To Pay or Not to Pay: Directors Compensation Dilemmas in Tax-Exempt Health Care and Other Nonprofit Organizations

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To Pay or Not to Pay: Directors Compensation Dilemmas in Tax-Exempt Health Care and Other Nonprofit Organizations

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COMPENSATING DIRECTORS AND TRUSTEES OF NONPROFITS: WHAT THE FEDERAL TAX LAW ALLOWS

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COMPENSATING DIRECTORS AND TRUSTEES OF NONPROFITS:
WHAT THE FEDERAL TAX LAW ALLOWS

by

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1. CONTEXT

The post-Enron era has brought issues of conflict of interest and fiduciary responsibilities for corporate directors into sharp focus. Enron and other scandals spawned the Sarbanes-Oxley legislation at the federal level and a variety of corporate governance proposals at the state level. While Sarbanes-Oxley is targeted at for-profit, publicly traded companies, nonprofit organizations are by no means immune from scrutiny and criticism regarding their governance practices. Charities are much in the spotlight for a range of issues including proper use of charitable assets, conversions to for-profit status (particularly in the health-care arena), fiduciary conflicts of interest, executive compensation, and compensation paid to directors and trustees.\(^1\) Hawaii’s Bishop Estate made headlines nationwide in 1999 when its trustees were forced to resign over alleged financial mismanagement and excessive trustee fees that topped $1 million annually per trustee.\(^2\) Recent articles in publications such as *The Boston Globe*, \(^3\) *Forbes*, \(^4\) *The Rocky Mountain News*\(^5\) and the *Puget Sound Business Journal*\(^6\) have heightened public awareness of the potential for abuse when directors and trustees of nonprofit organizations determine their own compensation. A 2003 study that published data on compensation paid to directors and trustees of 238 foundations went so far as to recommend significant limitations on fees paid to foundation directors and trustees.\(^7\) A controversial McKinsey & Company study\(^8\) concluded that charities could apply an additional $100 billion to charitable programs by operating more efficiently and reducing overhead, including trustee and director compensation.

Reports of abuses in the nonprofit sector have attracted the attention of regulators and legislators. A bill passed by the House of Representatives in 2003 would have limited compensation to foundation executives to $100,000 for purposes of satisfying charitable distribution requirements and imposed additional restrictions on foundation administrative

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1. “Director” is used in this outline to refer to a voting member of the governing board of a nonprofit corporation. While directors of nonprofits are often referred to as “trustees,” this outline uses “trustee” in its narrower legal sense of a fiduciary with respect to a charitable organization that is formed as a trust.
expenses for federal tax purposes. In New York, Attorney General Eliott Spitzer has proposed that Sarbanes-Oxley concepts be applied to the charitable sector.

Certainly there is potential for abuse involving nonprofit trustee and director fees, and some number of documented clear abuses. The criticism in this area is not always well-placed, however. Some commentators have characterized a board member’s discretionary authority to select a foundation’s charitable grantees as a form of compensation to the board member – an interpretation that is surprising and unsupported from a legal perspective. Even when trustees and directors do indeed receive compensation, that fact by itself should not be cause for public alarm. Any analysis of whether and how much director or trustee compensation may be appropriate must take into account a variety of factors, such as whether the fiduciary is a professional manager with a market-based rate for compensation (e.g., a trust company in the business of managing charitable trusts), the director’s or trustee’s job description (e.g., whether the fiduciary manages a substantial investment portfolio in addition to overseeing operations and/or grantmaking), the level of expertise and amount of time involved in the fiduciary’s duties, any provisions in the nonprofit’s organizing documents that mandate compensation (e.g., provisions created by the donor/founder in a trust document requiring that the trustees be paid reasonable compensation), and the particular skills and experience that a trustee or director may bring to bear in the role.

Compensation of nonprofit directors and trustees as a legal matter is governed on the federal level by the Internal Revenue Code and Treasury Regulations, and on the state level by nonprofit corporation and charitable trust statutes, as well as state tax law and the common law. Many of the kinds of legal safeguards currently gaining attention in the for-profit world have long been in place for nonprofit organizations (e.g., a number of states prohibit loans to board members of nonprofit corporations). The enforcing authorities are the Internal Revenue Service (“IRS”) at the federal level, and, in most cases, the Attorney General’s office at the state level. This outline addresses the federal tax law. The tax law does not operate in a vacuum, however, and a compensation arrangement that may be permissible under federal tax law must also be examined with the overlay of applicable state law and broader issues of public policy and public perception.

The question of compensation for directors and trustees is different in an important respect from most other conflict of interest issues that arise for nonprofits. Conflict of interest policies generally provide procedures for disclosure of conflicts or potential conflicts, and a procedure under which disinterested members of the board may in their discretion approve a

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10 E.g., Revised Code of Washington 24.03.140.
11 For example, California Corporations Code Section 5227 requires that not more than 49% of a nonprofit corporation’s board may be “interested persons,” such as persons receiving any compensation from the corporation from services rendered to the corporation during the preceding 12 months as an employee or independent contractor, but excluding “any reasonable compensation paid to a director as a director.” State tax exemptions may also come into play. For example, under Revised Code of Washington 82.04.431(1), a business and occupation tax exemption is available to health and social welfare organizations, but only if an organization is managed by “a governing board of not less than eight individuals none of whom is a paid employee of the organization.”
12 In the case of nonprofit organizations that seek grant funding, providing compensation to directors or trustees may make the organization ineligible for grants from funders who object to board compensation on a policy basis.
transaction with a board member, without the participation of the interested member, once they have assured themselves that the transaction is fair to the organization. This process is appropriate for isolated transactions with an individual director, e.g., approving compensation to be paid to a director as the corporation’s chief executive. An objective procedure may not be possible, however, when the question is whether the directors or trustees should as a group receive compensation for their roles as directors or trustees. No board member can be disinterested with respect to that decision.

2. II. OVERVIEW OF FEDERAL TAX ISSUES

1. A. Categories of Tax-Exempt Organizations.

The federal tax law neither prohibits nor expressly permits payment of compensation to directors or trustees of nonprofit organizations. It instead provides standards for the level of compensation that is permissible for interested persons generally with respect to the organization. It also looks to the objectivity of the procedure by which the compensation is determined as a measure of its fairness.

The applicable standards differ depending on the organization’s classification for tax purposes. To identify the standard that applies in a given situation, it is essential to understand the various classifications for federal tax exemption. The substantial majority of nonprofit organizations that have determinations of federal tax exemption are classified under Section 501(c)(3), which encompasses charities generally. Section 501(c)(3) organizations include schools, hospitals, churches, grantmaking foundations, environmental groups, arts and social service organizations, as well as many other types of organizations. Section 501(c)(3) organizations may, for state law purposes, be formed as nonprofit corporations (or, in rare circumstances, as business corporations controlled by nonprofit corporations), as charitable trusts, or unincorporated associations. Most organizations that desire Section 501(c)(3) status must affirmatively apply to the IRS for recognition of exemption, subject to limited exceptions for churches and very small organizations.

2. B. Section 501(c)(3): Private Foundation/Public Charity Distinction.

Under provisions added to the Code by the Tax Reform Act of 1969, all Section 501(c)(3) organizations are classified as either “public charities” or “private foundations.” Section 509(a). Private foundation is the default category. A Section 501(c)(3) organization must affirmatively demonstrate that it is a public charity in order to be classified as such.

The purpose of this distinction is to differentiate between charities that are controlled or substantially influenced by one or a small group of individuals, such as a family, or a for-profit corporation, and those that are subject to broader public oversight. Organizations in the former category, classified as private foundations, were identified as presenting greater potential for abuse, and were therefore targeted for restrictive regulation, while those in the second category,

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13 All section references, unless otherwise noted, are to the Internal Revenue Code of 1986, as amended (the “Code”), Title 26 U.S.C., and the Treasury Regulations thereunder.
14 Section 508.
generally referred to as public charities (although that term does not actually appear in the Code or the Treasury Regulations), were subject to more lenient rules.

An organization can demonstrate qualification as a public charity in one of three ways. First, it can operate as one of a short list of favored types of organizations: churches, schools, hospitals, or medical research organizations. Sections 170(b)(1)(A)(i)-(iii). Second, an organization can meet one of two complex tests for “public support” that look to the organization’s sources of funding over a four- or five-year rolling average period. Sections 509(a)(1), 170(b)(1)(A)(vi), 509(a)(2); Treas. Reg. Sections 1.170A-9(e)(3); 1.509(a)-3. The tests are designed to demonstrate that an organization receives its funding from a broad array of sources (and on that basis it is presumed to be accountable to the public). This is the most common means of qualification as a public charity. The public support tests are highly (some might say absurdly) complex, and a detailed discussion is beyond the scope of this outline.

The final means of qualification as a public charity is by operation as a “supporting organization” to another public charity, or to a trade association under Section 501(c)(6), a labor or agricultural organization under Section 501(c)(5), or a social welfare organization under Section 501(c)(4) if such organizations are publicly supported. Section 509(a)(3). The supporting organization rules are quite complex, and a detailed discussion is beyond the scope of this outline. Grossly simplified, they require that either (1) the supported organization control the supporting organization; (2) the two organizations be operated under common control; or (3) the supporting organization distribute substantially all of its income in support of the supported organization’s purposes.


As set out in detail below, all Section 501(c)(3) organizations are subject to a prohibition against “private inurement,” which includes payment of excessive compensation to directors or trustees. Private inurement is grounds for revocation of Section 501(c)(3) status.

Two separate regimes impose excise taxes (not technically penalties under the tax law, but often referred to as such) on interested persons such as directors and trustees who receive excessive compensation. The regime that applies depends on whether the organization is a private foundation or a public charity.

When Congress enacted the rules distinguishing between private foundations and public charities in 1969, it also enacted the “self-dealing” rules, which apply only to private foundations. Section 4941. The rules generally prohibit a private foundation from paying compensation to any “disqualified person,” including a director or trustee, subject to limited exceptions. An important exception applies for payments for “personal services” performed by a disqualified person that are “reasonable and necessary” to carrying out the organization’s exempt purposes, so long as compensation is “not excessive.” Section 4947(d)(2)(E); Treas. Reg. Section 53.4941(d)-3(c)(1).

Prior to 1996, no penalty existed under the federal tax law for an interested person who received excess compensation from a Section 501(c)(3) organization classified as a public charity. The only remedy under federal tax law for such a transaction was revocation of the
organization’s exemption on the basis of private inurement. In 1996, Congress enacted so-called “intermediate sanctions” legislation, providing an intermediate remedy of imposing excise tax on the interested person who receives the excessive compensation. Section 4958. The intermediate sanctions rules are based in many respects on the older self-dealing rules. Rather than prohibiting transactions with interested persons subject to exceptions, however, the intermediate sanctions rules apply an arm’s-length standard, permitting transactions with interested persons so long as they are made at fair market value. Any compensation payable to an interested person is required to be reasonable.

The intermediate sanctions rules also provide a very helpful procedure for establishing a rebuttable presumption of reasonableness. This presumption will generally be difficult or impossible to establish in the context of compensation payable to all directors or trustees of an organization, however, because it requires approval by the disinterested members of the governing body or a committee of that body.

3. III. RISKS TO THE EXEMPT ORGANIZATION: PRIVATE INUREMENT

An organization qualifies for tax exemption under Section 501(c)(3) only if “no part of [its] net earnings . . . inures to the benefit of any private shareholder or individual.” This is generally referred to as the prohibition against private inurement. The private inurement prohibition also extends to organizations that are exempt under Section 501(c)(4) (social welfare organizations) for inurement occurring on or after September 14, 1995. Section 501(c)(4)(B).

The term “private shareholder or individual” refers to “persons having a personal and private interest in the organization,” commonly known as “insiders” (although that term does not appear in the Code or Treasury Regulations). Treas. Reg. Section 1.501(a)-1(c). The determination of whether a person is an insider is based on all relevant facts and circumstances. A voting member of the governing board of a nonprofit corporation or a trustee with respect to a charitable trust will almost certainly be an insider. Excessive compensation paid to an insider may constitute prohibited private inurement. Consequently, any decision to compensate directors of a nonprofit corporation or trustees of a charitable trust that is qualified under Section 501(c)(3) or Section 501(c)(4) poses at least a potential risk of private inurement.

Any amount of private inurement is technically grounds for the IRS to revoke the organization’s tax exemption. As a practical matter, however, the IRS generally pursues revocation of exemption in only the most egregious inurement situations. See e.g., LAC Facilities, Inc. v. United States, U.S. Fed. Cl. (No. 94-604T) (filed 9/14/94).

4. IV. SELF-DEALING: DIRECTORS OR TRUSTEES OF PRIVATE FOUNDATIONS

1. A. Overview.

As described above, a private foundation is a Section 501(c)(3) charitable organization that has not demonstrated that it qualifies as a public charity. Section 509(a). Private foundations include family foundations, corporate foundations and private operating foundations (which primarily make direct program expenditures for charitable purposes, as opposed to
making grants). All private foundations are subject to a general prohibition against engaging in “self-dealing transactions” with “disqualified persons.” Sections 4941, 4946.

2. B. Disqualified Person Defined.

The term “disqualified person” includes all “substantial contributors” to a foundation; all “managers” of the foundation; an owner of more than 20 percent of (a) the voting power of a corporation; (b) the profits interest of a partnership; or (c) the beneficial interest of a trust or unincorporated business, that is a substantial contributor to the foundation; a family member of any individuals described above; a corporation, partnership, trust, estate or unincorporated entity in which more than 35 percent of the interest is owned by disqualified persons; and a government official. Section 4946(a).

A substantial contributor is any person who makes total contributions to the foundation of more than $5,000 that exceed two percent of the total contributions ever received by the foundation as of the close of the taxable year in which the contribution is received. A substantial contributor may be an individual, trust, estate, partnership, association, company, or corporation. Subject to limited exceptions, once a donor becomes a substantial donor, that status is permanent. Section 507(d)(2).

Foundation managers include the officers, directors, or trustees of a foundation, and in certain cases employees with authority over a particular act. Section 4946(b).

A family member includes a spouse, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren. A brother or sister is not a family member under this definition. Section 4946(d); cf. the definition of family member under the intermediate sanctions rules at Section 4958(f)(4).

3. C. Prohibition Against Self-Dealing.

A private foundation is prohibited from engaging in self-dealing transactions with disqualified persons. Section 4941. Self-dealing includes payment of compensation, subject to the exception for personal services set out below. Section 4941(d)(1)(D). It also includes sales, exchanges and leases with a disqualified person; loan transactions with a disqualified person; furnishing of goods, services or facilities between a foundation and a disqualified person; and any transfer to, use by, or for the benefit of a disqualified person of a foundation’s assets, all subject to limited exceptions. Section 4941(d)(1). It is immaterial for purposes of determining whether an act of self-dealing has occurred whether the transaction was fair or even beneficial to the foundation.

4. D. Personal Services Exception.

1. 1. Generally.

15 The intermediate sanctions rules at Section 4958 apply to “disqualified persons” with respect to public charities. Confusingly, however, the definition of a disqualified person under Section 4958(f)(1), discussed below, differs in material respects from the definition at Section 4946(a) with respect to private foundations.
A private foundation’s payment of compensation for services to a disqualified person is generally an act of self-dealing. Section 4941(d)(1)(D). An exception applies, however, for payments for “personal services” that are “reasonable and necessary” to carrying out the foundation’s exempt purposes, if the compensation is not excessive. Section 4941(d)(2)(E); Treas. Reg. Section 53.4941(d)-3(c)(1). This is generally referred to as the “personal services” exception to the self-dealing rules. Not all services constitute personal services for purposes of the personal services exception. A compensation arrangement with a director or trustee must be reviewed to ensure that the services performed are “personal services,” and the compensation level must be reviewed to determine whether it is “excessive.”

2. Definition of “Personal Services.”

The Treasury Regulations provide that the term “personal services” includes the services of a broker serving as agent for the corporation, but not the services of a dealer who resells to third parties. Treas. Reg. Section 53.4941(d)-3(c)(1). The regulations in addition provide the following examples of personal services: legal services that are reasonable and necessary for carrying out the foundation’s exempt purposes, services of an investment advisor, and general banking services such as the provision of checking and savings accounts by a commercial bank. Treas. Reg. Section 53.4941(d)-3(c)(2), Examples 1, 2 and 3. The IRS has also acknowledged informally that services of an accountant would generally be treated similarly to the personal services of a lawyer.

The portion of any payment that represents payment for property is not treated as payment for compensation for the performance of personal services. Treas. Reg. Section 53.4941(d)-3(c)(1). To illustrate, the regulations provide that payment to a disqualified person for the manufacture of microscopes for a private foundation was an act of self-dealing. Treas. Reg. Section 53.4941(d)-3(c)(2), Example 4. See also Rev. Rul. 73-363, 1973-2 C.B. 383 (rental of charter aircraft to a private foundation by a disqualified person that was a charter aircraft company was not personal services but rather a furnishing of property prohibited by Section 4941(d)(1)(C)).

The IRS has issued a number of private letter rulings regarding the services that may constitute personal services under the exception. Such rulings do not constitute legal precedent and cannot be relied upon by anyone other than the taxpayer who requested the ruling. Section 6110(k)(3). They may nevertheless provide an indication of IRS policy in this area.16

The IRS has ruled in many instances that services performed by foundation managers, which includes trustees and directors, for grant administration are within the personal services exception. See PLR 200007039 (Nov. 24, 1999) (approving board members services, including investigation of potential grantee organizations and overseeing the use of grants, within the exception); PLR 199927046 (July 12, 1999) (services of trustees, including “selecting grant program areas and grantees, are services of the same character as the professional and managerial type services discussed in the examples of Section 53.4941(d)-3(c)(2) of the regulations”); PLR 9226067 (March 31, 1992) (employee services including grantmaking and

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16 For additional indications of IRS policy in this area, see IRS Exempt Organizations Continuing Professional Education Textbook, “Private Foundations in the Mid-1990s With an Emphasis on IRC 4941 and IRC 4945” (FY 1995) at 270-73.
similar functions, general corporate administration, and real property investment administration); PLR 9015066 (Jan. 17, 1990) (services of project coordinator employee regarding scholarship grantmaking, including accounting, bookkeeping and routine day-to-day business operations).

The IRS has also ruled that services in connection with real property and other assets used in charitable activities are within the exception. For example, in PLR 199913040 (Dec. 23, 1998), the IRS ruled that a private foundation’s compensation and provision of housing to its president and secretary as part of the development of a retreat and conference center was not an act of self-dealing. The disqualified persons’ responsibilities included: management and oversight of maintenance, security, finances, successful completion of the feasibility study phase, and commencement of phase one development; oversight of the zoning, utilization, access and other property issues, including regulatory approval; and management and supervision of phase one development of the property. See also PLR 9327082 (Apr. 14, 1993) (services of foundation manager living on foundation’s ranch to protect it and deal with potential property developers); PLR 9115046 (Jan. 15, 1991) (services of caretaker trustee to prevent vandalism and supervise interior restoration of historic residence); PLR 8948034 (Sept. 6, 1986) (services of executive director who chaired meetings, oversaw financial management, hired personnel, oversaw maintenance of grounds and house, located museum acquisitions, oversaw security and day-to-day affairs and other duties as directed by the trustees); cf. PLR 9011050 (Dec. 21, 1989) (brokerage services for sale of works of art bequeathed to foundation where the disqualified person specialized in the sale of this type of art).

3. Definition of “Excessive” Compensation.

In order for compensation payments to fall within the personal services exception, the compensation may not be “excessive.” Treas. Reg. Section 53.4941(d)-3(c)(1). The determination of whether compensation is excessive is made with reference to Treas. Reg. Section 1.162-7, which addresses the circumstances under which compensation for personal services may be deducted by the payor for income tax purposes. That regulation states that a deduction is allowed “for salaries or other compensation for personal services actually rendered.” Such payments are deductible if they are “reasonable and are in fact payments purely for services.”

From a practical perspective, it is advisable to determine compensation to be paid to any disqualified person based on some form of market comparables. Depending on the nature of the services to be performed, comparables may or may not be readily available. If the trustee is a trust company that performs similar trustee services for a number of organizations that are unrelated to the trustee, those other arrangements may be appropriate comparables. In many cases, however, comparables will not be so easily identifiable for trustee or director services. It is often advisable to engage an experienced independent consultant to evaluate what is reasonable compensation for the services performed. Compensation consultants sometimes decline such engagements, however, being less comfortable in the realm of director or trustee compensation than in the more familiar terrain of executive compensation.

4. Reimbursement of Expenses.
The personal services exception encompasses reimbursement of expenses, “including reasonable advances for expenses anticipated” in the immediate future. “Reasonable” is defined as not “ordinarily” exceeding $500, unless the advance is made to cover “extraordinary expenses to the incurred in fulfillment of a special assignment,” such as “long distance travel.” Treas. Reg. Section 53.4941(d)-3(c)(1).

5. **E. Self-Dealing Taxes.**

1. **1. On Disqualified Person.**

The consequence of self-dealing is an initial excise tax against the “self-dealer” in the amount of 5% of the compensation for any services that did not constitute personal services or of any compensation to the extent found to be excessive. Section 4941(a)(1). The IRS has no authority to abate this tax. Section 4962(b). The self-dealing transaction must then be “corrected,” *i.e.*, the disqualified person is required to pay back to the foundation the compensation for any services that did not fall within the exception. If the disqualified person fails to do so, the person may be subject to an additional tax equal to 200% of the amount involved.

2. **2. On “Foundation Managers.”**

1. **a. Tax Imposed.**

In addition, a tax equal to 2½% of the amount involved applies to “foundation managers,” including trustees or directors, who “participated” in the payment, unless the participation was not willful and was due to reasonable cause. Section 4941(a)(2). A foundation manager who refuses to agree to a correction of the payment may be subject to an additional tax of up to 50% of the amount involved, subject to a cap of $10,000. Section 4941(b)(2). “Participation” is defined to include approval, as well as silence and inaction with respect to a transaction when the person was under a duty to act. Treas. Reg. Section 53.4941(a)-1(b)(2). A director or trustee who knowingly participates in payment of excessive compensation may therefore be subject to two separate self-dealing taxes, one as the disqualified person who receives the compensation and one as a foundation manager who approves it.

