

## Introduction to the Rules of Foundations for New Directors

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The paper introduces the legal issues with which a director of a private foundation should generally be aware. It is not intended as a comprehensive overview of all issues that might confront a private foundation. Private foundations are subject to a complex set of rules and regulations overseen by the Internal Revenue Service. In addition, typically as a not-for-profit corporation (or trust) organized under state law, the foundation is also subject to various State laws and the oversight of the Attorney General.

It is strongly recommended that a private foundation and its directors frequently consult with competent counsel whenever questions arise (and preferably beforehand) and periodically invite counsel to provide briefings on relevant issues and developments in the sector. The costs of counsel can be a consideration in deciding how often counsel should be consulted or even to have in house counsel. As this paper will identify, however, there are many legal pitfalls that a private foundation can confront, and spending a little bit to save the foundation from damages, monetary and reputational, is prudent and, in the author's opinion, worth the cost.

It is not expected that a director be intimately familiar with the rules in all their complexities. A director should, however, be generally aware of the basic concepts and, of course, his/her duties to the foundation. **One of the most important unwritten rule is to ask questions of legal counsel if you are at all uncertain about your duties or an issue.** There is really no question that is too "dumb" to ask. A director should never be in a position if a problem arises of wishing she wished she had asked a question.

A director should all be aware of and have copies of the basic governance documents and policies that are particularly relevant to directors, such as the by-laws, articles of incorporation, charters for Board committees, compensation and expense reimbursement policies if applicable, the code of conduct or conflicts of interest policies applicable to directors and similar documents that may be relevant to the particular foundation.

### **General Duties of Directors of Not-for-Profit Corporations**

Directors of not-for-profit corporations have fiduciary duties similar to the directors of for-profit companies. Each director owes two primary obligations to the corporation that he or she serves: A duty of care and a duty of loyalty. Many not-for-profit commentators also suggest that there is a separate duty of obedience, which is a duty to conform the organization's activities to its charter and applicable law. In for-profit companies, the duties run generally to the corporation and its shareholders; in the case of not-for-profits, the duties run directly to the corporation and derivatively to the general public.

The duty of care requires directors to use that amount of care which an ordinarily careful and prudent person would use in similar circumstances and consider "all material

information reasonably available” in making business decisions.<sup>1</sup> A breach of the duty of care can arise from a board decision that is made in a negligent manner, as well as a board’s failure to act to prevent loss to the corporation. Courts in Delaware have focused increased attention on a corporate board’s duty to oversee and monitor the corporation and the conduct of its affairs by management.

The duty of loyalty requires directors to act in good faith and solely in the best interests of the corporation. A director should seek to avoid conflicts of interest and, if actual or potential conflicts are present, to disclose the nature of the conflict and abstain from voting on the matter. Decisions made by directors should be independent such that any decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence. Also implicit in the duty of loyalty is an obligation of each director to maintain the confidentiality of information the corporation treats as confidential and information regarding the board’s deliberations.

Each foundation should have a conflicts of interest policy that requires each director to disclose certain relationships to help the foundation address any perceived or actual conflict. Disclosures should be completed on at least an annual basis, and updated whenever relationships change during the course of the year.

Directors of a private foundation also should generally be familiar with certain rules applicable to private foundations arising from the Internal Revenue Code or relevant state law. Some of the more important rules are described below.

### **Protection Provided to Directors**

The risk of claims against foundation directors is considerably lower than the risk to directors of public or private for-profit companies. Nevertheless, many foundations will indemnify their directors or carry directors and officers liability insurance. A director should be aware of the scope of any indemnification or insurance and understand its limitations. **It is wise for directors asked to serve to understand the scope of the protections before agreeing to serve.** Often indemnification is provided in the bylaws or by special resolution. Insurance may not be necessary if there is a broad indemnification provision backed by a credit worthy foundation, but many foundations will obtain insurance to provide additional protection. Sample indemnification clauses can be provided upon request.

### **Legal Overview of the Regulation of Foundations**

In 1969, Congress, reacting to perceived abuses by private foundations, created a legislative and regulatory overlay for private foundations that is complex and pervasive.<sup>2</sup>

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<sup>1</sup> *In re Walt Disney Co, Derivative Litig.*, 907 A.2d 693,749 (Del. Ch. 2005) (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) and *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000)), *aff’d*, 906 A.2d 27, 55 (Del. 2006).

<sup>2</sup> For a historical perspective see *The 1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings*, ( Thomas A. Troyer)

Since then, heightened Congressional or regulatory scrutiny of the not-for-profit sector has occurred from time to time triggered by perceived abuses or special cases that attract media attention. From 2005-2007, for example, not-for-profit organizations came under considerable scrutiny by the Senate Finance Committee, various States' Attorneys General, and the media because of alleged abuses detailed in the media. At the request of the Senate Finance Committee, Independent Sector, a membership organization, convened a panel of experts to address the perceived abuses. The Panel issued two reports and a list of thirty-three principles for good governance and ethical practices that it encourages all nonprofits to follow.

