

California Attorney General's

Guide For CHARITIES



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INTRODUCTION

The California Attorney General has primary responsibility for regulating, enforcing and supervising organizations and individuals that administer and/or solicit charitable funds or assets in California. The Attorney General has the duty to protect donors to charity, charities themselves and the beneficiaries of charities. In addition, the Attorney General has broad authority under State statutes to regulate charitable organizations and trusts and to commence law enforcement investigations and legal actions to protect the public interest. This Guide summarizes California's laws that govern charitable organizations, professional fundraisers, and trusts, including laws that require registration with the Attorney General and laws that require notice to the Attorney General of some specific transactions involving charitable organizations and trusts.

In carrying out these charity oversight duties, the Attorney General's office also provides information and assistance to many individuals who serve as directors, officers, volunteers, fundraisers, accountants and attorneys for charitable organizations. Because of the dramatic growth in the number of charities operating in California, and the large increase in public requests for information, the Attorney General's office recognized the need to publish a practical written Guide for charitable organizations.

What is the "Guide for Charities"?

The Attorney General's Guide for Charities is intended to help volunteers and others who serve as directors, officers or fundraisers for nonprofit charitable organizations. It provides practical information and answers to questions frequently asked about charities. In addition, the Guide summarizes some of the more important California laws affecting the creation and operation of nonprofit charitable corporations. At the end of the Guide, there are two important listings. The "Directory of Services" lists government agencies, legal services and general resources that assist charities. The "Bibliography" lists many useful publications for charities.

The Guide for Charities is not intended as a substitute for legal advice or tax consultation from private attorneys or tax experts. Depending on the circumstances, it may be important for your organization to hire a private attorney to assist with specific legal problems. Your local bar association chapter can provide for you the names of attorneys who specialize in nonprofit tax-exempt corporations and related matters. For low cost legal services, consult the "Directory of Services" in this Guide.



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Chapter 1

WHAT IS A “CHARITY”?

Many people contact the Registry of Charitable Trusts to ask if their organization is a charity. If the organization is classified as a California nonprofit public benefit corporation or has received federal tax exemption under Internal Revenue Code section 501(c)(3), it is a charity. Under the traditional common law definition, charitable purposes include relief from poverty, advancement of education, religion and other purposes beneficial to the community. Under the federal tax law definition and to qualify for tax-exempt charitable status, the organization must be organized and operated exclusively for an “exempt” purpose. Exempt purposes are religious, charitable, scientific, testing for public safety, literary, education, fostering national and international sports competition, or the prevention of cruelty to children or animals. In addition to these requirements, federal tax law also requires that there must be no “private” inurement or improper private benefit to anyone in a position of control over the charitable organization, and that the organization not engage in activity on behalf of political candidates or carry on substantial lobbying activity.

As of August, 2004, there were over 90,000 charitable organizations registered with the California Attorney General’s Registry of Charitable Trusts. These registered charities reported total revenues for 2003, their last reporting year, of over \$200 billion and total assets of over \$300 billion. Charities represent an important economic sector in California and have the ability to make a significant impact on the communities they serve.

Charitable Purposes

Historically, charities developed to meet certain needs of society. They were formed to do “public good” and to provide aid to segments of the community that fell outside of the general scope of public assistance. In common usage, the term “charity” refers to an organization that performs charitable programs or sets aside any fund to be used for charitable purposes. California common law defines “charitable purpose” very broadly to include relief of poverty, advancement of education or religion, promotion of health, governmental or municipal purposes, and other purposes that are beneficial to the community. Federal and California tax laws define charitable purposes more specifically for exemption from income tax. Federal and state laws have been enacted to encourage the making of charitable gifts and to facilitate the operation of charitable organizations. These laws reflect the public policy favoring charitable giving and recognize that many charities relieve the public tax rolls from the burden of financing human and community services. As a result, certain benefits and privileges are conferred on charities that are not available to for-profit businesses.

Exemption From Income Tax

One of the most important benefits available to a charity is its ability to qualify under federal and state income tax laws for “tax exempt status.” Income tax exempt status may confer on the charitable organization exemption from payment of income tax and also allow charitable donors to deduct from

their taxable income contributions made to the organization. Exemption from income tax is discussed in more detail in Chapter 3 of this Guide.

Legal Forms

A charity may operate in California under any of several legal forms, including a nonprofit corporation, a trust or an unincorporated association. Most California charities are organized as nonprofit corporations. The three most common types of nonprofit corporations under California law are: public benefit corporations, mutual benefit corporations and religious corporations. The majority of the registered nonprofit corporations in California are organized as public benefit corporations.

