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Foundation Director May Approve Grant To Organization of Which She Is Also a Director

Other director stays in office after expiration of her term until a successor is selected and qualified

Two children of the founders of a family private foundation don't seem to see eye-to-eye on the operation of the foundation they now lead following the death of their parents. The Seventh Circuit Court of Appeals has recently affirmed a District Court decision denying relief to the son who sought to overturn actions taken by his sister. (See *Nonprofit Issues*, 1/16.)

The Court of Appeals has held that the son, as a director of the Indiana nonprofit corporation, cannot bring a derivative action on behalf of the foundation to recover grants approved by his sister. It has also held that a third director did not lose her place on the board when her term expired without the election and qualification of a successor. And it has held that there was no impermissible conflict in the sister's approving grants to the University of Saint Francis of Fort Wayne on whose board she sits.

The foundation was originally formed in 1990 with the two parents and their two children, Richard Doermer and Kathryn Callen, were named directors for life. The mother died in 2000 and in January, 2010 the board elected Phyllis Alberts to a three-year term as a director. The father died in October 2010, leaving three directors, with Phyllis Alberts' term expiring in January 2013.

Under Indiana law, a nonprofit corporation must have at least three directors. But state law provides a "safety valve," the Court said, providing that when a director's term expires without further action by the board, "the director continues to serve until … a successor is elected, designated, or appointed and qualifies." The foundation's bylaws also stipulated that a director would serve for three years "and until her or his successor is elected and qualified."

In September 2013, pursuant to a resolution and bylaws, Kathryn and Phyllis voted to elect Phyllis for a second term. Richard opposed the election and a number of actions taken by the board over his objection. After the board elected John Callen, Kathryn's son, as an additional member of the board, Richard brought suit, both as a derivative action on behalf of the foundation and in his own right as a director.

The District Court granted the defendants' motion to dismiss and

the Court of Appeals has affirmed.

The Court said that a derivative action on behalf of the corporation had to be brought by a "member" of the corporation, and could not be brought by a director. A "member" of a corporation is roughly analogous to a shareholder of a business, usually having the right to vote for or remove directors. Reviewing the statute and a series of cases in the state, the Court concluded that "the [Indiana] Nonprofit Corporation Act does not authorize, nor have Indiana courts suggested they would approve, a non-member director's derivative action."

On his individual claims, the Court said his claim for money damages had to fail because he is the wrong party to bring the claim. Essentially, he had suffered no personal loss, and if the foundation suffered a loss, he did not have the standing to bring the derivative action on behalf of the foundation to recover it.

He also sought injunctive relief, citing two different sections of the statute as his authority. The first section, however, permitted a court to remove a director for misconduct in a proceeding brought by "at least 10% of the members" entitled to vote for the director. Again the Court said there were no members of the corporation and no basis for such removal.

The second section permits a director to seek to enjoin an action where a third party has not acquired rights. But even if he had a right to sue under this provision, the Court said, he had not pled a plausible basis to justify relief. "His complaint turns on two faulty theories of corporate wrongdoing," the Court said.

Richard argued that Phyllis Alberts' term expired in January, 2013 and that everything done thereafter with only two directors was invalid because he opposed and nullified his sister's vote, and because the foundation was acting without the statutorily required three directors.

The Court cited the statute, the bylaws, and the resolution electing Phyllis to the board for the proposition that she remained a director until such time as her successor was elected and qualified.

It also said that Richard had no cause of action from the allegation that Kathryn was "conflicted" in approving a grant to Saint Francis where she also serves on the board. "Richard has not identified any authority for the proposition that, merely by voting in favor of a charitable contribution from one nonprofit organization to another, Kathryn somehow breached a fiduciary duty or committed some other wrong. Richard cannot cite a case, a statute, a regulation, or even a provision of the corporate instruments that would render Kathryn's vote unlawful."

The state law "does not expressly immunize a 'conflicted' director, but it provides that a transaction between two nonprofit corporations is not void or voidable solely because a director who votes to authorize the transaction serves on the boards of both corporations. With no explanation from Richard as to why Kathryn's approval of the gifts to Saint Francis was impermissible, and with clear statutory guidance showing that the transaction itself could survive irrespective of any 'conflict,' Richard's final theory of corporate wrongdoing is without merit," the Court concluded. *(Doermer v. Callen, 7th Cir., No. 15-3734, 2/1/17.)*

YOU NEED TO KNOW

Here is what we said when we reported this case at the District Court level:

Despite the law giving directors the right to vote on grants to organizations on whose boards they serve, many grantmakers have internal conflict of interest policies that require directors to recuse themselves where such a conflict exists. They don't want the appearance of favoritism that can result from such

grants. Where there is a large board, it probably doesn't make any difference so long as there is general support for the grant among the other board members. But with a board of only four, the conflict policy could prevent the grant on the basis of a single negative vote if a grant required the affirmative vote of a majority of the directors. It wouldn't prevent the grant if the bylaws provided that the directors could act by majority vote. This is another instance where the voting language of the bylaws can be critical in the outcome, but it is not always considered carefully in drafting governing instruments.

