

# THE VIRTUOUS TRUSTEE?

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Fort Worth Chapter TSCPA Free CPE Day 2016

Fort Worth, Texas

June 16, 2016

What does it take to avoid  
hidden dangers?

Remember the lesson of Indy:  
Know the rule,  
interpret the rule,  
apply the rule





KNOW THE RULE

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# The Rules: State Law

## Duty of Care

- Good faith
- Person of ordinary prudence
- Decisions reasonably believe to be in the foundation's best interest
  - May be afforded protection from business judgment rule or trust indenture

## Duty of Loyalty

- Act unselfishly
- Transactions with the foundation (if allowed) must be fair
- Maintain confidentiality
- Don't take foundation's business/investment opportunities

## Duty of Obedience

- Remain faithful to and pursue the goals of the foundation
- Follow the governing documents
- Follow gift restrictions
- Abide by the law/IRC
- Ensure charitable assets are not diverted



# Duty of Care: Business Judgment Rule and Directors

Directors of nonprofit corporations are not liable where they exercise their business judgment in making decisions on behalf of organization.

The diagram features a central light blue circle containing the main statement. Three lines extend from the right side of the circle to three separate text boxes on the right, each providing additional context or clarification.

Parameters not clearly defined (compare for profit context)

Statutory law governing nonprofit corporations simply refers to the duty of care

Essentially means directors are not liable for simple negligence absent fraud, illegality or a disabling conflict of interest

Keep the following  
information  
accessible in a  
Board  
Book/Director's  
Notebook:

- Articles of Incorporation/Certificate of Formation
- Bylaws
- Conflict of Interest Policy
- Minutes for the previous year
- Most recent audit/review
- Budget and most recent financials



**A Director  
Should  
Seek to Do  
the  
Following:**

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Familiarize herself with material aspects of the organization

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Faithfully attend meetings

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Read materials and prepare for meetings

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Ask questions before, during and after meetings

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Exercise independent judgment

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Rely on appropriate sources of information

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Review minutes of the board

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Seek to stay informed as to legal obligations and good governance

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# Corporate Opportunity

- Prohibits a director from usurping corporate opportunities (i.e. opportunities in which the corporation has a legitimate interest or expectancy and the financial resources to exploit)
- Where closely related to corporate operations, must disclose (timely)
- Defenses where no disclosure:
  - Not same line of business
  - Corporation abandoned opportunity
  - Corporation lacked financial resources to pursue the opportunity

# Interested Transactions

Not inherently unethical or a violation of law

**Note: Loans to directors are a statutory violation**

Key is disclosure and how the director and board then deal with a disclosed conflict (i.e. upon disclosure the board should provide a disinterested review of the matter)

Decision makers should consider adopting a conflict of interest policy



# Interested Transactions

An officer or director is interested if he:

Makes a personal profit from the transaction with the corporation

Buys or sells assets of the corporation

Transacts business in the officer's or director's capacity with a second corporation of which the officer or director has a significant financial interest

Transacts corporate business in the officer's or director's capacity with a member of his family

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# Genesis of the Constraint

- Express restriction (such as in a gift instrument)
  - This gift is for the express purpose of medical research into cures for the Ebola virus.
- Response to solicitation
  - All funds raised will be used for humanitarian aid in Liberia.
- Arising from governing documents
  - This Corporation is organized and shall be operated for the charitable purpose of animal rescue.

# What is the Legal Effect of the Constraint?

- Analogized to the creation of a charitable trust [does not impose duties of trustees on directors]
- Binding on charitable recipient
- Fiduciary duty imposed on directors
- Debate concerning restrictions arising from governing documents



# Governance and the IRS

Form 1023

Public Charity  
Excess Benefit  
Rules

Private  
Foundation  
Prohibited  
Transactions

990 and 990  
Instructions

- Policies/  
Procedures

Position  
Paper/  
Speeches/  
Work Plans

# Part VI – Governance, Management and Disclosures

- Who is an **independent member** of the governing body?
- Regulations define independent for *rebuttable presumption* purposes.
- 3-prong test
  - Compensation as an employee
  - Compensation as an independent contractor
  - Schedule L Transactions Test
- Reasonable efforts to obtain – **questionnaire**



# Part VI – Governance, Management and Disclosures

Did any ODTKE have  
a family relationship  
or business  
relationship with any  
other ODTKE?

