

Background Information and Resources for the CAPLAW Governance Case Studies

I. BACKGROUND INFORMATION — SETTING COMPENSATION

The Head Start administrators, the IRS, and state regulators are each interested in compensation levels and the process by which they are determined.

A. HEAD START LIMITATIONS

Section 653 of the Head Start Act limits the compensation of Head Start staff. The language precludes use of any Federal funds to pay any part of the compensation of an individual employed by a Head Start agency whose compensation exceeds the rate payable for level II of the Executive Schedule, which is currently \$172,200 (effective January 2008).

1. COMPENSATION DEFINED

Compensation is specifically defined in Section 653 to include “salaries, bonuses, periodic payments, severance pay, the value of any vacation time, the value of a compensatory or paid leave benefit not [explicitly] excluded and the fair market value of any employee perquisite or benefit not [explicitly] excluded.” Explicitly excluded from counting as compensation is “any Head Start agency expenditure for a health, medical, life insurance, disability, retirement or any other employee welfare or pension benefit.”

2. THE CAP

The cap precludes any Federal funds being used to pay an individual whose compensation exceeds the cap, not just Head Start grant funds. Moreover, unlike previous policy in which grant funds could be used to pay up to the cap, but not for any compensation that exceeded the cap, the new statutory requirement precludes any funds being used to pay any part of an individual’s compensation, if that individual’s compensation exceeds the cap. For example, previously if an individual who worked full time for Head Start had a 2008 compensation level of \$180,000, that grantee would have been autho-

rized to charge up to \$172,200 of that compensation to the Head Start grant, finding \$7,800 in non-grant funds to fully pay that individual.

The new requirement will not permit any Head Start (or other Federal) funds, to be used to pay any part of that individual’s compensation. That is, all \$180,000 would have to come from non-federal sources or the individual’s compensation would need to be reduced. It is important to note that this cap applies to all staff who receive any part of their compensation from Head Start (or other federal funding sources), including those whose salaries are part of an indirect cost pool.

3. EFFECTIVE DATE

The Office of Head Start recognizes that some grantees will need to make adjustments to their personnel policies and/or will need to have their indirect cost rate redetermined by their cognizant federal agency. In order to give these agencies a reasonable period of time to make such changes, implementation of the compensation cap will be effective for all Head Start grantees beginning with the awarding of their FY 2009 annual grant award.

4. AUTHORITY

The foregoing discussion is based on a Program Information memorandum, ACF-PI-HS-08-03, issued on May 12, 2008 by the U.S. Department of Health and Human Services (Office of Head Start in the Administration for Children and Families).

B. SETTING COMPENSATION

Although there may be slight differences between how the IRS and state regulators judge the procedures used to set compensation and its reasonableness, in practice, the same procedures

should suffice for both state regulatory and tax purposes. These procedures include: (i) the use of meaningful comparables; (ii) linkage of pay to performance; (iii) the approval of the compensation package by an independent board of directors (or an authorized committee thereof); and (iv) the contemporaneous documentation of the decision and the basis for it.

C. THE INTERMEDIATE SANCTIONS

The intermediate sanctions are a comprehensive set of tax rules designed to assure that compensation paid to key employees and other insiders reflects market-rate compensation. If the IRS determines that the compensation is excessive, it can force the recipient to return the excess to the exempt organization and assess an excise tax equal to 25% of the excess on the recipient.

The centerpiece of this regime is a rebuttable presumption that compensation is reasonable if certain procedures are adhered to when setting the compensation. Specifically, the organization must demonstrate that (i) the compensation arrangement was approved in advance by the board of directors (or a committee thereof); (ii) such board (or committee) was comprised entirely of individuals who do not have conflicts of interest; (iii) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the compensation arrangement; and (iv) such board (or committee) adequately documented the basis for its determination concurrently with the decision.

The rules contemplate otherwise conflicted individuals recusing themselves from the process. A rebuttable presumption does not mean that the IRS cannot question the reasonableness of the compensation. But if the IRS does question compensation, it has the burden of proving the compensation is unreasonable.

1. COMPLEX

Unfortunately, the intermediate sanctions are a complex set of rules. This complexity is attributable to the fact that the rules not only apply to social service agencies, but to large nonprofit hospitals, cultural institutions, and colleges and universities. Smaller social service agencies will want to work with their legal counsel

or accounting firm to assure that the rebuttable presumption is available. Competent advisors should be able to provide practical advice without running up large professional fees.

2. DISQUALIFIED PERSONS

The intermediate sanctions only apply to compensation arrangements between the organization and individuals who are referred to as disqualified persons. Disqualified persons include voting members of the board, the president, chief executive officer, chief operating officer, the treasurer, the chief financial officer, and other persons who have substantial influence over the affairs of the organization.

