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READY REFERENCE PAGE

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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)(29).

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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AG May Use Tainted Evidence In 'Redacted v. Redacted' Case

PA Supreme Court vacates opinion limiting use of information disclosed by defendant's attorney

The Pennsylvania Supreme Court has overruled the Commonwealth Court's opinion in "Redacted v. Redacted" and allowed the state Attorney General to proceed against several charities and their officers using information allegedly disclosed by the charity's attorney in violation of her obligation to preserve confidentiality. The Supreme Court has said that evidence should be admitted in the case "based on established evidentiary principles and not the broader Code of Professional Conduct."

The Supreme Court's order also overruled the Commonwealth Court's order limiting the participation of two top attorneys handling the case for the state and required the Commonwealth Court "to prepare an opinion setting forth its rationale in implementing a blanket seal in connection with the underlying litigation (as opposed to redacting or sealing only documents which reveal specific attorney-client confidences.)" (*Commonwealth v. New Foundations, Inc.*, No. 145 MAP 2014, 6/15/15.)

The decision came to light only after the Commonwealth Court filed a order in December unsealing documents filed in the case on or after June 15, 2015 and overruling the defendants' preliminary objections to the Attorney General's amended complaint. (*Commonwealth v. New Foundations, Inc.*, No. 36 M.D. 2014, 12/10/15.)

The case caused quite a stir in Pennsylvania legal circles when the Supreme Court let it be known that it was considering whether a lawyer for a charitable organization who believes that charitable assets are being improperly diverted could disclose the information to the Attorney General "as *parens patriae* for the public to whom the charity and its counsel owe a fiduciary duty?" (See *Nonprofit Issues*, February, 2015.) At the time, the context of the question, along with the identity of the parties, the counsel, and the issues involved, were all kept secret.

Additional information came to light when the Supreme Court unsealed portions of the parties' briefs and it became clear that the is-

sue was not whether the attorney could disclose confidential information, but whether the Attorney General could use such information in prosecuting the charity and its officers and directors. (See *Nonprofit Issues*, March, 2015.) The information now unsealed, including the opinion of the Commonwealth Court in April 2014 with only limited redactions, gives a more complete view of the circumstances and the issues.

The underlying case involves charges of unlawful diversion of charitable assets at a group of nonprofits founded and run by Allen Ertel, a former Democratic member of Congress and candidate for governor of Pennsylvania, his wife and family members. The agencies provide services, predominately funded by the state, for persons with disabilities, foster care, and other social services. (Ertel died in November.) The lead agency is known as Firetree, Inc., in Williamsport. The complaint alleges breach of fiduciary duty under the Nonprofit Corporation Law and misrepresentations under the Solicitation of Funds for Charitable Purposes Act.

According to the initial opinion by the Commonwealth Court, the in-house counsel for Firetree became concerned about improper action. Her attorney called the Attorney General to say that they had information that the Attorney General would be interested in investigating. In response to a request, the attorney for the in-house counsel supplied a memo describing the alleged improprieties.

The Attorney General's office opened an investigative file and reviewed the public Form 990 tax returns "as per standard procedure." Concerned that unrelated nonprofit corporations had overlapping board members and engaged in related-party transactions, an investigator prepared investigative subpoenas that were sent to Firetree and related entities. The in-house attorney requested an extension of time to respond, but then called to say that she had been terminated.

The in-house attorney's lawyer subsequently sent to the Attorney General's office a copy of a whistleblower complaint that the in-house attorney had filed in Lycoming County. The complaint contained attachments spelling out the lawyer's concerns. (That case was subsequently sealed also.)

Believing that the Commonwealth's complaint was based on information covered by attorney-client or work-product privilege, attorneys for the defendants deposed Heather Vance-Rittman, the Deputy Attorney General assigned to the case, and then filed preliminary objections seeking dismissal of the complaint. If the Court did not dismiss the case, they asked for disqualification of Vance-Rittman and Mark Pacella, the Chief Deputy Attorney General, who had also consulted on the case. The defendants contended that they had been irrevocably tainted by the in-house counsel's improper disclosures.

