are not permitted to discuss the privileged or confidential information outside privileged executive sessions of the board or with anyone other than University counsel or their own counsel. Each trustee is required to acknowledge this requirement before viewing any of the information that is claimed to be privileged or confidential.

YOU NEED TO KNOW

The Court properly rejected the University's argument that a majority of the board could tell individual directors that they could not look at information they believed was important to have to fulfill their fiduciary duty. Fiduciary duty has always been an individual obligation. A director is allowed to rely on others where it is reasonable to do so, but has never been obligated to rely on others to the exclusion of doing his or her own due diligence.

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State May Require Donor List For Charitable Registration

Ninth Circuit says requirement does not violate First Amendment rights

California's requirement to submit an unredacted list of major donors as part of its charitable solicitation registration materials does not violate the First Amendment, the Ninth Circuit Court of Appeals has ruled. The Court has affirmed the denial of a preliminary injunction sought by a charity that wanted to remove the names of donors shown on Schedule B to the Form 990 that is a required part of the registration package. (*Center for Competitive Politics v. Harris*, 9th Cir., No. 14-15978, 5/1/15.)

The Center for Competitive Politics, a 501(c)(3) organization whose purpose includes defending First Amendment rights of free political speech, claimed that the requirement infringes on its and its supporters' First Amendment right of freedom of association. A federal District Court denied a request for a preliminary injunction and the Court of Appeals has affirmed.

California is one of the 39 states and the District of Columbia that require most charities to register prior to soliciting charitable contributions within their jurisdictions. Schedule B to the Form 990 includes the names, addresses, and amount of gifts from major donors, basically those giving more than $5000. Under the federal law, although the Form 990 is a public document, the names and addresses of donors on Schedule B are confidential and may be redacted before showing the Schedule to the public. (Since the amount of the contribution is not confidential, the identity of the donor can often be inferred, however.) California asks for the names, but does not make them available to the public. They are available only to in-house staff and are handled separately from non-confidential documents.

The Attorney General argued that there is a compelling law enforcement interest in having the information. She claimed that the information is necessary to determine whether a charity is actually engaged in a charitable purpose or is violating state law by engaging in self-dealing, improper loans or other unfair business practices. She also argued that having significant donor information allows the office to determine when an organization has inflated its revenue by

overstating the value of "in kind" donations, allows her to identify suspicious behavior, and obviates the need for expensive and burdensome audits.

The Center has been registered since 2008, but the state did not require the unredacted Schedule B until 2014. The Center argued that the requirement amounted to a compelled disclosure of its supporters' identities that infringed on its and their freedom of association. It also argued that the federal requirement of confidentiality preempted the Attorney General's requirement.

The Court of Appeals said the First Amendment argument presented "a novel theory" that is not supported by its case law or Supreme Court precedent. The Court agreed that the risk of chilling association triggered exacting scrutiny, but said the Supreme Court has made clear that it must balance the risk of harm with the "actual harm" to the organization's rights. The Center "has not shown any actual burden on its freedom of association," the Court held.

The Center, it said, did not argue that it feared reprisals from a government agency, but only that the AG's systems for preserving confidentiality are not secure and that the donors' names might be inadvertently released. "Such arguments are speculative, and do not constitute evidence that would support [the Center's] claim that disclosing its donors to the Attorney General for her confidential use would chill its donors' participation."

"On the other side of the scale," the Court said, "the Attorney General has the power to require disclosure of significant donor information as a part of her general subpoena power" and the disclosure requirement has a "plainly legitimate sweep."

The Court left open the possibility that the Center could show a reasonable probability that the compelled disclosure of its contributors' names will subject them to threats, harassment, or reprisals from either government officials or private parties that would warrant relief to a challenge to the rules as applied. But it held that the Center could not prevail on a facial challenge to the rules.

On the federal preemption argument, the Court said that Congress had to show its "clear and manifest purpose" for preemption. The Center argued that preemption was shown in Section 6104 of the Tax Code that allows the IRS to share such information upon the written request of an appropriate state officer. The Court rejected the Center's argument that the language showed a ban on such information, saying it "is better construed as a limited grant of authority than as a prohibition." But even if the statute were a prohibition, the Court said, it did not expressly preempt the state's rights to require such disclosure directly from the organizations they are regulating.