Under California law, a public benefit corporation must be formed for public or charitable purposes and may not be organized for the private gain of any person. A public benefit corporation cannot distribute “profits,” gains or dividends to any person. Public benefit corporations often qualify for exemption from income tax. Public benefit corporations (except for educational institutions and hospitals) must register and report to the Attorney General’s Registry of Charitable Trusts.

Religious corporations are organized for religious purposes. They are usually exempt from income tax and are not required to register or report to the California Attorney General. A religious organization may also be formed as a corporation sole.

Mutual benefit corporations are organized most often for the benefit of their own members. They may not be formed exclusively for charitable purposes. If a mutual benefit corporation holds some of its assets for charitable purposes, however, it must register and report on the charitable assets to the Attorney General.

Mutual benefit corporations may qualify for different income tax benefits than public benefit corporations. Familiar examples of mutual benefit corporations include private homeowners associations, private clubs, and trade and professional associations.

A trust may be created by language in a will or in a written trust instrument. The trust creates legal obligations for the person (“trustee”) who manages the assets of the trust. A trust for charitable purposes can be enforced by the Attorney General, and the trustee must register and report to the Attorney General.

It is not essential to form a nonprofit corporation, a trust or other legal entity to create a charity. In California, any individual or organization who solicits funds and represents that such funds will be used for charitable purposes may be held to be a “trustee for charitable purpose” and accountable for such funds. In addition, the failure of a public benefit corporation or trust to qualify for exemption from income tax does not necessarily free the organization and its responsible directors, officers or trustees from accountability as a charity.

Any individual or group of persons who operates as a charitable organization, but does not create a nonprofit corporation or a trust, may be treated under California law as an “unincorporated association.” Under this classification, the individuals may be exposed to substantial risk of personal liability if the organization is sued.

- How do the standards of liability for directors vary between nonprofit and for-profit corporations, and as compared to trusts and unincorporated associations (or other possible forms of organization)?
- Will the organization have members, and will they be voting members?
- Will the organization have chapters or other related groups?
- How much flexibility of operation is desired?
- How long is the entity anticipated to be in existence?

This Guide may help to answer some of these preliminary questions. Additional guidance from a qualified attorney or other tax expert may be needed.

Basic Steps For Incorporation Of A Public Benefit Corporation

A California nonprofit public benefit corporation may be formed by completing the steps summarized here:

- 1. Choose a corporate name.** You may clear and reserve the corporate name by contacting the Secretary of State’s office. After clearing the corporate name, you can reserve it by paying the appropriate fee to the Secretary of State (\$10 as of this writing). For additional information, contact the Secretary of State’s office. See the “Directory of Services” for listings.
- 2. Draft and file articles of incorporation with the Secretary of State.** The articles of incorporation typically specify the purpose of the organization, its name, place of business, key officers and limitations on its operations. In California, the articles of incorporation filed with the Secretary of State (original and two copies) must include the name of the public benefit corporation, its purpose, and language ensuring that it is not organized for the private gain of any person and that it will comply with other applicable requirements (including, if tax exemption is desired, the requirements for tax exemption). (For sample articles of incorporation, see the “Bibliography” listings.)
- 3. Draft the bylaws of the corporation.** Bylaws set out the overall structure and basic rules for operating the corporation, including how directors and officers are elected and how the governing board operates. These rules are limited by California laws and are very important to the governance of the corporation. (See “Bibliography” for assistance on drafting bylaws.)
- 4. Draft action of incorporator and have it signed by all incorporators.** If the articles of incorporation were signed only by an incorporator and not by the initial board of directors, the incorporator needs to appoint the first board. The incorporator may also take other actions at the same time, including adopting the bylaws, appointing the officers, and authorizing the opening of bank accounts.
- 5. File federal application for employer identification number (EIN) with the IRS.** You can apply for an EIN by mail, fax, or phone, by using IRS Form SS-4 and following instructions that normally are available from the IRS’ website. See “Application for Employer Identification Number” in Chapter 4 of this Guide, and see the “Directory of Services” for listings.

6. File a statement by domestic nonprofit corporation. The Statement by Domestic Nonprofit Corporation is sent by the Secretary of State within 90 days of filing Articles of Incorporation. You must complete and return this statement to the Secretary of State. You will have to file this form again at least every second year during the life of the corporation.

