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Rational Exuberance: An Exploration of the Adaptation by California's Charitable Sector to Changing Governance Standards

Notes from the Field

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Senator Charles Grassley, Chairman of the Senate Finance Committee, began the committee's hearing into charitable law reform on April 5 with a vivid example of donor wrongdoing. It seems that the Washington Post had, that morning, run an article on a tax scam promoting the notion that one could take a charitable deduction for the cost of a safari in Africa, so long as the taxpayer contributed his mounted game trophy to a charity.

Standing before a dusty and tattered stuffed Spring Bok, Senator Grassley said, and I quote:

> *I have here a Spring Bok from South Africa. Unfortunately, some people think its name is "Free Buck." The Spring Bok is known for its ability to leap when startled. Boy, were we startled when we learned of this new tax scam. The story in this morning's Washington Post makes me think that many people think the "tax" in taxidermy is meant to allow them to write off safaris to Africa as tax deductions if they give away a stuffed animal. This type of scam gives new meaning to the term tax "game."*

This bit of low comedy reached a nadir not even attained by last year's farce when the same committee, also at a hearing on charitable law reform, called on two confidential witnesses who were there to testify to examples of charitable abuse in low-income housing and car donations. They spoke from behind a curtain and through a machine that distorted their voices. They were referred to, of course, as Mr. House and Mr. Car. We are not told whether they were also hooded or whether they now have been given new identities as part of the federal witness protection program.

At the hearings, Senator Max Baucus, Ranking Member of the Senate Finance Committee, stated that "any reform effort needs to be a balance between cracking down on the bad guys, and not unduly burdening the good guys." As these examples indicate, however, the committee's hearings have been far from balanced. The committee has made little attempt to showcase the good guys and their stories, yet it gleefully displays examples of wrongdoing and adds theatrical flourishes.

What I want to do today is to take a different approach, to consider a variety of ordinary charitable organizations as they struggle in California with changing standards of governance in the charitable sector -- a sector dominated by good people and worthy organizations that are here, in the words of Yale Law School's John Simon, "to teach us, to heal us, to entertain us, to defend our natural resources and our civil liberties, and ultimately to receive our ashes."

California Legislation

In California, Attorney General Bill Lockyer's staff developed legislative proposal drafts in the fall of 2003, combining a state version of the federal Sarbanes-Oxley Act (SOX) with increased regulation of charitable solicitations.

During the winter, the Attorney General invited representatives of the California Association of Nonprofits (CAN) to review and discuss those early drafts. A fundamental disagreement soon arose between the staff of the Charitable Trust Section of the Attorney General's office and the delegates from CAN concerning the trigger for mandatory annual audits. The Attorney General's draft used annual revenues of over $250,000 as the trigger. This was not an arbitrary threshold. It had also appeared in the Standards promulgated by the national Better Business Bureau, among others, as a measure of audit suitability. However, CAN representatives argued strongly that such a low trigger would mean that very small human service organizations would be required to increase their annual expenses by audit fees estimated at $7,000 to $14,000, an amount that would imperil vital programs, and they urged a higher threshold be chosen instead.

The draft legislation developed by the Attorney General emerged on February 13, 2004, as SB 1262, introduced by Senator Sher. The audit trigger had been raised to $500,000. By the time of the first hearing on SB 1262, one month later, however, the overwhelming feedback from CAN's charitable organization constituents throughout California was that

$500,000 was still too low. At the hearing before the Senate Judiciary Committee, many witnesses testified against SB 1262 but only three in support of the bill. Most witnesses emphasized the impact of high audit fees on small charities. At the close of the hearings, in an unexpected development, Senator Sher announced he had been persuaded that audit costs could well become an unmanageable burden for small charities, and he agreed, with the consent of the Attorney General's representative, to amend SB 1262 on the spot, raising the audit threshold to apply only to charities with annual revenues of $2 million or more. Attorney General Lockyer pushed ahead with SB 1262, and it was signed into law as the Nonprofit Integrity Act of 2004 (NIA) in September of 2004.