YOU NEED TO KNOW

California, New York and a few other states say that they require an unredacted Schedule B, but California and New York are the apparently only ones that currently refuse to register an organization that fails to provide it. The Attorney General's defense of the demand in this case seems something of a stretch, but there haven't, to our knowledge, been significant examples of improper disclosure of the names to the public.

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Members' voting rights not required for associational standing

Members' right to vote for directors of a nonprofit advocacy group is not required to give the group standing to bring a lawsuit alleging violations of state and federal environmental laws, a federal District Court in Pennsylvania has ruled.

The Citizens Coal Council, a Pennsylvania nonprofit corporation, filed suit against a contracting company claiming that pollution emanating from its property was violating environmental protection laws. The contractor filed a motion to dismiss on the ground that the Council lacked standing to bring the case.

Associational standing is a complex issue for which standards were set by a 1977 U.S. Supreme Court case (*Hunt v. Washington State Apple Advertising Commission)*. The Supreme Court said that an association has standing when (a) its members would otherwise have standing to sue on their own, (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires participation of individual members in the suit. To determine whether someone qualifies as a "member," the "indicia of membership" test looks at whether the members have the ability to elect members of the governing body, serve on the governing body, and finance its activities, including the cost of litigation.

The Council had four members who lived near the site in question and paid $10 to become members. The Council's bylaws called for four categories of membership; member organizations, associate member organizations, individual members and alliance groups. The member organizations were each entitled to elect a member of the Coordinating Committee, which functioned as the organization's board of directors. Individual members did not have a right to vote for directors but could serve as an at-large member of the Coordinating Committee if elected by the organizational members and could serve on committees. Alliance group members had no voting rights.

The contractor argued that none of the four local members met the test for associational standing because they did not have the right to vote, could not serve on the Coordinating Committee and did not

finance its activities. The Council argued that it allows its members to directly influence the course of litigation, which more than made up for the lack of voting rights.

The Court agreed with the Council. Nothing in the Hunt decision indicated that the enumerated factors were the only factors to be considered, the Court said. "Rather," it wrote, "the purpose of the Hunt inquiry is to determine whether an organization provides its members with the means to express their collective views and protect their collective interests." The Council met with the four members and obtained their approval before bringing the action, the Court said. Because it is a relatively small advocacy organization, the members continue to have direct access to and communication with the executive director and were consulted at every step of the way. Some serve on an advisory committee formed directly to influence the litigation. "Therefore, their lack of voting rights does not equate to a lack of influence" over the Council and the litigation.

It went on to say that the Council's members, including the local members, had a common interest in the elimination of coal dust and other pollutants, which was germane to the Council's mission. It rejected the contractor's argument that the Council had "manufactured members" in order to have standing to bring the suit. The Court said "there is simply nothing inappropriate with an organization engaging in a grassroots effort to recruit members who share common interests with the mission of the organization." (*Citizens Coal Council v. Matt Canestrale Contracting*, W.D. PA, No. 13-896, 8/22/14.)

YOU NEED TO KNOW

Although the membership form of nonprofit corporations frequently makes little sense, where an organization is likely to engage in litigation membership may be required to give the organization standing to bring the suit.

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Executor of Foundation Trustee's Estate Has Standing to Review Foundation Actions

Court says executor needs to be able to estimate liability for excise taxes, without regard to family discord

An executor of the estate of a private foundation trustee has standing to discover materials about foundation operations when he claims he needs the information to estimate possible liability for foundation excise taxes, the Pennsylvania Superior Court has held. This is true without regard to the long-standing family discord between the parties. (*In Re: Raymond G. Perelman Charitable Remainder Unitrust*, Superior Ct., PA, No. 155 EDA 2014, 3/17/15.)

The case primarily involves Raymond G. Perelman, billionaire businessman and philanthropist, and his son Jeffrey, who was named executor of the estate of his mother Ruth, who died in 2011. The father and son have fought over business issues for many years.