7. Register with the Attorney General's Registry of Charitable Trusts. Charities must register with the Attorney General's Office within 30 days after receiving their first assets by filing Articles of Incorporation and bylaws with the Attorney General's Registry of Charitable Trusts and pay a \$25 registration fee. Organizations must renew registration and file financial reports annually thereafter.

8. Hold first meeting of directors. Agenda items for the first meeting typically involve organizational issues, such as adopting bylaws, electing officers, establishing a bank account, setting the accounting year and basic accounting procedures, planning a budget for the first year, and adopting procedures for safekeeping of minutes, bylaws, and other corporate records. If not meeting in person, and to the extent permitted by the organization's bylaws, the directors may take these actions by "unanimous written consent," which requires the signatures of all directors. It is important for the corporate secretary to record and keep minutes of all meetings (and unanimous written consents) of the board of directors and board committees.

9. File application for exemption from federal income taxes with the IRS and state income taxes with the California Franchise Tax Board. Use IRS Form 1023 for the federal income tax application and FTB Form 3500 for the state income tax application. (See Chapter 3 of this Guide.)

10. Review the corporation's need for state and local permits and licenses and establish procedures to meet deadlines for required periodic filings with the IRS, FTB, Secretary of State and Attorney General. This procedure is important to keep the organization in good standing and avoid the need to pay delinquency fees. (See Chapters 3 and 10 of this Guide.)

There are several books and government publications that discuss in more detail the steps for forming a nonprofit corporation. See the "Bibliography" for listings.

This Guide and the publications cited in the "Bibliography" are not a substitute for professional legal assistance. You may wish to seek the professional services of an attorney or other expert who is experienced in forming new nonprofit corporations.

FREQUENTLY ASKED QUESTIONS

Q. Is it necessary to hire an attorney to form a public benefit corporation?

A. No. California law does not require that you retain an attorney to form a corporation. However, as noted earlier, there are many questions to review prior to deciding to form a public benefit corporation. An attorney who specializes in the area of nonprofit corporations could assist in this review and guide the organizers through the steps to incorporate and apply for income-tax exemptions.



Chapter 3

APPLICATION FOR TAX-EXEMPT STATUS

Most charitable organizations in California seek exemption from income tax under federal Internal Revenue Code (IRC) section 501(c)(3) and California Revenue and Taxation Code section 23701d. These provisions generally exempt a charity from federal or state income tax on all forms of income derived from the charity's exempt purposes. Currently, individuals who itemize and corporate donors may deduct contributions to "section 501(c)(3) organizations," subject to various limitations set forth in IRC section 170.

What Is 501(c)(3) Status

A section 501(c)(3) organization must be “*organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes.*” To qualify, an organization must satisfy an organizational test and an operational test. The *organizational test* is met if the articles of incorporation include language limiting the purposes of the organization to one or more of the exempt purposes set forth in section 501(c)(3) and do not empower the organization to engage in any substantial activities which do not further one or more exempt purposes. In addition, the organizational documents (or applicable state law) must require the organization to expressly dedicate its assets to exempt purposes in the event of a dissolution.

The *operational test* requires the organization to be engaged primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). The test will not be met if “more than an insubstantial part” of the organization’s activities is not in furtherance of exempt purposes. Examples of impermissible conduct include diversion of charitable assets to private individuals, excessive compensation to officers and directors, and engaging in certain prohibited political activities, such as participation in political campaigns on behalf of or in opposition to candidates for public office or substantial lobbying. To obtain recognition of tax-exempt status in California, nonprofit California public benefit corporations also may be required to show that no more than 49 percent of the organization’s directors are “interested persons” or their close relatives, as defined in California Corporations Code section 5227. See Chapter 6 for discussion of “interested” directors.

“Public Charity” or “Private Foundation”?

Organizations that qualify for exemption under IRC section 501(c)(3) will be classified by the IRS as either a public charity or a private foundation. Most organizations (with a few exceptions, such as churches) are presumed to be private foundations unless they receive a determination from the IRS that they are a "public charity." Most commonly, an organization will be classified as a public charity if it receives a certain percentage of its total support from government sources, other public charities, or a broad base of individual donors. Nonprofits should be aware that achieving public charity status based on public donations is a complex calculation and early consultation with a tax professional is strongly recommended. An organization also may avoid being classified as a

Newly formed nonprofit organizations should not state that they have obtained recognition of tax-exempt status until recognition is granted. Once granted, the tax-exempt status is generally retroactive to the date of organization.

