Hahn Loeser + Parks LLP

NONPROFIT ADVISORY

The United States Senate Finance Committee is considering legislation that could significantly impact the governance and operations of nonprofit organizations. On June 22, the Panel on the Nonprofit Sector presented its 112-page report on recommendations the Committee should consider in its effort to raise the bar on, among other things, governance practices within the nonprofit community. The Panel on the Nonprofit Sector is a blue ribbon advisory group of nonprofit experts that was formed last fall at the encouragement of the Senate Finance Committee.

If adopted into law, the Panel's recommendations would affect a large segment of the nonprofit community. For instance, grantmaking organizations need to be aware of the proposed limitations that could be placed on donor advised funds and Type III supporting organizations. Perhaps the change that could have the greatest impact on all charitable organizations is the call for annual audited financial statements for larger charitable entities and a financial statement review by an independent public accountant for smaller charitable entities. The following highlights some of the Panel's suggested changes.

BOARDS, COMMITTEES AND GOVERNANCE

The Panel suggests requiring charities to have a minimum of three members on their governing board in order to qualify for tax exempt status. Also, at least one-third of the board members must be independent, meaning, that they must not receive compensation or material financial benefits from the organization (excluding compensation for board service) or be related to an individual that does. Further, as a matter of good practice, the nonprofit experts recommend that the positions of CEO, board chair and board treasurer be held by separate individuals and that an organization periodically review the size of its board. Because one of the primary duties of the board and the audit committee is oversight of financial matters, the Panel suggests that charitable organizations have individuals with financial literacy on their board and audit committees.

FINANCIAL AUDITS AND REVIEWS

The report urges that audits of a charitable organization's financial statements and operations be required for organizations with annual revenues of $1 million or more, and that such audited financial statements be attached to the organization's Form 990 or Form 990-PF. Further, the Panel advocates that charities with revenue of at least $250,000 but less than $1 million should have their financial statements reviewed by an independent public accountant. According to the advisors, audited statements should be made available to the public in the same manner as the organization's annual information returns.

COMPENSATION

Another recommendation involves increased penalties for board members receiving excessive compensation and those approving self-dealing or excessive benefit transactions. The nonprofit experts specify that transactions would be considered improper if board members or managers knew of the impropriety or failed to follow the appropriate processes to determine the reasonableness of the compensation.

CONFLICTS OF INTEREST

The report states that, as a matter of good practice, all charitable organizations adopt and enforce a conflict of interest policy. According to the Panel, organizations should also adopt policies and procedures that encourage individuals to act as "whistle blowers" when activities are illegal or in violation of an organization's policies.

DONOR ADVISED FUNDS

The advisors support an aggregate minimum distribution of five percent of the balance of all donor advised funds from the previous year. Additionally, the report provides details on certain fund activity requirements, including a mandatory twenty percent distribution of donor-advised fund assets when no distribution advice is received from a donor/advisor for three consecutive years, and a termination of advisory privileges when no distribution advice is received for five consecutive years. The Panel recommends putting a number of prohibitions in place that are designed to prevent donors from receiving impermissible benefits from donor-advised funds.

NONPROFIT ADVISORY

TYPE III SUPPORTING ORGANIZATIONS

For a Type III supporting organization, the Panel suggests that the organization should be required to make an annual distribution of five percent of its net non-operating assets to the supported organization. Also, the nonprofit experts recommend that Type III organizations not support more than five qualified organizations. Furthermore, the Panel would require Type III organizations to provide verification of their relationship with the supported organization, and in the case of Type III trust supporting organizations, a demonstration of an ongoing, close relationship with the supported organization.

CONSIDERATIONS

So what should a nonprofit do in the wake of the Panel's report?

While it is unclear what changes may be ultimately approved by Congress, there are some practical steps that nonprofit organizations should take to ensure that they currently have the best governance practices in place that may likely comply with forthcoming legislation or, at a minimum, will make the process of compliance with additional legislative requirements more manageable and less disruptive.

- Foster greater accountability and transparency within the organization.
- Adopt and follow a conflict of interest policy.
- Be sure that all board and committee members fully understand their duties, especially with regard to financial matters.
- Voluntarily conduct financial reviews or audits (depending on the size of the organization).
- Adopt and educate staff and board members on your organization's code of ethics.
- Establish procedures for reporting conduct that is illegal or against organizational policies.
- Set up and follow a process to determine the compensation of board members and executive officers.

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