An employee who earns less than \$105,000 during the 2008 tax year (this number is indexed for inflation and adjusted annually) generally will not be considered a disqualified person if the employee is not a voting member of the board or one of the officers named earlier. There are related-party rules which can cause someone otherwise not considered to be a disqualified person to be treated as one because of family membership or beneficial ownership interests.

3. THE INCENTIVES

Although people normally think of the intermediate sanctions applying to tax-exempt entities, the operation of these rules has the greatest practical impact on the executive director and other highly-compensated individuals. If the IRS successfully challenges the reasonableness of the executive director's compensation package, it is the executive director who must return any excess benefit to the organization and pay the 25% penalty. Consequently, the executive director and other disqualified persons should be the ones who insist that the necessary conditions are satisfied so as to permit reliance on the rebuttable presumption.

4. COMPARABLES

In a 2006 phone forum, the IRS indicated that reasonable compensation is an amount ordinarily paid for (i) like services (ii) by like enterprises (whether taxable or tax-exempt) (iii) under like circumstances.

a) Services are considered like by examining whether the work is “hands-on” or general involvement, national or local in scope, the number of employees managed, the size of the budget or assets managed, whether the management function involves multiple functions, departments, facilities, or entities, whether the position is full- or part-time, and whether the service is in multiple capacities or for a group of related entities.

b) Enterprises are considered alike by examining budget, revenues, number of employees, and persons served, whether the same type of business is involved (pre-school vs. university), and whether there is a mix of non-profit and for-profit entities. Additionally, the entities must be competing for the same pool of talent.

c) To ascertain whether the circumstances surrounding two nonprofits are similar, the analysis should ascertain whether the nonprofits are providing the services in an urban or rural environment, in similar size geographic areas, and in areas with the same costs of living. To be comparable, the compensation must consist of a similar mix of compensation items, and include all compensation items (whether taxable or not).

d) Organizations should consider reviewing Form 990s for comparable organizations to help them develop compensation comparables. Organizations are required to disclose compensation information for their five-highest paid employees, as well as for key employees, officers, and selected others. The redesigned Form 990, which will be first used for the 2008 tax year, requires more detailed compensation disclosures. Organizations can obtain copies of the three most recent Form 990s for most charitable and other tax-exempt organizations at <http://www.guidestar.org>

D. BEST PRACTICES

1. USE A COMPENSATION COMMITTEE

Developing a compensation package is a time-consuming process. The board can best preserve valuable meeting time by delegating to a compensation committee the task of arriving at an appropriate compensation package for the executive director and any other designated employees. Once the committee has developed a recommendation, it should then present the recommendation to the full board for review and approval.

2. USE A TALLY SHEET

Each member of the board should understand the form and the amount of compensation being paid to the executive director and other key employees. A one- or two-page tally sheet should be distributed to each board member before a compensation package is approved. It should list and succinctly value each item in the compensation package.

3. ASSURE BOARD INDEPENDENCE

Those approving the executive director’s compensation should be independent. Board members should not be related to the executive director or have a financial relationship with the organization that is controlled by the executive director or someone who reports to the executive director. For example, the board may have a lawyer as a member. Arguably, that lawyer is not independent if her law firm provides legal services to the organization and the executive director is the one who selects the law firm. Unfortunately, for purposes of the intermediate sanctions, the IRS has been less than forthcoming in defining the outer limits of independence.

4. LINK PAY TO PERFORMANCE

Compensation levels and bonuses should always be linked to performance. Setting compensation goes hand in hand with evaluating performance and setting goals. Boards should avoid routinely ratcheting up compensation levels simply because of the passage of another

year. In other words, pay for performance, not seniority.

5. AVOID THE LAKE WOBEGONE EFFECT

Garrison Keillor has famously said that the residents of his fictional Lake Wobegone boast that all their children are above average. Too many nonprofits believe the same of their “average” executive director. When relying on comparables, many organizations simply place their executive director at the 70th percentile. There are legitimate reasons why an executive director should be paid at a rate that places him or her below the 50th percentile. One is inexperience. Before paying an executive director at the 70th or 80th percentile, the organization should be able to demonstrate through concrete evidence that the executive director performs better than most other executive directors working for comparable organizations.

6. RELY ON MEANINGFUL COMPARABLES

The IRS wants to see organizations rely on comparables when setting compensation. Those comparables must be meaningful. That means making sure that the organizations used for comparison are similar to the organization relying on the comparables. To be considered comparable, an organization should conduct similar programs, be relatively equal in size, and have a similar workforce. It certainly is permissible—and may even be enlightening—to include outliers in the data set, but the people relying on the comparables must analyze all the data, recognizing the differences and explaining why those differences may or may not be relevant. In sum, compare apples to apples, but looking at oranges is certainly permissible as a part of an effort to gain a deeper perspective.