Q. If IRS denies the application by our organization for recognition of income tax exemption, what can we do with the funds already donated to the organization?

A. In most cases, all funds collected by a charitable organization are irrevocably dedicated to charitable purposes. Even if the organization fails to be recognized as exempt by the IRS, the funds must be used for charitable purposes, and cannot be refunded to the donors.

In special circumstances, such as where an organization was formed as a public benefit corporation by mistake, where its organizers intended it to be a mutual benefit corporation, and where all the funds received were dues from members, the organization may be allowed to terminate as a charity and refund the dues and other assets to members, rather than to charity. However, the Attorney General's written consent must be obtained if the organization was formed as a public benefit corporation.

Q. What are the procedures for obtaining recognition of exemption from state income tax for our organization?

A. The procedures for being recognized as exempt from California income or franchise tax by the California Franchise Tax Board are similar to those for the IRS. California FTB Form 3500 must be completed and submitted to FTB. The FTB will notify the applicant of its decision on exempt status, and also send instructions for annual filing of FTB Form 199. See "Directory of Services" for FTB listing.

Q. Our charitable organization has special tax problems. Where can we find an expert on charitable tax-exempt organizations?

A. The law on charitable tax-exempt organizations is very complex and quite specialized. Be certain if you hire a tax attorney or other tax expert that the person is knowledgeable about this area of tax law. You may contact any of the following for referrals to tax experts. Be sure to specify the area of expertise that your organization seeks.

- The County Bar Association referral service in your area.
- Accredited law schools in your area will usually have a tax specialist on their faculty who may be able to refer you to an attorney who specializes in tax-exempt organizations.
- Large charitable organizations in your area may be able to give you names of tax experts who have assisted their organization.

Q. If our charity is recognized as exempt from federal and state income taxes, does the charity have to pay property tax on property it owns? Does the charity have to pay sales tax on items it sells?

A. A charity exempt from income tax may still have to pay property tax and sales tax. The rules that apply to exemption from property and sales taxes are different from the rules for exemption from income tax. Contact the State Board of Equalization and the local county assessor's office for additional information. See the "Directory of Services" listings.



Chapter 4

CHARITY AS AN EMPLOYER

Many charities hire employees to staff their offices, provide program services, conduct fundraising, maintain books of account, file tax forms, and provide other necessary services for the operation of the charity. The fact that a charity has “tax-exempt status” and is a nonprofit corporation does not excuse it from the same legal obligations to its employees that apply to any business corporation. This chapter describes several important legal obligations of employers.

1. Application for Employer Identification Number

Even if a charity does not intend to hire any employees or workers, it must still apply for an Employer Identification Number (“EIN”) with the IRS. An EIN is a nine-digit number which is assigned to entities for tax filing and reporting purposes. It is the corporate equivalent of a Social Security Number and is used by the IRS to identify the corporation’s information returns in IRS records. An entity prepares and files Form SS-4 to request an EIN from the IRS. The Form SS-4 may be obtained on the IRS website.

A charity can apply for an EIN by telephone, fax, or mail depending upon how soon the charity needs to use its EIN. A charity can receive its EIN over the telephone (and use it immediately) by calling (800) 829-4933 and providing the IRS with the information requested on Form SS-4. The IRS may request that the caller fax the SS-4 to the IRS, and will issue the EIN either over the phone or by return fax.

Alternatively, a charity can receive its EIN from the IRS via fax within four business days. In order to do this, the charity needs to complete Form SS-4 and fax it to the IRS at (215) 516-3990. The charity can also obtain an EIN through the mail, which takes about four to five weeks. Finally, the IRS website sets forth a procedure for obtaining an EIN over the Internet. Please note that these procedures for obtaining an EIN and contact information are subject to change.

2. Federal and State Corporate Employment Taxes

A corporation’s own tax-exempt status allows exemption from tax on the corporation’s income. As an employer, the corporation remains obligated to report any employee’s income and to make proper withholding payments to the federal and state governments. It is also responsible for depositing, paying, and reporting federal income tax, social security and Medicare taxes (FICA), and federal unemployment tax (FUTA), unless the charity is specifically exempt from the applicable requirements. Withholding requirements are strictly enforced. Failure to comply could result in penalties for the organization, its directors, and its employees. The penalty is generally equal to the tax evaded or not collected.

FREQUENTLY ASKED QUESTIONS

Q. During the early years of operation, our charity had insufficient funds to pay key employees the true value of their services. Now that we have adequate revenues, can we pay our employees retroactively?