In 1995 and 1996, Raymond and Ruth Perelman had established four private foundations under separate but similar trusts and a charitable remainder unitrust. Ruth was a co-trustee with her husband for most of her life. Raymond had revised the trusts to provide that Jeffrey could never become a successor trustee.

Jeffrey sought documents concerning the operation of the foundations and also information from organizations allegedly controlled by his brother Raymond concerning allegedly improper transactions with the foundations. Jeffrey argued that he needed to determine whether his mother might be liable for self-dealing or other foundation excise taxes during the operation of the foundations. He also argued that she might be entitled to compensation for her service as trustee.

The Orphans' Court in Philadelphia sustained preliminary objections on the ground that Jeffrey lacked standing to see the documents, citing the fact that he was not a beneficiary of any of the trusts, there was no imminent threat of tax liability, Ruth had not requested compensation, and Raymond had committed individually to indemnify Ruth for any liability arising from her administration of the trusts. The Superior Court, an intermediate appellate court, has reversed.

“There is scant Pennsylvania authority relative to the standing questions presented,” the Court wrote. “But it seems clear to us that the question lying at the heart of the issues presented is a practical one: While it may be true that Jeffrey’s pleadings do not assert present misconduct with certainty, Jeffrey submits that the information he seeks will enable him to determine whether the Estate for which he is responsible is at risk of exposure to IRS liability. In suggesting that Jeffrey is on an unbounded fishing expedition motivated by animus rather than fiduciary concern, Raymond disregards Jeffrey’s detailed recitation of potentially wrongful transactions and relationships entered into by the Trusts during Ruth’s tenure. Jeffrey’s allegations are fortified by reference to the publicly available 990-PF forms for the Charitable Entities and span fourteen detailed paragraphs of specific allegations…”

The allegations included ownership in property owned or controlled by Raymond and ownership in Revlon, Inc., which is substantially owned by Ronald.

“It cannot credibly be disputed that, were Jeffrey to learn that Ruth was associated in any way with any misconduct by the Charitable Entitiesvis-à-vis the Internal Revenue Code such that the Estate might be held liable or that her service as a trustee was merely contemporaneous with such misconduct by another trustee, his best course would be to inform the IRS and work proactively to rectify the situation. This approach plainly is more likely to minimize the Estate’s exposure, not only because it will reduce the fines and/or penalties associated with the oversight or misconduct but also, less quantifiably, because it can be expected to engender good will.”

The Court also found that Raymond’s “putative indemnification of the Estate is immaterial.” It said that the indemnification only covered liability, not costs of defense or resolving the issues. It said it wasn’t clear that Raymond would read the commitment to include such costs, or that Raymond would have sufficient resources to cover any obligation.

The Court reversed only on the ground of standing. It did not determine what specific discovery requests would be permitted and remanded the case to the Orphans’ Court for such determinations.

The Court also reversed the trial court on the issue of trustee commissions. It questioned the trial court’s reasoning, which, it said, “appears to infuse its reasoning with assumptions about Jeffrey’s motives, which do not bear upon the legal questions presented. That Jeffrey is a beneficiary of the Estate hardly strikes us as a sound reason to object to his efforts to ensure that the Estate collect such monies as it is rightly entitled to.”

YOU NEED TO KNOW

The appellate court has clearly disregarded the personal animosity within the family to order the Orphans’ Court to consider the specific discovery requests. One can only wonder whether this public airing of the family disputes has encouraged the IRS to investigate the very questions that the Estate has raised in this case, issues that might have gone undetected but for the family litigation.

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Donor Lacks Standing To Enforce Conditions on Gift

Court says donor did not show that gift created trust

The donor of a charitable contribution has no standing to enforce conditions imposed on the gift when enforcement would require the recipient's board of directors to declare a default on a loan made with the donated money, the Pennsylvania Commonwealth Court has ruled. (*In re: Foundation for Anglican Christian Tradition*, Commonwealth Ct., PA, 11/5/14.)

