

Nonprofit Laws and Prescriptions for Transparency

The New York and California Attorneys General Offices of Charities Sound Off on Money, Secrets, and Justice

BY JESSICA DARRABY

Introduction and endnotes by Stephanie Dominguez

On October 13, 2006, the ABA Forum on the Entertainment and Sports Industries presented a roundtable at the Annual Meeting regarding nonprofit laws and prescriptions for transparency moderated by Jessica Darraby, an art and architecture lawyer in private practice and author of the treatise *Art, Artifact, Architecture and Museum Law*.¹ This CLE program reunited a panel of national experts such as Ed Able, past CEO and president of the American Association of Museums (Washington, DC); James M. Cordi, supervising deputy attorney general from the Charitable Trusts Section of the California Attorney General's Office in Los Angeles; and Gerald A. Rosenberg, chief of the Charities Bureau from the Office of the Attorney General of the State of New York (New York, NY). Here is a transcript of their discussion, which remains timely and relevant.

Corporate governance of museum boards is under scrutiny by enforcement agencies and professional associations for conduct ranging from acquisitions to compensation. Board activities revealed in 2006 that some cases have triggered flash points in a public debate about the proper use of public assets. This panel of experts explored new models of compliance for cultural boards and trustees based upon the new Non-Profit Integrity Act,² Uniform Charitable Trust laws,³ and arts groups' codes of ethics. They discussed interesting cases involving charitable organizations and forging strategies for challenges at art institutions by adapting the lessons learned from corporate boards like Enron and the financial reporting mandated by new state laws as well as federal laws like the Sarbanes-Oxley Act.⁴ In spite of the seriousness of the subject and the then-

recent publication of the Getty Report⁵ some days before this meeting, it was with good humor that this roundtable took place.

CONFIDENTIALITY

JESSICA DARRABY: Hewlett-Packard ("HP") has been in the news of late, and in Congress as well, regarding so-called leaks on the board and the board's investigation of the sources of those leaks. Putting aside HP's investigative methods, let's examine the broader issue—confidentiality—which is as applicable to nonprofits as it is to the for-profit sector. How does a board properly define and protect its information perimeter?

GERRY ROSENBERG: The question of confidentiality requires that you ask the prior question, which is, secret from whom? Because the question of protecting the secrecy of what happens in the boardroom depends enormously on who's asking the questions and who's seeking disclosure. The board has a relationship to its members, if it's a true membership organization, and the members' rights to find out what's going on in the boardroom will generally be answered by looking at the bylaws. If we step back a little bit and we ask about the attorney general, who is statutorily the regulator of the nonprofits, the board really can do very little to insulate itself from the legitimate inquiries made by the attorney general. Confidentiality orders, secrecy pacts, and the like will yield to Jim's or my offices' subpoenas. There are all kinds of matters for which I think secrecy works and is appropriate. But there are public policy deliberations of the board, particularly advocacy organizations and museums and other nonprofits, which should not be shielded from legitimate inquiry.

ED ABLE: I find nonprofits are not very good—including our own museums—about getting out ahead of the problem. They wait until a problem exists and there's a question about whether or not something should be kept confidential after the fact, and then it's very difficult to make policy about what should be confidential and what's not in the middle of an argument over whether something should be confidential. So, the issue here is for these nonprofits, in an era of demanded transparency and public accountability, to think through ahead of time and establish the policies, certainly with advice and participation of legal counsel, on what of their deliberations should be confidential and what should be public.

GERRY ROSENBERG: Let me respond to Ed's point, which I think is very important, and it's to say this: Unlike business corporation law, not-for-profit corporation law in New York and in most other jurisdictions actually has a sizeable component of ethics in [the law]—at least, read properly. Most nonprofits are subject to, or board members and officers, as you know, are subject to the duty of care, the duty of loyalty, and the duty of obedience, the last two of which, I think, cannot be understood apart from ethical norms. On the subject of confidentiality, as you know, I've had discussions with the American Civil Liberties Union on this subject; I think it's a very difficult field. I think that we may differ on this. I think there are domains where a board may well say, "We're going to go into executive session, and nothing leaves this room," and that's entirely appropriate. But where an organization such as the ACLU is deliberating on public policy issues of enormous importance and where it's going to take a public stand—such as whether the Patriot Act should be defied, obeyed, or rallied against—it seems to me impermissible for the deliberations at the ACLU board level to be sealed.

