REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – FALL 2014

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Two Topics:

Is the Connecticut Department of Children and Families Doomed to Dysfunction? Can Nonprofits Provide Equity Incentives to Employees?

The Connecticut Department of Children and Families (the DCF) is a very large public agency. Its legislatively mandated tasks include working with families and communities to improve child safety and well-being, ensuring that children have permanent families, protecting children who are abused or neglected, and strengthening families and communities. This is a mountain-sized mission with an almost infinite degree of difficulty in that it requires neck deep involvement in intimate aspects of personal and family lives in a milieu of poverty, teenage parents, domestic violence, substance abuse, mental illness, and the like. The DCF is similar to agencies in other states which, like Connecticut, decided some time ago that the state has a mediating role to play within the child-parent-family relationship.[1]

We have extensive experience with the DCF and nonprofit child and family service providers, and decided to discuss this topic after reading two dueling editorials about the DCF in the *Hartford Courant* in August of this year. The editorials offered decidedly different opinions about the DCF. The first took its lead from a report of the Connecticut Office of the Child Advocate for the year 2013. The report and the editorial both took the DCF to task for the deaths of 24 children under DCF supervision that year. The editorialist's suggestion: fire and replace the DCF Commissioner. The second editorial was written by a representative of the Annie E. Casey Foundation (which has been developing new programs for the DCF). This editorialist's opinion: the Commissioner is doing a fine job, and the new programs will make things better.

The editorials are typical of the DCF commentary genre in that the first treats the DCF as a whipping boy (everyone's favorite), and the second offers an improved version of the equivalent (the same old stuff). Neither editorial broaches the higher order questions that (in our experience) are on the minds of nonprofit executives in this field but rarely spoken by them in public. First, is there such a fundamental misfit between the DCF (a square peg) and the mission (a round hole) that the DCF (as a state agency) is doomed to dysfunction regardless of the skills of the Commissioner or the ingenuity of the programs? Second, would better results be achieved if executive authority for the mission were delegated to private nonprofit organizations (are they a better fit)? There are reasons to believe that the answer to both questions is "yes."

The DCF was created in 1969, and over its 45-year lifespan its statutory mandate and size have grown substantially. The DCF currently has (these figures are approximations taken from its website) 3,200 employees, an annual operating budget of over $800 million, and a case load of 36,000 children and 16,000 families. The website also states that despite this growth, the DCF's resources have been

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[1] The federal and state governments entered the social services arena in a large way in the 1960s as evidenced on the federal level by the numerous Great Society programs introduced by the Johnson Administration. Previously social issues were largely addressed by nonprofit organizations and associations and extended family members. See for example, the Fall 2013 issue of this Report titled "Deconstructing Micromanagement at the Connecticut Department of Developmental Services," available on our website, www.rrlawpc.com.

"outmatched by the scope of child maltreatment in Connecticut." This is a disturbing statement which brings several *non-rhetorical* questions to mind, as follows below.

It is, of course, self-evident that prior to 1969 there were no employees, budget, or caseload because there was no DCF. According to federal government data, the state's population was approximately 3 million in 1969. It is 3.6 million today. So, if since 1969 the DCF has had thousands of employees and spent billions of dollars, and if there has been a relatively modest increase in population over 45 years, why is the DCF "outmatched?" On a percentage basis are there more bad parents in the state? Has the DCF expanded its interpretation of terms such as "abuse" and "neglect" to include a wider variety of behaviors? Is it "outmatched" because of the expansion of the numbers of professions included in the "Mandated Reporter" statute?[2] Is data available to compare occurrences of abuse and neglect (on a percentage of the population basis) for the period prior to 1969 to various points in the DCF's history?

A disturbing possibility is that the agency has unwittingly created a self-perpetuating client base. While we have heard anecdotal accounts to this effect from DCF representatives, we call attention to the November 2013 DCF Strategic Plan (on its website at page 21) where the need to "assist families with multi-generational DCF involvement" is listed as an action item. The 2013 Child Fatality Review Report referenced in the first of the two *Hartford Courant* editorials noted that 62.5% of the mothers of the deceased children "had a history of DCF involvement" as children. Is it possible that the DCF is "outmatched" by a problem it has fostered?

This is a very messy and expensive picture that leads back to the reasons to believe that community based nonprofits would be a better fit to the mission, if adequately enfranchised and funded, as follows:

<u>Reason One</u>: The intimidating power of the DCF is inconsistent with the intimate nature of the mission. A few years ago we were at a nonprofit law conference and heard a comment offered by the executive director of a nonprofit child services provider: families in crisis react differently (defensively) when a person with a governmental identification badge shows up at the door because that person represents the power of the state. This power is potentially life altering (to remove children from parents, make arrests, interview teachers, order treatment, and the like). The point is not that severe intervention is never necessary, but that people do not respond as openly when the person "helping" them wields so big a stick. Members of a family in crisis will have conversations with a local minister that are much different from conversations with a DCF investigator or, for that matter (and this is our point), with a case worker from a nonprofit with ties in the community.[3]

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[2] Readers may not be aware of the "Mandated Reporter" statute under which members of fifty different professions (such as dental hygienists, chiropractors, optometrists, teachers, and coaches) have an obligation to report to the DCF any suspected child abuse or neglect – with fines of between $500 and $2,500 and a mandatory training program for a failure to report.