The facts of the case were somewhat convoluted. David W. Rawson had made a gift to the Foundation for Anglican Christian Tradition and helped it raise additional funds "for the purpose of supporting Biblical and traditional Anglican Christian principles." The Foundation loaned money to the Church of the Good Shepherd to buy property adjoining the Church in 2000. Rawson subsequently demanded that the note be amended to guarantee that the Church would continue to follow the precepts of the Foundation and Rawson's direction. To objectively measure whether the Church followed the precepts, the note was revised to state that the Church would be in default if a majority of the members of its vestry were removed and replaced other than as a result of the annual elections.

Rawson sued when a majority of the vestry was removed and the Church decided to put the property up for sale rather than lose it under the default provisions. He claimed the right to enforce conditions of a charitable trust that had been created by his gift.

Both the Foundation and the Church filed preliminary objections, claiming that Rawson had not created a charitable trust and had no standing to enforce the conditions even if he had done so. The trial court agreed. Rawson appealed.

The Commonwealth Court first found that Rawson had not created a charitable trust. Under the Uniform Trust Act, the Court said, a trust may be created only if the settlor signs a writing that indicates an intention to create the trust and contains provisions of the trust. An oral trust is not enforceable. Although the Uniform Trust Act was

not in effect when the gift was made, common law also required “clear and unambiguous language or conduct indicating that the settlor intended to create a trust.”

The Court said that the language of the gift had been one of “donation” and that nothing had suggested the creation of a separate trust. His advocacy of traditional Anglican principles and even his effort to have the note revised did not change the legal situation.

Rawson argued that even if it was only a gift, he was entitled to enforce the restrictions. But the Court said that the restrictions in the note were imposed after the gift was made and were imposed without any reference to Rawson. Any conditions imposed by the amendment of the note were not contemporaneous conditions of the gift, it held.

The Court also rejected Rawson’s claim that it should disregard its common law ruling and utilize the newer provisions of the Uniform Trust Act that allow a donor to enforce conditions imposed upon a trust. The Court said the Act applies only to charitable trusts, not to charitable gifts.

YOU NEED TO KNOW

Even if the donor had imposed contemporary conditions on his gift, it would still be a leap to find that the Church should be enjoined to enforce terms of a note.

In a footnote to the opinion, the Court noted that in 2013 Pennsylvania had expanded the concept of standing for those permitted to sue a nonprofit corporation for “corporate action.” Previously, standing was limited to persons whose rights and duties as a member, director, or officer could be affected by corporate action. Under the amendment, any person aggrieved by corporate action has standing. The Court said Rawson had not shown he was aggrieved, but it “left for another day” “whether a donor who imposes contemporaneous conditions on a charitable gift has standing to enforce the conditions.”

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Court Can't Limit Use of Trust Income To Coverage of Deficits at Hospital

Trial court sought to assure income would be used only for local hospital after its inclusion in larger system

When a bank trustee asked for guidance on how to distribute income from eight testamentary trusts left for the benefit of Bloomsburg Hospital in Pennsylvania, there wasn't much debate about authorizing continued use of the trust income for the Hospital, even though the Hospital had been absorbed within a large regional healthcare system.

But the trial court wanted to assure that the income would not be used for other facilities within the system. It limited use of the income to making up deficits at the Hospital and ordered that income not necessary for that purpose be placed in a "pour over" trust to be utilized to make up deficits in the future. An intermediate appellate court has ruled that the trial court had no power to do so and reversed the decision. (*In re: Shoemaker Trust,* Superior Ct., PA, No. 828 MDA 2014, 5/7/15.)

Bloomsburg Hospital was incorporated in 1905 to care for the sick in Columbia County, especially in and about Bloomsburg. Through a series of "complicated transactions," Bloomsburg Hospital and its related and ancillary corporate entities have joined under a much larger corporate umbrella of the Geisinger Health System Foundation. The bank trustee stated its concern that the amended articles of incorporation of the Hospital permitted trust funds to be diverted to other charitable entities within the system that did not benefit the Bloomsburg area.