7. AVOID BUILT-IN CONFLICTS WHEN USING A COMPENSATION CONSULTANT

Some organizations will use a consultant to help them develop compensation packages for executive officers. This is appropriate, but only if the consultant is independent. The board

should not rely on a compensation consultant who is already performing consulting work for the organization, particularly if the executive director or other key employee retains the consultant. In that situation, the consultant has a built-in incentive to protect the benefits, human resources, and actuarial work performed for the organization by recommending higher than appropriate compensation for the executive director or other key employees. One-stop shopping may at first appear to be efficient, but it could prove costly and should therefore be avoided.

E. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Letter from the Massachusetts Attorney General to Citi Performing Arts Center, http://www.charitygovernance.com/charity_governance/files/2007_12_05_citicenter_attachment1.pdf.

This letter certainly is not the final word, nor should it be viewed as a legal requirement mandating a specific set of procedures. The letter was the culminating step in an investigation by the Massachusetts Attorney General into whether an arts group’s executive director was over-compensated. The analysis provides an excellent example of how any board should approach the determination of compensation.

2. House Committee on Oversight and Government Reform, EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS (Majority Staff Report, December 2007), available at <http://oversight.house.gov/documents/20071205100928.pdf>

3. Brian H. Vogel and Charles W. Quatt, DOLLARS AND SENSE: THE NONPROFIT BOARD’S GUIDE TO DETERMINING EXECUTIVE COMPENSATION (BoardSource 2005)

4. Executive Compensation: Audio version of

teleconference seminar, published by Board-Source and available at <http://www.boardsource.org>

5. The Intermediate Sanctions: Treasury Regulation Section 53.4958.

6. Bruce Hopkins, *THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NON-PROFITS* (Wiley 2003). This book is out of print, but used copies can probably be found on the Web.

7. IRS Continuing Education Materials

- a) “Automatic” Excess Benefit Transactions under IRC 4958, <http://www.irs.gov/pub/irs-tege/eotopice04.pdf>
- b) Intermediate Sanctions (IRC 4958) Update, <http://www.irs.gov/pub/irs-tege/eotopice03.pdf>
- c) Section 4958 Update, <http://www.irs.gov/pub/irs-tege/eotopicb00.pdf>

8. IRS Executive Compensation Initiative—A 2007 report on how the IRS is applying the intermediate sanctions in the field, <http://www.irs.gov/charities/charitable/article/0,,id=169164,00.html>

9. Organizations seeking comparables may want to consider using the Economic Research Institution’s Nonprofit Compensation database, available through subscription at <http://www.erieri.com/index.cfm?fuseaction=ERICA.Main&trkid=479-161>. The database is taken from the IRS Form 990 and 990EZ. The annual subscription rate for the professional edition is currently listed as \$489. Demo software can be requested.

II. BACKGROUND INFORMATION — INCENTIVE COMPENSATION

Incentive compensation raises issues under both federal tax law and the rules governing federal and CSBG grants.

A. FEDERAL TAX LAW

The following are considerations that should be taken into account when developing any bonus or incentive compensation plan:

1. BUSINESS PURPOSE.

There should be a “real and discernable business purpose” that furthers the CAA’s exempt purpose (for example: motivating and reinforcing efficiency and quality of service and encouraging cost containment). The plan must not be a device to distribute profits to principals of the organization or transform the organization’s principal activity into a joint venture.

2. APPROVAL BY INDEPENDENT BOARD

The plan should be established and implemented by an independent board of directors or an independent committee of the board, such as a personnel or compensation committee.

3. SAFEGUARDS

The plan should include safeguards to prevent a reduction in the charitable services the agency would otherwise provide and to prevent abuse of the plan (for example, taking steps to ensure that the agency is on track to provide all the program services it has committed to in its annual program budgets and plans before paying out bonuses and to ensure that program managers do not set aside funds for the bonus pool that should be used to provide program services).

4. REASONABLE COMPENSATION

Total compensation – including amounts paid under the plan, plus all other forms of compensation – provided to each employee should be reasonable.

5. CAP ON THE BONUS

The bonus plan should include a cap on the

size of a bonus that employees may earn (e.g., a certain percentage of their regular salaries). This will help the CAA determine in advance whether the employee’s total compensation is reasonable and will help in budgeting for payments under the plan.

6. OBJECTIVE STANDARDS

The bonus plan should set objective standards for judging employee performance that are linked to the agency’s accomplishment of its exempt purposes. It should also reward an employee for her actual accomplishments, rather than for the overall performance of parts of the organization in which the employee does not do significant work or on which the employee’s own work performance is not likely to have an impact.