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Lawyer not liable to unnamed beneficiaries of will

Reversing a decision by a state appellate court, the Pennsylvania Supreme Court has held that a lawyer cannot be liable for legal malpractice to potential third-party beneficiaries of a decedent's estate when the potential beneficiaries have not been named in testamentary documents actually executed by the decedent.

The case arose when an attorney was asked to revise various estate planning documents for Robert Agnew, a long-time client. As part of the estate plan as of 2010, the residue of his estate was to be distributed among four colleges and universities. After the Agnew was admitted into a hospice program in March 2010, his niece contacted the lawyer saying Agnew wanted to make changes. The lawyer met with Agnew, who told him that he wanted to leave less to the universities and more to his nieces and nephews.

The lawyer took revised documents to Agnew for his signature, but neglected to take an amendment to a trust agreement that was part of the plan and left the residue to the universities. When Agnew died shortly thereafter, the nieces and nephews did not inherit what he apparently said he had wanted. They sued for legal malpractice.

A trial court granted summary judgment to the lawyer. The state Superior Court reversed, saying that prior decisions allowed an inference from the lawyer's admitted "oversight" that there was a duty to potential beneficiaries even though they were not named in the documents. It relied heavily on a footnote from a 1983 Supreme Court case. (See *Nonprofit Issues*®, 2/15.) In a lengthy opinion comparing the parties' arguments in detail, the Supreme Court has reversed and remanded the case to the trial court for dismissal of the relatives' claims.

"We hold an executed testamentary document naming an individual as a legatee is a prerequisite to that individual's ability to enforce the contract between the testator and the attorney he hired to draft that particular testamentary document," the Court wrote. It said that the nieces and nephews were named in Agnew's will and recovered as provided in the will. But they were contesting the failed amendment of a separate trust, in which they were not named in an executed document but only in the document that was never signed.

The Court distinguished the 1983 case because it involved a claim by a person actually named in an executed document that failed because the attorney had the wrong witnesses. It said that Agnew's earlier trust could be revoked only by substantial compliance or an executed

amendment. It concluded that the unexecuted amendment was not proper evidence of Agnew's intent to give the relatives standing to sue.

The Court said the best evidence of a testator's intent was the written and signed documentation. While the parties argued about his intent, "the execution requirement and the bar on extrinsic evidence act precisely to prevent courts from speculating regarding a testator's intent under such circumstances, when that intent is properly reflected only in an executed testamentary document."

"We are persuaded public policy considerations weigh against allowing a party to use an unexecuted testamentary document to establish standing to sue the testator's lawyer for breach of contract as a third party beneficiary," the Court wrote. "Requiring an alleged heir to point to an executed testamentary document — expressly identifying him — before he may sue the testator's lawyer for breach of a contract to which he was not a party serves to protect the integrity and solemnity of the testator's bequests from fraudulent claims. Correspondingly, such a requirement lessens the chance a testator's attorney will be required to pay a bequest the testator never intended to make in the first place." (*Estate of Agnew, Alzamora v. Ross*, Supreme Ct, PA, No. 76 MAP 2015, 1/19/17.)

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Fired COO may pursue whistleblower, RICO claims

A fired chief operating officer of a nonprofit provider of mental health services may pursue not only whistleblower protection claims but also racketeering claims against employers who, she claimed, had illegally "lured" her into her position at an agency diverting Medicaid funds away from program and into private hands. A federal District Court in Philadelphia has refused to grant motions to dismiss by several of the defendants.

Caryn Gratz claimed that she was lured away from her position at the Public Health Management Corporation "in order to gain her unwitting assistance to maintain their scheme to divert funds" away from the employer's charitable purposes and into the hands of some of its leadership. She claimed that the CEO "falsely represented the nature" of the agency's operations and "falsely stated the reasons for [its] financial plight."

She claimed that shortly after she began work under a three year employment contract she discovered that the agency was paying inflated rent for properties owned by the CEO, improperly paying the CEO's personal expenses, and had made undocumented loans that were never repaid. When she started cost-cutting efforts, such as not hiring staff through the CEO's staffing company, she faced push back and was ultimately fired.

The Court had little problem denying the motion to dismiss the whistleblower claim. Pennsylvania law gives whistleblower protection only to organizations that receive governmental funding but has recently made clear that it applies both to governmental entities and also private employers that receive money from a public body to provide services. The Court said the claim was clearly within the coverage of the statute.