The trial court ruled that the settlors' intent "cannot be assured without accounting restrictions, given [the Hospital's] stated intent of distributing Trust income throughout the Geisinger system in the event of consolidated surpluses at [the Hospital]. Money is fungible. A dollar into a bank account is always a dollar in a bank account. [The Hospital] and [the Geisinger system] cannot be permitted to regard the first $100,000 of operational expenses to be paid for by a hypothetical $100,000 of Trust income, and then pay the dollars which come from patient revenues to affiliate hospitals 100

miles away from Bloomsburg when there is an operational net profit, at least limited to the Trust income. Simply put: That is too easy."

It invoked the cy pres doctrine and went on to limit the use of the trust income to making up operating deficits and requiring any funds not necessary for that purpose to be placed in the pour over trust for later use. It also ordered the Hospital to amend its articles of incorporation to require that funds restricted to use by the Hospital could not be used for any other purpose.

The Superior Court ruled, however, that the trial court had abused its discretion in establishing the pour over trust. Because the Hospital is "utilizing the trust funds in accordance with the settlors' intent, the doctrine of cy pres does not apply," it said. "There is no need for judicial intervention as none of the trusts has failed and none of the settlors' intentions has become impracticable or impossible, which would trigger the application of the doctrine of cy pres."

It further ruled that there was nothing in the trusts that restricted the gifts to meet operating deficits and that it was error to impose such a condition on the income.

The Court affirmed, however, the requirement for the Hospital to amend its articles of incorporation to require that the funds be used in accord with the stipulations of the trusts. The Hospital argued that the Attorney General could adequately assure the proper use of the funds through its normal parens patriae functions without amendment of the articles, but the Court said that the language of the amendment "tracks the recommendation made by the Attorney General" and "thus, this is the 'normal course' of oversight that the Attorney General exercises in its monitoring of charitable trusts."

YOU NEED TO KNOW

The Superior Court does not directly deal with the issue that so concerned the trial court in this case, which is how to assure that the funds are used for the Hospital and not diverted elsewhere. It is simple to say that the first funds in from the trusts are used for the Hospital and other revenue can be used for other purposes, but money is fungible and that is often the way things are done to assure the proper use of trust income. A donor cannot really expect anything else unless the donor stipulates something else. A gift for general operating purposes is just that and can be used for general purposes

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Court reverses punitive damages against directors

In the latest development in a long-running bankruptcy case involving a failed nursing home in Pittsburgh, the Third Circuit Court of Appeals has affirmed a jury verdict of joint and several liability of $2.25 million in compensatory damages for breach of fiduciary duty against 15 officers and directors of the home but has reversed the award of $350,000 each in punitive damages against five directors. It has refused to reverse, however, a punitive damage judgment of $1 million against the CEO and $750,000 against the CFO.

The Court said that the Unsecured Creditors Committee had failed to establish that the directors had acted with "malice, vindictiveness and a wholly wanton disregard of the rights of others." It had "no such concerns" about the evidence against the officers.

Lemington Home had been beset with financial troubles for decades, but its financial difficulties became particularly acute during the early 2000s. It had a high rate of deficiencies, two patients had died under suspicious circumstances, and its patient records and financial records were in disarray. Its administrator worked only part time while seeking long-term disability benefits, although state law required a full time administrator. Its CFO failed to maintain a general ledger and failed to bill Medicare for more than $500,000 in fees to which the home was entitled. The Board delayed a bankruptcy filing recommended by its attorneys and reduced the census of patients.

When the board ultimately did file, the unsecured creditors filed a claim against the officers and directors for "deepening insolvency" in violation of their fiduciary obligation to the creditors. A trial court dismissed the claim on the ground that the directors were protected by the business judgment rule. (See *Nonprofit Issues*®, 12/1/10.) The Court of Appeals reversed, finding evidence of a possible breach of fiduciary duty for not acting in good faith. (See *Nonprofit Issues*®, 9/16/11.) After a jury trial, the jury awarded the damages that the trial court refused to overturn. (See *Nonprofit Issues*®, 3/16/13.)

The Court of Appeals affirmed the finding of compensatory damages against all of the defendants but rejected the finding of punitive damages against the directors.