7. RIGHT TO CANCEL

The plan should specify that the board may, in its sole discretion, cancel the bonus plan at any time if doing so is in the CAA’s best interests and that the board may cancel or reduce potential bonus awards at the time they are scheduled to be paid if payment of the awards would be in violation of any law or regulation, would jeopardize the agency’s ability to meet its obligations to funders, would jeopardize the agency’s ability to carry out its tax-exempt purposes or would otherwise not be in its best interest. (The agency should discuss with its employment law attorney how to structure and operate the plan so that cancellation of the plan or cancellation or reduction of potential bonus award will not run afoul of any state law concerning the payment of wages. In particular, if the plan can be unilaterally canceled, that fact and the basis for cancellation should be spelled out in the employee handbook or other appropriate written document made available to employees.)

B. FEDERAL GRANT LAW

Any incentive compensation arrangement must also be structured to comply with the requirements of OMB Circular A-122, Cost Principles for Non-Profit Organizations. Under Circular A-122, incentive compensation is an allowable cost

under a federal grant to the extent that: (i) overall compensation is determined to be reasonable (this requirement is consistent with the IRS requirement that an employee's total compensation be reasonable) and (ii) the incentive compensation is paid or accrued either: (a) under an agreement entered into in good faith between the organization and the employees receiving the incentive compensation before the employees performed the services on which the incentive compensation was based or (b) pursuant to an established plan followed by the organization so consistently as to imply an agreement to make an incentive compensation payment.

C. RESOURCES

1. See I_E, above.

2. See Private Letter Ruling 200601030 (Jan. 6, 2006); IRS Information Letter 2002-0021 (Jan. 9, 2002); and General Counsel Memorandum 39674 (June 17, 1987).

3. See OMB Circular A-122, Att. B, ¶ 8.j (available online at http://www.whitehouse.gov/omb/circulars/a122/a122_2004.html, which is not codified at 2 CFR Part 230, App. B

III. BACKGROUND INFORMATION — CONFLICTS OF INTEREST

Many believe that conflicts of interest are easily dealt with: Just adopt a policy, make sure that interested parties recuse themselves, and prices are determined by competitive bids or evaluated using independent appraisals. Unfortunately conflicts of interests are not so easily dealt with.

A. CONFLICTS-OF-INTEREST POLICIES

There are hundreds of conflicts-of-interest policies available on the Internet. It is tempting to just copy and adopt one of those policies. This is to be avoided. Any meaningful conflicts-of-interest policy must take into account the particular non-profit's specific circumstances and culture. At a minimum, the board should consider:

1. WHO?

Who should the policy apply to? Officers, directors, and employees are likely candidates, but what about independent contractors, vendors, volunteers, and beneficiaries of services? And what about past employees or retired directors, or family members or related entities?

2. WHAT?

What conflicts are covered? Everybody agrees that transactions between the organization and employees should be covered, but what about

- a) The local banker who is a nonprofit director if his bank agrees to make a market rate loan to the nonprofit? At first, this seems like a great idea, but what happens if the organization defaults on the loan and the banker also sits on the organization's finance committee?
- b) What about the education expert who sits on the nonprofit's board and agrees to provide her advice on a particular matter for free? Price certainly isn't the issue, but doesn't this potentially provide her with the equivalent of a super-majority vote because she can manipulate the board and the action it takes by how she formulates her advice.
- c) What about the architect who is the son of the board chair and who is submitting a bid

for work?

3. NOTIFICATION

If a person subject to the policy becomes aware of a potential conflict, who should he notify? Should the employee notify his immediate supervisor, or should there be one person who centrally reviews all conflicts?

4. ENFORCEMENT

How is the policy enforced? Typically, under the terms of the policy, those who are covered by the policy have an affirmative duty to identify potential conflicts.

- a) Should those subject to the policy be required to re-affirm it (and their compliance) once a year?
- b) Should someone be charged with auditing transactions to make sure there are no conflicts?

5. PENALTIES

The policy should clearly spell out the consequences of violating the policy, particularly if violations will result in a job action such as termination or suspension. In the case of a director, is an undisclosed conflict a basis for automatic removal?

B. DUALITY

With the tripartite board structure, the boards of CAAs are divided between low-income community members (and people who represent such individuals), government representatives, and other interested parties. Although probably unanticipated by the architects of this structure, this segmentation creates dual loyalties that pose potential conflicts.

1. LOW-INCOME REPRESENTATIVES

Is a low-income representative supposed to act in the best interests of low-income individuals served by the agency or in the best interests of the agency? Some people will assume the two focuses neatly dovetail, but suppose someone proposes spending \$2 million on a new program that benefits low-income members of the com-

munity when the organization is already running significant deficits?

2. GOVERNMENT REPRESENTATIVES

Assume the organization's bylaws provide that the mayor is an ex-officio board member, with full voting power. Further assume that the mayor has been advised by his staff to recommend that grant money be awarded to a competing CAA or other social service agency. How should the mayor resolve the conflict resulting from his dual roles as mayor and board member? He is supposed to do what is best for both the city and the organization.

A strong case can be made that the organization's bylaws and conflicts-of-interest policy address the potential for conflicting loyalties. Wherever addressed, the policy regarding these conflicts should be established from the outset and clearly explained to all interested parties.