On the RICO claim, the Court went into greater analysis. To have standing to bring the claim, the Court said, the plaintiff had to establish that she was injured by a violation of the statute by an action that was "independently wrongful under RICO and not merely by a non-racketeering act in furtherance of a broader RICO conspiracy. The violation must be the "proximate cause" of the injury.

The defendants argued that Gratz had no standing to bring the claim because she claimed injury from her termination, not an act that was "independently wrongful" under RICO. But the Court said the complaint alleged three predicate acts of racketeering.

First, it said, Gratz alleged that the defendants committed wire fraud insofar as they used the wires to lure her away from her old job based on "false representations as to the reasons" for the agency's financial condition and the CEO's commitment to make improvements.

Second, it alleges that the defendants committed wire fraud insofar as they intentionally misled her to convey inaccurate information to the funder to increase revenue and this damaged her reputation with the funder.

Third, it alleges "witness tampering" insofar as the defendants wrongfully terminated her employment and pressured her to sign a confidentiality agreement to prevent her from further investigating and reporting their crimes and self-dealing and she was injured because her employment contract was breached.

Gratz argued that these acts were an integral part of the racketeering scheme because the organizational and individual defendants' objective in procuring her services was to increase the agency's revenue to increase the sums that they were able to unlawfully divert and that the termination was to prevent her efforts to impede this scheme.

"Without the benefit of legal argument on this point, we decline to conclude at this stage of the proceedings that the alleged predicate acts based on Gratz's hiring, employment, and firing are not sufficiently related to the racketeering scheme to be pertinent to our standing analysis," the Court wrote.

The Court also rejected defense claims that the complaint did not spell out the claims with sufficient particularity.

Gratz had included a wrongful termination claim in her complaint that the defendants sought to dismiss on the ground that Pennsylvania law does not permit a wrongful termination claim for a person working under an employment contract. But since the claim was made in the alternative, and since the defendants specifically reserved the right to argue that Gratz did not have an employment contract, the Court was unwilling to dismiss the claim on a motion to dismiss. (*Gratz v. Ruggiero*, E.D PA, No. 16-3799, 5/19/17.)

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DOJ Stops Funding for Nonprofits In Regulatory Settlements

Sessions reverses former policy of providing money to nonprofits working to remediate problems at core of dispute

Attorney General Jeff Sessions has reversed an Obama-era policy of having corporate defendants fund nonprofit organizations as a part of settlements of claims for civil or criminal liability. In a policy memorandum issued June 5, the Attorney General said the practice will stop immediately.

In recent years, a settlement with JPMorgan Chase provided $7.5 million to the American Bankruptcy Institute to fund programs on financial literacy, and several banks settling claims relating to sales of mortgage backed securities paid about $3 billion to multiple housing counseling groups like NeighborWorks, National Council of LaRaza, Habitat for Humanity, the National Urban League and state legal aid organizations. Several Republican members of Congress had criticized the program for creating a "slush fund" and complained that it was funding "leftist" organizations.

Sessions' memo said "It has come to my attention that certain previous settlement agreements involving the Department included payments to various non-governmental, third party organizations" as a condition of settlement. "These third-party organizations were neither victims nor parties to the lawsuits. The Department will no longer engage in this practice."

Sessions said that "the goals of any settlement are, first and foremost, to compensate victims, redress harm, or punish and deter unlawful conduct." He said the Department would not accept any settlement that "provides for a payment or loan to any non-governmental person or entity that is not a party to the dispute." Any money paid in settlement will go directly to the U.S. Treasury.

YOU NEED TO KNOW

Some people would argue that deterring unlawful conduct can be more likely achieved by giving consumers the tools to prevent or fight improper practices through knowledge and advocacy than by merely raising the cost of doing business on a one-time basis.

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Supreme Court Says "Church Plans" May Be Established by Church Affiliates

Decision ends years of confusion after lower courts had ruled that plans had to be established by churches

The Supreme Court has ended years of confusion among religious organizations by ruling that an employee pension plan established by religiously affiliated organizations is considered a "church plan" and not covered by the Employee Retirement Income Security Act (ERISA). Several Courts of Appeals had previously ruled that such plans would be subject to more protective ERISA requirements if not established directly by a church. (See Nonprofit Issues, March 2016.)

ERISA was originally passed in 1974 to require private employers offering pension plans to adhere to rules designed to ensure plan solvency and protect plan participants but the act excluded "church plans" from coverage of the rules. A church plan is defined as a plan "established and maintained … for its employees… by a church." In 1980, Congress amended ERISA to provide that the definition of a church employee included an employee of a church affiliated organization. It also provided that a church plan "includes a plan maintained by an organization … the principal purpose or function of which is the administration or funding [of a retirement plan] … if such plan is controlled by or associated with a church."

The three federal agencies supervising ERISA plans have read these provisions to include plans, like the hospital plans involved in the Supreme Court case, that are maintained by religiously affiliated organizations, even if "established" by the affiliates and not by a church.