A. This problem is not unusual. The answer is complicated by the law that says that charitable assets may not be distributed as “profits” or dividends to any person. Under this rule, a charity that hired an employee for a \$20,000 yearly salary (assuming that to be a fair rate for the services performed) but was unable to make those payments the first year, would be allowed later to make up the amounts due as revenues become available, because of the contractual obligation. However, if the charity had not contracted to pay the employee the “fair” price, but some lesser amount, or if, without a contract, the charity simply paid the employee what it could afford from available monthly revenues, the charity could be barred from later paying an additional “bonus” to the employee. Payment of charity funds as a gift or “bonus” to any person may be an illegal distribution of charitable assets, for which directors of the charity can be held personally liable. A person who works as a volunteer for charity has no legal right to payment of compensation from the charity. Actual expenses may be reimbursed.

Q. Our charity has been sued by an employee for breach of employment contract and for discrimination. Will the Attorney General act as attorney to defend our charity and save us the expense of hiring a private attorney?

A. No. The Attorney General acts as the attorney for the general public to protect all beneficiaries of charitable assets against fraud and mismanagement of those assets. When the Attorney General sues charity directors for fraud, the action usually seeks repayment from the directors to the charity. In other types of cases, where directors and the nonprofit corporation are sued by employees or other persons for violations of contract, for injuries, or for other civil wrongs, it is the obligation of the directors to hire an attorney to defend the corporation at the corporation’s expense.

Q. If an employment-related lawsuit is filed against our charity, will insurance pay for the costs of an attorney to defend the corporation and its officers and directors?

A. Whether the corporation can look to its insurance carrier to defend the action depends on the type of insurance coverage the corporation has purchased. When corporations are able to purchase “general liability” insurance, the insurer will usually provide an attorney to defend the corporation against a lawsuit. However, many general liability insurance policies exclude coverage for employment matters. The corporation, therefore, ordinarily should also purchase “directors and officers” insurance, which will protect these individuals from many types of civil claims, including some employment-related lawsuits. If the corporation’s employment force is large enough, it may be advisable for the corporation to obtain an employment practices liability (“EPLI”) policy. An EPLI policy usually will cover the organization and all of its officers, directors, employees, agents and subsidiaries for employment-related claims within the scope of the policy. It’s important to note that employment actions constitute a substantial percentage of the lawsuits filed against charitable corporations.

Q. We just learned that an employee embezzled substantial funds from our charity. What can we do about it?

A. Upon learning that an employee has embezzled funds from the charity, the directors have a legal duty to take reasonable steps to try to recover the funds and to refer the matter to the local District Attorney for possible criminal prosecution. The directors may have to hire a private attorney to file a civil suit for restitution against the employee. Directors must evaluate whether the prospect of recovery outweighs the probable costs of suit. The loss to charity should be reported on the Form RRF-1 filed with the Attorney General, with an attached explanation of the action taken by the directors to recover the loss.



Chapter 5

FISCAL MANAGEMENT: BOOKKEEPING, ACCOUNTING REPORTING REQUIREMENTS

Efficient and accurate fiscal management is very important to all charitable organizations. The directors are responsible for organizing and documenting the financial affairs of the charity. It may be useful for the charity to hire an accountant, controller, or other fiscal manager. In choosing a method of fiscal management, the needs of various users of the accounting information must be considered. There are two general categories of users: (1) internal users -- management staff, board of directors and members; (2) external users -- governmental agencies, grantmaking organizations, banks and other financial institutions.

Internal Controls Over the Fiscal Management System

The goal in establishing internal controls over the fiscal management of a charity is to prevent error, fraud, theft, or mismanagement. Good internal controls safeguard charitable assets and insure reliability of financial records. Items which make up an effective control system include budgets, segregation of duties, policy and procedures manuals, clear definition of, and adherence to, set procedures for management authority, and periodic review of the control system. A system requiring two signatures on all the corporation's checks is an important control measure. Continuing cost-benefit analysis by charity managers is vital to effective operation and survival.

The charity's directors play a key role in establishing internal controls for the charity. Their approval of policies and procedures determines the fiscal management system. The minutes of the board meetings should reflect these important policies.

Many charity directors seek expert advice from a professional accountant to assist in designing and implementing the fiscal management system. Choose an accountant carefully and be specific about the charity's needs. Ask the accountant about his or her experience with other charitable organizations. Check references.