2. **b. “Knowing and Willful.”**

“Knowing” is defined as having actual knowledge of the facts, being aware that such an act may violate the self-dealing rules, and negligently failing to make reasonable attempts to ascertain whether the transaction is an act of self-dealing. Treas. Reg. Section 53.4941(a)-1(b)(3). The regulations provide that “knowing” does not mean “having reason to know,” but evidence tending to show that a person has reason to know of a particular fact or rule is relevant to the determination of whether a person acted knowingly.

“Willful” is defined as “voluntary, conscious and intentional.” It is not necessary that the person have a motive to avoid the tax rules. An action is not willful, however, if the person is unaware that he/she is participating in an act or self-dealing. Treas. Reg. Section 53.4941(a)-1(b)(4).
3. c. **Reliance on Opinion of Counsel.**

A foundation manager, such as a board member, who relies on legal advice expressed in a reasoned written legal opinion will not ordinarily be considered to participate knowingly and willfully in a self-dealing transaction, and will not ordinarily be liable for the tax on foundation managers under Section 4941(a)(2) in the event that the transaction is subsequently held to be an act of self-dealing. Treas. Reg. Section 53.4941(a)-1(b)(6).

3. 3. **On the Foundation.**

A private foundation that engages in a self-dealing transaction is not subject to an excise tax on the self-dealing transaction. Any violation of the private foundation rules, however, including the self-dealing rules, that is willful and repeated or willful and flagrant can be grounds for termination of private foundation status and loss of Section 501(c)(3) status. Section 507(a)(2). Upon involuntary termination of private foundation status, a foundation is subject to a termination tax equal to the lesser of its net asset value or the aggregate tax benefits that have resulted from the organization’s Section 501(c)(3) status (including benefits from exemption from income tax and from charitable contribution deductions claimed by donors). Section 507(c).

6. F. **Accountability: Form 990PF Public Disclosure.**

All compensation payable to directors or trustees of a private foundation must be reported annually on the organization’s IRS Form 990PF Return of Private Foundation, at Part VIII, line 1(c). The Form 990PF is a public document. All private foundations must provide copies of their three most recent returns to anyone who requests them in person or in writing. Section 6104(d)(1), (2). Most Form 990PF returns are readily available online at [www.guidestar.org](http://www.guidestar.org). A private foundation must accordingly be prepared to answer questions from the press or the public about compensation paid to directors or trustees.

5. V. **INTERMEDIATE SANCTIONS: DIRECTORS OF PUBLIC CHARITIES**

1. A. **Overview.**

Congress in 1996 added Section 4958, the so-called “intermediate sanctions” provision, to the Code. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452, Section 1311(a). The purpose of the intermediate sanctions rules is to penalize insiders who receive a personal benefit from a public charity in a private inurement transaction. Directors and trustees of public charities may be taxed under the intermediate sanctions rules if they receive compensation that is deemed to be excessive. The intermediate sanctions rules may also penalize a director or trustee who approves compensation to himself/herself or to other directors or trustees, knowing that the compensation is excessive. The intermediate sanctions rules do not penalize the organization itself.

By following specified procedures, an organization may create a rebuttable presumption that a compensation arrangement is reasonable, and therefore does not give rise to intermediate sanctions. As a practical matter, however, it will be difficult to create the presumption in the
context of director or trustee compensation paid for director or trustee services when all such trustees or directors receive compensation.

In one of its first applications of the intermediate sanctions rules, the IRS asserted excise taxes against the trustees of the Bishop Estate (a Hawaiian public charity that operates the Kamehameha Schools), each of whom had received in excess of $1 million in annual compensation. The IRS did not ultimately revoke the trust’s exemption, but the resignation of all trustees was a condition to the Bishop Estate’s retention of Section 501(c)(3) status.\footnote{For press coverage of the Bishop Estate situation, see the archives at www.starbulletin.com.}

2. **B. Applicable Tax-Exempt Organizations.**

The intermediate sanctions rules apply to transactions with Section 501(c)(3) organizations that are public charities \(i.e.,\) that are not private foundations, as defined in Section 509(a). Section 4958(e)(1). (Transactions with private foundations are instead subject to the self-dealing rules of Section 4941, discussed above.) The intermediate sanctions rules also apply to transactions with Section 501(c)(4) (social welfare) organizations. Section 4958(e)(1).

The rules also apply to transactions with any organization that has been exempt under Section 501(c)(3) or 501(c)(4) at any time during the five-year period ending on the date of the transaction. Section 4958(e)(2). Accordingly, the rules will continue to apply for five years to transactions with exempt organizations that have lost their exemptions or converted to taxable status.

3. **C. Disqualified Person Defined.**

1. **1. Substantial Influence.**

A disqualified person is any person who, with respect to any transaction with an applicable tax-exempt organization, was in a position to exercise substantial influence over the exempt organization’s affairs at any time during the five-year period ending on the date of the transaction. Section 4958(f)(1); Treas. Reg. Sections 53.4958-3(a), -3(c). Under the five-year rule, an influential person, such as a board member, who resigns \textit{will continue to be a disqualified person for a period of five years}. Compensation paid to an individual who was a board member at any time during the previous five years may therefore potentially be an excess benefit transaction.

The term also includes a member of any disqualified person’s family, defined as: a spouse of a disqualified person; a disqualified person’s ancestors, children, grandchildren and great-grandchildren; and the disqualified person’s siblings (by whole or half blood) and their spouses. Section 4958(f)(4); Treas. Reg. Section 53.4958-3(b)(1); \textit{cf.} the definition of “disqualified person” under the private foundation self-dealing rules, at Section 4946(d).

A 35%-controlled entity, \textit{i.e.,} a corporation, partnership, trust or estate in which disqualified persons directly or indirectly own more than a 35% interest, is a disqualified person. Section 4958(f)(3); Treas. Reg. Section 53.4958-3(b)(2).
2. Directors and Trustees Are Per Se Disqualified Persons.

The regulations under Section 4958 designate specific categories of individuals who are, without further analysis, automatically disqualified persons. First on the list is a voting member of the exempt organization’s governing body. The president, chief executive officer, chief operating officer, treasurer and chief financial officer are also per se disqualified persons.

The per se categories of disqualified persons are defined by reference to the actual powers and responsibilities held by the person, and not merely by the person’s title or formal position. An individual who has or shares ultimate responsibility for implementing the governing body’s decisions or supervising the organization’s management, administration, or operations will be a disqualified person, as will anyone who has ultimate responsibility for managing the organization’s financial assets. Treas. Reg. Sections 53.4958-3(c)(2), -3(c)(3).


1. Generally.

An excess benefit transaction is any transaction in which an applicable tax-exempt organization provides an economic benefit, either directly or indirectly, to a disqualified person, where the value of that economic benefit exceeds any value that the organization receives in return, including the value of services performed. Section 4958(c)(1)(A); Treas. Reg. Section 53.4958-4(a)(1). Payment of excessive compensation is a clear and common example.

2. Exceptions.

Under Treasury Regulation Section 53.4958-4(a)(4), certain economic benefits are disregarded for purposes of Section 4958, including the following that might be provided to directors:

- an economic benefit that is excluded from income as a “fringe benefit” under Section 132, except any liability insurance premium, payment, or reimbursement that must be taken into account as compensation;

- amounts paid under reimbursement arrangements that meet the requirements of an “accountable plan” under Treasury Regulation Section 1.62-2(c);

- economic benefits provided to a volunteer for the exempt organization if the benefit is provided to members of the public in exchange for an annual membership fee of $75 or less per year;

- an economic benefit provided to a member of an organization solely on account of the payment of a membership fee, or to a donor solely on account of a contribution for which a charitable contribution deduction is allowable under Section 170, regardless of whether the donor itemizes deductions or may not take the deduction because of the applicable percentage deduction limits – provided that: (a) any other donor is given the option of receiving substantially the same economic benefit; and (b) other donors in fact make a contribution at that level;
• economic benefits provided to a disqualified person solely as a member of a charitable class.

3. 3. Reimbursement of Reasonable Expenses.

The intermediate sanctions regulations permit reimbursement of reasonable expenses of an employee or volunteer according to the standards under Sections 162 and 274. This approach permits reimbursement of expenses for board members’ travel, so long as the travel is not “lavish or extravagant” under the standard that applies to business expense deductions. On the other hand, expenses for spousal travel generally will not be reimbursable. These expenses do not constitute working condition fringe benefits. Organizations should document reimbursement for spousal travel as compensation to the board member on Form W-2 or Form 1099. Any such amount must be considered along with other forms of compensation for purposes of determining whether the board member has received an excess benefit. Treas. Reg. Section 53.4958-4(a)(4)(i).

4. 4. Insurance and Indemnification.

Directors’ and officers’ liability insurance premiums that cover potential liabilities of board members (other than intermediate sanctions taxes) will generally constitute a “working condition fringe” benefit to the individuals. Treas. Reg. Section 53.4958-4(b)(1)(ii)(B)(2). As a result, such premiums will not be taxable income to directors or officers.

Premiums paid for insurance for a disqualified person for intermediate sanctions taxes will not constitute an excess benefit, so long as the premium is treated as compensation at the time that it is paid, and the total compensation is reasonable. As discussed below, an organization treats a payment as compensation by reporting it on Form W-2, Form 1099, or the organization’s Form 990. The additional premium amount attributable to intermediate sanctions coverage must be included for purposes of the excess benefit analysis. Treas. Reg. Section 53.4958-4(b)(1)(ii)(B).

Also included in a disqualified person’s compensation for intermediate sanctions purposes is the reimbursement by the exempt organization of extraordinary employment-related litigation expenses and expenses resulting from an act or failure to act where the person acted willfully and without reasonable cause. Treas. Reg. Section 53.4958-4(b)(1)(ii)(B).

5. E. Reasonableness of Compensation.

1. 1. Generally.

Compensation paid to a disqualified person may not exceed what is reasonable under all of the circumstances. Compensation is reasonable if it is in an amount that would ordinarily be paid for “like services by like enterprises under like circumstances.” Treas. Reg. Section 53.4958-4(b)(1)(ii)(A). “Like enterprises” are defined to include for-profit enterprises.

2. 2. Timing of Determination.
In determining reasonableness under all of the circumstances, it is generally the circumstances at the time the contract was entered into that are relevant. Treas. Reg. Section 53.4958-4(b)(2)(i) (reasonableness of any fixed payment is determined at the time the parties enter into the contract). The reasonableness of any amounts not fixed in the contract itself or paid pursuant to an objective formula will be based on all the facts and circumstances up to and including the date of the payment at issue. The regulations specify that circumstances existing at the date when the contract is questioned shall not be considered in making a determination of reasonableness, so that the determination cannot be made in hindsight.

3. Calculation of Compensation.

Compensation for purposes of Section 4958 includes all items of compensation paid by the exempt organization, including all cash and noncash compensation, deferred compensation attributed to the year in which services are performed, the amount of any premiums paid for liability or other insurance coverage, and all other benefits, whether or not included in income for tax purposes, such as medical, dental, life insurance and disability benefits and expense allowances or reimbursements (other than expense reimbursements pursuant to an “accountable plan” that meets the requirements of Treasury Regulation Section 1.62-2(c)). Section 4958(c)(1)(A); Treas. Reg. Section 53.4958-4(b)(1)(ii). Exceptions apply for working condition fringe benefits described in Section 132(d) and de minimis fringe benefits described in Section 132(a)(4), (e). Treas. Reg. Section 53.4958-4(b)(1)(ii)(B). The calculation of total compensation extends to any economic benefit provided through any other entity owned, controlled by, or affiliated with the exempt organization, whether or not tax exempt. Section 4958(c)(1)(A); Treas. Reg. Section 53.4958-4(a)(2).

4. Intent to Treat as Compensation.

An economic benefit will be treated as compensation for services only if the organization clearly indicated its intent to treat it as such at the time it was paid. Treas. Reg. Section 53.4958-4(c)(1). This rule is intended to prevent organizations from attempting to justify payments after the fact as having been made for services rendered. An exempt organization must provide “written substantiation that is contemporaneous with the transfer of benefits at issue.” Treas. Reg. Section 53.4958-4(c)(1).

If the organization reports the economic benefit as compensation on an original amended IRS Form W-2 or Form 1099, or on the organization’s own IRS Form 990 annual information return before the commencement of any IRS examination, or before notice from the IRS of a potential excess benefit transaction, then the organization has provided contemporaneous written substantiation of it intent to treat the benefit as compensation when the benefit was paid. Treas. Reg. Section 53.4958-4(c)(3)(i)(A). Similarly, if the disqualified person reports the benefit as income on an original or amended Form 1040 before commencement of any IRS investigation or before notice from the IRS of a potential excess benefit transaction, then there is contemporaneous written substantiation of the intent to treat the benefit as compensation when it was paid. Treas. Reg. Section 53.4958-4(c)(3)(i)(A).

1. **On Disqualified Person.**

Section 4958 imposes an excess tax on any “disqualified person,” including a voting member of the governing body, who engages in an “excess benefit transaction” with an applicable organization. Initially, the statute imposes a first-tier excise tax in the amount of 25% of the excess benefit. Section 4958(a)(1); Treas. Reg. Section 53.4958-1(c)(1).

If the transaction is not “corrected,” i.e., it is not undone to the extent possible to place the organization in a position no worse than it would be in if the disqualified person were dealing under the highest fiduciary standards, the disqualified person is subject to an additional tax equal to 200% of the excess benefit. Sections 4958(b), (f)(6); Treas. Reg. Section 53.4958-1(c)(2).

2. **On “Organization Managers.”**

1. **a. Tax Imposed.**

Section 4958(a)(2) imposes a tax equal to 10 percent of the excess benefit on the knowing participation of any “organization manager,” including directors and trustees, in an excess benefit transaction, unless such participation is not willful and is due to reasonable cause. This organization manager penalty tax is subject to a maximum of $10,000 for any one excess benefit transaction. Section 4958(a)(2), (d)(2); Treas. Reg. Section 53.4958-1(d).

An organization manager includes any officer, director, or trustee of the organization, or any individual having powers or responsibilities similar to those persons, regardless of title. Section 4958(f)(2); Treas. Reg. Section 53.4958-1(d)(2)(i). A person is considered an officer if designated as such under the organization’s organizing documents, or if the individual regularly exercises general authority to make administrative or policy decisions on behalf of the organization. Treas. Reg. Section 53.4958-1(d)(2)(i).

2. **b. “Knowing Participation.”**

The tax on organization managers applies only to an individual who “knowingly participated” in the excess benefit transaction. A person participates knowingly only if he or she:

- has “actual knowledge of sufficient facts” based solely upon which the transaction would be an excess benefit transaction;
- is “aware” that the transaction may be an excess benefit transaction; and
- either is “in fact” aware that the transaction is an excess benefit transaction, or negligently fails to make reasonable attempts to determine whether it is an excess benefit transaction.

Treas. Reg. Section 53.4958-1(d)(4). “Knowing” does not mean having reason to know. Treas. Reg. Section 53.4958-1(d)(4)(ii). Evidence tending to show that a manager had reason to know of a particular fact is relevant in determining whether the manager had actual knowledge, however.
3. c. Reliance on Professional Advice.

The Treasury Regulations provide a safe harbor under which a manager is not subject to sanctions if the manager relied on a reasoned written opinion by an “appropriate professional” that a transaction is not an excess benefit transaction to establish that the manager did not “knowingly participate.” Treas. Reg. Section 53.4958-1(d)(4)(iii). “Appropriate professional” is defined as legal counsel, certified public accountants and accounting firms and certain independent valuation experts.

Reliance upon the advice of a professional is allowed only on an opinion “within the professional’s expertise” after full disclosure of the facts. Treas. Reg. Section 53.4958(d)(4)(iii). A manager may not rely on an opinion that is merely conclusory. The regulations do allow reliance on an opinion of an outside advisor as to “elements of the transaction,” even if the opinion does not address the ultimate question of whether the transaction is an excess benefit transaction. Treas. Reg. Section 53.4958-1(d)(4)(iii).

An organization manager’s participation in an excess benefit transaction is not “knowing” if the organization meets the rebuttable presumption requirements. Treas. Reg. Section 53.4958-1(d)(4)(iv). The Preamble to the final regulations notes that the relief given by this provision is only a safe harbor, so failure to satisfy the rebuttable presumption requirements does not necessarily mean that the organization manager acted knowingly.

3. 3. Liability and Abatement.

Liability for all of the intermediate sanctions penalties is joint and several, where more than one disqualified person or manager is liable. Section 4958(d)(1). The penalty taxes may be abated if the transaction is corrected within specific periods. Sections 4961, 4962; Treas. Reg. Sections 53.4958-1(c)(2)(iii), -1(d)(8). The first court to consider intermediate sanctions excise taxes evidenced a willingness to consider abatement if the transactions were corrected within 90 days after the court’s opinion sustaining the tax became final. Caracci v. Commissioner, 118 T.C. No. 25 (2002).

7. G. Establishing a Rebuttable Presumption of Reasonableness.

1. 1. Generally.

The legislative history to Section 4958 indicates that a rebuttable presumption that a compensation arrangement is reasonable arises when the organization’s board has taken certain procedural steps designed to ensure objectivity in the approval process. H. Rep. No. 506 at 41. The rebuttable presumption procedure is now set out in detail in the Treasury Regulations at Section 53.4958-6. Where an organization satisfies the rebuttable presumption procedures, intermediate sanctions may be imposed only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence submitted by the transacting parties. The procedures require three steps:

- Approval by an independent board or committee;
- Reliance on “appropriate comparability data”; and
• Adequate documentation of the approval.

2. Approval by Independent Board.

The transaction must be approved by a board or committee composed entirely of individuals who do not have a conflict of interest with respect to the transaction. Treas. Reg. Section 53.4958-6(a)(1).

Specifically, a person does not have a conflict of interest with respect to a transaction if the person:

• is not the disqualified person involved in the transaction, and is not related to any disqualified person involved in the transaction;

• is not in an employment relationship subject to the direction or control of any disqualified person involved in the transaction;

• is not receiving compensation or other payments subject to approval by any disqualified person involved in the transaction;

• has no material financial interest affected by the transaction; and

• does not approve a transaction providing economic benefits to any disqualified person participating in the transaction, who in turn has approved or will approve a transaction providing economic benefits to the board or committee member.

Treas. Reg. Section 53.4958-6(c)(1)(iii).

In a context where directors or trustees all receive compensation from the organization, so that each is approving the other’s compensation, it will not in most cases be possible to meet this element of the procedures. One possible exception involves the use of a committee. The regulations allow approval by a committee of the board comprised of disinterested members, and defines committee as a committee of individuals as permitted under state law. Treas. Reg. Section 43.4958-6(c)(1)(B). If state law permits delegation of authority to a board committee that does not include directors, it would seem possible to satisfy this element. Cf. Revised Code of Washington, 24.03.115, requiring that at least two board members serve on every board committee.

3. Appropriate Compatibility Data.

1. a. Generally.

A critical question in establishing the rebuttable presumption is what constitutes “appropriate” comparability data. The regulations provide that a board or committee has appropriate data if, given the knowledge and expertise of its members, it has sufficient information to determine whether a compensation arrangement is reasonable or a transaction is for fair market value. Relevant information includes compensation paid by similar organizations, both taxable and tax-exempt; the availability of similar services in the area;
independent compensation surveys compiled by independent firms; actual written offers from similar institutions; and independent appraisals of property. Treas. Reg. Section 53.4958-6(c)(2)(i). The information must be current and the organization must consider the transaction in its entirety in evaluating its reasonableness for purposes of comparability.

The question of what is “appropriate comparability data” in the context of compensation for board or trustee services raises difficult questions. The regulations indicate that compensation paid for similar services by similarly situated organizations, “both taxable and tax-exempt,” is relevant. Does this mean that compensation paid for board services performed for a taxable compensation in the same line of business, of a similar size, in the same geographic area, is appropriate comparability data? Is board service for a taxable corporation ever comparable to service on the board of a nonprofit organization? It is common for a for-profit corporation to pay for board service and uncommon for a public charity to do so. Does this speak to the value of services, and the reasonableness of compensation, or rather to traditions in the charitable sector, and are such traditions relevant in ascertaining value? The intermediate sanctions rules provide no guidance on these issues.

The regulations caution that national compensation surveys that do not divide data by organization size or other relevant data may not be appropriate, particularly when the board lacks expertise in the area. Treas. Reg. Section 53.4958-6(c)(2)(iv) Example 1. On the other hand, where a hospital commissioned an independent, customized compensation survey that covered executives with comparable responsibilities at a “significant number” of hospitals and sorted data by a number of variables, the board members had a detailed written analysis of the survey results comparing the hospitals’ executives to those in the survey and an opportunity to ask questions of a member of the survey firm, the survey constituted appropriate comparability data. Treas. Reg. Section 53.4958-6(c)(2)(iv) Examples 2 and 3. The regulations do not specifically require that all these steps be taken, but offer this as a clear case example of when the appropriate data standard is met.

2. b. Special Rule for Small Organizations.

Small organizations, with annual gross receipts of not over $1 million, are permitted to use data from three comparable organizations in the same or similar communities for similar services. Accordingly, small charities are able to conduct an informal survey of three similarly situated organizations to determine reasonable compensation for an executive director and avoid the expense of an independent consultant’s compensation analysis. Treas. Reg. Sections 53.4958-6(c)(2)(ii), -6(c)(2)(iv) Example 5. The regulations assure that if a small organization fails to take advantage of the safe harbor, the IRS will not infer lack of reasonableness. Treas. Reg. Section 53.4958-6(c)(2)(ii).

4. Written Documentation.

The regulations set out specifically what must be included in the written documentation of the approval:

• the terms of the transaction;
• the date it was approved;
• the members of the board or committee who were present during debate and those who voted on it;
• the comparability data obtained and relied on and how the data were obtained; and
• the actions taken by anyone who is a member of a body or a committee but who had a conflict of interest with respect to the transaction (e.g., whether the person was present for questions and left the room for the discussion and vote).

Treas. Reg. Section 53.4958-6(c)(3)(i).

The decision must be documented “concurrently” with the action. The records must be prepared by the later of the next meeting of the authorized body or 60 days after final approval by the authorized body. Treas. Reg. Section 53.4958-6(c)(3)(ii).