The NIA became effective on January 1, 2005. It addresses three areas of activity of a charitable organization: (1) audits: mandating financial audits, audit committees, and public disclosure of audited statements by certain charities; (2) salary review: requiring a periodic review of the compensation package of the CEO and CFO of every charity by the board of directors or board committee and a determination that those benefits are just and reasonable; and (3) fundraising: requiring charities to establish and exercise control over their own fundraising activities and over fundraising conducted by others for their benefit, imposing mandatory contract provisions between a charity and any commercial fundraiser or fundraising counsel, and prohibiting misrepresentation and other improper solicitation practices.

Education and Training

Why do people obey laws? At least within the charitable sector, a vibrant culture of compliance appears to exist. Our task is to nurture it. We rely on the notion that education and training of directors and officers of charitable organizations will promote compliance far more than exclusive reliance on legal enforcement.

The development of changing governance standards in the charitable sector has provided an opportunity to witness different approaches to legal compliance. Early on, New York's Attorney General Elliot Spitzer introduced a state-SOX bill for New York's nonprofits. By the end of November, 2004, however, his zeal had abated. He announced in a radio interview that he had re-evaluated the situation and had withdrawn his support for the bill, explaining that he now favored educating and training directors and officers of nonprofit organizations rather than imposing new laws. Some New York colleagues claim that it is also true that General Spitzer was unable to move his bill out of committee.

In California, learning about the NIA has become an opportunity for considering larger governance issues that might otherwise lie dormant. For example, after giving a lecture on the NIA last year, sponsored by the Center for Volunteer and Nonprofit Leadership of Marin, and attended by representatives of 50 or more charitable organizations, I was taken aside by Linda Davis, the Center's CEO, who explained that the Center would probably have drawn only five or six people had the event been billed as a lecture on

bylaws or governance. The new law, she added, had provided a chance to talk about a wide-range of governance issues that would not have occurred in the absence of that legislation.

Throughout the state, charitable sector organization directors, officers, staff, and advisers have turned out in large numbers for lectures, workshops, and conferences about the NIA sponsored by community foundations, nonprofit management service organizations, and similar groups. The response has been overwhelming. In San Francisco, CompassPoint held a lecture and discussion on the NIA featuring a joint presentation by Belinda Johns, Deputy Attorney General, and an attorney from the private bar. The crowd of 100-plus exceeded the standing-room-only limit of the hall, and nearly an equal number was turned away.

This is a new phenomenon. No state or federal tax or corporate law has before generated such an outpouring of interest from charitable sector representatives.

And leading the educational and training effort have been officials from Attorney General Lockyer's Charitable Trust Section. The Attorney General's website (www.caag.state.ca.us/charities/index.htm.) quickly became the center of helpful information and interpretations of the NIA. Through that website, charitable organizations and their advisors were invited to contact Belinda Johns (Northern California) and James Cordi (Southern California) by e-mail. As a result, e-mail queries on the NIA have poured into the Attorney General's offices, resulting in over 300 e-mail responses or informal rulings so far. Since the effective date of the NIA on January 1, 2005, Ms. Johns and Mr. Cordi have added to their calendars a full schedule of speaking engagements before charitable organizations throughout the state.

Implementation

The examples below are based on actual events, but the names are fictitious.

Some principles of SOX, applicable only to publicly traded companies, may have an indirect impact on large charitable organizations, particularly when corporate officials, steeped in the culture of SOX, sit on the boards of directors. And we learn that once highly motivated directors begin to engage in ethical rule-making, they can be surprisingly strict.

- California Opera, Symphony, and Ballet (COSB) is a large and successful performing arts organization. COSB's Board includes several directors who are officers of publicly traded companies, and they also serve on COSB's Executive Committee. At a recent committee meeting, one such director explained that he was awash in SOX training at his company, particularly about conflict of interest policies and codes of ethics, yet at COSB, which he expected to have

adopted even higher ethical standards long ago, such policies had not yet even rated a mention on a meeting agenda. Due to the insistence of those directors, the Chair of COSB's Executive Committee has instructed legal counsel to prepare drafts of a suitable conflict of interest policy and code of ethics. The Executive Committee told its Chair to make sure the code covered employees and volunteers as well as directors – and to add teeth by providing that any director who fails to comply with the code may be removed from the Board and any employee or volunteer who fails to comply may be put on notice or terminated at the discretion of the Executive Director.