Preventing Internal Fraud and Theft of Charitable Assets

Fraudulent diversion of charitable assets by employees, officers, or directors with control over those assets can occur at either the receipt or the disbursement phase. Charities may receive many donations in the form of cash and checks. The person who receives and records the cash and checks could, without proper controls, deposit those funds into unauthorized bank accounts and divert the funds to personal use, without the knowledge of other employees or directors. For this reason it is very important to separate the function of recording cash receipts from responsibility for access and control over the receipts. Assigning different people to the separate tasks of recording receipts and making bank deposits minimizes the risk of fraud.

At the disbursements level, it is important to require two signatures on all checks drawn on the charity's account. This reduces the risk of such fraudulent practices as writing checks for non-existent expenses or paying fictitious creditors or phantom grantees.

Directors should continually monitor the budget and anticipated revenue sources and amounts during the year, and compare expected revenues to the actual revenues reported during the year. Any sizable differences between expected and actual revenue should be carefully investigated by directors or designated officers to obtain a full explanation. The directors or their designee should review quarterly the charity's bank account statements, check reconciliations, and the books of account for any obvious irregularities.

Annual independent audits can help to protect against internal fraud and fiscal mismanagement. Independent audits can be expensive, however, and may be beyond the budget capabilities of small charities. A good alternative is to retain an independent accountant to conduct a review of the charity's financial statements, and issue a review report to the directors. A review is usually much less expensive than an audit, and can alert directors to serious deficiencies in the internal control system as well as possible fraud.

Components of an Accounting System

A charity's accounting system should reflect accurate, understandable data that is useful in making management decisions and preparing reports. Accounting records should adhere generally to the standards of Accounting and Financial Reporting for Nonprofit Health and Welfare Voluntary Organizations, and to generally accepted accounting principles. The actual books of account to be maintained depend on the type of organization.

For example, a grant-making organization would have different accounting needs than a health clinic or museum. Generally, an organization's books of accounts will include:

1. General Ledger

A general ledger consists of a number of accounts representing stored information about a particular kind of asset, liability, fund balance, revenue, or expense. Information is taken from the general ledger to prepare financial statements such as the Balance Sheet or the Income and Expense Statement. The amounts reported in the General Ledger accounts are often totals for a given time period for a class of accounts detailed in subsidiary ledgers.

2. Subsidiary Ledgers

Subsidiary ledgers provide greater detail for a particular account. For example, an accounts receivable subsidiary ledger lists information on each customer's purchases, payments, and balance. The general ledger contains one figure representing the total for a period from all subsidiary ledgers for that account.

3. Journals

Information from business papers is recorded in chronological order in journals. Various types of journals include:

- Sales Journal - Sales are recorded as they are made; usually all information is taken from the invoice

FREQUENTLY ASKED QUESTIONS

Q: What specific fiscal management procedure will help to protect our charity against fiscal mismanagement and embezzlement?

A: Generally, fiscal management policy should provide for careful periodic review of financial records by directors and by independent accountants. Procedures such as a dual- signature requirement on all charity bank accounts, periodic review of monthly statements by the board, and an annual independent audit are highly recommended.

Q: What if our charity cannot afford an annual independent audit or review?

A: As of January 1, 2005 charitable organizations with gross revenue of \$2,000,000 or more must have independent audits and must appoint an audit committee. (Government Code § 12586, subd. (d).) At minimum, the board of directors of organizations which are below this threshold should review the charity's financial records regularly. An audit committee could be created to review the charity's finances and watch for irregularities. Low-cost accounting services may also be available. See the "Directory of Services" listings.

Q: I was recently appointed to the board of directors of a charity, and I have discovered that the charity's records are disorganized and incomplete. I also suspect that a former director misused the charity's funds. What should I do?

A: Some persons who find themselves in the situation described above simply resign from the board of directors. If a director decides to continue to serve in the circumstances described, he or she should protect against possible liability for negligence by insisting that an independent audit of the charity be conducted immediately, and that a competent person be hired to establish a proper accounting system and to maintain the corporate records. He or she should recommend at a board meeting that the board investigate the conduct of the former director and take appropriate action. He or she should make sure that recommendation is recorded in the minutes of the meeting.

Any person who suspects fiscal abuse regarding charity assets is encouraged to report the matter to the Attorney General's Charitable Trusts Section, which has investigative audit powers and may bring a civil action to recover diverted charitable assets. Any evidence of criminal activity, such as embezzlement of charitable assets, should be reported to the local police or district attorney for possible criminal prosecution.