In general, the law divides charitable organizations into private foundations and public charities and imposes additional requirements and burdens on private foundations. A charitable organization is presumed to be a private foundation unless it can demonstrate otherwise.

Among the existing rules most relevant to the activities of private foundations are the following:

- The establishment of a class of persons known as "disqualified persons" of which directors, among others, are a part;
- Rules restricting or prohibiting certain conduct or activities by the foundation or its disqualified persons. This includes (i) lobbying (except in self-defense), (ii) self-dealing as defined in the Internal Revenue Code, (iii) participation in political campaigns, (iv) certain types of investments that would constitute jeopardizing investments, and (v) owning controlling interests in companies engaged in business not related to charitable activities. These topics and others are described more generally in "Selected Topics", which begins on the next page;
- The imposition of taxes on investment income, self-dealing transactions, failure to distribute income, certain activity or certain gains; and
- A requirement that private foundations distribute as charitable distributions a minimum of five percent (5%) of their qualifying assets each year.

Sanctions for failure to comply with private foundation rules potentially include a tax on both the foundation **and its disqualified persons**, possible loss of tax exemption, and repayment of all tax benefits accrued.

The following pages contain a more detailed description of the special rules applicable to private foundations.

## **Selected Topics**

### **Lobbying**

A private foundation may not lobby except in self-defense.

Public charities may use a portion of their funds to lobby. A private foundation can make grants to public charities that lobby, *provided* certain rules are met. Simply put, with respect to both general operating support grants and project grants, foundation grant funds cannot be earmarked for lobbying purposes. For project grants, the foundation must also show that the amount of its grant is less than the non-lobbying expenditures of the grantee in connection with the project.

There are exceptions to the definition of lobbying that permit a private foundation to fund or participate in certain activities. In shorthand, these exceptions are as follows:

- Supporting or participating in non-partisan analysis, study or research;
- Providing support for or directly providing technical analysis to legislators at the written invitation of the legislative body; and
- Examinations of or communications regarding broad social, economic and similar problems.

### **Private Inurement and Private Benefit**

Private inurement refers to the prohibition in the Internal Revenue Code against any part of the net earnings of a § 501(c)(3) organization from inuring to the benefit of any private shareholder or individual. The private inurement doctrine forbids ways of causing the income or assets of a tax-exempt organization from flowing away from the organization to a person who has a significant relationship with the organization and is considered an "insider".

Forms of prohibited private inurement include unreasonable compensation, unreasonable rental arrangements, unreasonable borrowing arrangements, unreasonable sales arrangements and some involvement by tax-exempt organizations in joint ventures or partnerships.

In many respects, the self-dealing rules, described below, directly applicable to private foundations are a codification of the important parts of the private inurement doctrine.

Private benefit is similar in concept to private inurement and prohibits a private foundation from permitting an outsider from benefiting from a transaction in a manner that is more than incidental to the primary charitable purpose of the transaction.

A violation of the private inurement doctrine has serious consequences in that it can lead to the revocation of the tax-exemption of an organization. The private inurement rules

tolerate less benefit to insiders as incidental to a charitable purpose than would be permissible under the private benefit test for transactions with outsiders.

The prohibition against private inurement does not extend to the payment of reasonable compensation or the provision of reasonable benefits to staff. For the foundation's purposes, any time an "insider" is receiving a benefit we look carefully at the circumstances to be sure we do not run afoul of the private inurement or self-dealing rules and that there is a sound and proper justification for the case.

### **Self-Dealing**

One critical part of the Congressional effort to curb perceived abuses by foundations in the 1969 legislation was prohibiting a foundation from having any financial transactions, direct or indirect, with "Disqualified Persons" except in very limited circumstances. "Disqualified Persons" include persons who create, fund, or control the foundation, **directors** and officers, and likely other senior executives and **their respective spouses and immediate families**. It also includes government officials above a certain pay grade.

This prohibition applies even if the foundation benefits from the transaction. An extreme example, often cited, is that a foundation cannot buy for \$1 an asset owned by a Disqualified Person that is worth \$1 million.

The rules can be complicated and it is in this area that a foundation can unwittingly violate the rule. Penalties can be imposed on both the Disqualified Persons AND the foundation managers who approved the transaction.

The basic prohibited transactions are as follows:

- Sale, exchange or leasing of property between a private foundation and a Disqualified Person;
- Lending of money or other extension of credit between a private foundation and a Disqualified Person;
- Furnishing of goods, services or facilities by a private foundation to a Disqualified Person and vice versa;
- Payment of compensation/reimbursement of expenses by a private foundation to a Disqualified Person;
- Transfer to or use by or for the benefit of a Disqualified Person of any income or assets belonging to a private foundation; and
- Agreement by a private foundation to pay a government official.