C. OMB CIRCULAR A-110 (NOW CODIFIED AS 2 CFR PART 215)

The Office of Management and Budget has issued Circular A-110, Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations. These rules generally apply to federal grants and sub-grants, including some state-administered block grants, such as CSBG grants. The federal rules require that states must "ensure that cost and accounting standards of [the OMB] apply to a recipient of [CSBG] funds" See 42 USC 9916(a)(1)(B).

1. CONFLICTS OF INTEREST

Paragraph 42 of Circular A-110 requires that the grant recipient maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts. No employee, officer, or agent may participate in the selection, award, or administration of a contract supported by Federal funds if a real or apparent conflict of interest would be involved. Such a conflict arises when the employee, officer, or agent, any member of her immediate family, her partner, or an organization

which employs or is about to employ any of the indicated parties, has a financial or other interest in the firm selected for an award. The officers, employees, and agents of the recipient must neither solicit nor accept gratuities, favors, or anything of monetary value from contractors or other interested parties. However, organizations may set standards for situations in which the financial interest is not substantial or the gift is an unsolicited item of nominal value. The standards of conduct must provide for disciplinary actions to be applied for violations of the rules.

2. CONTRACT AWARDS

Paragraph 43 addresses the rules that apply to an agency's expenditure of grant funds, requiring competitive bidding. The grant recipient must be alert to organizational conflicts of interest as well as noncompetitive practices among contractors that may restrict or eliminate competition. The grant recipient is further instructed that when it awards contracts, the award is to be made to the bidder whose bid or offer is responsive to the solicitation and is most advantageous to the recipient, with price, quality and other factors considered.

D. HEAD START LEGISLATION

Section 642 of the Improving Head Start for School Readiness Act of 2007 addresses program governance, with subsection (c) focusing specifically on conflicts of interest. Under this recently enacted legislation, members of the governing body may not (i) have a financial conflict of interest with the Head Start agency (including any delegate agency); (ii) receive compensation for serving on the governing body or for providing services to the Head Start agency; or (iii) be employed, or have members of their immediate family be employed, by the Head Start agency (including any delegate agency).

Moreover, the governing body is given an affirmative duty to operate independent of staff employed by the agency. There are limited exceptions for individuals who hold a board position as a result of public election or political appointment if such position carries with it a concurrent appointment to serve as a member of a Head Start agency's

governing body. In such case, the individual can receive compensation if it payable as a consequence of the election or the appointment. Additionally such person can serve despite a conflict described in (ii) or (iii) above. These rules are now codified at 42 U.S.C. 9837.

E. IRS FORM 990

Beginning with the 2008 taxable year, the IRS and the public will know whether an organization has a conflicts-of-interest policy. Question 12a of Part VI of the Core Form to the recently revised Form 990 asks whether the organization has a conflicts-of-interest policy. Question 12b then asks whether officers, directors, and key employees are required to disclose annually interests that could give rise to conflicts. Finally, Question 12c asks whether the organization regularly and consistently monitors and enforces compliance of its conflicts-of-interest policy.

F. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Independent Sector, PRINCIPLES OF GOOD GOVERNANCE, available at <http://www.nonprofitpanel.org/>

2. American Law Institute, PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS: TENTATIVE DRAFT NO. 1 (March 19, 2007).

3. Marion R. Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (Belknap Press 2004).

Fremont-Smith is the dean of nonprofit governance. She served as the Assistant Attorney General and Director of the Division of Charities in Massachusetts and is a retired partner of Choate, Hall, and Stewart. The book may be more than many want, but it is what everybody needs. A soft-cover edition is scheduled for publication sometime in 2008.

4. Jack B. Siegel, A DESKTOP GUIDE FOR NONPROFIT DIRECTORS, OFFICERS, AND ADVISORS: AVOIDING TROUBLE WHILE DOING GOOD (Wiley 2006).

IV. BACKGROUND INFORMATION — WHISTLEBLOWERS

A. WHISTLEBLOWER POLICIES

In an effort to open up the line of communication, every organization should give serious considerations to adopting a whistleblower policy.

1. AVAILABILITY

The policy should be available to employees, independent contractors, volunteers, vendors and service providers, and service recipients.

2. RECIPIENT

The policy should identify the person who should receive the report. Policies often direct the whistleblower to a member of the board's audit or finance committee when the concern is over financial matters. In the case of employment practices, policies often direct the whistleblower to contact HR or a member of the organization's board (possibly a member of the board's compensation committee). Every policy should specifically name the person who the report is to be directed, provide for an alternative in that person's absence, and provide contact information.

3. EARLY REPORTING

The policy should encourage early reporting of concerns.