[3] Greater Hartford Legal Aid, Inc. has a publication on its website titled <u>Family Problems, DCF, and the Law</u>, which includes the following at page 15: "*It can feel very threatening and like a violation of your privacy to have someone from the State ask you questions about private family matters…. Nobody can force you to work with DCF. But sometimes, if you want to keep your kids, you'll have to get the help DCF says you and your kids need.*" The question, of course, is whether or not the "help" the DCF says is needed is appropriate to the situation and the coercion implicit in any suggestion when it comes from the DCF. See the discussion of the DCF's hierarchical management system under "Reason Two" on page 3.

Reason Two: The bureaucratic/political system of governance of public agencies is not as well suited for this mission as the fiduciary governance system followed by nonprofits. Bureaucratic governance is hierarchical with tiers layered from the bottom to the top; each tier is restricted as to its tasks and how to perform them. People at lower levels are often unable to question rules or decisions of people at higher tiers, and those at the higher levels are far removed and not in communication with those at the lower level where the actual work is performed. Management and staff in these bureaucratic systems are not fiduciaries and have little (if any) personal accountability. The following (taken from the Table of Contents from the DCF's Foster Care Manual) speaks for itself: "*Typical Chain of Command in a DCF Office: Regional Office Staff, Program Director, Program Manager, Social Work Supervisor, The Child's Regional Office Social Worker (ROSW), Foster and Adoptive Services Unit (FASU), Recruiting Social Worker, Licensing Social Worker, Matching Social Worker, Family Specialist Support Social Worker*."

In contrast, nonprofits are managed by governing boards and officers with personal "skin in the game" in the form of legally enforceable fiduciary duties of care and loyalty that create accountability. Board members and management often live in the community, understand its challenges better, and have a personal stake in that community's stability. The distance between upper management and the persons delivering the services is short, allowing for quick communications and adjustments. Nonprofits are private organizations, and privacy has its governance virtues, enabling people to act and speak more frankly and freely (they are not subject, for example, to the Freedom of Information Act).[4] Finally, nonprofits are a few steps removed from the political theatre and can focus more on what works best for the mission and less on what plays best at the ballot box.[5]

Can Nonprofits Provide Equity Incentives to Key Employees?

Providing equity incentives to key employees may sound like an oxymoron in the nonprofit context because nonprofit corporations do not issue shares of stock and have no owners. In contrast, in the for-profit sector it is common to provide equity/ownership incentives as a means of recruiting and rewarding key employees. For-profit organizations typically use options for this purpose, and the employee is permitted to exercise the options and to "cash in" the equity at retirement or at other pre-determined times.

The possibility of equity incentives in the nonprofit context presents itself when a nonprofit creates a for-profit affiliate to conduct business activities intended to generate income that can be transferred to the nonprofit parent for its use. The for-profit affiliate could be formed either as a corporation (the equity/stock of which would be owned by the nonprofit) or a limited liability company/LLC (the equity/membership interests would be owned by the nonprofit).

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[4] For a discussion of the Freedom of Information Act and nonprofits see the Spring 2013 issue of this Report titled "Fighting FOIA with FOIA."

[5] There is an organizational management principle – *subsidiarity* – which states that outcomes improve when tasks are delegated to the lowest or least centralized competent authority within a system. The principle is based on scientific analysis of the manner in which complex multivariable physical, economic and social systems operate, and supports the conclusion that networks of actors (in this case nonprofit entities) operating in close proximity to the problem achieve better results on a sustained statistical basis over time.

So the question is this: may a for-profit affiliate of a nonprofit provide options or other forms of equity incentive compensation to employees? The answer is "yes" – but the yes is qualified by two important principles. First, nonprofits will want to avoid what the IRS refers to as "private benefit" or "private inurement" problems – in other words, the value of any equity compensation award must not be "excessive" relative to the value of the employee's contributions (expert compensation consultants can be hired to help with this). Second, both the nonprofit and its for-profit subsidiary should adhere carefully to corporate formalities (board meetings, expert reports, and the like) to document procedural fiduciary prudence so that any inquiries by the IRS, donors, and outsiders (such as the press) can quickly be handled without even a hint of impropriety.[6]

Let us offer two other thoughts about this topic. First, this technique makes sense *only* if there is in fact a viable business conducted under the auspices of your nonprofit (in a for-profit affiliate), which is "easier said than done." In other words, do not put the cart before the horse. Second, this technique, if it works, could help with a phenomenon that is common in the nonprofit sector – key employees who dedicate their entire working lives to creating a successful nonprofit organization, only to realize that the compensation paid to them over the years (including what may be in their retirement plan) has left them unfairly disadvantaged as they near retirement. An equity interest in a for-profit subsidiary that could be cashed out at retirement might be a way to address this situation while providing the desired performance incentive.[7]

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.

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[6] Nonprofits interested in this topic can find guidance in IRS Private Letter Ruling 201125043, in which the IRS gave its approval to an equity compensation arrangement of the type discussed above.

[7] We have been involved in several cases in which an executive director spends decades building a very successful nonprofit organization, only to find that retirement is unfairly daunting financially given the years of effort. As a result, a person in this position may stay on too long, or even prove to be an impediment to a merger (that otherwise makes sense) that will cost the employee his or her job. The best we have been able to do for clients in this position is prepare "deferred compensation" contracts which pay out after retirement, and which are based on compensation consultant opinions that the employee was paid less than fair market value in prior years such that the newly created deferred compensation arrangement is a "make up" of past deficiencies.