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The directors argued that there had been no showing of their individual wealth as a basis on which to establish punitive damages. The Court said evidence of wealth was only one of several factors that could be considered in determining punitive damages, but was not necessary for a finding.

The Court said that punitive damages are an “extreme remedy” in Pennsylvania and should be awarded “in only the most exceptional circumstances.” It was concerned that the jury had awarded the punitives against only five directors because they were the ones most often mentioned in testimony and the ones who had received the most internal information. It said that it did not think that “on its own, evidence of the receipt of correspondence provided the jury with a sufficient basis to conclude that any of the five Director Defendants had engaged in ‘a quantum of outrageous conduct in addition to that undergirding the liability.’”

It also found that the absence of evidence of self-dealing by the directors “weighs heavily against the imposition of the extreme remedy of punitive damages and that three of the sanctioned defendants had not testified in the proceeding. “In light of the lack of state-of-mind evidence,” it said it would vacate the jury’s award.

The Court affirmed the finding of punitive damages against the CEO and CFO, however. It found evidence of self-dealing with the officers, the CEO getting paid full time while working part time, and the CFO seeking a sale of the facility in which he would stay on as CEO of the operation. It further found that their “obfuscations” at trial offered further support for the conclusion that they had acted outrageously. (*In re: Lemington Home for the Aged*, 3rd Cir., No. 13-2707, 1/26/15.)

YOU NEED TO KNOW

In a footnote, the Court noted that the defendants had urged the Court to reconsider its threshold decision that Pennsylvania courts would recognize the tort of deepening insolvency in light of several decisions of other courts refusing to recognize it. This panel said it could not reconsider an earlier finding by the full Circuit Court without a reversal by the full court. It also noted that the defendants did not argue that a different standard might apply to a nonprofit corporation.

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Trustee Not Liable For Exhaustion of CRAT

Court finds no breach of fiduciary duty when $1.9 million fund is depleted by 7.5% payout

A bank trustee has been found not liable for breach of fiduciary duty or breach of contract when a $1.9 million charitable remainder annuity trust (a "CRAT") designed to provide a 7.5% annual payout to the annuitants for life was totally exhausted in 11 years. An appellate court in Georgia has ruled that the bank neither violated its fiduciary duty within the applicable statute of limitations period nor breached its contract with the beneficiaries. (*Wells Fargo Bank v. Cook,* Ct. of Appeals, GA, No. A15A0202, 7/8/15.)

A married couple had obtained shares of a publicly traded technology company in gifts from the wife's uncle. The wife, age 47, was a certified financial planner with an MBA who had owned a financial services company. The husband, age 50, owned his own video production company. In 2000, after consulting their estate planning attorney, they decided that they would invest in a CRAT to assure their retirement goals and obtain the tax benefits. Wells Fargo Bank suggested an annual payout of 7.5%.

The stock was contributed to the CRAT on February 25, 2000 at a total value of $1,904,250, thereby fixing the annual payout at $142,818. The bank sold the stock to diversify the investments on February 28, 2000, but by then its value had dropped to only $1,678,984. Thereafter, the trust made its annual $142,000 payout, but never had an investment return over 7.5% and lost value every year. By September 2011, it was entirely depleted.

The annuitants sued the bank, claiming breach of fiduciary duty and breach of contract. A trial court refused to grant summary judgment to either the bank or the annuitants, and the Court of Appeals accepted an interlocutory appeal from each. It reversed the trial court and granted judgment to the bank to dismiss the claims.

The Court of Appeals first had to determine the applicable statute of limitations for the breach of fiduciary duty claim. Under Georgia law, there are two different limitation periods on breach of fiduciary duty, one of six years and one of two years. The limitation period is reduced from six years to two when the beneficiary has received a

written report that adequately discloses the existence of a claim. Although the annuitants argued that there was no breach of duty until the bank failed to make a payment in 2011, the Court held that the quarterly and annual reports of the investments of the trust were sufficient to show the decline in value and the possibility of a claim. The Court held that the annuitants could contest fiduciary duty for only two years prior to filing suit. It then found there was no evidence of breach of duty during that period.