4. METHOD

Reports are best made by telephone or in a secure written form. Potential whistleblowers should be advised to avoid inter-office routing envelopes and e-mail reports. To encourage reports, the policy should state the mechanisms that are in place to protect the whistleblower's identity. For example, whistleblowers might be notified that the whistleblower's phone number will not appear as part of a caller id system when calling a hotline (assuming that is the case). The policy should also advise the potential whistleblower not to leave details as part of voice mail messages.

5. REPORTING THRESHOLD

The policy should require that any report should be made in good faith and be based on objective facts. It should also clearly state that malicious, intentionally false, or trivial reports will not be tolerated and may result in disciplinary action. Employees should be advised that unless the circumstances warrant, they should first address their concerns with their immediate supervisor, or when appropriate, HR. The policy should provide examples of situations where it is appropriate to bypass supervisors such as when there is clear evidence of criminal activity, extensive and ongoing harassment or discrimination, or threat to life.

6. CONFIDENTIALITY

The policy should never guarantee confidentiality, but it should assure that the organization will use reasonable efforts to keep the person's identity confidential if requested. An organization can never guarantee confidentiality because investigations, discovery, court proceedings, and other factors beyond the organization's control may result in the whistleblower's identity becoming known.

7. THE PROCESS

The policy should explain the process: What will happen as a consequence of the report? This aspect of the written policy will have to be general because each report will require different responses. The recipient of the report should respond immediately, notifying the whistleblower that the report has been received and briefly describing the steps that will be taken in response to the report. When possible, the recipient also should tell the whistleblower when the recipient will next contact the whistleblower.

8. INVESTIGATIONS

Investigations stemming from reports should be discreet and made on a need-to-know basis. E-mail and other unsecure modes of communication should be avoided for discussions in connection with the investigation.

9. FOLLOW-UP

The policy should provide for follow-up with the whistleblower to make sure that the whistleblower truly believes that the issue raised has been satisfactorily dealt with. A whistleblower who perceives that his efforts have been ignored is a dangerous person from the organization's standpoint. This is a person who may decide to contact the media, a regulator, or a lawyer.

10. LOGGING AND AUDITS

Each report should be recorded in a secure log. Log entries should include the whistleblower's identity, the date and nature of the report, a description of the responses and the resolution, a statement that the whistleblower has been notified of the resolution, and an indication whether the whistleblower is satisfied with the outcome. A designated compliance officer should audit the logs and the policy periodically. Good candidates for this task include the organization's general counsel, a board member, or the organization's outside legal counsel.

11. RETALIATION

The policy should prohibit retaliation against whistleblowers and specify the consequences resulting from retaliatory actions.

12. AFFIRMATIVE DUTY

Some organizations impose an affirmative duty on employees to report activity that violates organizational ethics codes, other standards, or the law. In theory, this sort of affirmative duty makes sense. Unfortunately, childhood has taught many of us that tattletales and teacher's pets are to be shunned. As a consequence, imposing an affirmative duty to report may provide the organization with a false sense of security. If an organization decides to impose an affirmative duty on its employees, it should clearly spell out the consequences resulting from noncompliance.

13. BOARD REVIEW

The board should periodically receive a report on the nature and number of complaints. The board should consider organizational changes when there are repeated reports raising the same

issue.

14. EMPLOYEE HANDBOOK

The policy should be included as part of the employee/volunteer handbook. It should state that it is subject to change at the discretion of management. The policy will need to be communicated to others through memo or contract terms.

B. THIRD-PARTY HOTLINES

Some organizations rely on third-party whistleblower hotlines to assure their employees greater anonymity in filing whistleblower reports. The proliferation of these providers is a direct result of the Sarbanes-Oxley Act of 2002, which mandates that certain publicly-traded corporations provide employees with the opportunity to report certain concerns on an anonymous basis. Anecdotal evidence indicates that nonprofits probably have not widely adopted the use of these third-party hotlines, but some hospitals and universities probably have.

1. EVALUATING THIRD-PARTY HOTLINES

In evaluating any third-party hotline, the CAA should ask the following questions?

- a) Is the hotline 24/7/365?
- b) Is the hotline staffed by personnel or is it a web-based or e-mail system?
- c) How do callers know that it is anonymous? How does a caller's number appear on the caller id system?
- d) What is the background of those who answer telephone-based hotlines? Are they lawyers or paralegals? Do they receive special training?
- e) Do the operators utilize scripts to conduct the interview or do they make it up as they go? What does the hotline do to assure consistency in how calls are handled?
- f) How do the operators record the data? Do they type comments into a computer database? Are phone conversations recorded? If so, how is anonymity maintained?
- g) Does the hotline provide callers with

case numbers so that they can call back at a later time with additional information and concerns without the need to start from the beginning?

- h) Does the hotline have multi-lingual capabilities?
- i) Are calls taken in a call center or in a more private setting?
- j) Does the system have time-stamp and other controls that prevent reports from being altered after the fact?
- k) How does the hotline report calls to the organization? Are the reports encrypted if transmitted electronically?
- l) Does the service offer materials and information sessions to the nonprofit's employees and other stakeholders so they are aware of the system?