Ordinary course of  
business exception

Privileged  
relationship  
exception

- Attorney and client
- Medical professional and patient
- Clergy and communicant

\$10,000 threshold for  
reporting

Reasonable efforts to  
obtain -  
questionnaire

- With name, title, date,  
and signature of each  
person sent any time  
during year

# Part VI – Governance, Management and Disclosures

- Contemporaneous Documentation
  - Does the organization contemporaneously document meetings of the governing body and related committees through preparation of minutes and other similar documentation?
    - Contemporaneously means within 60 days of meeting or at the next meeting whichever is later.
    - If no, explain in Schedule O circumstances, process, or changes to be made going forward.



# Part VI: Governance Policies

## Conflict of Interest/Annual Disclosures

- Adopting a conflict of interest policy helps ensure that officers and directors disclose their interests.
- Adopting a conflict of interest policy is not a state or federal law requirement.

## Some transactions are simply not allowed:

- loans to directors and (subject to certain exceptions) officers (prohibited under Texas law; TBOC § 22.225)
- Directors who vote for or assent to the making of any such loan in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid.

# Part VI: Governance Policies

## Whistleblower Policy

- encourages staff to come forward with credible information on illegal practices or violations of adopted policies of the organization;
- specifies protection from retaliation; and
- identifies staff, board members, or outside parties to whom such information can be reported.



# Part VI: Governance Policies

## Document Retention and Destruction Policy

- identifies the record retention responsibilities of staff, board members, and outsiders for maintaining and documenting the storage and destruction of the organization's documents and records.

## A Document Retention and Destruction Policy

- should include guidelines for handling electronic files
- should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system.

Again, unlike most SOX provisions, the document preservation provisions of SOX apply to nonprofit corporations and carry significant criminal penalties.



# Other Policies



**Joint Venture Policy**



**Policy on  
Chapters,  
Affiliates, and  
Branches**



**Gift Acceptance  
Policy**



**Expense  
Reimbursement  
Policy**



**Executive  
Compensation  
Policy**



**Political Activity  
Policy**



**990 to the Board  
Policy**



**Code of Conduct**



# Private Foundations: Self-Dealing – IRC 4941

- Imposes excise taxes with respect to any direct or indirect act of self-dealing between a PF and a DP
- Two tier tax: Applies to self-dealer and foundation managers who knowingly and willingly approve transaction
- Numerous special rules and exceptions apply

# Private Foundations: Jeopardizing Investments – IRC 4944

- Imposes excise taxes with respect to any amount invested in such a manner as to jeopardize the accomplishment of PF's exempt purposes (short-term/long-term)
- Two tier tax: Applies to PF and any foundation manager who knowingly and willingly approved investment (care and prudence is key)
- Important exceptions: Donated investments; PRI's



# Private Foundations:

## Taxable Expenditures – IRC 4945

- Imposes excise taxes with respect to any amount paid or incurred for non-exempt purposes
  - Lobbying, political intervention, grants to individuals for travel, study or similar purposes without IRS pre-approval of procedures, grants for non-charitable purposes, grants to non-public charities without expenditure responsibility
- Two tier tax: Applies to PF and any foundation manager who knowingly and willingly approve expenditure
- Due diligence and proper documentation is essential
  - Beware of special situations: PF to PF, PF to controlled entity, PF to certain SO's

# Operational-type liability may still exist

- Employment claims (e.g. sexual harassment)
- Fraud claims
- Contractual liability (personal guarantee, made in personal name)
- Failure to withhold and pay employment tax
- Aiding and abetting tax fraud
- Defamation





**INTERPRET THE RULE**

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# What's virtue got to do with it?