5. No Inference From Failure to Meet Presumption.

If a disqualified person was in the room when the vote was taken, or if the secretary failed to prepare records in time, all is not lost: the fact that a transaction does not meet all of the requirements for establishing a rebuttable presumption does not create any inference that the transaction is an excess benefit transaction. Treas. Reg. Section 53.4958-6(e).


All compensation payable to directors or trustees of a public charity must be reported annually on the organization’s IRS Form 990 Return of Organization Exempt From Tax, at Part V. The Form 990 is a public document. All public charities must provide copies of their three most recent returns to anyone who requests them in person or in writing. Section 6104(d)(1), (2). As a practical matter, Forms 990 are readily available online at http://www.guidestar.org/.
I. THE CURRENT CORPORATE GOVERNANCE ENVIRONMENT RESPECTING COMPENSATION ISSUES: A MATTER OF ORGANIZATIONAL INTEGRITY

- Organizational integrity is the overriding responsibility of Boards of Directors and senior management.

- What stakeholders need most from Boards of Directors and senior management is assurance of an organization’s integrity – including an assurance that the organization’s values and culture support that integrity.

  - Critical to an organization’s integrity is the “tone at the top.” The Board and senior management must recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance.

  - Boards and senior executives must be extremely sensitive to the signals they send to the organizations they lead. Compensation may be the single most visible of those signals. How people are rewarded and what behavior is incented is an important element of an organization’s culture and values.

  - Underlying many of the highly publicized examples of corporate (including nonprofit) misconduct are often cultures of excess and greed, an imperial CEO/executive management team and Boards which are overly deferential to management or passive.

  - Nothing undermines a corporate culture more quickly than compensation practices which are perceived as unfair or rewarding behavior which is inconsistent with an organization’s values.
- Actual or perceived conflicts of interest detract from an organization’s integrity, and compensation decisions may involve actual or apparent conflicts of interest.

- **Boards of Directors should look to best governance practices in making compensation decisions.**
  - As the primary objective of a nonprofit corporation is to serve the mission for which the entity was organized, compensation decisions must be aligned to serve the best interests of the organization as well.
  - Boards of Directors should consider adopting an overriding philosophy of compensation which provides a context for director, management and other employee compensation.
  - Boards of Directors should consider creating compensation committees comprised solely of independent directors. Boards should define “independence,” and make their definitions available to stakeholders.
  - Compensation committees should have charters which detail their responsibilities.
  - Director compensation should be fair, take into account the demands of director service and the risks involved, and be paid in cash. Benefits and “perks” should be minimized or eliminated, as they may in actuality or appearance detract from the director’s independence, and promote longevity of service.
  - Boards, or compensation committees, should utilize appropriate resources of the organization to procure advice in the establishment of director and executive compensation. Boards and compensation committees, rather than management, should hire any professional advisors used to assist in compensation determinations.

- **Boards should look to the five basic principles outlined in the recent National Association of Corporate Directors’ Blue Ribbon Commission Report on Executive Compensation and the Role of the Compensation Committee in making compensation decisions.**
  - Independence.
  - Fairness.
  - Linkage to performance.
  - Long-term value for the organization and its stakeholders.
  - Transparency.
II. BOARD AND COMMITTEE EDUCATION

- Board and committee members should periodically obtain education on compensation practices generally and with respect to like organizations.

III. EVALUATION

- Boards and compensation committees should evaluate the performance of the compensation function, and assess both the performance of those making the decision and the effectiveness of compensation plans.
I. THE CURRENT CORPORATE GOVERNANCE ENVIRONMENT AND THE RESPONSIBILITIES OF BOARDS OF DIRECTORS: A MATTER OF INTEGRITY.

1. Organizational integrity is the overriding responsibility of Boards of Directors and senior management.

2. What stakeholders need most from Boards of Directors and senior management is assurance of an organization’s integrity – including an assurance that organization’s values and culture support that integrity.

   • Critical to an organization’s integrity is the “tone at the top.” The Board of Directors must be uncompromising in the selection, evaluation and retention of directors of high integrity and skill, who are knowledgeable about organizational governance and dedicated to the organization’s integrity and performance.

   • Equally important is the Board’s selection, evaluation and retention of executive management of high integrity and skill, dedicated to the organization’s integrity and performance.

   • The Board and senior management must then recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance.

3. A key element of leadership is trust. Boards and senior executives must be extremely sensitive to the signals they send to the organizations they lead. Signals include who is selected for Board service, who is hired to serve as a senior executive, what behaviors are endorsed or permitted at the Board, management and line employee levels, how people are rewarded, how customers and suppliers are treated, etc.

   • While reports on Enron, WorldCom, Tyco and a number of other highly publicized examples of corporate misconduct cite a variety of failures, underlying those specifics are often cultures of excess and greed, an imperial CEO/executive
management team and Boards which appear in many ways to have worked for management rather than the reverse. Similar issues have arisen in nonprofit organizations.

- Nothing undermines trust more quickly than compensation practices which are perceived as unfair or rewarding behavior which is not consistent with an organization’s values.

4. Actual or perceived conflicts of interest detract from the integrity of an organization and its governance and must be avoided or properly dealt with.

5. An organization must have in place compliance systems and procedures that will give it early warnings of activities that would threaten the integrity of the organization – and when the warning comes that the Board will investigate the issue independently and without restrictions that might compromise the investigation.

6. An organization must select advisors and consultants, including lawyers and accountants, will act to protect the organization’s integrity, and take issues that are important to the organization, to senior management and the Board of Directors to assure that they are acted on appropriately.

7. The bottom line of governance is that the ultimate authority for the governed entity is responsible for the entity’s integrity. In many of the current corporate scandals the Boards failed because they did not take responsibility for the organizations’ integrity. The directors did not see their organization’s integrity as an extension of their own integrity – and ultimately that is the critical point.

II. TWO REACTIONS TO RECENT CORPORATE GOVERNANCE PROBLEMS BODE WELL FOR THE FUTURE: THE EMERGENCE OF RECOGNIZED BEST GOVERNANCE PRACTICES, AND THE EVOLUTION OF THE PROACTIVE BOARD

1. First, the emergence of recognized good governance practices.

- For several years there has been emerging a body of “best practices” in corporate governance. The sources are many:
  - Corporate governance practices articulated by Boards of Directors (this got a huge public push from General Motors a number of years ago).
  - Corporate governance practices authored by institutional investors such as TIAA-CREF and CALPERS, and proxy advisors such as Institutional Investors Services.
  - State and federal legislatures. State corporate laws for the most part do not distinguish between public, private and nonprofit organizations with respect to governance and the duties of directors.
Various regulatory agencies, e.g. the Internal Revenue Service, the SEC, and the Comptroller of Currency.

Various self-regulatory organizations such as the New York Stock Exchange and NASDAQ.

State and federal officials charged with enforcement – note the recent actions of several state Attorneys General.

State and federal court decisions.

Various business organizations such as the Conference Board and Business Roundtable.

The National Association of Corporate Directors which has issued a number of Blue Ribbon Commission Reports on matters such as director professionalism, executive compensation, director and executive evaluation, detection of fraud, etc.

The American Law Institute’s Principles of Corporate Governance.

The American Bar Association Task Force on Corporate Responsibility.

Corporate Governance Ratings Agencies. Institutional Shareholder Services (61 metrics), Governance Metrics (625 metrics), The Corporate Library, Moody’s and Standard and Poors are providing corporate governance ratings for public organizations. Many of their metrics will also be a source of governance best practices.

- Good governance practices generally speak to the following subjects:
  - Board organization and leadership.
  - Board composition.
  - Director selection/orientation/education.
  - Board size.
  - Board processes.
  - Board service conditions.
  - Board duties.
  - Board compensation.
  - Board meetings (number, agenda, materials, etc.).
• Board/management relations.

• CEO evaluation and compensation.

• Director service (terms, resignation, age limits, etc.).

• Director and management service on other Boards.

• Director protection (indemnification, insurance, etc.).

• Evaluation of Board and Committee performance.

• Evaluation of director performance.

• Committee organization; compensation.

• Stakeholder interaction/communications.

• The ABA Corporate Responsibility Task Force Report.

• The Task Force was charged with looking at corporate responsibility issues raised by a number of high profile corporate accounting and conduct issues which raised questions about the effectiveness of corporate governance, accounting and disclosure of public companies. The Report makes clear, however, that the issues raised are also applicable to private companies and nonprofit organizations.

• The Task Force made a number of governance recommendations and compares those with recommendations made by the New York Stock Exchange, NASDAQ, the SEC and other selected organizations:

2. Next, the subject of proactive Boards.

• It used to be the law and the practice that directors were not responsible for discovering problems; they were only responsible to act once there had been some kind of a “triggering event” – something that called their attention to a matter which needed to be addressed.

• That started to change with the development of the Federal Sentencing Guidelines which reduced corporate penalties for infractions where it could be demonstrated that the corporation had taken reasonable steps to avoid the conduct of which the corporation was accused.

• Board proactivity got a further push from the Delaware court decision in the Caremark case where Chancellor Allen articulated the proposition that Boards cannot wait for a triggering event, but must act proactively to assure that management puts systems and processes in place, and engages in active
monitoring, in an attempt to avoid illegal conduct, and to pick up warnings of such conduct.

- The current corporate scandals and resulting litigation are underscoring the importance of, and need for, proactivity at the Board level. This is supported by the Sarbanes-Oxley Act with its certification requirements and criminal penalties, the listing standards such as those proposed by the New York Stock Exchange and NASDAQ, governance rating agencies, current court decisions, as well as the positions taken by institutional investors and business groups, and the ABA Corporate Responsibility Task Force.

III. SARBANES-OXLEY AND ORGANIZATIONAL INTEGRITY.

1. First, recognize that many of the concerns dealt with by Sarbanes-Oxley are applicable to nonprofit organizations. Nonprofits have had their share of highly publicized accountability issues.

2. Sarbanes-Oxley’s Underlying Principles: a focus on organizational integrity.

- The Board is responsible for the integrity of the organization. Vigorous oversight of the organization and its management and greater proactivity are required of Boards.

- Director independence is essential.
  - Independence needs to be defined.
  - Executive sessions of the Board are an important aspect of Board independence.
  - Organizational resources should be utilized to support independent Board oversight.

- Auditor independence is essential.
  - Non-audit services must be scrutinized.
  - Partner rotation and firm rotation should be considered. Relationships between audit partners and management should be scrutinized.
  - Consider whether the organization’s auditors should be prohibited from providing the following non-audit services, as is the case for publicly-held companies:
    - Bookkeeping.
    - Financial system design and implementation.
Appraisal/valuation services; fairness opinions and contribution in kind reports.

Actuarial services.

Internal audit outsourcing services.

Management functions; human resources.

Broker-dealer, investment advisor or investment banking services.

Legal services and expert services unrelated to the audit.

- The Board should have an independent audit committee with authority to hire and fire the organization’s auditors.
  - Audit Committee members should be financially literate; in larger nonprofits at least one should be a financial expert.

- The Board should have an independent governance committee to oversee all governance aspects of the organization, including nomination of directors, evaluation of the Board, committees and individual directors, and articulation of the organization’s corporate governance principles.

- The Board should have an independent compensation committee which oversees director and executive compensation.
  - Loans to directors and employees should be prohibited. In some states loans are prohibited or conditioned by law. Question: is the advancement of expenses for indemnification purposes a loan?
  - IRS regulations, and other applicable laws and regulations, regarding compensation must be understood and complied with.

- A corporation’s attorneys’ primary duties are to the entity and not management. Concerns affecting the well-being of the entity should be addressed with management and reported up the ladder.

- The organization’s financial and business information should fairly present, on a current basis, the condition of the organization. The Board should consider the subject of CEO and CFO certification to the accuracy of the information.

- The organization should have a code of ethical conduct applicable to directors, executives and employees (and independent contractors and suppliers).
  - The Board is responsible for compliance, and should see that procedures and processes are in place to monitor the organization’s compliance with laws, regulations and its own policies.
Conflicts of interest must be avoided, and carefully dealt with when they occur.

- Corporate information must not be tampered with or destroyed if relevant to an actual or prospective government investigation or proceeding, or private litigation.

- Corporate employees who alert the organization to compliance issues must not be the subject of retaliation.

- Board, committee and director performance should be periodically evaluated.

- The Board and its committees should have the authority and resources to hire independent advisors to assist with the performance of their duties.

3. Observations.

- We will continue to see a shift to proactive Boards. Vigorous oversight will become more the norm.

- There is a heightened focus by Boards on governance of the organization, and the organization and leadership of the Board.

- There is a greater focus on the audit committee, its composition, responsibilities and performance.

- Certification on the part of the CEO and/or CFO will be utilized by Boards of nonprofit organizations. Certifications are also being used by CEOs and CFOs at other levels of responsibility in their organizations.

- State legislatures will consider, and are considering, enacting provisions similar to many of those in the Sarbanes-Oxley Act; or preparing their own version of corporate disclosure/conduct requirements.

- Regulators will look at the best practices articulated by other regulatory agencies and self-regulatory organizations and begin to incorporate these into regulations affecting, and settlements with, organizations.

- Without regard to what the regulators do, Boards of Directors are looking at examples of good corporate governance practices, and bringing those practices to the organizations, public or private, for-profit or nonprofit, that they govern.

- Good governance policies adopted by various organizations will become benchmarks for regulators as well as litigants.

- The subject of conflicts of interest, already a focal point for the press, will receive even more scrutiny from Boards, regulators and litigants.

- Loans to directors, officers and employees are receiving increased attention from regulators.
• Non-audit services provided by auditors are being increasingly scrutinized, and this is true of services provided by other consultants as well, to minimize conflicts and insure objectivity.

• The amount and structure of Board and committee compensation in the for-profit sector is changing, and this will be an increasing issue for certain types of nonprofits.

• After the New York Stock Exchange executive compensation issues, Boards will increase their efforts to manage this subject more appropriately.

• Codes of ethics and compliance policies are being routinely adopted by organizations, and Boards will more carefully monitor adherence. Given the attention focused on the waiver of certain conflicts of interest by the Enron Board of Directors, Boards will (and should) be very cautious about waiving conflicts or suspending ethical conduct policies.

• Document retention policies are being adopted by more organizations, and Boards and management will more closely monitor compliance.

  - Document retention policies apply to written and electronically stored data. Email is worthy of special note, and organizations should address their rights to access and view employee email as well as sending, forwarding and saving email messages.

• Boards and Board committees will more frequently engage independent counsel and other advisors to assist them in the performance of their duties.

IV. HOW CAN BOARDS USE GOVERNANCE TO BUILD ORGANIZATIONAL VALUE?

1. Governance is a discipline different from management. It’s about proactive, vigorous oversight. Who populates most Boards? Often it’s people who have excelled at management.

2. Integrity is everything. It is the root of stakeholder and public confidence in an organization. Organizational integrity starts at the top, i.e., the Board of Directors and senior management. And donors are becoming increasingly interested in this subject.

3. Organizational culture and Board/management leadership is critical. Boards must take more responsibility for ensuring that the Board and management has appropriate leadership, and that leadership is held accountable. The Board must actively monitor the culture of the organization to assure that it reflects ethical values and trustworthiness, and must require management to build/maintain an ethical culture.

4. Boards must take more responsibility for compensation, perks and incentives. Recent disclosures of compensation levels and perks paid to senior management of
organizations have incensed the public and their political representatives. Compensation plans for senior executives and other managers must be reviewed to assure improper behavior is not incentified. Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment.

5. **Boards must carefully assess actual and perceived conflicts of interest.** Conflicts of interest in general, but particularly involving directors, senior management and key advisors, must be carefully assessed, and independent advice sought where necessary. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on Boards’ independence, integrity and judgment.

6. **Boards must pay more attention to the organization’s human capital.** Boards have always accepted responsibility for the organization’s financial capital. They must devote equal attention to the organization’s human capital.

7. **Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.**

8. **Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly.** Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity. History provides ample lessons of the disastrous consequences of cover-ups. A cautionary note: When conducting an investigation pay close attention to issues of attorney-client privilege.

9. **Transparency is good; obscuring reality is bad.** Transactions, schemes or practices which make it difficult for those who rely on the organization’s financial information to clearly understand that information will be questioned. Boards need to be increasingly aware that if third parties’ decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.

10. **Targets are good; financial performance obsessions are bad.** Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of “cutting edge” accounting or business practices. A survey by *CFO Magazine* found that 17% of CFOs, many from the nation’s largest companies, had been pressured by CEOs one or more times in the last five years to misrepresent financial results. Directors need to be aggressive about investigating and ending that pressure.

11. **Monitor corporate disclosures.** Boards are increasingly aware of the organization’s responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, and others who rely on or
require the organization’s business and financial information. Boards must also be aware of the many ways in which the organization provides information, e.g., public comments by management, management conduct, media interviews, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.

12. **Boards must be extremely conscious of the signals they send to the organizations they govern:** signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it’s about the culture of the organization for which they are ultimately responsible.

13. **Directors need to be schizophrenic:** vigilant overseers, on the one hand, and effective, constructive collaborators on the other.

14. **Boards must focus on reputational value:** reputations take years to build; moments to lose. For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise an organization’s reputation for integrity and trustworthiness with its various stakeholders. As we’ve seen the consequences of a breach of trust can be brutal.

15. **Good governance practices.** Good governance in actuality, not just in appearance. The Boards of many organizations now in the news are populated with individuals who have excellent credentials. Often the appropriate governance documents and Board structures are in place. However, good governance is about organization, process, education and **EXECUTION.** And finally **EVALUATION** -- evaluation of management, principally the CEO/Executive Director, evaluation of the Board, and evaluation of directors.
I. Definitions

1. “Sarbanes-Oxley Reforms” applicable to Boards Are:
   
a. Reforms Imposed by Sarbanes-Oxley Act, directly or indirectly by mandate to SEC, U.S. Sentencing Commission, Stock Exchanges (e.g., requirements for composition of Audit Committees)

b. Reforms Initiated by SEC and other Regulatory Agencies on their own (e.g., certificates of disclosure controls, in addition to internal controls and procedures)

c. Reforms Initiated by New York Stock Exchange, and Nasdaq, etc. for Listed Companies

d. De Facto “best practices” arising from latest egregious examples of “bad practices” (e.g., Disney board, NYSE board failures to evaluate CEO compensation)

II. What are Boards Doing?

1. Still Enormous Variety of Responses
   
a. “This Too Will Pass” Mentality

b. Well-Meaning Mimicry

c. Cherry Picking

d. Audit Committee-Only Approach

e. Still Thinking

2. Reactive or Pro-Active Responses: Changes May be Initiated by Internal or External Pressures – from Board Members, Senior Management, D&O Carriers, Banks and Others to Adopt Sarbanes-Oxley-Type Reforms

a. Current Board Members
(i) Want to know what they need to do to perform their duties, avoid liability

(ii) May want to be viewed as progressive/meeting current standards or governance

b. Prospective Board members May Assess the Merits of the Organization by “Compliance” with Sarbanes-Oxley; Liability Concerns

c. D&O Carriers, Lenders, Performing Governance Structure Reviews to Evaluate Risk: premiums, terms may be more onerous for “non-compliant” organizations

d. Senior Management – evaluating need for organization to adopt Sarbanes-Oxley-type reforms

3. Specific Actions

a. Creation/Upgrading of Audit Committee

(i) Independent/Non-Management Directors

(ii) Separation from Finance Committee

(iii) Financial Expert, Financial Literacy Requirements

(iv) Scope of Responsibilities

(v) Financial Compliance Issues vs. “General” Compliance Issues

b. Revision of Compensation Committee Charter

(i) Responding to Disney case

(ii) Assuring compliance with IRS standards for rebuttable presumption of reasonableness

c. Updating Conflict of Interest Policies

(i) Beyond IRS Model Policy, Towards Codes of Conduct

(a) Looking at fiduciary conflicts

(b) Interpersonal conflicts (e.g., Oracle)

(c) More specifics on duty of loyalty standards

(ii) May or May Not Maintain Current Model
d. Considering Certifications

(i) Be very, very careful

(ii) How thoroughly will certificates be made “down the ladder”

(iii) Who will review all potential problems, document response?

(iv) What are sanctions for certificates that are negligently /deliberately wrong?

(v) What have you gained?

(vi) Responding to regulatory, creditor certification requests

e. Board Chair, Board Member and President/CEO Job Descriptions

f. Some Focus on Board Nominating Process, and on Articulating Requirements and Criteria for Board Members

g. Board and Director Evaluations

h. Less focus on permanent “Governance Committee”

i. Board Education on Fiduciary Duties in General and in Post-Sarbanes World

III. Issues for Nonprofit Healthcare Organizations

a. Definition and Application of “Independent” Standards When Seeking to Apply Sarbanes-Oxley Standards

(i) Comparison to “Community Representative” Standards

(ii) Direct/Indirect; Defining “Family”

(iii) Non-Management

(iv) No Significant Vendor Relationship

(v) No Significant Donor/Donee Relationship

(vi) The New Frontier – evaluating personal relationships (Oracle approach), for effect on ability to exercise independent judgment, as director generally and as member of specific committees

(a) Personal ties as donors, grateful patients; ties to other board members
(b) Religious Sponsors

(c) Physicians as Board Members of Health Care Organizations

(d) Kevin Bacon problem

(e) Kevin Bacon, resolved: What would outsiders think?

