REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – WINTER 2012

HAVE YOU HAD A WHISTLEBLOWER YET? What would you think if you opened your mail and found an anonymous letter about your nonprofit addressed to local officials and the press, with the following opening paragraph (paraphrased and redacted from a real letter).

> I have sent this letter because you are a public official or a nonprofit struggling for funding. This letter is intended to bring to light public information that should be examined. For several years _____ and other community leaders have used their positions to pay themselves excessive/unreasonable salaries, and to profit personally from dealings with nonprofits they control, from government grants and charitable contributions.

We have been called in to provide legal advice on an unusually large number of whistleblower cases in the last twelve months – a number large enough to cause us to suspect an emerging trend. Whistleblower letters (baseless or not) present an unusually difficult set of problems for board members, and in all candor are challenging assignments for lawyers. We have acquired some knowledge from the cases we have handled, and thought it would be helpful to explain why we foresee an emerging trend and to pass along some of the lessons we have learned.[1]

We expect to see more whistleblower activity because the "transparency in governance" movement (which began about ten years ago) has matured to become a fixture of nonprofit culture and practice. While "transparency" is only a principle, the "one-two" combination of GuideStar® (the free web based portal to the Form 990 tax return of any nonprofit) and the 2008 revisions to IRS Form 990 (which dramatically increased the amount of reported data), put the principle into practice in a robust manner. It is now easy for anyone (friend or foe) to dig into a nonprofit's most intimate affairs by logging onto GuideStar. The anonymous letter paraphrased above included the URL internet address for GuideStar. As public awareness of GuideStar increases, so too will the number of people looking behind your curtain.

The lessons we have learned include:

First, the probability of having to deal with a whistleblower letter is not a function of how carefully you obey the law but of how likely it is that someone is angry enough to want to "drop a dime" on your organization. *In other words, don't rest easy because you are sure you have done everything right – because dealing with an unfounded set of accusations from an angry parent, client or former employee can be just as challenging.*

Second, at all times you must clearly distinguish the interests of the nonprofit from the interests of the individuals who govern its affairs. The law is clear that the interests of the organization are entitled to protection from directors, officers and staff who abuse their positions. While it is not common, a nonprofit can bring litigation against these individuals for the harm they cause.

[1] Note that our focus is limited to whistleblower claims which raise tax, financial and corporate law issues and the conundrum they present to the board rather than the equally daunting "operational issues" raised by such claims. By operational issues we mean, for example (and this is a real example): allegations that senior staff members are having affairs with junior staff and "playing favorites." Also, we are not touching upon state and federal whistleblower statutes which generally exist to protect whistleblowers from retaliation.

As lawyers we always make it clear that our client is the nonprofit entity and not any individual officer or member of the board or staff (who may need his or her own lawyer).

Third, the tax returns are typically a source of information for whistleblowers, so it is helpful to remember a few things about them. Tax returns are serious documents and are signed under penalties of perjury.[2] This means more than the need to be diligent in their preparation. It means that the return's information can create a Catch-22 in the following sense: you cannot dismiss a whistleblower claim based on what is reported on the return because you did, after all, sign under penalties of perjury; and if (after the investigation) it turns out that the reported information is wrong, you will be required to file an amended return (which requires some explanation and is likely to call the IRS's attention to your organization).

Fourth, whistleblower letters put board members between a rock and a hard place because the allegations typically require some board members to investigate other board members or management – people with whom there is usually a personal relationship. If the need to investigate "one of your own" is a potential conundrum, the corollary is another Catch-22: the failure to conduct an adequate investigation could be a bigger breach than the subject of the letter. The situation is most troublesome in cases in which the board is small in number and there is an overlap between the board and management because the people involved essentially must investigate themselves.

Fifth, perhaps the most intractable difficulty whistleblower claims present is a function of the fact that, even if a claim is baseless, you won't know or be able to prove its baselessness until after you have endured the investigation. Does this mean that every letter must be investigated? If you don't investigate, will there be a follow up whistleblower letter citing you for not investigating the first complaint?

Sixth, we did a Google® search to look at sample whistleblower policies and literature. The sample policies encouraged whistleblowers, obliged the organization to undertake investigations, and also addressed interviewing witnesses, preserving documents and the like. However, we did not find an answer to the previous point – is there a way to avoid the need to investigate or at least to limit its scope to save time and money? We offer the following thoughts on this question:

(1) We think that some level of investigation is needed in all cases, but that it behooves you to have in place a written protocol to triage the allegations and determine the scope of the investigation in a rational manner based on the nature of your activities, the seriousness of the allegations and other relevant factors. A formal protocol will give immediate procedural guidance to board members and, just as important, will provide fiduciary "air cover" to them if there is a later charge that a matter was not investigated thoroughly enough.[3]

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[2] The tax return signature block states the following: "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." The penalties for perjury include up to three years in prison. But, importantly, for there to be a problem there must be a showing that there was actual knowledge and belief that a statement was not true. Innocent mistakes are not perjury. Notably, Question 11a of Part VI of Form 990 asks if *"[t]he organization provided a complete copy of this Form 990 to all members of its governing body before filing the form?"*

[3] For example, in the case that was the subject of the letter paraphrased at the beginning of this article, one of the excess compensation allegations was dismissed quickly by demonstrating that the author had simply misread the Form 990.