The impact of media scrutiny and concern about the consequences of unfavorable publicity has become a powerful motivating force to a growing number of boards of directors and is likely to prove a far stronger deterrent to improper conduct than the risk of legal sanctions by regulatory agencies.

- The Board of Directors of Silicon Valley Tomorrow (SVT), a public interest urban planning organization, discussed standards of governance at a recent Board meeting. The Chairman asked whether the sense of the Board was that SVT should follow the legal minimum standard of governance or the highest ethical standards. During the discussion that followed, the Chairman said he saw no reason why the Board would decide to do otherwise than follow the highest standards. His goal was to avoid the slightest scandal at SVT and the risk that his reputation and the reputation of fellow directors would be impugned by an exposé of SVT on the front page in the Mercury News. The Board then agreed that it would follow the highest ethical standards and directed legal counsel to draft a code of ethics expressly providing that all actions of the Board must not only be legally permissible, they must also reflect the highest ethical standards, as determined in the sole discretion of the Board.

The interplay of state and federal laws is not always transparent. There is a growing trend for charitable organizations to comply with the highest standard of accountability and transparency – and whether or not required by law.

- The Sierra Economic Opportunity Commission (SEOC) was formed as a charitable organization shortly after the enactment of the Economic Opportunity Act of 1964 to administer or coordinate programs to combat poverty in communities located in the Sierra foothills of California, such as Head Start, Migrant Services, and Homeless Services. SEOC's 15-person Board of Commissioners is divided evenly between representatives of three constituencies: local governmental agencies, low-income persons, and business/labor. SEOC's funding is

substantial, far above the $2 million annual gross revenue threshold set by the NIA. But the NIA excludes from the calculation of that threshold funds received as grants or contracts with governmental agencies, which is the case with SEOC. Those governmental agencies have required SEOC to obtain an annual independent audit of its financial statements. Even though California law does not require an audit, it does require disclosure of any audited statements, whether or not required. Although neither federal nor state law requires that SEOC appoint an Audit Committee, the Board of Commissioners has decided that the Board and SEOC would benefit from the involvement of such a committee. The Board has begun a search for individuals with financial expertise, from one of the three constituencies, who would be interested in joining the Board and the Audit Committee.

One consequence of the continuing discussion among directors and officers of charities in California about changing governance standards is that some charities are finding themselves adopting governance practices that are not only beyond the law but also beyond accepted best practices.

- The Smith Family Foundation has assets of $50 million. Claire Smith, the new Chair, represents the youngest generation to take office. After checking with her colleagues at other foundations, she was surprised to learn that despite all of the publicity in California about the mandatory audit requirement of the NIA, that requirement will not apply to many charitable funders with substantial assets because the audit trigger is based on revenue rather than assets. Thus, the Smith Family Foundation, despite an asset base of $50 million, is not subject to the mandatory financial audit because its annual gross revenue, taken from line 12 of page 1 of IRS Form 990-PF (consisting of interest, dividends, and capital gains) is less than $2 million. Claire's colleagues differ about whether foundations should, as a matter of best practices, obtain annual audited financial statements. Nevertheless, Claire explained to her Board of Directors that she did not want to defend the public policy that compelled audits of small charities with a few million dollars of revenues but allowed large charities with assets of $50 million, such as theirs, to escape audits altogether. She also alerted the other directors that any interested person could download the Foundation's tax returns at www.guidestar.org. The Board agreed, with no dissents, to obtain annual financial audits, and to post the audited statements on the Foundation's website, beginning with the current fiscal year.

Federal Legislative Activity

In response to corporate scandals at Enron and elsewhere, Congress enacted the Sarbanes-Oxley Act of 2002. Best practice codes for business corporations were soon adopted and promulgated by a wide range of organizations, including NASDAQ, NYSE, the Business Roundtable, the Conference Board, General Electric, and TIAA/CREF – a "best practices supermarket," wrote one observer.