(vii) Defining what standards of independence apply when-eligibility to serve as director generally, or on certain committees?

b. Uses and Implications of Sarbanes-Oxley Standards for Nonprofit Organization

(i) Remedial measures

(a) Voluntary/Mandatory

(b) Governance Structural Changes

(c) Certifications

(ii) New Laws and Regulations Applicable to Nonprofits

(a) N.Y. Attorney General Proposals to Amend N.Y. Nonprofit Corporation Act

(b) ABA Model Nonprofit Act Revisions: Clarifying fiduciary duty status of boards and other designated bodies exercising board powers

(c) Massachusetts Attorney General Proposals under Act to Promote the Financial Integrity of Public Charities

(d) California Attorney General S-Ox Clone Proposals under Nonprofit Integrity Act of 2004

(iii) Concern that Lack of Sarbanes-Oxley “Compliance” will be Seen as Prima Facie Evidence of Board Failure of Duty

(a) Educational resource on Corporate Responsibility and Corporate Compliance for Health Care Boards, by Office of the Inspector General, HHS

(b) Concerns regarding use to allege director liability in regulatory compliance cases
(c) Need to assure Board Minutes Reflect Board Member Questions, Involvement

(iv) Spill-Over to General Concepts of Board Oversight

(a) Boards trying to identify what information and in what form, they need to assure adequate corporate oversight

(b) “Literacy” issues: easier to analogize from Sarbanes-Oxley and address need for compliance literacy on regulatory and medical quality/U.R. issues

(c) Enhanced committee powers, specification of duties, expected access to officers and outside advisors: more of a roadmap for Committee operations

(d) Consideration of Compensation of Nonprofit Directors

(a) “Reverse” donations role

(b) Liability shield issues

(e) Movement from purely mission-directed governance to governance based on perceived best practices
Incorporation

Introduction

A corporation is an entity which comes into existence when, upon application to the by one or more persons, the state issues a certificate of incorporation. By law, a corporation is an independent entity, a “person.” It has a life of its own, separate and apart from its owners, officers and employees with the ability to sue, be sued and conduct other business affairs. Unlike a partnership, its life does not depend on the existence of any individual or group. In addition, the owners’ liability for the debts of the corporation is ordinarily limited to the amount of the owners’ investment.

The word “corporation” immediately brings to mind companies like General Motors, IBM and Microsoft. However, corporations come not only in various sizes but also in various types. One such type is the nonprofit corporation. A nonprofit corporation is usually a charitable entity, such as a hospital, college, church or other religious organization. Typically, nonprofit corporations are headed by boards of trustees or directors, and do not have shareholders. Although they are often run like a business, their purpose is to aid in the accomplishment of various social goals.

Benefits

A religious organization should plan to incorporate as soon as possible rather than continue as an unincorporated association, unless it is not permitted to incorporate under state law. As mentioned above, incorporating creates a distinct legal entity that is separate and apart from the members. Consequently, members of an incorporated organization are not responsible for the debts and obligations of the organization, unless they have guaranteed a debt or participated in conduct that created a claim against the organization. Members of an unincorporated association may not be protected from such liabilities and can be held individually and severally liable for all indebtedness incurred by the association. Simply, a single member could be held jointly and severally liable for the debts of the organization.

In addition, when a religious organization is involved in more complex business transactions, many businesses and financial institutions require that the organization be incorporated before initiating negotiations. For example, most lenders will require the organization be incorporated prior to making any loans to the organization for the purchase of real estate. Because an unincorporated association has no legal existence that will permit it to hold property, the property is deemed to belong to the members as tenants in common. Incorporation provides the prospective creditor with an entity that is distinct from the members, removing any questions as to whether the transaction involves the organization or its members.

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1 Currently, Virginia and West Virginia prohibit issuance of a charter of incorporation to any church or religious denomination under their respective state’s constitution.
An incorporated organization also benefits from clearer rules of governance than an unincorporated association. The laws regarding the governance of nonprofit corporations are more developed than unincorporated associations. Consequently, the law provides more clarity and less likelihood for disagreement between members over the proper operation of the organization. Finally, the staff and members of an unincorporated association have a greater exposure to tort liability. As a general rule, any member of an unincorporated association may be held liable for the actions of others acting on behalf of the organization. There are federal and state laws that offer some charitable immunity, but in most states the immunity is very limited and the federal immunity laws may not apply to unincorporated organizations.

An affirmative vote of a majority of the members present at a special meeting called to discuss incorporation is normally required for the organization to take the action. The consent of the members of the organization should be memorialized in the form of a written resolution. The resolution should authorize one or more individuals to serve as incorporators for the organization to begin the process and should authorize them to take such steps required or necessary to complete the incorporation. The resolutions should also transfer all assets of the organization to the corporation as soon as it is incorporated. The signing of deeds normally affects the transfers of real estate and the signing of bills of sales for personal property. Furthermore, contracts and other agreements should be changed to the name of the corporation.

Review of State Laws on Incorporating a Religious Organization

Corporate Name

The first step to incorporating in most states is reserving the organization’s name with the office of the secretary of state. The name of any nonprofit corporation must contain the word “corporation,” “incorporated,” “limited” or an abbreviation of those terms in its name. The secretary of state will then issue the incorporator a reservation number that is effective for some period of time, typically 60 to 120 days. Sometimes, a new corporation will select a name that is similar to the name of an existing organization in the same area potentially resulting in public confusion. For example, a new corporation calling itself Crossroads Baptist Church establishes a church in a city that already has a Baptist church called “Crossroads.” In most cases, the preexisting corporation will have a legal basis for stopping the use of the similar name by the other corporation under unfair competition laws. Courts have consistently protected nonprofit organizations as well as businesses for unfair competition because a corporate or trade name may be an asset of great value. In addition, the use of identical or similar corporate names may result in confusion or deception. The name of the preexisting corporation may also be protected under common law trademark principles or under federal trademark law. Finally, some states have name protection statutes protecting the names of religious corporations against later use of the same or confusingly similar name. Consequently, incorporators should take

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4 Volunteer Protection Act (1997).
care in selecting a corporate name that is not confusingly similar to an existing organization.

**Articles of Incorporation**

Once the appropriate name has been reserved, the incorporator then must prepare duplicate articles of incorporation, also called the charter. Similar to for-profit corporations, most states have few provisions that must be included in the articles. The following provisions are required under the nonprofit corporation laws of most states:

- The name of the corporation;
- The street address and county of the corporation’s initial registered agent;
- Name and address of the incorporator(s);
- Whether or not the corporation will have members (the most common form is the membership corporation)
- The mailing address of the initial principal office of the corporation; and
- A statement that the corporation is organized pursuant to the state’s nonprofit corporations act.

The purpose or purposes for which the corporation is formed is not required under the laws of many states. However, if the nonprofit desires to obtain an exemption from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (“IRC”), certain other provisions must be included. The articles must limit the organization’s purpose to one or more of the exempted purposes provided in IRC § 501(c)(3). The articles must not expressly permit the corporation to engage, other than an insubstantial part of its activities, in activities that are not in furtherance of one or more of those exempt purposes. This requirement is met if the purposes stated in the articles are limited by reference to Section 501(c)(3). The articles must also provide that upon dissolution of the corporation, its assets must be distributed for an exempt purpose, to the federal government or to a state or local government for a public purpose. Typically, a religious organization will specify it assets be distributed to another religious organization rather than leaving this determination to a judge’s discretion. If these provisions are omitted, upon filing of the applications for exemption the IRS will request the articles be amended, costing the organization time and money.

The articles may also provide the names and addresses of the individuals who are to serve as the initial directors. However, including this provision in the articles should be carefully considered, as it is likely the board members will change prior to the nonprofit organization beginning its operations. Furthermore, the addresses of the directors should be omitted for privacy reasons unless the state’s nonprofit corporations law requires inclusion
of their address. If this provision is not added to the articles, written minutes will be necessary from the incorporator(s) naming the initial directors. In addition, a provision eliminating or limiting the liability of a director to the corporation or its members may be included. Several states also recognize trustee organizations where the trustees constitute and control the organization.

Provisions not inconsistent with state law may also be added to the articles regarding:

- Managing and regulating the affairs of the corporation;
- Defining, limiting, and regulating the powers of the corporation, its board of directors, and members; and
- The characteristics, qualifications, rights, limitations and obligations attached to each class of members

The incorporator then must send the duplicate articles, with any necessary application form and the prescribed filing fee to the secretary of state. The secretary of state reviews the articles to ensure compliance with the state’s nonprofit corporations act and then issue a certificate of incorporation. Generally, the organization’s corporate existence begins at the moment the certificate of incorporation is issued. In some states, incorporation is considered effective the date received by the secretary of state unless a post-effective date is specified in the application. Finally, initial minutes must be prepared to ratify the incorporator’s actions, adopt the articles of incorporation, and appoint officers. These minutes should be maintained in the corporation’s minute book.

Publication of Notice

In some states, corporations are required to publish notice of intent to incorporate in the newspaper which is the official legal organ of the county where the initial registered office of the corporation is to be located, or in a newspaper of general circulation in such county and for which at least sixty percent of its subscriptions are paid. Often, the notice of intent to incorporate and a publication fee should be forwarded directly to the newspaper no later than the next business day after filing articles of incorporation with the secretary of state.

Religious Corporations Laws

Some states have adopted laws relating to the incorporation and governance of religious corporations. Generally, incorporation under these laws is simpler that incorporation under nonprofit corporation laws. Typically, the religious organization adopts articles setting forth the organization’s name, address, purpose and the names and address of its officers and directors. The articles are then filed with a local state court,
county recorder or the secretary of state for approval. States that permit this type of incorporation generally place few regulations over the operation of religious corporations and no annual reporting requirements.

Constitution

Many religious corporations adopt a constitution during formation stage. Typically, the constitution contains the organization’s position on faith, worship and polity, especially if the organization operates autonomously and not subject to the control of other ecclesiastical bodies. The terms “constitution” and “bylaws” often are used interchangeably. However, bylaws generally refer to the rules of governance adopted by the corporation, and constitution generally refers to the supreme law of a corporation. The term constitution, when properly used, is a set of rules superior to the bylaws with more important provisions assigned to the constitution. In some cases, the religious organization will combine the two documents, such as “constitution and bylaws.” In such instances, the corporation will generally require a greater number of members to amend the constitution than the bylaws.

Review of Incorporation Under the Revised Model Not for Profit Corporations Act

Corporate Name

Under the Revised Model Not for Profit Corporations Act of 1987 (“Model Act”), a person may reserve the exclusive use of a corporate name by delivering an application to the secretary of state for filing. The application must be executed by the presiding officer of the corporation’s board of directors, its president, or by another of its officers or if directors have not been selected or the corporation has not been formed, by an incorporator. The person executing the application must sign it and state beneath or opposite the signature his or her name and the capacity in which he or she signs. In addition, the secretary of state may also prescribe any applicable fee.

The corporate name does need not be in English if written in English letters or Arabic or Roman numerals, and any certificate of existence required of foreign corporations does need not be in English if accompanied by a reasonably authenticated English translation. However, the corporate name may not contain language stating or implying that the corporation is organized for an unlawful purpose or a purpose other than that permitted by its articles of incorporation. Upon finding that the corporate name applied for is available, the secretary of state will reserve the name for the applicant's exclusive use for a nonrenewable 120-day period.
Articles of Incorporation

Following the reserving of a corporate name, the corporation will select one or more individuals to complete the incorporation. These individuals are considered the incorporator or incorporators of the corporation and are charged with delivering duplicate articles of incorporation to the secretary of state for filing. The articles of incorporation must set forth:

- The corporate name for the organization;
- One of the following statements: (i) This corporation is a public benefit corporation, (ii) This corporation is a mutual benefit corporation, or (iii) This corporation is a religious corporation;
- The street address of the corporation's initial registered office and the name of its initial registered agent at that office who must reside in the state or be a foreign business or nonprofit corporation authorized to transact business in the state;
- The name and address of each incorporator;
- Whether or not the corporation will have members; and
- Provisions not inconsistent with law regarding the distribution of assets on dissolution.

In addition to the provisions required under the Model Act, the articles of incorporation may set forth:

- The purpose or purposes for which the corporation is organized, which may be, either alone or in combination with other purposes, the transaction of any lawful activity;
- The names and addresses of the individuals who are to serve as the initial directors;
- Provisions not inconsistent with law regarding: (i) managing and regulating the affairs of the corporation; (ii) defining, limiting, and regulating the powers of the corporation, its board of directors, and members (or any class of members); and (iii) the characteristics, qualifications, rights, limitations and obligations attaching to each or any class of members.

If the articles delivered to the office of the secretary of state satisfy the requirements of the Model Act, the secretary of state files the document by stamping or otherwise endorsing "Filed." In addition, the secretary of state will stamp its name, official title and the date and the time of receipt, on both the original and copy of the articles and on the receipt for the filing fee. After filing the articles, the secretary of state will deliver the document
copy, with the filing fee receipt (or acknowledgement of receipt if no fee is required) attached, to the corporation or its representative.

The articles are considered effective on the date of filing, as evidenced by the secretary of state's endorsement on the original document; or at the time specified in the articles as its effective time on the date it is filed. The articles may specify a delayed effective time and date, and if it does so the articles becomes effective at the time and date specified. If a delayed effective date but no time is specified, the articles are effective at the close of business on that date. A delayed effective date for the articles may not be later than the 90th day after the date filed.

**Governance**

**Forms of Organization Rule (Governance)**

Once the organization has been incorporated, the affairs of the organizations are generally managed in one of three manners. The organization may be managed by:

- Its board of directors (leadership team, elders, trustees, deacon, etc.);
- Its members (congregationally led); or
- A combination of each

Under most state nonprofit corporations law, unless an express provision to the contrary appears in the articles of incorporation or bylaws, the presumption is that the corporation is to be managed by its board of directors. This further stresses the importance of specifying in the articles of incorporation or bylaws the form of governance the church has elected to use and the authority of its directors. If the church desires to operate as a member led organization and fails to provide that form of governance in its articles of incorporation or bylaws, the church will be considered a board of directors led organization and decisions made on its behalf by member vote may be void and subject to challenge.

**Board of Directors**

All corporations must have a board of directors. However, the articles or bylaws can limit the authority of the board. In a board of directors led or hierarchical corporation, the board of directors make all of the decisions on behalf of the corporation, except those matters that the law requires be put to a vote of the members. Generally, such matters include:

- The dissolution of the corporation;
- A plan of merger with another corporation;
• The sale, lease, exchange or otherwise disposition of substantially all of the assets of the corporation; and

• The amending of most provisions of the articles of incorporation

These decisions are made by approval of the members, after recommendation from the board. The board without the approval of the members may make all other decisions, unless limited by the articles or bylaws. The board may also delegate to a committee or committees any duty that is not specifically required by statute or the bylaws to be performed by the full board. However, it may not abdicate its own responsibilities. For example, some states prohibit a committee from presenting an issue directly to the members for a vote, filling vacancies on the board, setting compensation for board members or officers and amending the bylaws. Generally, the board approves the bylaws or a resolution detailing a committee’s authority and responsibilities.

Members

In a member (congregation) led organization, the members have the right to make all decisions on behalf of the organization. Under the Model Act, a "member" is (without regard to what a person is called in the articles or bylaws) any person or persons who on more than one occasion, pursuant to a provision of the organization’s articles or bylaws, have the right to vote for the election of a director or directors. Generally, a person is not a member by virtue of any of the following:

• Any rights such person has as a delegate;

• Any rights such person has to designate a director or directors; or

• Any rights such person has as a director

All business matters should be presented to and voted on by the membership prior to being adopted or implemented. If any individual makes a decision without member approval, they can be individually liable for the decision and its consequences. For example, individuals entering into contracts without membership approval could have personal liability for the obligations arising from the transaction if the organization fails to fulfill them. Under the Model Act, “approval by the members” means approved or ratified by the affirmative vote of a majority of the votes represented and voting at a duly held meeting at which a quorum is present (which affirmative votes also constitute a majority of the required quorum) or by a written ballot or written consent in conformity with the Model Act or by the affirmative vote, written ballot or written consent of such greater proportion, including the votes of all the members of any class, unit or grouping as may be provided in the articles, bylaws or the Model Act for any specified member action.
Combination

The third and most common form of governance is a combination of director and member rule. In this method of management, the corporation’s articles or bylaws create a board of directors, but provide limits on their authority. Typically, some decisions are to be made by the board, while other decisions are reserved to the members. Clearly, when this form of governance is used, it is important that the corporation’s governing documents specifically identify which decisions are to be made by the board and what decisions will be made by the members. Commonly, day-to-day, the board and church staff makes business decisions, with more important decisions put before the members. Thus, reducing the number and length of member meetings.

Bylaws

The articles of incorporation outline the general purposes of the corporation. The bylaws detail the specifics of how the corporation is structured and governed. Once legally adopted, bylaws outline the corporation’s governance structure and basic operating rules. Consequently, a nonprofit corporation must also prepare bylaws. The bylaws may contain any provision regulating and managing the affairs of the corporation that is not inconsistent with law or the articles of incorporation. The bylaws should clearly define whether authority for various decisions rests with the members (congregation), the board of directors or a combination of the two. If the decisions of the corporation are to be made by the congregation, the articles of incorporation or bylaws should clearly provide for such requirements and should limit the authority of the board of directors. At a minimum, the bylaws should also address the following areas.

Directors

Duties and Qualifications of Directors

Unless limited by the articles or bylaws, all corporate powers are exercised by and the affairs of the corporation managed under the direction of the board of directors. The name and constitution of the board varies widely within religious organizations. For example, the board within religious organizations maybe referred to as the leadership team, council of elders, deacons, diakonate, and other names. In addition, the articles may authorize a person or persons to exercise some or all of the powers that would otherwise be exercised by a board, such as a pastor, minister, rabbi, or trustee. It should be noted that clergy members are not entitled to serve as directors, trustees or officers unless specifically authorized in the corporation’s articles or bylaws. The bylaws should also state the qualifications to be a director such as membership in the corporation, age, spiritual maturity, record of service or other relevant criteria. The Model Act requires that a director be at least 18 years of age, but does not require the director be a resident of the state or a

7 Allen v. North Des Moines Methodist Episcopal Church, 102 N.W. 808 (Iowa 1905).
member of the corporation. Further, the corporation may require the director to attend a minimum number of meetings per year, or that director will be deemed to have resigned and his or her position deemed to have become vacant.

**Number of Directors**

The Model Act requires the corporation to have at least three directors. However, there are some states that permit the corporation to operate with only one director. The number of directors may be a fixed number or a variable range depending on the needs of the corporation. If the bylaws or articles of incorporation do not fix the number of directors, the number of director is equal to the number of the initial directors. Further, the number of directors may be increased or decreased (but to no fewer than the statutory minimum) from time to time by amendment to the articles or bylaws, or in the manner prescribed in the articles or bylaws. Corporations may also elect to establish classes of equal or nearly equal numbers of directors. Each class of would stand for election or reelection at different annual meetings. For example, the board is divided into three classes of directors with one-third of the directors elected or reelected each year. This type or arrangement provides continuity in leadership, while making it difficult for groups of members to gain control of the corporation.

**Election, Designation and Appointment of Directors**

If the corporation has members, all the directors (except the initial directors) must be elected at the first annual meeting of members, and at each annual meeting thereafter, unless the articles or bylaws provide some other time or method of election, or provide that some of the directors are appointed by some other person or designated. If the corporation does not have members, all the directors (except the initial directors) shall be elected, appointed or designated as provided in the articles or bylaws. If no method of designation or appointment is set forth in the articles or bylaws, the directors (other than the initial directors) shall be elected by the board.

**Terms of Directors**

The articles or bylaws should specify the terms of directors. If the articles or bylaws do not provide a length of term, the Model Act requires that each director be elected for a one year term and hold office until the next annual meeting. The term of a director filling a vacancy in the office of a director elected by members expires at the next election of directors by members; and the term of a director filling any other vacancy expires at the end of the un-expired term that such director is filling. Except for designated or appointed directors, the terms of directors may not exceed five years. A decrease in the number of directors or term of office does not shorten an incumbent director's term.
Generally, despite the expiration of a director's term, the director continues to serve until the director's successor is elected, designated or appointed and qualifies, or until there is a decrease in the number of directors. The articles or bylaws may provide for staggering the terms of directors by dividing the total number of directors into groups. The terms of office of the several groups need not be uniform.

A trend among nonprofit organizations is to limit the number of terms a director may serve, after which the individual must step down before he or she is once again eligible to be elected to the board of directors. An advantage of this approach is that it provides for regular turnover of directors, thus bringing new ideas to the governance function. A disadvantage is the possibility that a major supporter or vitally active member of the board, unable to stand for reelection to another term on the board, may be alienated and withdraw support. In the absence of terms limits, the Model Act does not prohibit the election of directors for successive years.

### Resignation of Directors

A director may resign at any time by delivering written notice to the board of directors, its presiding officer or to the president or secretary. A resignation is effective when the notice is effective unless the notice specifies a later effective date. If a resignation is made effective at a later date, the board may fill the pending vacancy before the effective date if the board provides that the successor does not take office until the effective date.

### Removal of Directors

The grounds and process for removal of a director is a very important provision in the corporation’s governing documents. If no such provision is in the articles or bylaws, the members of the corporation may remove one or more directors elected by them without cause. The members only at a meeting called for the purpose of removing the director may remove a director elected by members and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director. Generally, a director may be removed only if the number of votes cast to remove the director would be sufficient to elect the director at a meeting to elect directors. If cumulative voting is authorized, a director may not be removed if the number of votes, or if the director was elected by a class or grouping of members, the number of votes of that class or grouping, sufficient to elect the director under cumulative voting is voted against the director's removal.

A director elected by the board may be removed without cause by the vote of two-thirds of the directors then in office, unless the articles or bylaws require a greater number. However, a director elected by the board to fill the vacancy of a director elected by the members may be removed without cause only by the members, not the board. If, at the beginning of a director's term on the board, the articles or bylaws provide that the director
may be removed for missing a specified number of board meetings, the board may remove the director for failing to attend the specified number of meetings. The director may be removed only if a majority of the directors then in office vote for the removal.

Under the Model Act, the articles or bylaws of a religious corporation may limit the power to remove directors elected by the members or the board. Specifically, allowing members or the board remove a director only for cause. This is generally a mistake. There are many reasons why members may want to remove a director that may not arise to the generally acceptable definition of “cause.” Consequently, the corporation should always retain the power to remove directors without cause. The Model Act also permits the corporation to set forth other procedures by which the board or any person may remove a director elected by the members or the board.

Vacancy on the Board

Finally, the bylaws should describe the process for filling vacancies on the board. Unless the articles or bylaws provide otherwise, if a vacancy occurs on the board of directors, including a vacancy resulting from an increase in the number of directors, the members, if any, or the directors may fill the vacancy. If the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office. However, if the vacant office was held by a director elected by a class or grouping of members, only members of the class or grouping are entitled to vote to fill the vacancy. In addition, if an appointed director held the vacant office, only the persons who appointed the director may fill the vacancy. If a designated director held a vacant office, the vacancy may be filled as provided in the articles or bylaws. The vacancy may not be filled by the board in the absence of an applicable article or bylaw provision.