(2) This is an area ripe for insurance coverage. We suggest that you contact your insurance agent and ask if your policies (especially your Directors and Officers liability policy) will provide coverage *by paying for a lawyer to investigate the matter for you.* However, when approaching your agent you need to be specific because, while all policies cover "claims," the term "claim" is defined precisely in the policy, and the definition may not be broad enough to include whistleblower "allegations." In the sample policies we have looked at, a whistleblower letter *per se* would *not* be an insured "claim" even though the letter could lead to a "claim" at some point in the future. If most insurance policies do not cover whistleblower letters, then perhaps this is a type of coverage insurers should consider underwriting.

We think the transparency movement has proven to be a classic two-edged sword. While it is true that "sunlight is the best disinfectant," the other edge of the blade is the "law of unintended consequences." The most unfortunate unintended consequence is the ability of ill- intentioned people to exploit the transparency and cause nonprofits to endure the onerous time and expense of investigations by making bad faith or reckless accusations of wrongdoing.[4]

If you are interested in learning more about this topic, we will be addressing it in a presentation on May 16, 2012, in Farmington, Connecticut, at a program sponsored by TANGO (The Alliance for Nonprofit Growth and Opportunity). More information about this free, full day Best Practices for Nonprofits Program can be found on TANGO's website (www.tangoalliance.org).

THE RETURN ON YOUR INVESTMENTS. The lawyers in our Nonprofit Practice Area are not investment professionals, but we do help draft Investment and Spending Policies. In the context of shrinking government funding and the need to find alternative funding sources, the return on investment assets may be more important than ever to your organization. We recently sat down with David Sullivan (Manager of Reid and Riege's Fiduciary Services Group, which manages accounts for private and institutional clients) and the Investment Advisors (Crawford Investment Counsel) David uses, to discuss the current investment climate. We asked David if he had any policy insights specific to the nonprofit sector in what appears (at the time of writing) to be an improving market. His response was that much depends on the nature of the nonprofit's business (for example, a grant-making foundation compared to a human services agency) and its current and projected (two to three years) balance sheet and income statement. Nevertheless, as a general principle David offered that the art of his profession is finding the balance between the operating budget's need for cash flow from invested assets, and the asset allocation most likely to meet that need while preserving capital. If any reader has specific questions, please feel free to reach out to David at dsullivan@rrlawpc.com.

RECENT FIRST AMENDMENT CASES OF INTEREST. We periodically are engaged by churches and other religious organizations on matters with First Amendment (freedom of religion) implications. Two recent cases with religious aspects caught our attention – one from Connecticut and the other from Michigan. The Connecticut case involved a suit against a church brought by a woman who suffered head injuries after falling backwards while being anointed during a healing ceremony and "resting in the spirit." She claimed that the church was negligent by failing to provide enough "catchers" to protect participants. The court dismissed the case

[4] We have also witnessed the positive side of this movement. We have had a handful of engagements in which boards suddenly realized (after their accountants pointed out questions on their Form 990 tax returns) that they needed to change their ways.

saying that it was not within the State of Connecticut's power to interfere with a church's conduct of inherently religious activity. The Michigan case involved the other end of the spiritual spectrum. A self-proclaimed animist and pagan sued a private nonprofit nature conservancy after he was barred from the organization's premises following his threat to "have the spirits drop a widow maker" on the groundskeeper and put "him in a wheel chair." The court said that the plaintiff was not barred from the premises because of his religious orientation (but because of his threats), and that in any event the First Amendment bars governmental interference with the practice of religion and the nonprofit defendant was a private association.

FUNDRAISING SECRETS REVEALED? The topic of charitable giving is near and dear to every nonprofit organization. Experienced fundraising professionals will tell you that it is hard to know exactly what part of a donor's personality, religion, upbringing or psyche motivates gift giving – but that their job is to cultivate a relationship with donors to find the motivating factors and to make "an ask" that is consistent with those factors. We were thinking about the many fundraisers we have known when we read a paper entitled: *A Neuroeconomic Perspective on Charitable Giving*. The paper was prepared by researchers in the psychology department at the University of Arizona, and published in Humana.Mente, which holds itself out as a quarterly journal of scientific divulgation and philosophical studies. We found most interesting that portion of the paper which reduced the fundraiser's task to a human kindness utility function which they were able to express as a simple mathematical formula, which we pass along for use in your fundraising efforts or literature: $Ui\ (ai\ (h),(bij\ (h),(cijk\ (h))\ k \neq j)\ j \neq i) = \pi i\ (ai\ (h),(bij\ (h))\ j \neq i) + \sum\ (Yij \cdot kij\ (ai\ (h),(bij\ (h))\ j \neq i)\ \lambda ijk\ (bij\ (h),(cijk\ (h)\ k \neq j)\ )(4)$. ☺

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.

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