Chapter 6

DIRECTORS AND OFFICERS OF PUBLIC BENEFIT CORPORATIONS

Every corporation must have directors and officers. Legally, a public benefit corporation (defined in Chapter 1) may operate with only one director. However, most charities operate with three or more directors, which is strongly recommended. In addition to directors, every public benefit corporation is required to have a president, a chief financial officer and a secretary. Additional officers may be appointed. The powers, duties, and liabilities of directors and officers of public benefit corporations are governed by California statutes. Directors are required to discharge their duties consistent with a fiduciary obligation to the charity. (Corporations Code section 5000 et seq.)

DIRECTORS

Powers and Duties of Directors

The directors of a nonprofit public benefit corporation are responsible for conducting the corporation's affairs and for exercising the powers of the corporation. Directors may delegate many of their powers to others, such as officers and employees, but the directors are ultimately responsible for all corporate decisions.

Directors may be elected (usually by members) or designated (by the board of directors or other persons). The provisions for election, resignation, removal, terms of office, quorum necessary for action by directors, action by executive committee, delegation of powers, and other important issues affecting directors are generally covered by California statutes. Provisions governing these matters should be set forth clearly in the corporation's bylaws.

Compensation of Directors

Charities may not pay excessive or unreasonable compensation to their officers and employees. The board of directors or an authorized committee of the board, and the trustee or trustees of a charitable trust, must review and approve the compensation of the president or chief executive officer and the treasurer or chief financial officer to assure that it is reasonable. (Government Code section 12586.)

Most directors of public benefit corporations serve on a volunteer basis, and do not receive compensation, other than occasional reimbursement for actual expenses of attending meetings (mileage, parking fees, meal costs). However, California law permits directors to receive reasonable "compensation as a director or officer," and distinguishes such compensation from other payments to directors that raise conflict of interest questions. Reasonable compensation paid to a director or officer is not "self-dealing" and it does not impair the ability of the director to serve as a "disinterested" director in reviewing other corporate transactions. California law does not suggest what amount of compensation to a director is reasonable. That is determined on a case-by-case basis according to the particular facts and circumstances. The Attorney General audits payments to directors that are more than nominal.

Standards adopted by the Wise Giving Alliance state that trustees and directors should be volunteers and not compensated other than for expenses. Those standards are not legally binding.

Liability of Directors

In general, directors of nonprofit corporations, like directors of business corporations, are usually not personally liable for the debts, liabilities or obligations of the corporation. A director's personal liability to third parties (parties other than the corporation itself) is very limited. California law on directors' liability is complicated and has been changed frequently by the Legislature.

However, a director of a public benefit corporation may be held personally liable to repay damages to the corporation itself where he has breached his duty of care or loyalty to the corporation.

1. Disinterested Director Who Acts in Good Faith With Reasonable Care Is Not Liable to Corporation

A director of a public benefit corporation who performs his or her duties in good faith, in a manner the director believes to be in the best interest of the corporation, and with reasonable care and inquiry under the circumstances has no personal monetary liability to the corporation in an action based on alleged failure to discharge the director's duties. This protection against liability does not apply to a director who engages in self-dealing or who makes or receives a prohibited loan or distribution of the corporation's assets.

2. Volunteer Director Not Liable to Third Parties in Certain Circumstances

Although California statutes (Corporations Code sections 5047.5, 5239) purport to protect volunteer officers and directors of charitable corporations against personal liability for monetary damages to third parties under certain circumstances, these statutes cannot prevent the filing of lawsuits against individual directors and officers of nonprofit corporations. It can be expensive for an individual director to pay an attorney to defend the director against a civil lawsuit. For this reason, it is important for directors to review the matter of "directors and officers" insurance. (See discussion under Chapter 4.) Moreover, these statutes do not protect officers or directors from liability in a lawsuit brought by the Attorney General.

3. Duty of Loyalty and Conflict of Interest

a. Self-Dealing Transactions: Directors May Be Liable For Damage to Corporation

A "self-dealing" transaction is a contract, agreement, or other action affecting the assets or income of a public benefit corporation to which the corporation is a party and in which one or more of its directors has a "material financial interest." Such transactions may include payment of a salary, contract, fee, commission, or other benefit of material economic value from the public benefit corporation to one or more of its directors, or to a corporation or partnership in which a director has a material financial interest. In reviewing self-dealing transactions, the Attorney General considers a financial interest "material" to a director if it is large enough to create an appearance of conflict of interest. This is a question of fact in each case.