Membership

Selection and Qualifications

Religious corporations are not required to have members. However, most religious corporations elect to have members. Generally, the corporation’s bylaws provide a number of methods for admitting members such as by application, transfer (letter) or restoration. The membership of a religious corporation typically consists of an agreement between the member and the corporation, profession of faith and adherence to religious doctrines of the corporation. It is also a common requirement for membership that clergy and leaders of the corporation prior to being accepted as members interview the candidate or the candidate undergo training (orientation) provided by the corporation. Once an individual is admitted as a member, it is important that the corporation defines the on-going obligations of the member and determine what members are in “good standing.” Consequently, it is important
that the bylaws establish a procedure to admit members, and keep a current and accurate list of members.

**Authority of Members**

If the corporation has members, the bylaws should clearly set forth the rights and privileges associated with membership. This is important because membership typically grants certain rights and privileges to the member such as the right to attend meetings, nominating and voting privileges and the right to serve on committees. Generally, the most important decisions encountered by the corporation are made by the members. Generally, all members have the same rights and obligations with respect to voting and other matters, except as set forth in or authorized by the articles or bylaws. Often, the organization will establish more than one class of membership. Typically, religious corporations have at least two classes of membership: active and inactive. Active members are those individuals who regularly participate in church matters through attendance and/or financial support. Inactive members are typically individuals that have not attended regular church services for some specified period of time. Some corporations have additional classes of membership to meet a specific purpose. For example, the corporation may establish a mission or ministry in which it desires to admit those members into the corporation, but limit their rights to participate in the management of the corporation. In such a case, the corporation should clearly designate in its articles of incorporation or bylaws the classes of membership, and the qualifications and rights of the members of each class.

It is advisable that the articles or bylaws of a religious corporation address members’ rights to inspect and copy corporate records. The right to inspect corporate records can be used by members to disrupt and create conflict within the organization. Consequently, corporations should consider placing appropriate limits or abolishing the rights of a member to inspect and copy any corporate record. If the corporation’s governing documents are silent on inspection rights, then membership lists, financial statements and other records must be available for inspection by any member provided the member’s demand is made in good faith and for a proper purpose; the member describes with reasonable particularity the purpose and the records the member desires to inspect; and the records are directly connected with this purpose.

**Discipline and Dismissal of Members**

In addition, the bylaws should establish a procedure to discipline and dismiss a member from the organization. This situation may arise when a member’s conduct is clearly outside the proscribed commands of Scripture and negatively impact the corporation. No member may be expelled or suspended, and no membership terminated or suspended unless the procedure is fair and reasonable, and is carried out in good faith. A procedure is fair and reasonable when either:
The articles or bylaws set forth a procedure that provides: (i) not less than fifteen days prior written notice of the expulsion, suspension or termination and the reasons therefore; and (ii) an opportunity for the member to be heard, orally or in writing, not less than five days before the effective date of the expulsion, suspension or termination by a person or persons authorized to decide that the proposed expulsion, termination or suspension not take place; or

- It is fair and reasonable taking into consideration all of the relevant facts and circumstances.

Any written notice given by mail must be given by first-class or certified mail sent to the last address of the member shown on the corporation's records. Any proceeding challenging an expulsion, suspension or termination, including a proceeding in which defective notice is alleged, must be commenced within one year after the effective date of the expulsion, suspension or termination. A member who has been expelled or suspended may be liable to the corporation for dues, assessments or fees as a result of obligations incurred or commitments made prior to expulsion or suspension.

The bylaws should also proscribe what person or group will be responsible for the decision, and provide for reinstatement of the member if appropriate. Generally, organizations designate a group of individuals responsible for decisions regarding discipline and reinstatement of members. Commonly, this is the board of directors, membership committee, elders or similar group of individuals. Generally, courts follow the rule of non-intervention in internal church membership determinations since no “cognizable legal harm” had occurred. However, courts have increasingly become willing to intervene in these disputes and have granted a wide variety of remedies, including monetary damages. Generally, these cases are based on one or more of the following causes of action:

- Breach of contract;
- Defamation; and
- Intentional or negligent infliction of emotional distress

It should be remembered that an organization’s actions to discipline or dismiss a member could be viewed harshly by outsiders, such as a jury. This is reflected in the following comments that were made by jurors in a recent lawsuit in which a church was held liable for damages because of the way it handled the excommunication of a member who refused to repent of adultery:

"How a person lives his private life is between that person and God, not between that person and the elders of the church. Let these elders tend to more critical matters of their church."

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8 Gonzalez v. Roman Catholic Archbishop, 280 U.S. 1, 16 (1928).
In cases that have involved a dispute contesting the discipline of a church member, one key factor that has benefited corporations has been the member’s failure to exhaust all of the remedies available to them under the corporation’s bylaws. Generally, courts will not review a member’s claim of wrongful termination of membership unless the expelled member used every available procedure within the corporation to review their expulsion. The lesson to corporations is to provide a legitimate appeal process for all discipline and termination decisions.

Thus, religious organizations should implement guidelines for church discipline that are based upon and refer to scriptural references. The guidelines should specify the grounds for discipline and describe the process to be conducted. Statements by leaders to members concerning the discipline of a current member are conditionally privileged, unless the organization acted maliciously. However, disclosures made to a congregation during worship service in which non-members were present would not be protected. A good rule of thumb is to take steps that safeguard the privacy of the member. Constitutional protections generally allow a religious organization to govern its own affairs, including the decision of who are and who are not members. However, the rules adopted by the organization must be strictly followed when taking away the rights or privileges of a member. Failure to establish clear rules and procedures can create liability exposure to the organization.

Meetings

General

Typically, the decisions of the corporation are made in a meeting of the directors and/or members. Corporate meetings must be conducted in accordance with the procedural requirements ordinarily specified in the corporation’s articles or bylaws. The most common requirements pertain to notice, quorum, and voting. Thus, it is important that the governing documents describe the notice and quorum requirements of church meetings, as well as the rules of procedure. Most courts refuse to intervene in church disputes concerning the validity of a membership meeting that was not conducted in accordance with the procedural requirements specified in the church’s governing documents. However, a growing number of courts are willing to intervene in such disputes if they can do so without inquiring into religious doctrine or polity. The Alabama Supreme Court ruled that a trial court acted properly in vacating a church election that was conducted in violation of the church's governing document.

A female employee of a church filed an informal complaint with the church's board of deacons against the senior pastor, accusing him of improperly using the church's funds for his own use, providing false financial statements to the board at its monthly meetings, and failing to withhold income taxes from several employees' paychecks. The board later met with the pastor, and he admitted that he had misappropriated funds for his own use and that income taxes had not been withheld from some employees' paychecks, but assured the

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9 Yates v. El Bethel Primitive Baptist Church, 847 So.2d 331 (Ala. 2002).
board members that he wished to work with them to resolve these issues. The board attempted to remove the pastor from the management of the church so it could investigate the many allegations against him, but the pastor refused to cooperate. In response to the board’s attempts to remove him, the pastor proposed that the congregation elect new board members. A congregational meeting was held, at which the pastor encouraged the members to remove the deacons who opposed him. The pastor then introduced the pastor of another church to preside over the election. At the conclusion of the meeting, the congregation, by a vote of 130 to 100, ousted the board members who opposed the pastor and elected a new board comprised of church members who were in favor of the pastor.

Some of the ousted board members asked a court to set aside the election on the ground that it violated the denomination's book of discipline. Specifically, the board argued that the pastor (1) failed to inform the board of the matters he planned to raise at the church meeting as required by the denomination's book of discipline; (2) failed to follow the procedures of the book of discipline in conducting the election meeting, including denying any of the members present at the election meeting the right to ask questions or otherwise to be heard; (3) failed to determine whether persons voting in the election were "members of good standing" of the church, as required by the book of discipline; (4) intimidated the members into voting the way he suggested they vote; and (5) failed to use the denomination's own moderator to oversee the meeting, although he had offered his services, choosing instead to call in a moderator from another denomination.

The trial court set aside the election, concluding that a church is bound to follow its own rules, and that it had failed to do so. The case was appealed to the state supreme court. The court began its opinion by noting that it had on a number of occasions "exercised jurisdiction to determine whether an election meeting of a church, or a similar meeting, was conducted so improperly as to render its results void." Further, it noted that while the civil courts "will not assume jurisdiction to resolve disputes regarding their spiritual or ecclesiastical affairs . . . there is jurisdiction to resolve questions of civil or property rights." The court concluded that it could "properly exercise jurisdiction, given the financial and property rights of the church that were involved . . . and that the election violated the book of discipline in several material respects and also violated basic standards of due process." It emphasized that the parties in this case "argue no issues of differences in religious faith or creed, and argue no spiritual conflicts, or ecclesiastical doctrine. Rather, the underlying dispute revolves around the property of the church--control over its financial assets and affairs--and not God." The court concluded, "the record indeed supports a finding that . . . the procedures for elections, as enumerated in the book of discipline, were not followed. Thus, we hold today that the trial court did not err in setting aside the election."  \(^{10}\)

**Notice Requirements**

When establishing notice requirements, the corporations should establish procedures that balance the need that members have to be aware of important matters, with the burden the corporation would have in providing such notice. Care should be taken to not impose

\(^{10}\) Id.
onerous notice requirements on the organization. Generally, notices should be in writing, but may be oral if the circumstances are reasonable. Unless the bylaws provide that no notice of annual or regular meeting shall be required, the law of most states require that members be notified of the place, date and time of each annual, regular and special meeting of members in a fair and reasonable manner. Such notice may be communicated by telephone, public announcement, fax, e-mail or by mail or private carrier.

The corporation should also consider defining situations in which prior notice of the agenda should be communicated to the members. Most business matters can be conducted in regular business meetings without prior notice of the agenda. However, the nonprofit corporations laws of most states require prior notice be provided to members if the corporation is considering dissolution, merging with another organization, amending governing documents or the sale of substantially all of the corporation’s assets. The corporation may also consider providing prior notice of the agenda if dismissing a clergy member, purchasing or selling real property or other significant items.

Notice may be oral or written. Notice may be communicated in person; by telephone, telegraph, teletype, or other form of wire or wireless communication; or by mail or private carrier; if these forms of personal notice are impracticable, notice may be communicated by a newspaper of general circulation in the area where published; or by radio, television, or other form of public broadcast communication. Oral notice is effective when communicated if communicated in a comprehensible manner. Written notice, if in a comprehensible form, is effective at the earliest or the following:

- When received;
- Five days after its deposit in the United States Mail, as evidenced by the postmark, if mailed correctly addressed and with first class postage affixed;
- On the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee; or
- Thirty days after its deposit in the United States Mail, as evidenced by the postmark, if mailed correctly addressed and with other than first class, registered or certified postage affixed.

Written notice is correctly addressed to a member of a domestic or foreign corporation if addressed to the member's address shown in the corporation's current list of members. A written notice or report delivered as part of a newsletter, magazine or other publication regularly sent to members shall constitute a written notice or report if addressed or delivered to the member's address shown in the corporation's current list of members, or in the case of members who are residents of the same household and who have the same address in the corporation's current list of members, if addressed or delivered to one of such members, at the address appearing on the current list of members.
Quorum

A quorum is defined as the number of members required to be present at a meeting in order for the meeting to be considered a legal meeting of the corporation. The failure to have a quorum of members present could invalidate any business conducted at that meeting. The corporation may set any number or percentage of members required to constitute a quorum. The Model Act provides that one tenth of the members of the corporation entitled to vote constitutes a quorum, unless the articles of incorporation or the bylaws state some other percentage. Further, unless twenty percent or more of the members are present, the only matters that may be voted upon at an annual or regular meeting of members are those matters that are described in the meeting notice. These “default” percentages can place a significant burden on religious organizations that typically have difficulty attracting members to business meetings. Consequently, it is important that the corporation’s bylaws specify an attainable quorum requirement rather than resorting to the default percentage.

Voting

After fixing a record date for a notice of a meeting, the corporation should prepare an alphabetical list of the names of all its members who are entitled to notice of the meeting. Typically, a corporation’s secretary prepares the list. The list must show the address and number of votes each member is entitled to vote at the meeting. The corporation shall prepare on a current basis through the time of the membership meeting a list of members, if any, who are entitled to vote at the meeting, but not entitled to notice of the meeting. This list shall be prepared on the same basis and be part of the list of members.

Except in certain situations, the vote of a majority of the members present at a meeting at which a quorum is present is required to authorize any action by the corporation, unless the articles or bylaws requires a greater vote. In situations such as the corporation merging with another organization, dissolution of the corporation or the sale of substantially all of the assets of the corporation, a greater percentage is required. The Model Act requires that at least two-thirds of the members approve of such actions. Unless the articles or bylaws provide otherwise, each member is entitled to one vote on each matter voted on by the members. If a membership stands of record in the names of two or more persons, their acts with respect to voting shall have the following effect:

- If only one votes, such act binds all; and
- If more than one votes, the vote shall be divided on a pro rata basis, unless the articles or bylaws provide otherwise

The bylaws should also address the issue of voting agreements and proxy voting. A voting agreement is where two or more members provide for the manner in which they will vote by signing a written agreement for that purpose. Under the Model Act, such agreements are enforceable and may be valid for a period of up to ten years. For public benefit corporations such agreements must have a reasonable purpose not inconsistent with
the corporation's public or charitable purposes. A proxy is a written and signed authorization for another person to vote or otherwise act for the absent member. If the bylaws do not provide otherwise, proxy voting is permitted under the Model Act.

Parliamentary Procedures

A best practice is for the corporation to adopt rules of parliamentary procedure for the conduct of its meetings. If the corporation decides to adopt such rules for its meetings, the bylaws should specify which rules and edition are to be used. For example, Roberts Rule of Order and the Model Rules of Orders are commonly used in the conduct of meetings. Further, the corporations should designate someone to be responsible for learning the selected rules such as a moderator. Failure to follow the established rules of procedure can invalidate a decision made at that particular meeting.

Annual and Regular Meetings

Under the nonprofit corporations laws of most states, a corporation with members must hold a meeting of its membership annually at a time stated in or fixed in its articles or bylaws. However, under the Model Act the failure to hold an annual meeting at a time stated in the corporation's bylaws does not affect the validity of any corporate action. The purpose of the annual meeting is to keep the members of the corporation advised on the activities and financial condition of the corporation. Typically, this is accomplished by reports to the members from the corporation’s chief executive officer and the chief financial officer. The members may also consider and act upon other matters that may be raised consistent with the corporation’s notice requirements, such as election of directors and officers. Thus, the bylaws should also establish whether matters might be raised from the floor during the annual meeting of members.

The laws of some states do not require that annual meetings of members be held. The Georgia Supreme Court ruled that a provision in the state nonprofit corporations code mandating annual membership meetings did not take priority over a provision in a church’s bylaws calling for membership meetings once every four years. The court held that state nonprofit corporation law did not override the church’s own bylaws and therefore the church was required to conduct meetings only once every four years. The court observed that the state nonprofit corporations law itself specifies that if any of its provisions are inconsistent with religious doctrine governing a nonprofit corporation’s affairs on the same subject, “the religious doctrine shall control to the extent required under the Constitution of the United States or the Constitution of this state or both. The frequency with which a church’s membership meets is a matter of religious doctrine having constitutional precedence over inconsistent statutory provisions.” The court also noted that the church in this case was “hierarchical” in nature, and that the members had very limited authority to direct church affairs.11

11 First Born Church of the Living God, Inc. v. Hill, 481 S.E.2d 221 (Ga. 1997).
Most corporations also conduct regular meetings of its membership at monthly or quarterly intervals to consider and act upon business matters of the corporation. Generally, the corporation holds regular membership meetings at the times stated in or fixed in accordance with the bylaws. Annual and regular meetings of its members may be held at the place stated in the bylaws. If no place is stated in or fixed in accordance with the bylaws, annual and regular meetings shall be held at the corporation's principal office. Some states permit actions without a meeting. In such instances, any action taken at a meeting of members may be taken without a meeting if consent by all of the members entitled to vote is provided in writing.

**Special Meetings**

Special meetings, unlike annual and regular meetings, require written notice stating the place, day and hour of the meeting and the purpose or purposes for which the meeting is called to each member. Only those matters that are within the purpose or purposes described in the meeting notice may be conducted at a special meeting of members. A corporation with members must hold special meetings of members on call of its board or the person or persons authorized to do so by the articles or bylaws, such as the chief executive or chairman of the board. The Model Act also contains special provisions for religious organizations that permit the calling of a special meeting upon written demand of at least five percent of the voting power of the corporation, except as provided in the articles or bylaws. The close of business on the thirtieth day before delivery of the demand for a special meeting to any corporate officer is the record date for the purpose of determining whether the five percent requirement has been met. Any demand must describe the purpose or purposes of the special meeting. If a notice for a special meeting demanded is not given within thirty days after the date the written demand or demands are delivered to a corporate officer, regardless of the requirements, a person signing the demand or demands may set the time and place of the meeting and give notice in accordance with the corporations governing documents.

**Officers**

**Number and Qualifications**

Under the Model Act, the corporation may determine which officers it will have and what their duties will be. However, at a minimum, the organization must designate individuals to serve as president, treasurer and secretary. "Secretary" means the corporate officer to whom the organization has delegated responsibility for preparation and custody of the minutes of the directors' and members' meetings, as well as authenticating the records of the corporation. Some religious corporations have trustees. This is generally based on custom or simply a holdover from the organization’s pre-incorporation status when title to property was held in the name of the organization’s trustees. If the corporation does have trustees, it should be careful to define their duties and responsibilities, as well as transfer existing property interests from the trustees to the corporation.
In larger corporations, especially those with full time employees who do the staff work associated with various board and/or committee functions, it may be necessary to provide for assistant officers in the bylaws. In addition, the bylaws should provide for the qualifications of the officers such as membership, length of service or other relevant criteria, as well as whether the officer may hold more than one office. The Model Act permits the same individual to hold one or more offices except the offices of president and secretary.

**Election and Term**

The bylaws should also provide whether the officers are appointed, and if so by whom, or elected. If the officers are to be elected, care should be taken to establish procedures by which the officers will be elected, as well as the term of office for each officer. Some organizations impose limits on the number of terms a non-staff officer can hold office, such as two (2) one-year terms. Also, in some organizations it is the members, at their annual meeting, who elect the board chair and/or president and sometimes other officers as well. If so, provisions should be made in the bylaws. Courts have held that unless stated in the corporation’s governing documents or state law, officers and trustees are to be elected by a majority vote of the members.\(^{12}\)

Members of clergy present unique issues to religious corporations that are not common to other types of nonprofit organizations. The senior clergy member within the corporation is typically elected by the members of the corporation eligible to vote at a meeting specifically called for that purpose. Other clergy members may be selected by the senior clergy member, elected by the corporation’s membership or appointed by the corporation’s board or similar group.

**Removal**

Finally, provisions should be included that permit the removal of any officer at any time with or without cause, including clergy members. Most courts have concluded that they are barred by the first amendment guarantees of religious freedom and non-establishment of religion from resolving challenges by dismissed clergy to the legal validity of their dismissals. A Michigan court dismissed a lawsuit brought by a pastor against members of his church who were attempting to remove him as pastor.\(^{13}\) The court noted that the first amendment guaranty of religious freedom “severely restricts federal and state courts from resolving disputes between a church and its members. In fact, jurisdiction over such matters is limited to determining property rights that can be resolved by the application of civil law.” In this case, a group of church members were attempting to oust their pastor. The pastor sued these members, claiming that they used the church facility, without proper authority, for meetings critical of him and for the purpose of an

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\(^{12}\) Gervin v. Reddick, 268 S.E.2d 657 (Ga. 1980).

unauthorized election to overthrow him as minister. He also claimed that the members took steps to announce the election to the congregation without following church procedures and rules, and that they made defamatory statements regarding his use of the church facility and its funds.

A trial court dismissed the lawsuit on first amendment grounds, and a state appeals court upheld the dismissal of the case. It concluded, “What the complaint here presents is an internecine ecclesiastical dispute between plaintiff and defendants, all members of a church, concerning whether the plaintiff acted appropriately as the church's minister. Whether the minister’s actions were appropriate depends almost entirely on an understanding of the internal church discipline, faith and organization of the church; in other words, this dispute is governed by ecclesiastical rule, custom and law. Accordingly, we conclude that the exercise of civil court jurisdiction over this dispute would excessively inhibit religious liberty.”

Committees

Generally, the work of a religious corporation is carried out by a number of committees of the board. However, committees are not required under the Model Act, but rather are provided for in the bylaws or by resolution of the board. Consequently, the bylaws should address the number and types of committees, their powers, and selection/removal of committee members. Most religious corporations have at a minimum:

- Nominating committee responsible for proposing persons for election as directors, officers and other positions within the corporation;
- Audit/finance committee responsible for reviewing annual statements, evaluating internal accounting controls and other financial matters;
- Personnel/compensation committee responsible for reviewing and evaluating the performance of the board and officers, determining appropriate salary and benefits and other personnel decisions;
- Membership committee responsible for reviewing the qualifications of candidates for membership, recommending membership criteria and reviewing membership categories; and
- Risk management committee responsible for reviewing the corporation’s risk exposures, studying how to avoid or reduce any losses arising from risk, and developing appropriate policies and procedures.

14 Id.
Amendments

Corporations that already have bylaws are encouraged to review them periodically to ensure that they are consistent with both the corporation’s operations, as well as state law. As an organization grows and develops, inconsistencies may arise between actual operations and bylaw requirements; if the bylaws are found to be inconsistent with current operating practices, it may be desirable to form a board committee to recommend amendments or to draft new bylaws. The organization’s secretary or counsel may be the best candidate to chair such a committee. Regardless of what process the corporation elects to amend its bylaws, it is advisable that the corporation’s attorney review any bylaws before being adopted by the corporation’s members.