In recent years, at least three significant cases have been brought seeking ERISA coverage for the plan participants on the ground that the plans were not church plans because they were not "established" by a church. Three Circuit Courts of Appeals had agreed with the plaintiffs. The Supreme Court, by a vote of 8-0, has reversed.

In writing for the Court, Justice Elena Kagan called the statutory language a "mouthful" but said it could be read more simply by saying that the original definitional section of the statute (29 U.S.C section 1002(33)(A)) defines a church plan as one "established and maintained by a church" and the amendment (section 1002(33)(C))

provides that a church plan "includes" one maintained by what she calls a "principal-purpose organization." (In a footnote, she explains that the term "principal-purpose organization" is used as shorthand for "a church-associated organization whose chief purpose or function is to fund or administer a benefits plan for the employees of either a church or a church-affiliated nonprofit.")

"That use of the word 'include'," she says, is not literal — any more than when Congress says something like 'a state "includes" Puerto Rico and the District of Columbia.' Rather, it tells readers that a different type of plan should receive the same treatment (i.e., an exemption) as the type described in the old definition. And those newly favored plans, once again, are simply those 'maintained by a principal purpose organization' — irrespective of their origins."

She goes on to consider the issue as a "simple logic problem":

> Premise 1: A plan established and maintained by a church is an exempt church plan.
>
> Premise 2: A plan established and maintained by a church includes a plan maintained by a principal-purpose organization.
>
> Deduction: A plan maintained by a principal-purpose organization is an exempt church plan.

The opinion follows with some additional word game illustrations that counter the arguments made by the employees. She also reviews what little legislative history exists without finding it very helpful in understanding exactly what Congress intended when it amended the statute.

Justice Sonia Sotomayor filed a concurring opinion, agreeing that "the statutory text compels" the result, but lamenting the outcome of the case. The opinion, she says, means that "scores of employees — who work for organizations that look and operate much like secular businesses — potentially might be denied ERISA's protections. In fact, it was the failure of unregulated 'church plans' that spurred cases such as these." (*Advocate Health Care Network v. Stapleton*, U.S. Supreme Court, No. 16-74, 6/5/17.)

YOU NEED TO KNOW

The Court gave no deference whatsoever to the interpretation of the agencies administering the ERISA statute or to more than 30 years of actual practice under the law. If it had reached an opposite conclusion, there could have been chaos unless Congress acted to further amend the law.

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Church property subject to judicial sale

A church property for which real estate exemption was not requested for three years following its acquisition is subject judicial sale for failure to pay real estate taxes, the Commonwealth Court of Pennsylvania has held. It has refused the church's petition to stop the sale of its property for failure to pay more than $31,000 in taxes.

New Creations Family Worship Center bought the property in Greensburg from another church in June, 2008. At the time, it listed its address as being at the pastor's home in Pittsburgh. In accordance with the county's standard practice with transfers of tax-exempt property, the tax assessment office removed the property from the tax -exempt roll and notified the church at the Pittsburgh address. The pastor testified that he never received such a notice. The church did not apply for exemption until 2011, which the tax board granted for the year 2012 and thereafter. The opinion does not say whether the church had asked for a retroactive exemption, but the case is clear that the church did not appeal the decision or try to eliminate the gap.

The property was put up for tax sale in April, 2013 for the taxes of 2009 through 2011. When it did not generate a bid, the county asked for permission to sell it at judicial sale, which the church sought to stop. A trial court stayed the sale while the church petitioned for a retroactive exemption in court. The trial court denied the petition on the ground that it had no subject matter jurisdiction because the church had not appealed the decision granting exemption only prospectively from 2012 onward. The Commonwealth Court has affirmed.

Citing several similar cases involving exempt properties, the Court held that the failure to appeal the tax board's decision was "fatal" to its new claim in court. It held that the church could not raise the issue of prior exemption in this equity action and noted that the church had not offered an argument why the exemption should be considered nunc pro tunc "beyond the unavailing claim that Pastor was ignorant of the required procedures." (*In re: Petition of the Tax Claim Bureau of Westmoreland County*, New Creations Family Worship Center, Commonwealth Ct., PA, No. 316 C.D 2015, 12/6/16.)

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In Pennsylvania, tax exemption is based on the use of property on January 1 of the year in question and continues throughout the year, without regard to a for-profit or other use thereafter. But a charity acquiring property and wanting to qualify for the following year

must affirmatively request the exemption. It is a requirement easily lost in the activity surrounding acquisition of a new property and counties are not uniform in granting nunc pro tunc exemption for those who wait beyond the filing deadline. In Pennsylvania and any other state in which similar rules apply, organizations (and their lawyers) should be sure that the requirement is on their property acquisition checklist.