Many of these questions also are relevant to a nonprofit that relies on in-house whistleblower reporting schemes.

2. THIRD PARTY SERVICE PROVIDERS

Here are the names and Web addresses for a number of third-parties who provide hot line services:

- a) Allegiance at <http://www.allegiance.com>
- b) Clearview at <http://www.clearviewpartners.com/>
- c) Ethical Advocate at <http://www.ethicaladvocate.com>
- d) Ethics Point at <http://info.ethicspoint.com>
- e) Global Compliance at <http://www.global-compliance.com>.
- f) Lighthouse at <http://www.lighthouse-services.com>
- g) Report Line at <http://www.reportline.net>
- h) Silent Whistle at <http://silentwhistle.allegiance.com>

CAPLAW has not worked with any of these organizations. The inclusion of their names on this list is not an endorsement of their services. A CAA considering any of these organizations must conduct its own due diligence.

3. COST

A CAA should contact the providers to obtain cost estimates. For ballpark purposes, one provider claimed the cost could be as low as \$1.50 per employee per year.

4. MULTIPLE FOCUSES

A CAA that decides to use a hotline service should consider the types of complaints that it wants directed to the hotline. Many of these services focus on financial fraud and abuse, but some services also handle employment practice and client protection (e.g. child or elder abuse by staff members) issues.

C. FALSE CLAIMS ACT

The Federal False Claims Act provides for the imposition of penalties on entities that make false claims to the Federal government. Section 3730(h) of Title 31 of the United States Code provides protection to employees who blow the whistle. Specifically, Section 3730(h) provides:

Any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of his employer or others in furtherance of an action under this section, including investigation for, initiation of, testimony for, or assistance in an action filed or to be filed under this section, shall be entitled to all relief necessary to make the employee whole.

A number of organizations have adopted False Claims Act polices. These are typically hospital systems and other organizations that are dependent on government funding or reimbursement. These policies define what a false claim is, described the consequences from making a false claim, and include references to the organization's whistleblower policy.

D. RETALIATION—SARBANES-OXLEY

In 2002, Congress enacted comprehensive corporate governance legislation directed at publicly-traded companies. This legislation carries the

title “Sarbanes-Oxley Act of 2002.” Among its many provisions are four that pertain to whistleblowers, but only one is relevant to CAAs because it applies to all employers rather than just publicly-traded companies. This provision criminalizes retaliation by CAAs and other employers for retaliation against whistleblowers who provides a law enforcement officer with any truthful information relating to the commission or possible commission of any Federal offense.

Specifically, Section 1513 of Title 18 of the United States Code provides:

Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

E. RETALIATION – FEDERAL EMPLOYMENT LAW

Several of the better-known federal employment laws contain provisions providing protection to whistleblowers.

1. OSHA

To help ensure that employees are, in fact, free to participate in safety and health activities, Section 11(c) of OSHA prohibits any person from discharging or in any manner discriminating against any employee because the employee has exercised rights under OSHA. These rights include complaining to OSHA and seeking an OSHA inspection, participating in an OSHA inspection, and participating or testifying in any proceeding related to an OSHA inspection.

2. ADA

The Americans with Disabilities Act contains whistleblower provisions, which prohibit discrimination against any individual who makes a charge, testifies, assists, or participates in an investigation, proceeding, or hearing under the ADA. Moreover, it is unlawful to coerce, intim-

idate, threaten, or interfere with any individual who exercises rights granted under the ADA or assists someone to exercise their rights.

3. FLSA

Under Section 215 of Title 29 of the United States Code, it is a violation of the Fair Labor Standards Act to discharge or in any other manner discriminate against any employee because such employee files a complaint or institutes proceedings under the FLSA, or testifies in such a proceeding.

4. FMLA

Under Section 2615 of Title 29 of the United States Code, it is a violation of the Family and Medical Leave Act for any employer to interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the FMLA. Moreover, it is a violation of the FMLA for an employer to discriminate against any individual for opposing practices that are unlawful under the FMLA. The FMLA imposes liability on employers that retaliate against employees for exercising their rights under the FMLA.

F. THE FEDERAL SENTENCING GUIDELINES

Mention the Federal Sentencing Guidelines and most people say, “What do they have to do with nonprofits and corporations?” Actually a lot, if the nonprofit engages in criminal activity. Such activity could result from an employee’s efforts to obstruct a federal investigation, cover-up fraudulent reimbursement activity, or any of the other type of crimes that corporations can be charged with. The guidelines instruct judges to take into account the presence of a whistleblower policy when punishing a corporation for the misdeeds of employees that are attributed to the corporation. Chapter 8 of the Federal Sentencing Guidelines (2004) provides as follows:

The guidelines and policy statements in this chapter apply when the convicted defendant is an organization. Organizations can act only through agents and, under federal criminal

law, generally are vicariously liable for offenses committed by their agents. At the same time, individual agents are responsible for their own criminal conduct. Federal prosecutions of organizations therefore frequently involve individual and organizational co-defendants. Convicted individual agents of organizations are sentenced in accordance with the guidelines and policy statements in the preceding chapters. This chapter is designed so that the sanctions imposed upon organizations and their agents, taken together, will provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct.... These guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.

