REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – FALL 2011

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Institutional Integrity and Nonprofit Governance: Time to "Occupy Baltic Avenue?"[1]

The Occupy Wall Street movement has attracted substantial media attention recently. While critics mock the movement's lack of specifics, the general targets of its disaffection are clear: corporate mismanagement and greed. We have yet to meet anyone who supports mismanagement or greed, though we suspect that those whose greed is enabled by mismanagement generally keep a low profile anyway. Nevertheless, these protests provide a convenient backdrop against which to reflect upon mismanagement and greed in the nonprofit sector and the way regulators have addressed the problem – and also to make both an observation and a suggestion about preserving institutional integrity in the nonprofits you serve.

The starting point is the bursting of the "tech bubble" in 2000 and the subsequent collapse of Enron and WorldCom in 2001 – events which precipitated the well known *Sarbanes-Oxley* legislation of 2002 (referred to as SOX). While SOX was drafted to target fraud and mismanagement in publicly traded, for-profit corporations (imposing robust reporting and governance requirements), its spirit permeated the nonprofit sector and at the time the "applicability of SOX to nonprofits" was a hot topic. Three developments followed. First, at the urging of sector leadership many nonprofits voluntarily adopted as "best practices" changes SOX required of publicly traded companies. Second, some states adopted legislation requiring enhanced nonprofit reporting (such as the California Nonprofit Integrity Act of 2004). Third, the IRS amended Form 990 (the annual tax-exempt organization informational return) to add exhaustive questions and disclosure requirements concerning conflicts of interest, compensation, financial reporting and governance.[2]

Next, let's look at a few recent and relevant media reports. There is the story of the Chairman of the Manhattan Chamber of Commerce who resigned that position after he was accused of embezzling $2.3 million from the nonprofit Albert Ellis Institute while serving as its President. The Washington D.C. Attorney General has accused Miracle Hands, an HIV/AIDS service provider, of spending nearly $330,000 in federal grants intended to create employment for afflicted individuals to open a strip club. Earlier this year the Fiesta Bowl confessed that it had expended thousands on illegal campaign contributions, personal travel, gifts, strip clubs and a $33,000 birthday party for its president. *The New York Times* this summer discussed the Medicaid financed Young Adult Institute at which two brothers who ran the organization each made more than $1 million annually for some years, and were able to bill the Institute for the college expenses of their children. *The New York Times* also discussed the Pearson Foundation, a charitable organization related to Pearson, Inc., a multinational for-profit publisher of educational textbooks and related items. According to *The Times*, the Pearson Foundation sponsored free international trips (junkets) for education commissioners from states which purchased textbooks and other products from Pearson, Inc.

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[1] Readers unfamiliar with the famous Hasbro/Parker Bros. board game Monopoly™ may not understand the reference to Baltic Avenue. The strategy of Monopoly is to buy as many properties as possible and to charge other players "rent" when their game pieces land on them. The object of the game is to own most of the property, get rich, and drive the other players into bankruptcy. Baltic Avenue is one of the two lowest priced and lowest rent parcels on the game board - as opposed to high end parcels such as Park Place and Boardwalk. There is no Wall Street in the game.

[2] See the Summer 2008 Edition of this report entitled *The Nonprofit Sector: RIP (the New Form 990 or "SOX Lite")* available at http://www.rrlawpc.com/?t=40&an=5452&format=xml&p=3543&archive=1.

Nonprofit institutions have an interest in the stability and good will which accompany sustained ethical management. One bad headline can cause damage that takes years to overcome. Yet, as we peer down at this legal landscape we wonder if complex and expensive directives such as SOX and Form 990[3] really do all that much to promote institutional integrity – and if the only legislation we really need was handed to us by that ancient law giver Moses in the form of the eighth (*don't steal*) and the ninth (*don't lie*) Commandments. After all, the frauds, misstatements and conflicts behind the incidents described in the previous paragraph are no more than dressed up thefts and lies. Moreover, regardless of your religious beliefs, as a practical matter you have to admit that these two commandments have some advantages over SOX and Form 990: they are thousands of pages shorter, easier to read and don't require any governmental filings, audit committees or conflict of interest policies (all of which would probably be unnecessary if everyone simply listened to Moses).

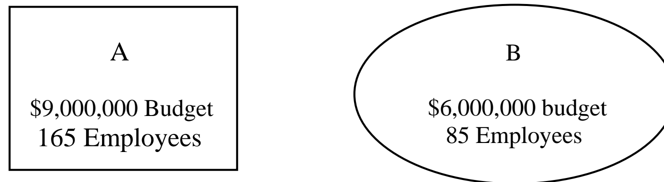
Thieves and liars lived among us before and after Moses, and will continue to do so notwithstanding SOX and Form 990 – our efforts to curb them are essentially a perpetual game of "whack a mole" in which another Bernie Madoff will inevitably pop up again somewhere. Yet, it is especially disconcerting when these problems occur within charitable institutions, not only because it diminishes resources available to fulfill their missions, but because it tarnishes the moral patina they rely upon for support and which is often used to distinguish them from for-profits.