If the corporation does not have bylaws, or the existing bylaws are silent regarding amendments, the process to adopt or amend the corporation’s bylaws is governed by state nonprofit corporations law. Generally, the first step to adopt or amend existing bylaws is for the members to be given “fair and reasonable” notice of a meeting for the stated purpose of adopting or amending the corporation’s bylaws. To be considered “fair and reasonable,” the notice should notify the members of the place, date and time of the meeting no fewer than ten days nor more than sixty days before the meeting date. The corporation might consider mailing/emailing notices to members when important topics such as amending bylaws are being considered. Next, the directors must recommend the bylaws to the members, unless the directors elect to make no recommendation because of a conflict of interest, and communicate the basis for its recommendation to the members. Finally, unless the bylaws require a greater vote, two-thirds of the votes cast is required to approve the amendment.

Indemnification

The corporation may want to consider adding a provision to indemnify its officers, staff and/or volunteers from lawsuits. Indemnification occurs when the corporation compensates or reimburses a person for a loss. Commonly, this is done if the individual is a party to a legal proceeding because the individual is or was a director, or performed some other duty on behalf of the corporation. Typically, state nonprofit laws limits indemnification to acts taken in his or her official capacity, and the act was in good faith and in the best interest of the corporation. The corporation should review its insurance policy to ensure adequate coverage (Director & Officer, volunteer coverage). If the corporation elects indemnification, it should also decide whether it desires to advance funds to pay for or reimburse reasonable expenses incurred while defending a lawsuit. In addition, if the corporation desires to limit an officer or staff member’s liability, or to limit the indemnification provided under applicable law, it must add a provision in the corporation’s articles of incorporation.

Disputed Control

Introduction
In the past, the vast majority of disputes within religious organizations were resolved through internal reconciliation or the aggrieved member disassociated from the organization. Aggrieved members would seek resolution of the dispute through the courts only in rare cases and with limited success. A long line of U.S. Supreme Court cases has held that “whenever the questions of discipline, or of faith, of ecclesiastical rule, custom or law have been decided by the highest church judicatory, the legal tribunals must accept such decisions as final.”\(^ {15}\) However, courts have increasingly become willing to intervene in these disputes and have granted a wide variety of remedies, including monetary damages.

The Georgia Court of Appeals recently ruled that it was not barred by the first amendment guaranty of religious freedom from resolving an internal church dispute involving compliance by the church’s members with state nonprofit corporation law in the dismissal of church board members.\(^ {16}\) In this case, the church’s board of directors terminated the senior pastor. The pastor refused to vacate his position, and the members of the church voted to remove the board members from both the board and the church. Church members then failed suit against the dismissed board members, claiming that they wrongfully took control of church bank accounts, issued checks from the church’s account and interfered with the church’s ability to sell its property. The dismissed board members asked the trial court to dismiss the lawsuit on first amendment grounds and the court agreed. The church members appealed.\(^ {17}\)

On appeal, the court observed that “while it is true that the court may not inquire into a controversy relating to religious matters, such as internal church procedures and expulsion from church membership, the court does have jurisdiction to resolve issues that do not require an impermissible intrusion or excessive entanglement into ecclesiastical matters. Without intruding upon religious or doctrinal matters, trial courts may legitimately considers matters such as the distribution or disposition of tangible church property such as bank accounts, property and other temporal assets. Here the trial court would not have to delve into any ecclesiastical matters to determine whether the former board matters are duly elected members of the church board of directors under the relevant statutes and controlling documents and to determine the disposition of the tangible church property at issue.”\(^ {18}\)

**Religious Protections**

All courts would agree that they are prohibited by the first amendment guaranty of religious freedom from resolving any internal church dispute requiring an interpretation of church doctrine. However, the courts interpret doctrine differently with some, such as the Georgia Court of Appeals, interpreting doctrine very narrowly, and therefore willing to resolve some church disputes. Most courts have interpreted these concepts much more broadly, and have refused to intervene in internal church disputes. A case in point is a recent ruling of a Texas court that it could not resolve an internal church dispute on the

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\(^ {17}\) Id.
\(^ {18}\) Id.
basis of the church’s constitution and bylaws since the critical provisions in these documents could not be applied without the court delving into church doctrine and governance.\textsuperscript{19}

In this case, the church hired a new senior pastor and sometime later, the church’s four trustees decided to fire him. However, the pastor refused to accept his termination. The trustees then sued the pastor and obtained a temporary restraining order restraining him from entering church premises and attempting to conduct services at the church. Several days later the congregation met after a morning worship service. It voted to remove the trustees and elected five new trustees. The new trustees then rehired the ousted pastor and asked the congregation to ratify its action by vote. All but two persons present at that meeting voted to rehire the pastor. A few days later, the new trustees sought a court order restraining the original trustees from acting in the name of the church, including any attempts to secure a new minister. The trial court rescinded the initial restraining order against the pastor and granted a new restraining order in favor of the new trustees. It restrained the original trustees from expending funds and acting in the name of the church, including any attempts to secure a minister for the church. The original trustees also were ordered to turn over the church’s books, records, and keys to the new trustees. The case was appealed to a state appeals court.\textsuperscript{20}

The court began its opinion by noting that the “central dispute” between the parties involved “who has the right to select and remove the trustee-directors and the minister.” Both sides relied on the church's articles of incorporation in support of their position. The court noted that the articles of incorporation specified, “The number of directors of the corporation shall be seven. The directors of the corporation shall at all times be selected according to the custom and practices of the church.” Similarly, the bylaws contained the following provision regarding the selection of officers, “The officers of the corporation shall be a chairman, a secretary and a treasurer selected according to the doctrine, custom and practices of the church. They shall serve until removed for cause or their successors are chosen by the congregation.”

The court noted, “ordinarily, we would construe the articles of incorporation of a Texas nonprofit corporation according to the body of neutral legal principles that governs Texas corporations generally. If we could do so without running afoul of constitutional constraints, we would also apply those principles to construe the articles of incorporation of a nonprofit corporation organized for religious or spiritual purposes.” However, it concluded that it could not apply neutral legal principles in construing articles of incorporation or bylaws of the church, since both documents used the phrase “custom and practices of the church.” Such language, removed any dispute regarding the selection of its directors from the purview of the judicial system. Interpreting this phrase would require the court to examine the historical, administrative, and ecclesiastical affairs of a religious organization and decide the outcome of the issue based on its determination of what are the customs and practices of the church. . . . Our deciding the central issue here would require us to interpret religious law and usage. Not only is that issue ambiguous, its resolution

\textsuperscript{19} Cherry Valley Church of Christ v. Foster, 2002 WL 10545 (Tex. App. 2002).
\textsuperscript{20} Id.
would require the state, through the judicial system, to determine issues of internal church governance. We may not delve into those issues. Further, both parties relied on a “governance document” that had been adopted by the congregation several years before. But, the court noted that this document was “replete with Biblical references. For example, a section entitled ‘the government of the local church’ is a list of citations and quotations from the New Testament.”

Religious organizations under the Model Act are afforded additional protections through express language that resolves inconsistencies between governance documents and religious doctrine. Specifically, if religious doctrine governing the affairs of a religious corporation is inconsistent with the provisions of the Model Act on the same subject, the religious doctrine shall control to the extent required by the Constitution of the United States or the constitution of this state or both.

**Alternative Dispute Resolution**

One means a religious corporation may use to address disputes within the organization is to have all members agree to resolve their disputes through alternative dispute resolution. This can be accomplished through a provision in the corporate bylaws, followed by written acknowledgement or agreement by the members. Such a provision would require all disputes within the corporation or between a member and the corporation that cannot be resolved through internal procedures be submitted to mediation. The provision should also state, if necessary, the dispute be resolved by legally binding arbitration in accordance with the rules of procedure of a respected organization, such as the Institute for Christian Conciliation, and judgment upon an arbitration award may be entered in any court otherwise having jurisdiction.

Furthermore, the dispute resolution agreement should address the selection of mediators and arbitrators and require all mediators and arbitrators be in agreement with the corporation’s statement of faith, unless the requirement is modified or waived by all parties to the dispute. If the dispute involves an attempted revision of the articles, bylaws or statement of faith, the mediators and arbitrators should be in agreement with those documents, as they existed prior to the attempted revision.

**Judicial Relief**

If for any reason it is impractical or impossible for any corporation to call or conduct a meeting of its members, delegates, or directors, or otherwise obtain their consent, in the manner prescribed by its articles, bylaws, or the Model Act, then upon petition of a director, officer, delegate, member or the attorney general, a court of competent jurisdiction may order that such a meeting be called or that a written ballot or other form of obtaining the vote of members, delegates, or directors be authorized, in such a manner as the court finds fair and equitable under the circumstances.

21 Id.
22 Revised Model Not for Profit Corporations Act
The attorney general shall be given notice of the commencement of any proceeding that the Model Act authorizes the attorney general to bring but that has been commenced by another person. Whenever any provision of the Model Act requires that notice be given to the attorney general before or after commencing a proceeding or permits the attorney general to commence a proceeding if no proceeding has been commenced, the attorney general may take appropriate action including, but not limited to, seeking injunctive relief. If a person other than the attorney general has commenced a proceeding, the attorney general, as of right, may intervene in such proceeding.

This presents a difficult question of the appropriate role the civil courts should play in overseeing church elections. The New Jersey appeals court concluded that “in the absence of clear and unambiguous direction in church law, an intra-church dispute over eligibility for nomination to church office, implicating as it does the more fundamental question of church governance and congregational structure, does not present a proper issue for judicial consideration.” It concluded: “Irrespective of the approach used, courts are admonished to scrupulously avoid incursions into questions of ecclesiastical polity or doctrine that would be constitutionally impermissible. To be sure, the task of reconciling respect for the autonomy of religious organizations with the responsibility of courts to resolve conflicts involving civil matters is a difficult one. Admittedly, in some instances there is a gray zone between express secular terms and religious doctrine, and the distinction between the court's duty to abstain from religious questions and to decide legal disputes is blurred. Complicating the matter is the fact that the once simple dichotomy between hierarchical and congregational polities does not reflect the diversity of contemporary denominational structures. . . .

In the present case, the trial court adjudicated no simple property or contract dispute but rather an essential issue of church governance, polity, and administration--namely whether the church is a true democracy controlled by its membership or a more republican, representative structure governed by internal ecclesiastical bodies. Purporting to apply so-called "neutral principles" of law, the trial court opted for the former based on an interpretation of church bylaws that vested nominating authority in any church member without prior screening and recommendation by the nominating committee. . . . We conclude that the trial court's ruling in this regard was an inappropriate application of "neutral principles" jurisprudence. First and foremost, the method of neutral principles does not allow for construction of church documents if their interpretation is the focus of dispute and if such documents are not so clear, provable, and express that the civil courts could enforce them without engaging in a searching, and therefore impermissible, inquiry into church polity. 24

Here, the issue of eligibility for office was a highly controverted question of faith within the congregation. Despite the obvious division of opinion, the basis for the trial court's resolution allowing for floor nominations is unclear, as are the rules of common law it relied upon to structure the church-member relationship implicated in this matter. In

24 Id.
essence, the trial judge interpreted the term "eligible" to be without any religious significance despite plaintiff's contrary contention that the nominating committee pre-screens candidates for spirituality and religiosity. We emphasize that the application of neutral principles does not require courts to "neutralize" ecclesiastical words.

In the absence of clear direction in church law, judicial inquiry into church procedures is precluded. Although courts may intervene to determine whether established procedures of a religious organization, as proven, have been followed, courts should not intervene where such procedures are . . . less than clearly defined, or ambiguous. Because of such uncertainty, resolution of intrachurch disputes cannot be made without extensive, and therefore impermissible, inquiry into religious law and polity. . . . In this case, inquiring whether the nominating committee has exclusive ecclesiastical authority to determine eligibility necessitates interpretation of ambiguous religious law, the resolution of which would require a deeper probe into the congregational structure and allocation of power within the church. For instance, in the absence of an express procedure in the church bylaws, inquiry need be made as to where within the church the rules of polity, accepted by its members before the schism, had placed ultimate authority over the eligibility question. . . . Simply stated, neutral principles of civil law do not include standards for judging appropriate qualities for church leadership. . . .

Application of these principles compels judicial abstention in this case. The trial court's opposite conclusion . . . unwittingly entrenched itself in church affairs . . . . The court below became entangled in election procedures, appointing a monitor with broad powers to determine not only qualifications of voters, but in essence qualifications for office. Unfortunately, the court's involvement did not end there. After approving the results of the election for church officers, the court, through its appointed representative, continued to monitor and supervise the pastoral election after first designating those members responsible for recommending candidates to the church for consideration and vote, a task that the bylaws clearly and expressly assign elsewhere.

The court concluded that the first amendment bars the civil courts from intervening in church elections involving questions of ecclesiastical polity or doctrine. Such was the case here, since the basic questions involved the selection of the church’s pastor and lay leaders. The opposite conclusion would entangle the civil courts in church affairs. The court concluded that it could intervene in an internal church dispute to see if a church had followed its own procedures, but only if those procedures were clear and “proven” and a decision could be made without “extensive, and therefore impermissible, inquiry into religious law and polity.”

**Derivative Suits**

A proceeding may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor by:
• Any member or members having five percent or more of the voting power or by fifty members, whichever is less; or,

• Any director

In any such proceeding, each complainant shall be a member or director at the time of bringing the proceeding. A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand made, if any, to obtain action by the directors and either why the complainants could not obtain the action or why they did not make the demand. If a demand for action was made and the corporation's investigation of the demand is in progress when the proceeding is filed, the court may stay the suit until the investigation is completed.

On termination of the proceeding the court may require the complainants to pay any defendant's reasonable expenses (including attorney fees) incurred in defending the suit if it finds that the proceeding was commenced frivolously or in bad faith. If the proceeding on behalf of the corporation results in the corporation taking some action requested by the complainants or otherwise was successful, in whole or in part, or if anything was received by the complainants as the result of a judgment, compromise or settlement of an action or claim, the court may award the complainants reasonable expenses (including counsel fees). The complainants shall notify the attorney general within ten days after commencing any proceeding under this section if the proceeding involves a public benefit corporation or assets held in charitable trust by a mutual benefit corporation.

Pennsylvania Appeals Court affirming a trial court’s conclusion that the state nonprofit corporation laws could not be used by disgruntled church members as a legal basis for the removal of the church board of directors. Two groups within the church accused each other of attempting to take over the church and its assets for its own person gain. The struggle prompted one group to ask a civil court to remove the church’s board and appoint a custodian for the church pursuant to the state nonprofit corporation law which states that “the court may, upon petition of any member or director, remove from office any director in case of fraudulent or dishonest acts, or gross abuse of authority or discretion with reference to the corporation, or for any other proper cause. The corporation shall be made a party to such action.”

At trial, the plaintiffs attempted to prove that the conduct of the board constituted “illegal, oppressive or fraudulent acts” and that they “misapplied or wasted corporate assets.” The trial court concluded that the actions of the board were not sufficiently severe to trigger “the drastic remedy of judicial supervision of the church’s affairs.” It determined that much of what the plaintiff’s complained of was due to missing information for which records had never been maintained rather than information that had been hidden from members. Significant to the court was the fact that no member who demanded and received records from the board was sufficiently dissatisfied to challenge any action of the board.

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25 Section 5726
The plaintiffs also asked the court to rule that a $1.5 million transaction entered into by the board constituted an illegal diversion of corporate assets. According to the plaintiffs, the board, on two days notice, called a special meeting for the purpose of, among other issues, discussing an item described only as “ICP Funding.” When this item came before the board, a majority of the board voted to transfer the funds from the church to ICP. The ICP was composed of four members of the board, and the $1.5 million was placed in a fund under their sole control. The trial court declined to void the transaction on the ground that doing so would be prohibited by the first amendment.

A state appeals court agreed with the trial court’s conclusion that the board’s conduct was not so severe as to warrant relief under the state nonprofit corporation law. However, the appeals court disagreed with the trial court’s conclusion concerning the $1.5 million transaction. The court concluded, “The resolution of the dispute regarding the transfer of $1.5 million does not require a court to determine any ecclesiastical issue. The propriety of the transfer was a pure question of corporate law that should have been addressed by the trial court.” The court noted that the special board meeting in which the $1.5 million transaction was approved was “held on two days notice which means that the meeting was held in violation of the state nonprofit corporations laws that requires written notice of a special meeting be given to each member of the board at least five days before the day of the meeting.”

Disputes concerning the management and control of the organization can be minimized with effective and current bylaws. Require membership commitments that provide "informed consent" to policies of the organization. Use conciliation clauses in the organization’s bylaws; these clauses require that subsequent conflicts or lawsuits be resolved through mediation or arbitration based on scripture rather than litigation. Finally, the biggest source of dispute concerning the management of a religious organization is positions on faith itself. Religious organizations should develop a “statement of faith” that clearly outlines the position of the organization with respect to matters of scripture and worship.

27 Id.
ATHLETIC CODES OF CONDUCT: DOES YOUR PROGRAM NEED ONE?

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THINGS WE WANT TO STOP

- VERBAL ABUSE
- THREATS
- VIOLENCE
- LITTERING
TAUNTING/BAITING
- EMBARRASS
- RIDICULE
- DEMEAN
CHARACTER IS DESTINY: THINGS WE WANT TO PROMOTE

- SPORTSMANSHIP
- RESPECT: FOR EACH OTHER, OPPONENTS, OFFICIALS, PARENTS, COACHES, ACA2S
- GRACE UNDER PRESSURE
- PLAYING BY THE RULES
- “NICE CATCH, CHIEF”
LEGISLATING SPORTSMANSHIP

WAXING POETIC – RESOLUTIONS

RHODE ISLAND STATE SENATE
STATUTES & ORDINANCES

“THE FORCE OF LAW” – OK TO HAVE GUIDELINES AND PENALTIES
“GROUNDING” -- CUTTING THE FUNDING

some laws require that codes of conduct be promulgated and enforced or access to recreational facilities denied
CARB FREE

- CRIMINALIZE – GOING ALL THE WAY: ENHANCED CRIMINAL SANCTIONS FOR UNCIVILIZED BEHAVIOR
- NO PLEDGES, NO CODES OF CONDUCT, NO SEMINARS – GO STRAIGHT TO JAIL
HYBRIDS

- CODE OF CONDUCT
- ENHANCED CRIMINAL PENALTIES
- CUMULATIVE REMEDIES
STATE LAW

- NJ
- OR

LOCAL LAWS

- GLASSBORO, NJ
- WASHINGTON TOWNSHIP, NJ
- NEW YORK CITY, NY
- NASSAU COUNTY, NY
- CITY OF SCARSDALE, NY
- CITY OF MACON, GA
THE LAW STEPS
IN N.J.S.A. 5:17

ATHLETIC CODE OF CONDUCT
MAY BE ESTABLISHED BY
YOUTH SPORTS
ORGANIZATION OR
SCHOOL BOARD
MAY REQUIRE SIGNED AGREEMENT NOT TO ENGAGE IN THREATS/FIGHTS AGGRESSIVE CONDUCT
VIOLATIONS =
CANNOT ATTEND EVENTS
UNTIL ANGER MANAGEMENT COUNSELING
CITY OF MACON, GEORGIA
GUIDELINES FOR USE OF CITY FACILITIES AND GOVERNMENT FUNDED OR SUPPORTED SPORTS ORGANIZATIONS

- PARENTS MUST AGREE TO CODE OF ETHICS POLICY
- ANYONE ARRESTED BANNED UNTIL COURT ORDER
- VIOLATIONS OF SPORTSMANSHIP = SUSPENSION FROM ATTENDANCE FOR SEASON
CITY OF MACON, GEORGIA

- VERBAL ABUSE
- CONFRONTATION
- PROFANITY OR SLURS
- THROWING OBJECT ON PLAYING SURFACE DURING EVENT
- ENTERING “NO SPECTATOR ZONE”
  - ALL VIOLATIONS OF CODE
MACON, GEORGIA CODE

- “NO SPECTATOR ZONE”
- A DEFINED AREA FOR EACH SPORT POSTED AT VENUE
- GROUNDS FOR REMOVAL FOR DURATION OF SEASON
MACON, GEORGIA CODE

- PARENT/GUARDING MUST ATTEND ORIENTATION PROGRAM EACH YEAR
AN EDUCATIONAL EXPERIENCE – COST OF TICKET INCLUDES GOING TO CLASS BEFORE GOING TO A GAME
NASSAU COUNTY, NY

- “FAIR PLAY AGREEMENTS” REQUIRED
- SIGNED BY EACH PARTICIPANT/PARENT
- APPLIES TO ANY USE OF COUNTY PROPERTY FOR SPORTS OR REC
- NO SIGNATURES = NO PLAY
- PASSED 9/23/02 BY VOTE OF 10-9
SUFFOLK COUNTY, NEW YORK—PROPOSED REQUIREMENTS TO USE COUNTY SPORTS FIELDS

20 GUIDELINES REQUIRED OF ANY TEAM USING COUNTY FIELDS

- I.E., EQUAL APPLAUSE FOR BOTH TEAMS
- LAUGHING AT OTHERS’ MISTAKES UNACCEPTABLE
- NO CHEERING AGAINST OPPONENTS
NYCLU OPPOSED

PROPOSAL ABANDONED
CITY OF NEW YORK CODE OF CONDUCT FOR YOUTH SPORTS

REQUIREMENT

- Applies to any youth sports organization that uses city facilities or receives city funding.
- Anyone barred for misconduct can may be required to attend anger management counseling.
OREGON-CRIMINAL TRESPASS LAW- YOUTH SPORTS

GAME OFFICIAL MAY EJECT PLAYER, COACH OR SPECTATOR FOR “INAPPROPRIATE BEHAVIOR”

FAILURE TO LEAVE, OR RETURNING IS A CRIMINAL TRESPASS-CLASS B MISDEMEANOR
“INAPPROPRIATE BEHAVIOR”

- SERIOUS UNSPORTSMANLIKE
- ABUSIVE
- THREATENING CONDUCT
- CONDUCT THAT INTERFERES, OR THREATENS TO INTERFERE WITH AN EVENT

- NOTE: MINOR PARTICIPANT EJECTED? WHERE DO THEY GO? WHO DO THEY GO WITH?
PRACTICAL GUIDELINES FOR IMPLEMENTATION: 8 THINGS YOU NEED TO DO

1. HAVE OBJECTIVES
   - APPROPRIATE FOR PROGRAM
   - AGE GROUP, LEVEL OF COMPETITION
   - COMMUNITY
2. DEFINE PROHIBITED BEHAVIOR
3. REMOVE THE IRRITANTS
4. ENFORCE PLAYING RULES
5. COVER THE HIGH END
6. HAVE A PLAN – AND FOLLOW IT!
7. SIGN A CONTRACT
8. DON’T HAVE RULES YOU CAN’T ENFORCE
AN ACT concerning the establishment of athletic codes of conduct for players, coaches, officials and parents and supplementing Title 5 of the Revised Statutes.