The Commonwealth Court analyzed the issue under Rule 1.6 of the Rules of Professional Conduct, which prohibits disclosure of confidential information except in very limited circumstances and said such circumstances were not present in this case. It also denied a claim by the Attorney General that disclosure was permitted under the "crime-fraud" exception where the attorney's services are being or had been used by the client to commit a criminal or fraudulent act. The Court said there was no allegation that the in-house counsel's services were being used to commit an illegal act.

The Court specifically rejected the argument that the counsel had a fiduciary duty to disclose the information because the corporations were charities.

The defendants asked the Court to apply the "fruit-of-the-poisoned-tree" doctrine to dismiss the case because it was based on the counsel's improper disclosures. The Court refused to dismiss the case, but did disqualify Vance-Rittman and Pacella from further participation in the case. "This measure is necessary

to absolve the irrevocable taint which would otherwise color this litigation," it said.

In an unsigned *per curiam* order, the Supreme Court, "having discerned multiple material errors" in the Commonwealth Court's opinion, vacated the order and remanded the case for proceedings consistent with its own order.

Among the points the Supreme Court made were:

· The Commonwealth Court incorrectly indicated that the in-house attorney also represented the corporation's officers and directors.

· It "inappropriately conflated an attorney's ethical obligations with evidentiary privilege."

· It "questionably couched information as attorney 'work-product' when much of the relevant information seems to have nothing to do with preparation for litigation on behalf of the former client."

· The Commonwealth Court stated that the attorney had not set forth a single instance of her services being used to commit wrongdoing when various accusations indicate that multiple such instances occurred.

· It inappropriately relied on cases involving private litigants in substantially restricting the Attorney General from proceeding, in a *parens patriae* capacity, to redress asserted violations of the law impacting on the public interest.

· It erroneously applied a remedial fruit-of-the-poisonous-tree approach, as against the Attorney General, to a lawyer's purported ethical violations.

The Court asked the Attorney General to file an amended complaint "eliminating the specific and direct connection between the present litigation and the whistleblower litigation pending in Lycoming County." It said, however, that the Attorney General is not required "to screen any attorneys or agents from her office from the litigation or to disassociate the litigation entirely from the plaintiff in that [whistleblower] action and/or materials or documents which she may have provided."

"To the degree that provisions of this Order are beyond the matters affirmatively raised by the parties to this appeal," the Supreme Court said, "this Court invokes its King's Bench powers, in view of the severity of the Attorney General's allegation that non-profit organizations soliciting and accepting contributions from the public engaged in a prolonged course of conduct entailing unlawfully diverting corporate assets and resources to serve the interests of insider individuals."

YOU NEED TO KNOW

The initial question first made public in this case is significantly different from the issue actually being litigated. Although the Supreme Court's decision is clear that the Attorney General may use information that may have been disclosed improperly, subject only to evidentiary rules on admissibility and not the Rules of Professional Conduct, there is not much reasoning set out in its order. There is a suggestion that the mis-use of charitable funds creates a special interest in the Attorney General, but there is no statement that this creates a special rule for charities.

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PA OAG Reaches New Agreement With Trustees of Hershey School

Trustees had spent $3.6 million on internal investigations of possible insider trading, violation of conflict rules

The Pennsylvania Office of Attorney General has reached a new agreement with the trustees of the Hershey Trust Company and Hershey School only three years after an agreement made in 2013.

The agreement comes after published reports that the trustees had spent more than $3.6 million in legal fees investigating whether two of them had been involved in insider trading of stock in the Hershey chocolate company, and whether a former chairman of the board had been involved in a conflict of interest in obtaining an internship for his son with one of the outside managers of the Hershey Trust portfolio.