Self-dealing transactions between a director and the corporation on which the director serves are inherently suspect. The director's first duty of loyalty is to the corporation, and it may be difficult for

Derivative Actions Against Directors

Legal actions filed against directors to recover damages resulting from breach of a director's duty to the corporation are called "derivative actions." They are usually filed by the Attorney General or a disinterested director on behalf of the corporation and its charitable beneficiaries. Derivative actions against directors usually seek recovery of monetary damages from the responsible director(s) and other equitable relief. Any repayment is made to the corporation or another similar charity.

Statutory Transactions

California law requires that certain transactions by public benefit corporations require either consent by or notice to the Attorney General. These transactions are treated with special attention because they significantly change the corporation. These transactions include dissolutions, mergers, sales of substantially all assets, and amendment of articles to change the form of the corporation (e.g., from a public benefit to a business (i.e., for-profit) corporation). See Chapter 10 for more detail on statutory transactions.

Indemnification and Insurance

California law (Corporation Code Section 5238) allows a nonprofit charitable corporation to indemnify directors and officers for costs and expenses of civil litigation under certain circumstances. However, no indemnification, is permitted for director's fraud, acts of bad faith or unsuccessful defense of self-dealing.

Many nonprofit corporations purchase "directors and officers" insurance to provide a source of payment for these litigation costs, in addition to the corporation's own funds. Public benefit corporations may purchase indemnification insurance to protect directors from liability for most claims, but not for fraud and self-dealing.

Officers

Every nonprofit public benefit corporation must have at least three officers: a president (or chairman of the board), secretary, and a chief financial officer. The officers are usually appointed by the directors. Officers' responsibilities are spelled out in the corporation's bylaws. Their duties usually include maintaining books of account, responsibility for deposits and disbursements, keeping minute books, giving required notices, and such other duties as the directors prescribe.

The duties of officers and methods for their appointment and removal should be clearly stated in the corporation's bylaws. Generally, officers are not liable to the corporation or to third parties who sue the corporation. If an officer has acted in a fraudulent or grossly negligent manner, he or she may be liable. The president or chief executive officer is generally responsible for the day to day operations of the corporation.

FREQUENTLY ASKED QUESTIONS

Q. What criteria does the Attorney General apply in reviewing self-dealing and loan transactions that are submitted for approval to the Attorney General's office?

A. The Attorney General applies the statutory criteria for determining fairness of self-dealing transactions, as set forth in California Corporations Code section 5233. Facts are reviewed to determine whether the self-dealing is for the benefit of the corporation, whether the terms are fair and reasonable to the corporation, and whether there is no better alternative available to the corporation.

In reviewing requests to approve proposed loans from a public benefit corporation to a director or officer, the Attorney General applies a standard of strict scrutiny. Unlike self-dealing transactions, which may be validated under statutory standards, most loans from a public benefit corporation to a director or officer are prohibited in the absence of Attorney General approval. In reviewing a loan transaction, the Attorney General asks whether the loan is strictly necessary to carry out the charitable program and to protect charitable assets. Additional criteria applied by the Attorney General in reviewing a loan transaction include whether better alternatives are available to the corporation, whether the terms and interest rate are fair to the corporation, and whether the loan is secured.

Q. The directors of our public benefit corporation, which operates a school, voted to convert it to a business corporation. Will the Attorney General approve this conversion? How long will it take to get an answer?

A. The Attorney General's answer will depend upon a thorough review of all the facts. Conversion is permitted by statute if the terms are approved by the Attorney General and all of the charitable assets of the converting public benefit corporation (which are irrevocably dedicated to charitable purposes) are distributed to another charity with charitable purposes similar to the purposes of the converting corporation. The Attorney General's office looks at all material facts of a conversion to determine its fairness to the corporation. Is the value assigned to the assets of the converting public benefit corporation the true fair market value of those assets? Is an independent appraisal needed? Will the directors of the public benefit corporation become the directors and shareholders of the new business corporation? Are there self-dealing issues? Are the terms of payment or purchase of the converting corporation fair and reasonable to charity? Is the charity designated to receive the payment or purchase price a qualified IRC 501(c)(3) organization with similar purposes to the converting corporation?

The review of facts and legal analysis required for the Attorney General's decision to approve or disapprove a corporate conversion may take from two weeks to several months, depending on the facts and complexity of the transaction and the workload of the Attorney General.