The media began to scrutinize charitable organizations more closely and articles about scandals within the charitable sector soon began to appear, mainly in the Boston Globe, the Washington Post, and the San Jose Mercury News.

Congressional concern resulted in hearings before the Senate Finance Committee beginning in 2004. In a highly unusual move, the Committee released a Discussion Draft as a staff document, enabling the Committee members themselves to avoid taking any public position on the recommendations for reform in that Draft. The Draft proposes far-reaching and expansive regulation of charities, including mandatory reapplication for an IRS exemption every five years, tightened regulation of private foundations, the application of private foundation restrictions to public charities, a mandatory audit requirement for a charitable organization with annual gross receipts over $250,000 and a compilation and review by an independent accountant if gross receipts are under that threshold but over $100,000. Not to be left behind, the Staff of the Joint Committee on Taxation issued a proposed report in January 27, 2005, entitled "Options to Improve Tax Compliance and Reform Tax Expenditures," containing over 100 pages proposing extensive reforms of tax provisions applicable to exempt organizations.

Back in September, 2004, the Senate Finance Committee sent a letter to the Independent Sector encouraging it to bring together leaders from the charitable sector to consider actions to strengthen governance, ethical conduct, and accountability within public charities and private foundations. Independent Sector appointed the Panel on the Nonprofit Sector, co-chaired by Paul Brest, former Dean of the Stanford Law School and currently President of The Flora and William Hewlett Foundation, to take responsibility for those tasks. The Panel, with more than 175 charitable leaders and top experts directly involved, has held at least 14 hearings around the country and has involved about 1500 participants in a series of nationwide conference calls. The Panel issued an interim report in March and it plans a final report in June, but it has announced its intention to continue to meet throughout the fall.

The interim report, a 68-page document, attempts to strike a balance between recommendations for action by the charitable sector and by charitable organizations and their boards of directors, recommendations for action by the IRS, and recommendations for legislative action to improve governance and oversight of the sector. Taking a page from the NIA, the Panel recommends mandatory annual audits of charitable organizations with gross revenues of $2 million or more.

What's Next?

Will efforts on the national level result in new legislation, and if so, in what form? Many knowledgeable observers expect that some sort of legislative package will emerge from this extensive public and private effort. The existence of the Panel should serve to comfort the charitable sector. Never before has so large, diverse, and knowledgeable a group served as a translator of the charitable sector to Congress and an advocate of timely governance changes to the sector.

Recently, the New York Times carried an article about AIG (American International Group) and the downfall of its CEO, Maurice (Hank) Greenberg. The authors wrote "How could a man who ruled for almost 40 years see his legacy slip away in a matter of days over events that, at another time, might have been dismissed as immaterial…. " The answer? The CEO was becoming a throwback to another era – "an executive working in a business world still shaken by the corporate scandals of recent years, but who failed to recognize the swirl of change engulfing him." The AIG example is about sudden change in corporate culture and about one CEO who just didn't get it. As we have seen, other CEOs and directors of charitable corporations as well as companies share that disability.

How can the honest director or officer protect herself or himself from becoming engulfed and confused by the "swirl of change" in standards of nonprofit governance? In this unsettled legal environment, charitable organizations and their directors or trustees, officers, and staff are likely to reach the safest harbor if they remain mindful of these principles:

1. Increasingly, charities are expected by the public to take the high road.

2. It is no longer sufficient for a charitable organization merely to comply with the letter of the law or even the spirit of the law. The charity must go beyond the law. The public now looks to charities to act as moral agents.

3. Charitable organizations with the greatest likelihood of satisfying emerging public expectations will be those that take all measures necessary to ensure that the conduct of their directors, officers, and employees reflects the highest ethical standards appropriate to the organizations' structure and mission.

4. To settle for less is to run the risks that the charitable organization's reputation for integrity will be weakened, its respect by the community will be diminished, and its ability to fulfill its mission will be imperiled.