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NONPROFIT ORGANIZATION REPORT – FALL 2015

Community Foundations: The Role of Governance in Grant Making

Nonprofit governance has been in the spotlight since the early 2000s, spurred in part by the corporate governance failures that led to the downfall of Enron, which in turn led to the adoption of the Sarbanes-Oxley Act of 2002 ("SOX"). SOX imposed rigorous governance practices on the boards and management of for-profit publicly traded companies, but its underlying principles were informally carried over to the nonprofit sector. There was good reason for this as the nonprofit sector had experienced embarrassing governance failures of its own, and the topic was given a boost when the IRS remodeled the nonprofit tax return in 2008 and added an entire section on governance practices.

We have written about governance before, and decided to do so again because it has reared its head in a context we did not foresee – the extent to which "community foundations" can or cannot reject a grant request based on an applicant's governance practices. The question has been asked of us by community foundations with applications from nonprofits which are as well-intentioned as they are uninformed about basic governance principles. We have also been approached by well-governed nonprofits whose applications were rejected for failure to adhere to what might be called "add on" governance requirements reflective of policy goals of community foundation management.

There is no set of "generally accepted governance practices" similar to the Generally Accepted Auditing Standards auditors follow when certifying financial statements.[1] Uniformly accepted governance practices would let applicants know what they must do to be eligible for assistance, and would prevent community foundations from using the "power of the purse" to compel adoption of standards reflective of their policy preferences. We also believe it would not be that hard to derive reasonable standards from the existing bodies of state and federal law and practice. We will analyze this issue with the use of a hypothetical involving a well-governed nonprofit whose grant application was rejected for failure to meet a community foundation's "add on" standards, and close with some thoughts about what uniform standards might include or look like.

The Case Study

Great Expectations Child Services, Inc., is a nonprofit provider of services to children living in poverty. It has a thirty year history, current by-laws, audited financial statements, a bank line of credit, a functioning volunteer board of directors, an annual gala and golf tournament, a conflict of interest policy, all requisite insurance policies, an HR department that stays abreast of employment law and practice, and government fee for service contracts. It has filed its tax returns on a timely basis and is in compliance with the governance section of the returns.

[1] The Financial Accounting Standards Board publishes standards auditors must follow to be sure that consistent practices are used when financial statements are prepared so that they will be easier to interpret and to enable readers to compare financial performance among different organizations on an "apples to apples" basis.

Great Expectations needs new kitchen equipment to prepare meals for the children. The board of directors instructs its development director to apply for a capital grant from the Heartfelt Community Foundation. Heartfelt is a decades old community foundation with $750 million in assets. Heartfelt raises funds from donors in the cities and towns in its service area, and it administers donor advised and directed funds, agency funds, and, relevant to this newsletter, makes grants of its own to operating nonprofits within the same area.

Great Expectations' development director contacts the grants administrator at Heartfelt and is informed that nonprofits are not eligible for grants unless they meet the following three governance standards: **(a)** board members must attend at least 75% of board meetings (attendance sheets are recommended); **(b)** board composition must reflect the diversity ratio of the town or city in which it is located (a demographic analysis is used to calculate the ratios the board must satisfy); and **(c)** CEO compensation may not be more than four times average employee compensation (data is to be presented with the grant application).[2]

The development director informs the board that Great Expectations is not eligible for a Heartfelt grant because: **(a)** Great Expectations' board attendance averages 70% (even though there is always a quorum); **(b)** while Great Expectations' board has members from a variety of career and demographic backgrounds, it does not meet Heartfelt's specific diversity ratios (even though there is a robust board development committee always on the lookout for motivated volunteers of all backgrounds); and **(c)** the heavily recruited CEO has a contract that pays him five times the average of Great Expectations' employees (but was found satisfactory by a qualified compensation consultant in conformance with IRS regulations). Great Expectations' board chair is upset because the new kitchen equipment is badly needed, and does not know where to find the necessary funding.

Legal Analysis

First. Great Expectations' board of directors has legal fiduciary responsibility for all of Great Expectations' financial, business and other affairs, including board attendance policies, the selection and recruitment of directors, and compensation levels. Neither the management nor the board of Heartfelt has legal responsibility or discretion with respect to these matters. Moreover, it is clear that Great Expectations' governance practices (financial audits, timely filed tax returns, current by-laws, a functioning board, vetted CEO compensation, insurance coverage, a conflict of interest policy, and the like) are up to date and in compliance with current practice. There is no need to alter them.