The annuitants also argued that the bank had guaranteed the annual payout so long as they lived. But the Court read the language of the CRAT to find otherwise. The trust agreement provides that the annuity "shall be paid from income and, to the extent income is not sufficient, from principal."

"Because the Trust states that payments can be made from principal," the Court said, "there is a recognition that payments can deplete the corpus of the Trust, but nothing in the Trust Agreement suggests that the trustee must continue making payments from its own funds if the Trust is depleted." The Court said that "the plain language of the Trust Agreement precludes the plaintiffs' argument that Wells Fargo was contractually obligated to pay them an annual distribution for their lives even after the corpus of the Trust had been exhausted."

YOU NEED TO KNOW

This case represents the-stock-market-always-goes-up thinking that was so prevalent before the tech bubble burst in 2000 and the Great Recession started in 2008. Probably more people invested in charitable remainder unitrusts (CRUTs) during the market heyday, expecting continually growing income payments based on the percentage of the rising value of the fund each year. While the payouts of a CRUT can drop precipitously, they will never drop to zero. But asking for a high payout from a CRAT or a gift annuity shows the risks of asking too much from a high fixed income payout. In a sustained period of low investment returns, the fund can actually be exhausted.

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Volunteer Protection Act Does Not Protect Against Sanctions for Contempt of Court

Court says VPA was intended to protect volunteers against ordinary negligence, not to curb courts' contempt power

The Volunteer Protection Act does not protect volunteer directors from personal liability for contempt of court when they violate a court injunction, the Ninth Circuit Court of Appeals has ruled. The law was intended to protect volunteers against claims for ordinary negligence and not to interfere with the inherent powers of courts to enforce their orders. (*Institute of Cetacean Research v. Sea Shepherd Conservation Society*, 9th Cir., No. 12-35266, 12/19/14.)

The Court had issued an injunction on December 17, 2012 against Sea Shepherd Conservation Society, its founder Paul Watson, and "any party acting in concert with them," enjoining them from attacking whaling ships of the Institute of Cetacean Research and other organizations or going within 500 yards of such ships while operating in open water. Watson received a copy of the order the next day and set to work to implement a "separation strategy" through which the U.S. organization would cede control of its Operation Zero Tolerance campaign and a great deal of equipment to affiliated organizations from other countries. The volunteer board discussed the strategy and approved.

The Australian affiliate took over control of the operations and Watson resigned from its board. The U.S. organization paid $163,000 in Australian expenses after the injunction, and gave several vessels and their equipment worth millions of dollars to other affiliates. Watson resigned from the U.S. organization, but stayed on one of the vessels to be involved in the operation. The affiliated ships violated the injunction, in many cases by coming within 500 yards of the Japanese ships. Watson was on one of the ships that collided with a Japanese ship. The Japanese sued, seeking sanctions for contempt of court.

The Court agreed that Sea Shepherd U.S. had aided and abetted others in performing acts that would have violated the injunction if committed by the U.S. organization and found the organization in contempt. It said that Sea Shepherd U.S. had ceded control to others it believed were beyond the injunction's reach, "knowing these enti-

ties were virtually certain to violate the injunction." It also provided financial and other assistance to these organizations.

The Court also found the volunteer board members liable for their ratification of the strategy and the transfer of property, without consideration, to those who undertook the mission. "The law is clear," it said, "that those who control an organization may be held liable if they fail to take appropriate action to ensure compliance with an injunction."

The volunteer directors argued that they could not be held personally liable because of the Volunteer Protection Act, which generally provides that no volunteer for a nonprofit organization shall be personally liable if acting with the scope of the volunteer's responsibility and the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed. (See Ready Reference Page: "Federal Law Protects Nonprofit Volunteers")

The parties argued a variety of reasons why the defendants' conduct was or was not within the definition of the Act and whether the Act applied to federal laws or only state laws. The Court said it did not have to address the specific arguments because the VPA "does not affect our power to hold those bound by our injunction in contempt."