## The Seven Deadly Sins

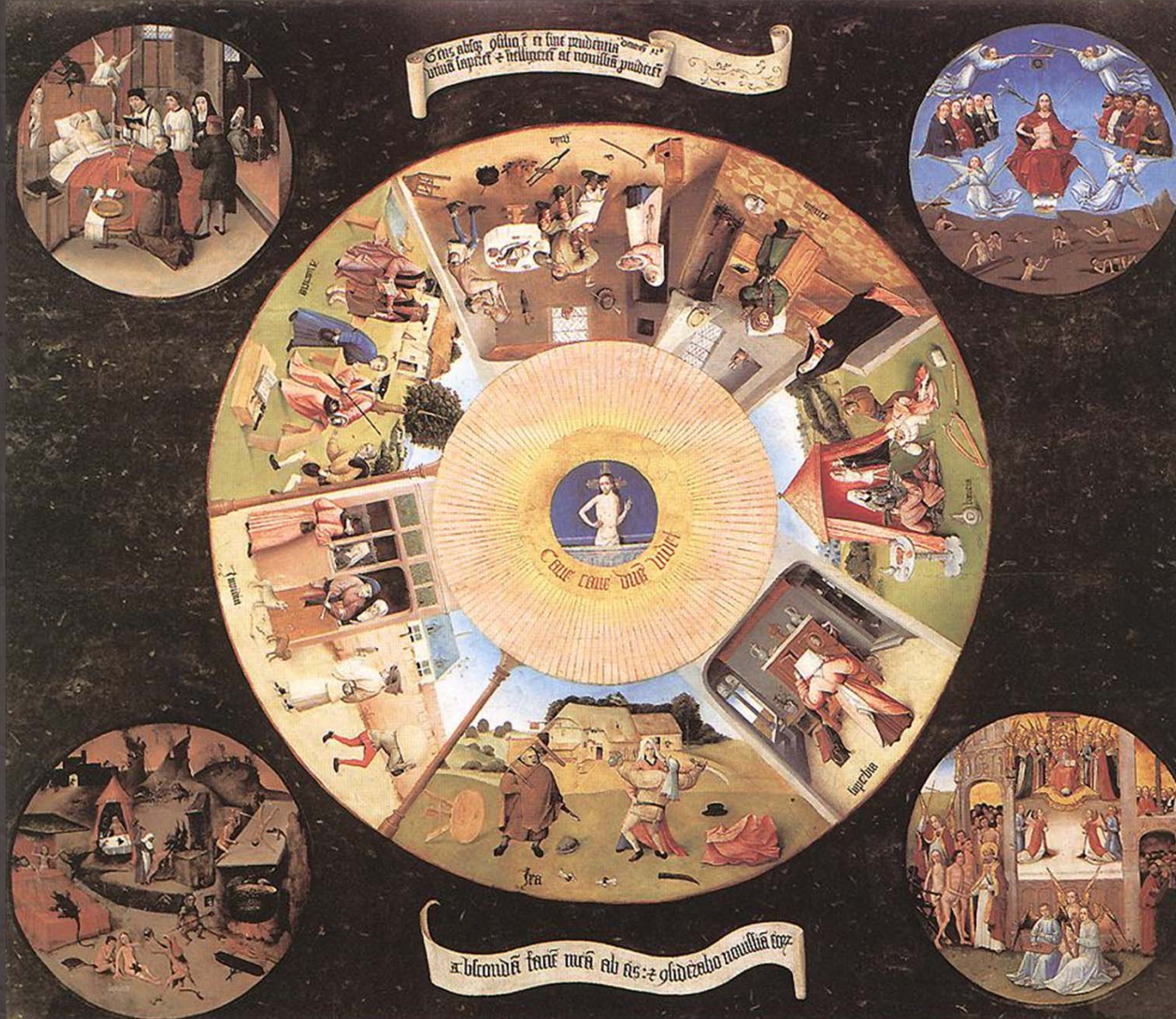
- Hubristic pride
- Greed
- Lust
- Malicious Envy
- Gluttony
- Wrath
- Sloth

vs.

## The Seven Heavenly Virtues

- Humility
- Charity
- Chastity
- Kindness
- Temperance
- Patience
- Diligence

*Credit Wikipedia for these lists*



Hieronymus Bosch's *The Seven Deadly Sins and the Four Last Things*





**APPLY THE RULE**

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Trustees: 1

2

3

4

5

6

7

25%

Yr. 10  
\$

# Childhood Trauma Foundation

Yr. 1 \$

(Brain Research)

Yr. 4 \$

(Drug Study)

UW Fetal Alcohol & Drug Unit

Yr. 8

\$ for  
25%

\$ Yr. 6

\$ Yr. 6  
IP

Veracity Pharmaceuticals, LLC

FDA



# Who's Watching?

**State Attorney General, IRS, and  
the Public a/k/a Whistleblowers**