According to reports published in the Philadelphia Inquirer, the trustees had spent $3 million in legal fees to Zuckerman Spaeder for an investigation of possible insider trading, and $650,000 to Weil Gotshal & Manges to determine whether there had been a violation of the conflict of interest policy. Both investigations had cleared the trustees.

The new agreement requires half of the current trustees to leave the board by December 31, 2017, imposes 10 year term limits, sets maximum annual compensation, and establishes specific conflict of interest and expense reimbursement policies.

The agreement was announced by the "office of the Attorney General" because Attorney General Kathleen Kane's license to practice law was suspended while she was under indictment for leaking grand jury information and lying about it to investigators. She was subsequently convicted and resigned her position.

The Hershey Trust Company manages a $12 billion endowment for the benefit of the Milton Hershey School, which provides a year-round program for about 2000 low-income, high-risk students in pre-K through high school. Although the investment management function of the Trust Company is significantly different from the educational function of the school, the boards are identical. Kane had reached a "reform agreement" with the board in 2013 after charges of breach of fiduciary duty and excessive compensation had been aired for months in the newspapers. (See *Nonprofit Issues®*, 3/16/13.)

The new agreement calls for three of the 10 current trustees/directors, including the former board chair whose son obtained an internship with an investment manager, to leave office by December 31, 2016 and two more to leave by December 31, 2017. The board is required to give 30 days' prior written notice to the Attorney General's office before appointing a new person. The board is supposed to use its "best efforts" to bring the board up to 13 members.

Board terms will be only for one year, up to a maximum of ten years, but an additional year may be provided "to assure continuity of leadership or to respond to other exceptional circumstances." No director may be reelected in a year they become age 75 or older.

Compensation for directors of the trust company is now set at a maximum of $110,000 per year, subject to annual cost of living adjustment. The prior agreement had called for regular compensation reviews with compensation set at the lower end of the spectrum. The board chair may be paid an additional $30,000, while committee chairs, other than the board chair, may get an additional $10,000, without regard to the number or committees they chair. If a trust company director also serves on the board of the Hershey Company or Hershey Entertainment and Resorts Company, the director may not be paid more than $80,000 by the trust company.

No more than three directors of the trust company may serve on the board of the Hershey Company at the same time and the CEO of the trust company and president of the school may not serve as a director of the Hershey Company. Beginning in 2017, the board will have to give the AG advance notice if they want to elect someone to the board of Hershey Entertainment.

The conflict of interest policy covers directors and family members and provides that they may not (1) seek to profit from information not disclosed to the public about the various Hershey entities; (2) accept personal favors or gratuities with a value over $100 from any person or organization providing goods or services to the Hershey entities; or (3) engage in personal transactions with any person or organization supplying goods or services to the Hershey entities other than on terms and conditions generally available to the general public.

As an illustration, the policy says it is a prohibited conflict if a director or member of the director's family asks a Hershey trust company staff person to make an introduction or otherwise support a contact with an entity that has a known transactional relationship with the trust company for assistance in obtaining a permanent or temporary position for themselves, a relative, friend, or associate. That sounds almost precisely like the situation described in the press that the lawyers, after payment of $650,000, found not to be a conflict of interest for the former board chair.

The expense reimbursement policy rules out reimbursement for first class air travel and a variety of other charges that had been disputed in press reports.

Although newspaper articles had said the AG was seeking reimbursement for the $3.6 million in legal costs of the internal investigations, the final agreement said that the AG's office found such reimbursement "unwarranted."

Many of the other terms of the prior agreement, including the requirement of an annual report to the AG's office, were continued in the revised agreement.

YOU NEED TO KNOW

It is sad to see the continuing controversy at the Hershey Trust Company, which has long been a political football and has frequently created the impression that the board members are more concerned with themselves than with the education of the students. How anyone could have countenanced paying the fees charged for these investigations is not clear. But it buttresses the feeling that Hershey has so much money it doesn't know what to do with it all and doesn't really care how much things cost.