"We find it highly improbable that when Congress passed the VPA, it intended to prohibit federal courts from finding volunteer board members liable for their acts of contempt," the Court wrote. "The text of the VPA does not specifically mention courts' equity jurisdiction or their contempt powers. Nor does the VPA's legislative history provide support for the conclusion that Congress's purposes included curbing the judicial power to enforce orders through contempt. The Committee on the Judiciary's report observed that 'H.R. 911, as amended, immunizes a volunteer from liability for harm caused by ordinary negligence.' [emphasis added.] The committee report also speaks of the 'litigation craze' and 'our "sue happy" culture.' It explains that the VPA is 'intended to remove a significant barrier — the fear of unreasonable legal liability — to inducing individuals to volunteer their time to charitable endeavors.' [emphasis added.] These references indicate that the VPA's purpose was to curb lawsuits against volunteers, not to curb courts' contempt power."

The Court went on to say that "the importance of the power of the courts to punish for contempt makes it highly unlikely that Congress would curtail that power without explicitly indicating its intention" and that the Court would not assume that Congress intended to limit its inherent powers.

The plaintiffs had asked for legal fess and $2 million in damages. The Court granted the claim for legal fees and referred the case to the Appellate Commissioner to determine the fees and the amount of compensatory damages that should be awarded.

YOU NEED TO KNOW

There are lots of reasons why the conduct of the volunteer directors in this case could be found to be outside the area of protection under the Act, but this Court has taken an appropriate step to decide that the Act was never intended to protect volunteers who participate in the violation of court orders. The VPA was clearly intended to reduce suits against volunteer coaches in youth sports leagues and a rash of other cases making it difficult to attract volunteers for charitable activities. It is hard to believe that anyone thought at the time it would be used as the defendants in this case argued it should be.

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Punitive damages for disclosure of protected health info?

A federal District Court in Philadelphia has rejected a motion to dismiss claims for punitive damages against a healthcare system, a hospital within the system, the director of the hospital's emergency department and an emergency room nurse who allegedly disclosed protected health information about a police officer injured in an automobile accident. The officer and his wife claimed damages from disclosure to superiors in his department.

Officer Stanley Boatright was injured in an accident and brought by emergency personnel to Crozer-Chester Medical Center, where he was admitted as a patient. The head of the emergency department, who knew Boatright's superior officers as either friends or neighbors, called the superiors, without Boatright's permission, to advise them of the accident and, according to the complaint, gave out protected health information. When the superior officers came to the hospital, the head of the department and the nurse gave them access to Boatright's treatment room and, again according to the complaint, disclosed protected information without consent.

Subsequent to the incident, the superior officers "encouraged, pursued, and subjected" Boatright to disciplinary proceedings on the basis of the information, which resulted in Boatright's demotion and suspension from employment. Boatright sued for compensatory damages and for punitive damages based on defendants' "malicious, outrageous, oppressive, willful, wanton and/or reckless" conduct. The defendants moved to dismiss the punitive damage claims.

The Court said that Pennsylvania has adopted the rule of the Restatement of Torts, which allows punitive damages for conduct that "is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others." It also permits punitive damages against an employer, but only if the employer authorized the act, the employee was unfit and the employer was reckless in employing or retaining the employee, the wrongdoer was a manager acting within the scope of employment, or the employer ratified or approved the act.

The Court went on to say that conduct that constitutes a mere "error in judgment" or even gross negligence does not rise to a level of culpability sufficient to warrant an award of punitive damages.

But the plaintiffs had claimed that the defendants knew that disclosure would create an unreasonable risk of harm to them, had breached their duty in the course of their employment, and had failed to properly train or supervise medical staff. As a result, the defendants' conduct was "malicious, outrageous, oppressive, willful, wanton and/or reckless," they claimed.

The Court said it would be premature to dismiss the claims. It could not "preclude the possibility that when provided an opportunity for discovery, evidence of the allegations … could potentially demonstrate conduct by [the hospital] to support the imposition of punitive damages," it said. As to the individual defendants, the Court said the actions may well turn out to be errors in judgment, but their conduct could "plausibly be shown to have been more culpable." (*Boatright v. Crozer-Keystone Health System*, E.D. PA, No. 14-7041, 7/23/15.)