BE IT ENACTED by the Senate and General Assembly of the State of New Jersey: C.5:17-1

Athletic code of conduct, permitted; "youth sports event" defined.
1. a. A school board or youth sports team organization may establish an athletic code of conduct. An athletic code of conduct established pursuant to the provisions of this act shall contain guidelines for conduct of behavior to be observed at youth sports events and shall permit the school board or youth sports team organization to ban the presence of any person at youth sports events who (1) engages in verbal or physical threats or abuse aimed at any student, coach, official or parent, or (2) initiates a fight or scuffle with any student, coach, official, parent, or other person if the conduct occurs at or in connection with a school or community sponsored youth sports event.

b. As used in this act, "youth sports event" means a competition, practice or instructional event involving one or more interscholastic sports teams or sports teams organized pursuant to a nonprofit or similar charter or which are member teams in a league organized by or affiliated with a county or municipal recreation department.

C.5:17-2 Athletic code of conduct established by school board, agreement required for participation.
2. A school board which has established an athletic code of conduct pursuant to the provisions of this act may require that all students, coaches, officials, or parents of students as a condition of participation in any athletic program by the student, agree in writing to a code of conduct established pursuant to section 1 of P.L.2002, c.74 (C.5:17-1) which would require the student, parent, coach or official to refrain from verbal or physical threats or abuse aimed at any student, coach, official or other parent, or, from initiating any fight or scuffle with any person. The board shall have the power to ban the presence of any student, coach, parent or official at any subsequent school sports event who shall violate the athletic code of conduct.

C.5:17-3 Athletic code of conduct established by certain sports teams, agreement required for participation.
3. Any sports teams organized pursuant to a nonprofit or similar charter or which are member teams in a league organized by or affiliated with a county or municipal recreation department may require that all youth athletes, coaches, officials, or parents of youth athletes as a condition of participation in any athletic program by the youth athlete agree in writing to a code of conduct established pursuant to section 1 of P.L.2002, c.74 (C.5:17-1) which would require the youth athlete, parent, coach or official to refrain from verbal or physical threats or abuse aimed at any student, coach, official or other parent, or, from initiating any fight or scuffle with any person. The sports team shall have the power to ban the presence of any youth athlete, coach, parent or official at any subsequent youth sports event who shall violate the code of conduct.

C.5:17-4 Violation of code, ban; resumption of participation on counseling.
4. Any student, coach, official, parent or other person subject to the terms and conditions of an athletic code of conduct established pursuant to the provisions of P.L.2002, c.74 (C.5:17-1 et seq.) who violates the provisions of the athletic code of conduct, may be banned from attending any subsequent school or community sponsored youth sports event. In the event that any student, coach, official, parent or other person subject to the terms and conditions of an athletic code of conduct is banned from attendance, that person may petition the school board or sports team for permission to resume attendance. Prior to being permitted to resume attendance, the
school board or sports team shall require the individual to present proof of completion of anger management counseling through a public or private source.

C.5:17-5 Attorney General to promulgate model code, policies.
5. The Attorney General shall promulgate:
   a. (1) A model athletic code of conduct which may be adopted by a school board or youth sports team organization pursuant to the provisions of this act; and
   (2) Model policies regarding banning a person from a school or community sponsored youth sports event, minimum requirements for anger management counseling and permitting a person to resume attendance subsequent to the completion of anger management counseling, which may be adopted by a school board or youth sports team organization pursuant to the provisions of this act.
   b. In developing these models, the Attorney General shall consult with youth interscholastic or nonprofit community sports organizations, county and municipal recreation departments and any other organization deemed appropriate.

6. This act shall take effect immediately.

State of New Jersey

Model Policies Regarding Banning a Person from a School or Community Sponsored Youth Sports Event

The following model policies regarding banning a person from a school or community sponsored youth sports event are promulgated in accordance with the provisions of P.L. 2002, Chapter 74.

Pursuant to the provisions of P.L. 2002, Chapter 74, a school board or youth sports organization may ban the presence of a person at a youth sports event in accordance with the following guidelines:

1. A coach, parent, player, participant, official or other youth sports event attendee who violates one or more of the provisions contained in the Model Athletic Code of Conduct may be banned from attending, coaching, officiating or participating in at least one youth sports event if the person;
   a. has been issued a prior written warning for violating one or more of the provisions contained in the Model Athletic Code of Conduct,
   b. violates the Model Athletic Code of Conduct by engaging in verbal or physical threats or abuse aimed at any coach, parent, player, participant, official or any other attendee, or
   c. violates the Model Athletic Code of Conduct by initiating a fight or scuffle with any coach, parent, player, participant, official or any other attendee.

2. A coach, parent, player, participant, official or other youth sports event attendee may be permitted to attend, coach, officiate or participate in a youth sports event from which the person has been banned pursuant to the provisions of Section 1 of these Model Policies if the person;
   a. provides a written request for permission to resume participation or attendance to the school board or youth sports organization which issued the ban,
   b. provides a written apology to the school board or youth sports organization which issued the ban, and to the person or persons who were the subject of the behavior which constituted the violation of the Code, as directed by the school board or youth sports organization,
   c. demonstrates the completion, as required by the school board or youth sports organization, of an anger management counseling program which satisfies the provisions of Section 3 of these Model Policies, and
   d. satisfies any other requirement set forth by the school board or youth sports organization.

3. a. An anger management counseling program shall, at a minimum, offer services to individuals, singly or in groups, for the purposes of promoting anger control principles and shall be administered by an individual;
   i. licensed as a professional counselor pursuant to the provisions of the “Professional Counselor Licensing Act,” N.J.S.A. 45:8B-33 et seq., or
   ii. licensed as a practicing psychologist pursuant to the provisions for the “Practicing Psychology Licensing Act,” N.J.S.A. 45:14B-1 et seq.
   b. Nothing contained in this section shall prohibit a school board or youth sports organization from requiring a person banned pursuant to the provisions of these Model Policies to complete an anger management counseling program specified by such board or organization.
The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter’s notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners and the Drafting Committee and its Members and Reporter. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.

March 3, 2004
UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

The Committee acting for the National Conference of Commissioners on Uniform State Laws in preparing the Revised Uniform Management of Institutional Funds Act is as follows:

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# UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

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UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

PREFATORY NOTE

In 1972 the National Conference of Commissioners on Uniform State Laws approved the Uniform Management of Institutional Funds Act [hereafter referred to as UMIFA (1972)]. At that time uncertainty existed as to the standards that governed directors of charitable corporations in managing and investing the funds of the charitable organizations. Directors of a charity organized as a nonprofit corporation had been held to the investment standards that applied to trustees of private trusts. See Lynch v. John M. Redfield Foundation, 9 Cal. App. 3d 293 (1970), (stating that directors of a charitable corporation are essentially trustees and as such are held to an investment duty similar to that of a trustee of a private trust). See also Restatement (Second) of Trusts § 389 (1959). For directors of large institutions, the then-current restrictions on trust investing made the use of modern investment strategies problematic.

UMIFA (1972) provided guidance and authority to the governing boards of those charitable organizations within its scope on several issues. The statute gave a governing board broad investment authority and indicated that a governing board was not restricted to investments authorized for trustees. The statute permitted a board to delegate authority to independent financial advisors. With respect to endowment funds, the statute authorized a governing board to expend unrealized appreciation, even if the endowment fund provided only for the distribution of “income.” This provision enabled fund managers to use modern investment techniques such as total-return investing and unitrust-style spending. UMIFA (1972) also permitted the governing board to release restrictions on the use or investment of institutional funds if the restrictions had become “obsolete, inappropriate, or impracticable” and if the governing board could obtain the consent of either the donor or the court. Thus, the statute provided a mechanism for charities organized as corporations similar to the doctrine of cy pres that applies to charitable trusts.

The investment standards adopted by UMIFA (1972) foreshadowed a more extensive treatment of trust investment law in the Uniform Prudent Investor Act (1994) [hereafter referred to as UPIA]. UPIA applies modern portfolio theory to trusts, including charitable trusts. The Uniform Principal and Income Act (1997) furthered the principles of UPIA, providing tools for the use of investment techniques authorized under UPIA. The Uniform Trust Code (2000) [hereafter referred to as the UTC] expanded the application of the doctrine of cy pres. These Uniform Acts have informed the work of the Drafting Committee of the Uniform Management of Institutional Funds Act (200-) [hereafter UMIFA (200-)].

Objectives of the Act. UMIFA (200-) conforms its investment provisions to those of UPIA. The investment standards of UPIA already apply to charitable trusts, so the changes in the Act make the application of these standards consistent regardless of whether a charitable organization is organized as a trust, as a nonprofit corporation or in some other manner. The rules governing expenditures from endowment funds have been modified to give a governing board more flexibility in making expenditure decisions, so that the board can cope with
fluctuations in the value of the endowment. These rules are available to decision makers of charities organized as charitable trusts, as nonprofit corporations, or in some other manner. The provisions governing the release of restrictions have been changed to permit more efficient management of institutional funds.

**Other Legal Rules.** UMIFA (200-) addresses investment issues and issues relating to endowment funds but is not a comprehensive statute addressing all legal issues that apply to charitable organizations. For matters not governed by UMIFA (200-), a charitable organization will continue to be governed by rules applicable to charitable trusts, if it is organized as a trust, or rules applicable to nonprofit corporations, if it is organized as a nonprofit corporation.
SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform Management of Institutional Funds Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) “Charitable purpose” means the relief of poverty; the advancement of education or religion; the promotion of health; the promotion of governmental or municipal purposes; or another purpose the achievement of which is beneficial to the community.

(2) “Endowment fund” means an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of a gift instrument. The term includes two or more endowment funds collectively managed. The term does not include assets of an institution designated by the institution as an endowment fund for its own use.

(3) “Gift instrument” means a record or records under which property is granted to, transferred to, or held by an institution as an institutional fund. The term may include an institutional solicitation in the form of a record from which an institutional fund results.

(4) “Institution” means any nonprofit corporation, trust, unincorporated association, or entity organized and operated exclusively for charitable purposes. The term includes a government, governmental subdivision or agency, or a governmental organization to the extent that it holds funds exclusively for a charitable purpose. A trust that has both charitable and noncharitable interests becomes an institution after all noncharitable interests terminate.
(5) “Institutional fund” means a fund held for the exclusive use, benefit, or purposes of an institution. The term includes two or more institutional funds collectively managed. The term does not include program-related assets and does not include a fund in which a beneficiary that is not an institution has an interest, other than rights that could arise upon violation or failure of the purposes of the fund.

(6) “Program-related asset” means an asset held by an institution if the prevailing purpose of the asset is to accomplish a charitable purpose of the institution and not exclusively for the production of income or the appreciation of property.

(7) “Record” means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Comment

Subsection (1). Charitable Purpose. The definition of charitable purpose uses the same formulation as that in UTC § 405 and Restatement (Second) of Trusts § 368 (1959). The definition is the standard legal definition of charitable purposes, developed from the definition of charity set forth in the English Statute of Charitable Uses, enacted in 1601.

Subsection (2). Endowment fund. An endowment fund is an institutional fund or a part of an institutional fund that is not wholly expendable by the institution on a current basis. A restriction on use that makes a fund an endowment fund arises from the terms of a gift instrument. An institution may manage several funds together if the funds all have the same purpose. These funds would be considered one endowment fund for purposes of this Act.

Board-restricted funds are institutional funds but not endowment funds. The rules on expenditures and modification of restrictions in this Act do not apply to restrictions placed by an institution on an otherwise unrestricted fund held by the institution for its own benefit. The institution may be able to change these restrictions itself, subject to internal rules and to the fiduciary duties that apply to those that manage an institution.

If an institution transfers assets designated as an endowment to another institution, then the second institution will hold that fund as an endowment fund.
Subsection (3). Gift instrument. The term gift instrument refers to the records that establish the terms of a gift. As used in this definition, “record” is an expansive concept and means a writing in any form, including electronic. The term includes a will, deed, grant, conveyance, agreement, or memorandum, and also includes writings that do not have a donative purpose. For example, under some circumstances the bylaws of the institution, minutes of the board of directors, or canceled checks could be a gift instrument or be one of several records constituting a gift instrument.

Solicitation materials may constitute a gift instrument. For example, a solicitation that suggests in writing that any gifts received pursuant to the solicitation will be held as an endowment may be integrated with other writings and may be considered part of the gift instrument. Whether the terms of the solicitation become part of the gift instrument will depend upon the circumstances of the gift and whether a subsequent writing superseded the terms of the solicitation.

The term gift instrument also includes matching funds provided by an employer or some other person and includes an appropriation by a legislature or other public or governmental body for the benefit of an institution.

Subsection (4). Institution. The Act applies generally to institutions organized and operated exclusively for charitable purposes, using the definition of charitable purposes from UTC § 405. The term includes charitable organizations created as nonprofit corporations, trusts, unincorporated associations, governmental subdivisions or agencies, or any form of entity, however organized, that is organized and operated exclusively for charitable purposes. As used in this definition, the term “trust” is intended to mean a trustee acting under a charitable trust. The term includes a trust organized and operated exclusively for charitable purposes, regardless of whether a charity or a noncharitable corporation such as a bank acts as trustee.

UMIFA (1972) did not include trusts within its definition of institution. UMIFA (200-) applies to trusts, to nonprofit corporations and to all entities operated for charitable purposes regardless of their form of organization. UMIFA (200-) appropriately includes trusts because the rules for the management and investment of charitable funds should be the same regardless of the organizational structure of the institution. Many of the provisions of UMIFA (200-) come from trust law, so charitable trusts have already been subject to many of these rules.

The definition of institution includes governmental organizations that hold funds exclusively for the purposes listed in the definition. Some organizations created by state government may fall outside the definition due to the way in which the state created the organizations. Because state arrangements are so varied, creating a definition that encompasses all charitable entities created by states is not feasible. States should consider the core principles of UMIFA (200-) for application to governmental institutions. For example, the control over a state university may be held by a State Board of Regents. In that situation, the state may have created a governing structure by statute or in the state constitution so that the university is, in
effect, privately chartered. The drafting committee does not intend to exclude these universities from the definition of institution, but additional state legislation may be necessary to address particular situations.

**Subsection (5). Institutional Fund.** The term institutional fund includes any fund held by an institution for its own use, benefit, or purposes, whether expendable currently or subject to restrictions. The term also includes a fund held by a trustee that is not an institution, if the fund is held exclusively for the benefit of an institution. UMIFA (1972) excluded funds managed by corporate trustees. The Drafting Committee concluded that the provisions of UMIFA should be available to any fund managed exclusively for charitable purposes.

A fund held by an institution is not an institutional fund if any beneficiary of the fund is not an institution. For example, a charitable remainder trust held by a charity as trustee for the benefit of the donor during the donor’s lifetime, with the remainder interest held by the charity, is not an institutional fund. However, this subsection treats as an institution a charitable remainder trust that continues to operate for charitable purposes after the termination of the noncharitable interests. The Act will have only a limited effect on a charitable remainder trust during the period required to complete the distribution of the trust’s property after the noncharitable interest ends. The prudence norm will apply to the actions of the trustee, but the trustee will make decisions about investment and management of funds knowing that the trust will distribute its assets and not continue indefinitely.

If a governing instrument provides that a fund will revert to the donor if, and only if, the institution ceases to exist or the purposes of the fund fail, then the fund will be considered an institutional fund until such contingency occurs.

**Subsection (7). Record.** This definition was added to clarify that the definition of instrument includes electronic records as defined in Section 2(8) of the Uniform Electronic Transactions Act (1999).

**SECTION 3. STANDARD OF CONDUCT IN MANAGING AND INVESTING**

**INSTITUTIONAL FUNDS**

(a) In addition to duties imposed by law other than this [act], each individual responsible for the governance of an institution holding an institutional fund must, in managing and investing an institutional fund, act in a manner the individual reasonably believes to be in the best interests of the institution.
(b) In managing and investing an institutional fund, an institution may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.

(c) Each individual responsible for the governance of an institution must, in managing and investing an institutional fund, act in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.

(d) The provisions of subsections (e) through (k) are default rules and may be expanded, restricted, eliminated, or otherwise altered by the provisions of a gift instrument.

(e) In managing and investing institutional fund the following factors, if relevant, shall be considered:

1. the terms of the gift instrument;
2. the charitable purposes of the institution;
3. the purposes of the institutional fund;
4. general economic conditions;
5. the possible effect of inflation or deflation;
6. the expected tax consequences, if any, of investment decisions or strategies;
7. the role that each investment or course of action plays within the overall investment portfolio of the institutional fund;
8. the expected total return from income and the appreciation of investments;
9. other resources of the institution;
10. the needs of the institution and the institutional fund to make distributions and to preserve capital; and
(11) an asset’s special relationship or special value, if any, to the charitable purposes of the institution.

(f) An institution’s management and investment decisions about an individual asset must be made not in isolation but in the context of the institutional fund’s portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.

(g) An institution shall make a reasonable effort to verify facts relevant to the management and investment of an institutional fund.

(h) In addition to an investment authorized by law other than this [act], and subject to any specific restrictions set forth in law other than this [act], an institution may invest in any kind of property or type of investment consistent with the standards of this section.

(i) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversifying.

(j) An institution has a reasonable time after receiving property to make and implement decisions concerning the retention or disposition of the property, or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, distribution requirements, and other circumstances of the institution and the requirements of this [act].

(k) An individual who has special skills or expertise, or is named in reliance upon the representation that the individual has special skills or expertise, has a duty to use those special skills or expertise in managing and investing institutional funds.

Comment
Purpose and Scope of Revisions. This section adopts the prudence standard for investment decision making. The section directs the governing board to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. Section 3 applies to all funds held by an institution, regardless of whether the institution obtained the funds by gift or otherwise and regardless of whether or not the funds are restricted.


The Drafting Committee discussed at great length the standard that should govern nonprofit managers. UMIFA (1972) states the standard as “ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.” Since the decision in Stern v. Lucy Webb Hayes National Training School for Deaconesses, 381 F. Supp. 1003 (1974), the trend has been to hold directors of nonprofit corporations to a standard similar to the corporate standard.

The language of the prudence standard adopted in UMIFA (200-) is derived from the Revised Model Nonprofit Corporation Act and from the prudent investor rule from trust law. The standard is consistent with the business judgment standard under corporate law, as applied to charitable institutions. That is, a manager operating a charitable organization under the business judgment rule would look to the same factors as those identified by the prudent investor rule. Trust law norms already inform managers of nonprofit corporations. The Drafting Committee decided that by adopting the language of UPIA, UMIFA (200-) could clarify that UPIA’s articulation of the standards of prudent investing applies to all charitable institutions. The Committee believed that the greater precision of the prudence norms of the Restatement and UPIA, as compared with UMIFA (1972), could helpfully inform managers of charitable institutions.

UPIA applies to trusts and not to nonprofit corporations, but the Prefatory Note to UPIA explains that “the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.” Further, comment b to Restatement (Third) of Trusts: Prudent Investor Rule § 379, at 190-91 states that “absent a contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations.” Section 3 clarifies that the investment rules that apply to charitable trusts through UPIA apply to charitable corporations as well.
Other than the duty of loyalty, the duty to minimize costs and the duty to act in good faith, the provisions of Section 3 are default rules. A gift instrument or the governing instruments of an institution can modify these duties, but the charitable purpose doctrine limits the extent to which an institution or a donor can modify these duties.

Subsection (a). Duty of Loyalty. This subsection applies the duty of loyalty to performance of investment duties. Under existing laws the duty of loyalty requires a fiduciary acting on behalf of the institution to make decisions in the interests of the institution and not in the interests of the fiduciary or a third party. Trust law requires a fiduciary to act solely in the interests of the beneficiary, while nonprofit law uses a “best interests” standard. To the extent that trust law imposes a higher standard, trust law will continue to govern trustees who are subject to UMIFA (200-).

Subsection (b). Duty to Minimize Costs. Subsection (b) tracks the language of UPIA § 7 and requires an institution to minimize costs. An institution may prudently incur costs by hiring an investment advisor, but the costs incurred should be appropriate under the circumstances. See UPIA § 7 cmt.; Restatement (Third) of Trusts: Prudent Investor Rule § 227, cmt. M, at 58 (1992); Restatement (Second) of Trusts § 188 (1959).

Subsection (c). Duty to Act in Good Faith. The language in subsection (c) comes from Section 8.30 of the Revised Model Nonprofit Corporation Act. The duty to act in good faith involves considering the factors set forth in subsection (e).

Subsection (e). Prudent Decision Making. Subsection (e) takes much of its language from UPIA § 2(a) and § 2(c). In making decisions about whether to acquire or retain an asset, the institution should consider the institution’s mission, its current programs, and the desire to cultivate additional donations from a donor, in addition to factors related more directly to the asset’s potential as an investment. The direction in subsection (e)(1) to consider the terms of the gift instrument means that the institution must consider the donor’s intent in making decisions under Section 3 but does not mean that the donor can or should control the management of the institution.

Subsection (e)(5) reflects the fact that some organizations will invest in taxable investments that may generate unrelated business taxable income for income tax purposes.

Subsections (e)(2), (e)(3), and (e)(10) indicate that a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose. For an investment that is not a program-related asset but serves program-related purposes, due weight should be given to the programmatic purposes in determining the suitability of the investment.

[The Comment will delete the following 2 paragraphs and replace them with an explanation of the decision to remove program-related assets from UMIFA.] The Drafting
Committee considered making UMIFA (200-) inapplicable to assets used in carrying out an institution’s charitable purposes but decided against that approach because some assets serve both a program-related purpose and an investment purpose. Some members of the Committee expressed concern that assets that were only partially programmatic should not fall outside the scope of the prudence standard. If UMIFA (200-) excluded programmatic assets, an institution might attempt to justify an imprudent investment decision by arguing that the asset was related to the institution’s charitable purposes. Further, a line based on whether assets were “primarily” programmatic in nature would be difficult to enforce. The Drafting Committee concluded that the best approach was to make the programmatic element one factor in the decision-making process.