### **Reasonable Compensation**

One of the most important exceptions to the self-dealing rules is that a private foundation may pay reasonable compensation for personal services "which are reasonable and necessary to carrying out the exempt purposes of the organization." The rules regarding reasonable compensation are not precise and it is important that there be an adequate basis and record to support compensation decisions especially for the more highly compensated individuals at a foundation.

The intermediate sanctions legislation directed at public charities provides some guidance that is helpful for private foundations. That includes a presumption that compensation decided by disinterested members of the Board, such as a compensation committee, based on suitable comparability data is reasonable and documented contemporaneously. If such procedures are followed, the burden falls on the IRS to demonstrate that the compensation is excessive.

Compensation paid to officers of not-for-profits is also a public relations' issue that carries with it its own set of issues. Besides potential bad publicity, compensation viewed as excessive by members of Congress could trigger public hearings and, possibly, adverse legislation.

### **Participation in Political Campaigns**

The IRS and the Treasury Regulations prohibit a private foundation (or other § 501(c)(3) organization) from participating in political campaigns. This is an area in which the IRS has been fairly active, spurred in part by complaints from organizations alleging that churches and other religious institutions and groups have been too active. Failure to comply with this prohibition subjects the offending organization to possible loss of its tax status, a step the IRS has taken in the last few years in especially egregious circumstances.

A foundation can fund voter registration drives if very specific rules are met. Consequently, when a grant is proposed in this area, counsel takes a close look at the proposal to be sure that it fits within the appropriate criteria.

### **Jeopardizing Investments**

A private foundation is prohibited under IRS regulations from making an investment that jeopardizes the carrying out of a foundation's exempt purpose. Under IRS regulations, an investment is considered to jeopardize the carrying out of the exempt purpose if it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long and short-term financial needs of the foundation under the facts and circumstances prevailing at the time the investment was made.

This determination is made on an investment-by-investment basis, in each case taking into account the foundation portfolio as a whole. Certain investments will be closely scrutinized such as trading securities on margin, trading commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls and straddles, the purchase of warrants and selling short. These will be viewed, however, in the context of the overall portfolio.

Generally speaking, the nature of a foundation's investment portfolio will help provide protection against jeopardizing investments if it is significant enough and diversified. Many foundations' investment approaches today also include complex derivatives and other instruments to hedge positions or increase exposures which under the jeopardizing

investment rules will merit additional scrutiny. Consideration should be given to obtaining legal opinions when warranted for particularly complex or sophisticated transactions..

There are also State statutes applicable to a foundation's management of its assets. Most states now have enacted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") and there may be other relevant statute trust or other statutes that should be considered. In Illinois, for example, the Illinois Trust and Trustees Act specifies that the trustees must invest and manage trust assets as a prudent investor would, considering the purposes, terms, distribution requirements, and other circumstances. This standard requires the exercise of reasonable care, skill and caution and in the context of the trust portfolio as a whole.

UPMIFA revises the prudence standard that applies to the management and investment of charitable funds by effectively merging the laws applicable to private trusts and business corporations. It provides that, in addition to complying with the duty of loyalty imposed by general corporate law, **each person responsible for managing and investing assets of a charitable institution shall manage and invest such assets in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.**

This standard is consistent with the business judgment rule under corporate law, as applied to charitable institutions. UPMIFA sets forth a number of factors that managers should consider, if relevant, in acting pursuant to the prudence standard:

- (a) General economic conditions;
- (b) The possible effect of inflation or deflation;
- (c) The expected tax consequences, if any, of investment decisions or strategies;
- (d) The role that each investment or course of action plays within the overall investment portfolio of the institution;
- (e) The expected total return from income and the appreciation of investments;
- (f) Other resources of the institution;
- (g) The needs of the institution to make distributions and to preserve capital; and
- (h) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

UPMIFA also incorporates a duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. It also provides that an institution should only incur costs that are "appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution".

Illinois' version of UPMIFA also affirms the power of a charitable institution to delegate to an external agent the management and investment of the institution's funds to the extent that it acts with the care that an ordinarily prudent person in a like position would use in

selecting the agent's actions. If it acts in this manner, it will not be liable for the decisions or actions of the agent. UPMIFA clarifies previous law in this regard.

**Unrelated Business Activity / Excess Business Holdings**

A private foundation is prohibited from engaging in activity that is not related to its exempt purposes in any substantial way. Excess business holdings also restrict a foundation from holding controlling equity interests in most types of entities. To determine whether the private foundation has an excess business holding, the ownership interest of the foundation and all Disqualified Persons (i.e., directors and members of their immediate family) are added together.

Significant penalties can attach to such activity. Certain income generated from various types of activity or investments, known as unrelated business taxable income, is not prohibited but is taxed at the normal corporate rates.