Second. Heartfelt is a "community foundation" – which is a unique type of tax-exempt entity. Community foundations emerged in the 1900s (the first was in Cleveland in 1914) when a growing industrial economy generated considerable wealth, and community leaders recognized the advantages of centralized investing and grant making. The IRS has specific requirements community foundations must satisfy to maintain their exempt status, which include service to a distinctly identified geographic community. The Council on Foundations, located in Washington, D.C., defines community foundations as follows:

> Community foundations are grant making public charities that are dedicated to improving the lives of people in a defined local geographic area. They bring

[2] These three requirements are taken from actual cases we have encountered.

> together the financial resources of individuals, families, and businesses to *support effective nonprofits in their communities* (italics added).

Third. The word "community" in "community foundation" is significant for reasons other than federal tax exemption – it defines the "charitable class" of nonprofits for whose benefit the community foundation exists – *and it circumscribes the community foundation's fiduciary grant making discretion*.[3] Here is the question: is it a lawful exercise of authority for Heartfelt to position its three governance requirements as a roadblock between community nonprofits (Great Expectations) and the assets that have been donated to Heartfelt for purposes of supporting the same nonprofits?

Here is another way to look at it: An anonymous benefactor creates a trust at a local bank to be used to pay the tuition of children from Great Expectations who go to college. The bank has fiduciary duties to the children who make it into college. What would happen if the bank trust officer decided not to pay a child's tuition (denies access to the trust) unless the child chooses to major in mathematics – because the officer thinks mathematics degrees lead to better job opportunities and represent a better use of the trust's assets?

The trust officer would be fired for using an improper reason to deny the child access to the funds set aside for her benefit, and the same reasoning applies in our case. It is an unlawful and coercive exercise of fiduciary discretion for Heartfelt to withhold funds from Great Expectations for its failure to adopt Heartfelt's three governance requirements. It is not the role of Heartfelt to tell Great Expectations how to govern itself, but….

Fourth. It is Heartfelt's obligation to distribute its grant funds prudently, and prudence requires that it review (through due diligence) an applicant's governance practices. However (and this is our point), when it does so its obligation is to make sure the practices are at or above a baseline of generally acceptable standards, and if they are, then the governance inquiry should go no further. With this said, here are some ideas about what baseline standards would look like, as well as some thoughts on how the due diligence could be conducted.

Standard One – *Legal "essentials" must be in place*: An applicant should provide a "certificate of legal existence" from the Secretary of State and copies of the current certificate of incorporation and by-laws. Absent unusual circumstances (such as a first time applicant), the community foundation should be satisfied with a cursory review of these documents, at most. In our example, Heartfelt's three governance requirements would have been, in essence, modifications of Great Expectations' by-laws.

Standard Two – *Require externally prepared audited financial statements*: Externally audited financial statements are critical[4] because the auditor is required to flag (with liability accruals, footnotes, or opinion limitations) problems, liabilities and other material issues concerning the applicant. Community foundations should look at the financial statement carefully, and should feel free to ask relevant questions of management, the board, and even the auditors in appropriate cases.

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[3] The term "charitable class" has legal significance. It is a term the courts use when determining the persons or organizations for whose benefit charitable assets (such as the endowment at a community foundation) exist.

[4] In the case of smaller organizations a CPA "reviewed" financial statement may suffice.

Standard Three – *Essential insurance coverage must be in place*: Nothing can wreck an organization as much as an uninsured or underinsured loss. Grant applicants can easily obtain a "certificate of insurance" from their insurance agent showing the type of insurance (such as Directors and Officers, General Liability, Employment Practices, as appropriate) and the amount of coverage. The community foundation should not need more than a copy of the certificate – remembering that the board of the applicant and the insurance agent are the first lines of responsibility for making sure coverage is sufficient.

Standard Four – *Miscellaneous (but important) matters should be checked:* In commercial and corporate law practice it is common for parties, such as banks making a loan, to ask the borrower to sign a document (an officer's certificate) representing or certifying to the absence or the presence, as the case may be, of certain matters – such as lawsuits, audits or investigations pending or threatened; the entity's having all licenses necessary to conduct its business; that the organization is not in default under any of its major contracts; and the like. It would be reasonable for a community foundation to rely on a certification of this type.

In closing, it occurs to us that it would behoove the nonprofit sector to find its way to a unified set of principles on issues of this type, and perhaps, someday, to make its way to a "common form" of grant application to lessen the administrative time that grant makers and grant seekers need to invest in this very important function.

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.

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