The degree to which an institution uses an asset to accomplish a charitable purpose will affect the weight given that factor in a decision to acquire or retain the asset. Thus, if a university acquires residential property near the edge of campus to hold for future development, the purpose of the property is one component of the decision to acquire the property but the institution must also consider other more directly investment-related factors. A decision to acquire land on which to build the university’s new science center will not be viewed as an investment for the production of a financial return but rather should be considered as an investment to accomplish a charitable purpose of the university. Assets held entirely for programmatic purposes should not be considered part of the institution’s investment portfolio for purposes of risk-return analysis and for benchmarking of investment returns. To do otherwise would adversely affect investment decision-making.

Subsection (f). Portfolio Approach. This subsection, taken from UPIA § 2(b), reflects the spread of portfolio theory in modern investment practice. UPIA and UMIFA (200-) both follow the articulation of the prudent investor standard in Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992).

Subsection (g). Duty to Investigate. This subsection incorporates the traditional fiduciary duty to investigate, stated in UPIA § 2(d). The subsection requires persons who exercise authority to make investment and management decisions to investigate the accuracy of the information used in making decisions.

Subsection (h). Broad Investment Authority. This subsection uses language derived from UPIA §§ 1(b). Consistent with the portfolio theory of investment, the subsection “clarifies that no particular kind of property or type of investment is inherently imprudent.” UPIA § 2, cmt. The reference to investments “authorized by law other than this [act]” includes state statutes creating legal lists for investments. This provision does not contravene any other state statute that authorizes specific investments and is designed to permit investments in a broad range of investments.

[Legislative Note: A state may want to delete the clause “in addition to an investment authorized by law other than this [act]” as unnecessary or may want to add a specific reference to
other law. Legislative counsel should review existing law to determine whether the legislature
should repeal existing rules on investments or should add a specific reference to those rules
here.]

Subsection (h) also provides that terms of a gift instrument or other law applicable to
institutions may limit the authority under this subsection. For example, the gift instrument for a
particular institutional fund might preclude the institution from investing the assets of the fund in
companies that produce tobacco products.

Subsection (i). Duty to Diversify. This subsection derives from UPIA § 3, see also
requires diversification but permits an institution to determine that nondiversification is
appropriate under the circumstances applicable to a fund. See UPIA § 3 cmt. (discussing the
rationale for diversification).

Subsection (j). Disposing of Unsuitable Assets. This subsection imposes a duty on an
institution to make a decision about retaining or disposing of property within a reasonable time
after the institution receives the property. The language comes from UPIA § 4, which restates
Restatement (Third) of Trusts: Prudent Investor Rule § 229 (1992), which itself took language
from Restatement (Second) of Trusts § 231 (1959). See UPIA § 4 cmt.

Subsection (k). Special Skills or Expertise. Subsection (k) states the rule provided in
UPIA § 2(f) requiring a trustee to use the trustee’s own skills and expertise in carrying out the
trustee’s fiduciary duties. The comment to RMNCA 8.30 describes the existence of a similar
rule under the law of nonprofit corporations. [MORE]

UMIFA (1972) contained two provisions that authorized investments in pooled or
common investment funds. UMIFA (1972) §§ 4(3), 4(4). The Drafting Committee concluded
that Section 3(h) of UMIFA (200-) authorizes these investments. The decision not to include the
two provisions in UMIFA (200-) does not mean that UMIFA (200-) implies no disapproval of
such investments.

SECTION 4. EXPENDITURE OF ENDOWMENT FUNDS; RULE OF
CONSTRUCTION.

(a) Subject to the terms of the gift instrument, an institution may expend or accumulate so
much of an endowment fund as the institution determines to be prudent for the uses, benefits, and
purposes for which the endowment fund is established. In making its determinations on
expenditures and accumulations, the institution shall exercise reasonable care, skill, and caution, and shall consider:

1. the purposes of the institution and the endowment fund;
2. general economic conditions;
3. the possible effect of inflation or deflation;
4. the expected total return from income and the appreciation of investments;
5. other resources of the institution;
6. preservation of the purchasing power of the endowment fund;
7. the investment policy of the institution;
8. the duration of the endowment fund; and
9. any other relevant circumstances.

(b) The following rules of construction apply to gift instruments executed or in effect before or after the effective date of this [act]:

1. To limit the authority to expend or accumulate funds under subsection (a), a gift instrument must specifically state the limitation.

2. A designation of a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends”, or “rents, issues, or profits”, or “to preserve the principal intact” or words of similar import, creates an endowment of indefinite duration but does not limit the authority to make expenditures or to accumulate under subsection (a).
Purpose and Scope of Revisions. This section revises the provision in UMIFA (1972) that permitted the expenditure of appreciation of an endowment fund to the extent the fund had appreciated in value above the fund’s historic dollar value. UMIFA (1972) defined historic dollar value to mean the value of all contributions to the fund. The new approach abandons the use of historic dollar value as a floor for expenditures and provides more flexibility to the institution in making decisions about whether to expend any part of an endowment fund. As under UMIFA (1972), a prudence standard applies to the process of making decisions about expenditures from an endowment fund.

Section 4 permits expenditures from an endowment fund to the extent the institution determines that the expenditures are prudent after considering the factors listed in subsection (a). These factors emphasize the importance of keeping the purposes of the institution and of the endowment fund in mind while also considering economic conditions. As under UMIFA (1972), expenditures do not depend on the characterization of assets as income or principal and are not limited to the amount of income and unrealized appreciation.

Institutions have operated effectively under UMIFA (1972) and have operated more conservatively than historic dollar value would have permitted. Institutions have no incentive to spend everything the law permits them to spend, and good practice has been to provide for modest expenditures while maintaining the purchasing power of a fund. Institutions have followed this approach even though UMIFA (1972) does not require an institution to maintain a fund’s purchasing power and allows an institution to spend any amounts in a fund above historic dollar value. The Drafting Committee concluded that eliminating historic dollar value and providing institutions with more discretion would not lead to depletion of endowment funds. Instead, UMIFA (200-) should encourage institutions to establish a spending approach that will be responsive to short-term fluctuations in the value of the fund. Section 4 allows an institution to maintain appropriate levels of expenditures in times of economic downturn or economic strength. In some years, accumulation rather than spending will be prudent, and in other years an institution may appropriately make expenditures even if a fund has generated no investment return that year.

Several levels of safeguards exist to prevent institutions from depleting endowment funds or diverting funds from the purposes for which they were created. Donors can restrict gifts and can provide specific instructions to donee institutions as to appropriate uses for assets contributed. Within institutions, fiduciary duties govern the persons making decisions on expenditures. Those persons must operate with the best interests of the institution in mind and in keeping with the intent of donors. If an institution diverts an institutional fund from the charitable purposes of the institution, the state attorney general can enforce the charitable interests of the public. By relying on these safeguards while providing institutions with adequate discretion to make decisions on appropriate expenditures, the Act creates a standard that takes into consideration the diversity of the charitable sector. The committee expects that industry standards will continue to evolve and inform institutions as the institutions apply this standard.
Section 4 provides guidance on factors to consider in exercising discretion but does not take away discretion by providing a cap or floor for distribution. The Drafting Committee discussed whether to provide a safe harbor for spending within a range based on percentages of the assets of the fund. The Committee concluded that specifying a range for appropriate distributions was unwise because a fixed range could not take into account the factors listed in subsection (a) or changes in market conditions. A fixed range might be appropriate under current conditions but would be unlikely to remain appropriate over time. Institutions have done a good job of developing spending policies under UMIFA (1972) and should be able to continue to develop spending policies that take into consideration the specific needs of a particular fund. Prudent decision making after considering all the factors is the standard under UMIFA (200-). A safe-harbor would simply create a new standard that could not take into account the needs of individual institutions and funds.

The Drafting Committee also considered creating a presumption of imprudence if expenditures in one year exceeded seven percent of the value of the endowment fund, averaged over three years. [The Comment will include an explanation of why the presumption of imprudence was not included and will include examples of ways in which donors can use a spending rule to limit the authority under subsection (a).]

For a discussion of spending approaches, see Joel C. Dobris, New Forms of Private Trusts for the Twenty-First Century—Principal and Income, 31 Real. Prop., Prob. & Tr. J. 1 (1996). For example, Dobris suggests spending 5% or 4% of a five-year moving average of market values might be appropriate. Id., at 39.

Donor’s intent must be respected in the process of making decisions to expend endowment funds. Section 4 does not allow an institution to convert an endowment fund into a non-endowment fund nor does the section allow the institution to ignore a donor’s intent that a fund be maintained as an endowment. Rather, subsection (b) provides rules of construction to assist institutions in interpreting donor’s intent. Subsection (b) assumes that if a donor wants an institution to spend “only the income” from a fund, the donor intends the fund to continue in perpetuity and expects the institution to expend amounts that represent a reasonable return on investments. The donor is unlikely to be concerned about designation of returns as “income” or “principal” under accounting principles. Rather the donor likely assumes that the institution will use modern investing strategies like total-return investing to generate enough funds to distribute while maintaining the long-term viability of the fund. Subsection (b) provides default rules to construe donor’s intent.

If a donor indicates that the rules on investing or expenditures under Section 4 do not apply to a particular fund, then as a practical matter the institution will probably invest the fund separately. Thus, a decision by a donor to require specific expenditure rules will likely also have consequences in the way the institution invests the fund.
Endowment funds include funds that may last in perpetuity but also funds that should continue for a fixed term of years or until the institution achieves a specified objective. Section 4 requires the institution to consider the intended duration of the fund in making determinations about spending. For example, if a donor directs that a fund be spent over 20 years, Section 4 will guide the institution in making distribution decisions. The institution would amortize the fund over 20 year rather than try to maintain the fund in perpetuity.

As a rule of construction, subsection (b) applies retroactively. Retroactive application is appropriate because subsection (b) does not alter the substance of an existing contract, but rather serves as a default rule that implements donor’s intent. The Colorado Supreme Court recently considered the question of retroactive application of a default statute involving the donative aspect of an insurance contract. See In re Estate of DeWitt, 54 P. 3d 849 (Colo. 2002). In holding that the statute did not violate the Contracts Clause, the court cited approvingly from a statement prepared by the Joint Editorial Board for Uniform Trusts and Estates Acts (the “JEB”). JEB Statement Regarding the Constitutionality of Changes in Default Rules as Applied to Pre-Existing Documents, 17 Am. Coll. Tr. & Est. Couns. Notes 184 app. II (1991). The JEB Statement explains why retroactive application of default statutes is appropriate and is not unconstitutional and states, “The JEB is aware of no authority for the application of the Contracts Clause to state legislation applying altered rules of construction or other default rules to pre-existing documents in any field of law, and especially not in the field of estates, trusts, and donative transfers.” Id. at 4 (citing J. Nowak & R. Rotunda, Constitutional Law § 11.8, at 394 et seq. (4th ed. 1991).

SECTION 5. DELEGATION OF MANAGEMENT AND INVESTMENT FUNCTIONS.

(a) Subject to any specific limitations set forth in a gift instrument or in law other than this [act], an institution may delegate to external agents the management and investment functions with respect to institutional funds that an institution could prudently delegate under the circumstances. An institution shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and
(3) periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the terms of the delegation.

(c) An institution that complies with the requirements of subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from the delegation.

Comment

This section incorporates into UMIFA (200-) the delegation rule found in UPIA § 9, updating the delegation rules in UMIFA (1972) § 5. Section 5 permits the decision makers in an institution to delegate management and investment functions to external agents if the decision makers exercise reasonable skill, care, and caution in selecting the agent, defining the scope of the delegation and reviewing the performance of the agent. Decision makers cannot delegate the authority to make decisions concerning expenditures and can only delegate management and investment functions. Subsection (c) protects decision makers who comply with the requirement for proper delegation from liability for actions or decisions of the agents.

Section 5 does not address issues of internal delegation and potential liability for internal delegation, and subsection (c) does not affect laws that govern personal liability of directors or trustees for matters outside the scope of Section 5. Directors will look to nonprofit corporation laws for these rules, while trustees will look to trust law. See, e.g., RMNCA, Section 8.30(b) (permitting directors to rely on information prepared by an officer or employee of the institution if the director reasonably believes the officer or employee to be reliable and competent in the matters presented).

The language of subsection (c) is similar to that of UPIA § 9(c) and RMNCA § 8.30(d). The decision not to include the terms “beneficiaries” or “members” in subsection (c) does not indicate a decision that this section does not create immunity from claims brought by beneficiaries or members. Instead, a decision maker who complies with section 5 will be protected from any liability resulting from actions or decisions made by an external agent.
Subsection (d) creates personal jurisdiction over the agent. This subsection is not a choice of law rule.

SECTION 6. RELEASE OR MODIFICATION OF RESTRICTIONS ON USE OR INVESTMENT.

(a) For purposes of this section, the term institutional fund includes a fund that is one of two or more institutional funds collectively managed.

(b) With the consent of the donor, in a record, an institution may release, in whole or in part, a restriction imposed by a gift instrument on the use or investment of an institutional fund. A release under this subsection may not allow a fund to be used for a purpose other than a charitable purpose of the institution affected.

(c) An institution may apply to the [appropriate court] for release or modification of a restriction imposed by a gift instrument on the use or investment of an institutional fund. The institution shall notify the [Attorney General], who must be given an opportunity to be heard. If the court finds that the restriction is unlawful, impracticable, impossible to achieve, or wasteful, the court may release or modify the restriction, in whole or in part, in a manner consistent with the charitable purposes expressed in the gift instrument.

(d) If an institution concludes that a restriction imposed by a gift instrument on the use or investment of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, after notification to the [Attorney General], may release or modify, in whole or part, the restriction if:
(1) the institutional fund subject to the restriction has a total value of less than $25,000; and

(2) more than [20] years have elapsed since the inception of the fund.

(e) If a restriction is released or modified, in whole or part, under subsection (d), the institution must use the property in a manner the institution determines, in good faith, to be consistent with the charitable purposes expressed in the gift instrument.

Comment

Section 6 expands the rules on releasing or modifying restrictions that are found in Section 7 of UMIFA (1972). Subsection (a) restates the rule from UMIFA (1972) allowing the release of a restriction with donor consent. Subsection (b) describes the application of court-ordered cy pres but does not require notice to the donor as was required in UMIFA (1972). Subsection (c), a new provision, permits an institution to apply cy-pres for small funds that have existed for a substantial period of time, after giving notice to the state attorney general.

Subsection (a) permits the release of a restriction if the donor consents. A release with donor consent cannot change the charitable beneficiary of the fund. Although the donor has the power to consent to a release of a restriction, this section does not create a power in the donor that will cause a federal tax problem for the donor. The gift to the institution is a completed gift for tax purposes, the property cannot be diverted from the charitable beneficiary, and the donor has no retained interest in the fund.

Subsection (b) applies the doctrine of cy pres to institutions governed by UMIFA. The circumstances for the application of cy pres under UMIFA (200-) are the same as those in UTC § 413; cy pres may be applied if the restriction is unlawful, impracticable, impossible to achieve, or wasteful. A restriction that may have made sense when a donor made a gift, may no longer be appropriate due to unanticipated changes. Subsection (b) allows the institution to apply for modification of the restriction, in keeping with the original intent of the donor. The institution must give notice to the state attorney general, who represents the interests of the public in ensuring that the donor’s charitable wishes as expressed in the gift instrument are followed. In determining the appropriate modification, the court will consider what the donor would have preferred if the donor had been aware of the unanticipated circumstances.

The Drafting Committee considered requiring notification of the donor in a cy pres application but concluded that such a requirement would make cy pres impracticable in situations involving multiple donors. Good practice dictates notifying known donors of any change considered by the institution. The Drafting Committee concluded that an institution’s concern
for donor relations would serve as sufficient incentive for following that practice. The interest of
donors who cannot be contacted will be protected by the attorney general, the court, and the
standard itself. An institution will be able to use cy pres only if there is a significant problem
with complying with the restriction and only with the supervision of the attorney general and the
court.

Subsection (c) permits an institution to release or modify a restriction using a cy pres
approach but without donor consent or court approval if the amount of the institutional fund
involved is small and if the institutional fund has been in existence for more than 20 years. The
Drafting Committee determined that under some circumstances a restriction may no longer make
sense but the cost of a judicial cy pres proceeding will be too great to warrant a change in the
restriction. The Committee discussed at length the parameters for allowing an institution to
apply cy pres itself, without court supervision. The Committee drafted subsection (c) to balance
the needs of an institution to operate efficiently for its charitable purposes and the need to protect
donors’ wishes. The subsection assumes that an institutional fund with a value of $25,000 or less
is sufficiently small that the cost of a judicial proceeding will be out of proportion with the need
to change the restriction. The Committee included a requirement that the institutional fund be in
existence at least 20 years because it seemed reasonable to require additional safeguards for
donors’ intent for some period of time after the creation of the institutional fund. The 20 year
period begins to run from the date of inception of the fund and not from the date of each gift to
the fund. The amount and the number of years have been placed in brackets to signal to enacting
jurisdictions that they may wish to designate a higher or lower figure.

Subsection (d) provides that, as under judicial cy pres, an institution acting under
subsection (c) must change the restriction in a manner that is in keeping with the intent of the
donor and the purpose of the fund. For example, if the value of a fund is too small to justify the
cost of administration of the fund as a separate fund, the term “wasteful” would allow the
institution to combine the fund with another fund with similar purposes. If a fund had been
created for nursing scholarships and the institution closed its nursing school, the institution might
appropriately decide to use the fund for other scholarships at the institution. In using the
authority granted under subsection (c), the institution must make a good faith determination of
which alternative use for the fund reasonably approximates the original intent of the donor. The
institution cannot divert the fund to an entirely different use. For example, the fund for nursing
scholarships could not be used to build a football stadium.

Although UMIFA (200-) does not create standing in donors seeking to enforce
restrictions on their gifts, a donor making a significant gift to an institution may include in the
gift instrument a right to notice of any modification or a right to standing to enforce a gift. In
addition, some states do provide for donor standing to enforce terms of a gift under certain
circumstances. See [citation].
SECTION 7. REVIEWING COMPLIANCE. Compliance with this [act] is determined
in light of the facts and circumstances existing at the time a decision is made or action is taken,
and not by hindsight.

SECTION 8. APPLICATION TO EXISTING INSTITUTIONAL FUNDS. This
[act] applies to institutional funds existing on and created after its effective date. As applied to
institutional funds existing on its effective date, this [act] governs only decisions or actions
occurring after that date.

SECTION 9. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND
NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the federal
Electronic Signatures in Global and National Commerce Act (15 U.S.C. Section 7001 et seq.) but
does not modify, limit, or supersede Section 101 of that act (15 U.S.C. Section 7001(a)) or
authorize electronic delivery of any of the notices described in Section 103 of that act (15 U.S.C.
Section 7003(b)).

SECTION 10. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In
applying and construing this Uniform Act, consideration must be given to the need to promote
uniformity of the law with respect to its subject matter among states that enact it.

SECTION 11. EFFECTIVE DATE. This [act] takes effect . . . .
SECTION 12. REPEAL.

The following acts and parts of acts are repealed:
Memorandum

To: UMIFA Drafting Committee

From: Susan Gary, Reporter

Re: Changes from prior draft and changes following our February 20-22 meeting

Date: March 3, 2004

Attached is a new draft of UMIFA. The draft incorporates our revisions to the draft as of our February meeting. In addition, I have made a few other changes pursuant to comments received after the meeting of the Joint Editorial Board for Uniform Trusts and Estates Acts. You have already received John Langbein’s memo reporting from that meeting. In this memo I will not describe the changes made during our meeting, but I will identify the changes made subsequent to the meeting.

I still have work to do on the Comments to incorporate everything we discussed at our meeting. I decided to go ahead and send the draft now, however, to get it to you as quickly as possible. The draft can be circulated to other people or groups at this point. I will continue to revise the Comments.

Please send your comments, suggestions and thoughts to me. I will track the comments from the committee, from observers, and from the other folks from whom we are soliciting feedback. I will be discussing UMIFA at the ACTEC meeting next week and will seek comments from that group. I will keep the Drafting Committee advised as we get more input.

Here are the changes made after our February meeting:

Section 3(a). The phrase “In addition to duties imposed by law other than this [act]” was added to the duty of loyalty. John’s memo explains the JEB’s concern that the higher trust standard of loyalty should govern small trusts.

Also in this subsection I added the phrase “holding an institutional fund” in the second line of the subsection. This addition is in response to a concern voiced by Gene Scoles, a member of the JEB, that the statute clarify that the decision makers are those that govern the institution with the fund and not an institution their institution supports. For example, for a foundation associated with a university, a director of the foundation and not the president of the university is an “individual responsible for the governance of an institution.” The phrase may help to clarify the situation. I will add more to the Comments in this regard.
Sections 3(c), (e). I created two subsections from what had been one subsection stating the duty to act in good faith and listing the factors a prudent decision maker must consider. The JEB thought that the duty to act in good faith should not be a default rule, so it was moved above the provision stating that the remaining subsections are default rules. I still need to add more to the Comment explaining that modifications to these rules should be limited.

Section 9. I added the electronic signatures section that we were instructed to include. I have checked the language and place to include this with Jerry Bassett, our Style liaison.

I deleted the section on severability. Jerry Bassett suggested deletion and says that Style recommends not including this provision. Jerry says that most states provide for severability by statute or case law. He is also concerned that including the section suggests that the drafters of the statute think that an aspect of the statute is unconstitutional.

At our meeting we discussed adding a section on conflicts. I included, and then deleted, the following section:

“In the event of a conflict between this [act] and another law of this state governing the management and investment of institutional funds, this [act] controls.”

There are several problems with this section. First, it is inconsistent with our duty of loyalty provision which says look to other law. Second, it may be unnecessary if the state follows the general rule of statutory construction that the statute enacted last controls. Third, it suggests repeal by implication which states dislike.