So, what are the observation and the suggestion we told you we would make? Our observation is that the approach taken by SOX and Form 990 (and similar directives) is one part punitive (penalties if you get caught) and one part prophylactic (policies making it harder to get away with it). Our suggestion is to consider approaching the problem from a different angle – as a function of the board recruitment and retention process. As a matter of law, the board of directors has ultimate responsibility for the business, property and affairs of the organization, and in our experience an organization's culture is reflective of the culture and character of the people who populate the board. In other words, we suggest that there is generally an inverse relationship between the integrity and quality of board members (a function of board recruitment and retention policies) and the likelihood of incidents of the type discussed in the above news stories. Integrity is a beautifully simple and powerful thing. It is not created by statute, regulation or governmental filings, but is a human quality that should be cultivated and valued within your organization to better enable it to fulfill its mission.

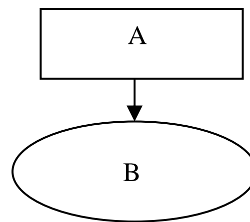
Demystifying "Mergers" – Structural Alternatives. The Fall 2010 Edition of this Report featured an article entitled *The Year of Merging (Affiliating) Gracefully.* In that article we discussed nonprofit sector consolidation and some of the threshold issues governing boards need to address when considering a transaction of this type. A year later, mergers remain an important topic, and based on our recent experience we thought it would be helpful to discuss the four principal corporate/structural alternatives used to "combine" the operations, assets and liabilities

[3] For example, if you look at SOX and the Form 900 their recipe includes an admixture of audit committees, finance committees, conflict of interest policies, whistleblower policies, document retention policies, compensation policies, the disclosures of myriad financial personal, family, governing board, business and related relationships, and a dollop of fear to the extent individuals on the board or in management are required or urged to review financial and tax reports.

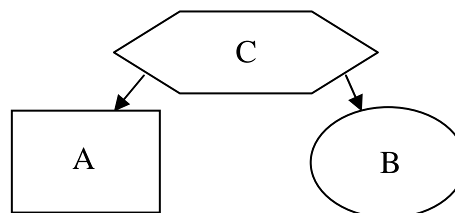
of nonprofits.[4] For these purposes we will use hypothetical Nonprofits A and B, and assume they have completed their due diligence reviews of one another and determined they should combine their operations. Nonprofit A is larger than Nonprofit B, but both operate similar programs in contiguous territories. This is what they look like "before" the transaction:



Model 1: Parent – Subsidiary. The governing board of A may conclude that it is uncertain about some of B's programs and potential liabilities, and that while it wants to combine operations with B it also wants to keep some distance for the foreseeable future. As a result, the Certificate of Incorporation and the By-laws of B are amended to name A as the sole member of B.[5] As a result of these amendments A will become the "parent" of B by virtue of the fact that A, as the sole member, will determine who will be on the board of directors of B.



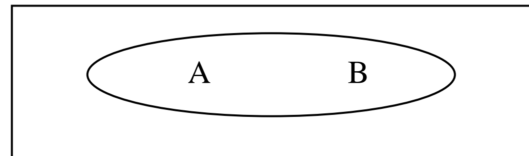
Model 2: New Parent Company. In this approach, for political and business reasons the notion of having one organization become the subsidiary of another is not feasible, but there are still reasons to keep both corporate entities alive and separate. As a result, A and B decide that both should become subsidiaries of a new "holding company" (called C), with the board of C populated with representatives from both A and B. C is incorporated and the Certificate of Incorporation and the By-laws of A and B are amended to name C as the "sole member" of each. As a result the board of C elects the board of A and B and is thereby able to control both.



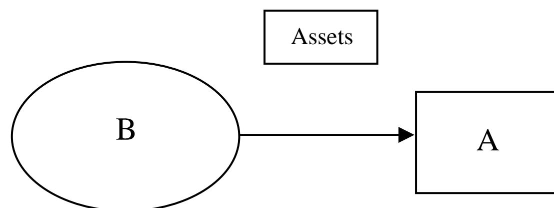
[4] Note that we use the term "combine" instead of merger because a "merger" is a technical term meaning the actual consolidation of all assets and liabilities (known and unknown) into one corporate entity (Model 3 above).

[5] For readers not familiar with the term, a "member" of a nonprofit corporation is roughly the same as a stockholder in a for-profit setting, except that the member has no proprietary or economic rights (dividends or proceeds), but does have the right to participate in governance – principally the right to elect and remove the board of directors.

Model 3: Statutory Merger. In this approach, the governing boards of A and B are completely comfortable with the results of their mutual due diligence reviews and have decided that they want to have one corporate entity. A Certificate of Merger is filed with the Secretary of State's office merging B into A (or A into B) – as a result of which all of the assets and liabilities of B became assets and liabilities of A and A is the only corporation remaining (or vice versa). The post-merger board includes individuals who were on the boards of A and B.



Model 4: Transfer of Assets. In this approach, B is an operationally troubled organization, and the Board of Directors of A does not want to risk tarnishing A's good will or reputation by getting "too close" to B and its problems. Nevertheless, there are some assets of B (perhaps real estate or a service line) that would fit in nicely with A's plans. B agrees that it will dissolve and liquidate its operations and business, and to transfer the selected assets to A at that time. As the transfer is between charitable entities, B could transfer the assets to A for no cost, as long as B's creditors will be paid in full in the liquidation.



Due to space limitations the discussion above is very general in nature and omits a multitude of variations. In real cases the analysis of structural choices can become very involved. Nevertheless, we hope this discussion and graphic displays will help readers understand some core concepts when and if they serve a nonprofit which is considering a "combining" transaction of this type.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them. This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment, and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel. For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Carrie L. Samperi at (860) 240-1008 or info@rrlawpc.com, or members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at www.rrlawpc.com.