Section 8B2.1(b)(5) then provides:

The organization shall take reasonable steps—

(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;

(B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and

(C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

G. STATE ANALOGUES

State laws also provide protection to whistleblowers. These protections are often analogous to

the ones under federal law, or they can take the form of more general protections under state fair labor laws. The following are two examples of state laws:

1. **ILLINOIS WHISTLEBLOWER ACT.** Under Illinois 740 ILCS 174, an employer cannot make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency if the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. Nor may an employer retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of a state or federal law, rule, or regulation. The act provides the employee with the right to bring a lawsuit for damages in the event of a prohibited retaliation.

2. **CALIFORNIA LABOR CODE.** Section 1102.5 of California's Labor Code provides that no employer may make, adopt, or enforce any rule, regulation, or policy preventing an employee from disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation. Moreover, no employer may retaliate against an employee for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation.

H. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. Stephen M. Kohn, Michael D. Kohn, and David K. Colapinto, **WHISTLEBLOWER LAW:**

A GUIDE TO LEGAL PROTECTIONS FOR CORPORATE EMPLOYEES (Praeger 2004).

2. Policies found on the Web should never be adopted by an organization without a thorough review and analysis of the policy in terms of the organization's own culture, needs, or operating environment. With that caveat, CAAs should google the phrase "whistleblower policy." This search will return a number of policy examples which will show how other organizations have dealt with the issue.

V. BACKGROUND INFORMATION — EVALUATING THE BOARD CHAIR

The members of the board should not automatically reappoint the board chair to repeated terms unless the board chair is adequately discharging his duties. A board chair is a good one if the chair:

- A. Starts and ends the meetings on schedule.
- B. Adheres to an agenda.
- C. Keeps the board informed of all major issues and seeks board member input.
- D. Maintains decorum during board meetings.
- E. Curbs extraneous comments and digressions during board meetings.
- F. Avoids creating board factions or regularly siding with one existing faction.
- G. Demonstrates respect for different points of view.
- H. Maintains an even-temperament.
- I. Appears and is approachable.
- J. Delegates tasks to appropriate committees and individuals on the board.
- K. Fosters and maintains an excellent working relationship with the executive director and staff members who have regular contact with the board.
- L. Stays on top of ongoing issues and problems, asking for regular or progress reports from the appropriate individuals or committees.
- M. Demonstrates follow through.
- N. Anticipates potential problems before they become actual problems.
- O. Seeks help from outside experts (e.g., lawyers,

accountants, and consultants) when the board or the organization lack the expertise (as opposed to winging it).

- P. Acknowledges when a mistake has been made.
- Q. Refuses to tolerate efforts to circumvent rules or engage in illegal activity.
- R. Keeps an eye on the long-term direction of the organization.
- S. Provides a good public face for the organization.
- T. Takes the board's oversight function seriously.

VI. BACKGROUND INFORMATION — FINANCIAL REPORTING, INTERNAL CONTROLS, AND AUDITING STANDARDS

A. RESOURCES

The following resources may prove useful to anyone who is looking for more detailed information.

1. AICPA, NOT-FOR-PROFIT AUDIT AND ACCOUNTING GUIDE (Updated Annually)
2. Gerald M. Zack, FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION (Wiley 2003).
3. Bruce Chase, NOT-FOR-PROFIT ACCOUNTING AND REPORTING: FROM START TO FINISH (AICPA 2006).
4. William E. Thompson, INTERNAL CONTROLS: DESIGN AND DOCUMENTATION (AICPA 2006).
5. Phil Sherman, ANALYTICAL PROCEDURES FOR NONPROFIT ORGANIZATIONS (AICPA 2005).
6. STATEMENTS ON AUDITING STANDARDS NO 99: CONSIDERATIONS OF FRAUD IN FINANCIAL STATEMENT AUDITS (AICPA 2002).

This auditing standard was promulgated in the aftermath of the Enron, WorldCom, Global Crossing, and other corporate scandals that came to light in 2001. It recognizes that the CPA's primary purpose in conducting a financial statement audit is not the detection of fraud, but that the public nevertheless assumes that is exactly the purpose of an audit. Although directed at external audits, this relatively short guide is an important resource for nonprofit boards because its focus is more on thinking about on the big-picture aspects of fraud rather than specific and technical methods for detecting fraud.