JESSICA DARRABY: May the board of a nonprofit adopt a bylaw or a protocol that renders certain discussion confidential? And, if so, what does it apply to?

JIM CORDI: Well, I think in California, they don't have to adopt such a bylaw. The records of the corporation, including the minutes of the board, are not publicly available, raising perhaps a question: Is that a good idea? Should we

think about whether they ought to be, some of these things, at least, accessible to the public?

JESSICA DARRABY: Ed has mentioned the term *transparency*, which is just a key concept in the not-for-profit sector right now, and given the way corporations are going, in the for-profit sector as well. How does this get factored in to board management is one question, and the other is FOIA—you've mentioned the state Freedom of Information Act⁶—how does that factor in with respect to both the public and the attorney general getting information?

JIM CORDI: Well, the attorney general doesn't need the FOIA because he has plenary powers of supervision over these organizations and can look at their records—any and all of their records—for any reason or no reason, just to satisfy himself that everything's okay. The public, however, would find that at least California's version of the FOIA is of no help to them concerning the records of a nonprofit. It applies only to government entities; again, raising the question of whether that ought to be changed somewhat.

GERRY ROSENBERG: The landscape in New York is somewhat different in that most sophisticated requestors—often the media, but not only the media—will hit my office with what are called

when we receive materials that have been either voluntarily submitted to us or submitted pursuant to subpoena, there is a question about whether these materials may have to be produced to an inquiry, and the requestor does not have to show a special interest. You just have to ask for it. And then the question becomes: Are the materials exempt? Do they fall under one of the limited exemptions recognized in the law? And this came up very graphically when the New York Public Library announced that it was going to sell a number of its Hudson River oil paintings, and there was a great hue and cry, at least in a few quarters. And *The Wall Street Journal* reporter who was on the story wanted to find out the basis of the board's decision. Well, the board's decision was contained in a report by a special committee chaired by former Harvard University President Rudenstein, and it was labeled confidential—but it was also submitted to our office, and the mere fact that you call it confidential doesn't make it so statutorily. That issue never got litigated because the New York Public Library board—I think wisely—decided to withdraw its request for confidentiality, and the Rudenstein report was then revealed, and with it, it became publicly available, and the reasoning underlying

organizations have gotten themselves into continuing problems publicly and cost thousands of dollars in PR firms and legal fees and everything else, it's when they didn't take a smart move like that. You know, there's enlightened self-interest today, I think, that needs to come into play.

GERRY ROSENBERG: It seems to me that there are areas where boards of nonprofits, like other organizations, are entitled to say “none of your business.” They can say it politely and firmly, and I think the FOIA recognizes what those carve-outs should be, and they include things like proprietary financial information, personnel records, and where there's a pending law enforcement investigation. If Jim's office is looking into a possibility of violations of California's code, and somebody makes a request of the California attorney general, the answer's going to be no as long as that investigation is pending, and the same would be true, I think, of any attorneys general office in the country. There are areas that are off-limits, or at least for some period of time should remain off-limits.

JESSICA DARRABY: So, I guess the board of tomorrow is not necessarily plugged in and webbed out for all the members and the public to see. I'd like to conclude with asking everyone what HP teaches us about confidentiality, and, in my own mind, I wonder: Is it an example that's so over the top that the confidentiality issue has been lost? Can anyone even remember what the underlying secret or leak was as it became so occluded by the processes and methods?

JIM CORDI: I don't know what the underlying leak was that the board was trying to plug. The ironic thing is that now, the president and some employees are charged with using false pretenses or conspiracy to use false pretenses to obtain the private information of individual board members. So, it kind of turned around on them completely. They were trying to guard some confidentiality and they're now being accused of violating other people's confidentiality.

JESSICA DARRABY: Any other thoughts? Or are they confidential? (LAUGHTER)

GERRY ROSENBERG: I'm not sure I have a firm reaction to this, but I do know one thing—and, that is, if we did not receive tips from dissenting board

THE ISSUE IS FOR NONPROFITS, IN AN ERA OF DEMANDED TRANSPARENCY AND PUBLIC ACCOUNTABILITY, TO THINK THROUGH AHEAD OF TIME AND ESTABLISH THE POLICIES, CERTAINLY WITH ADVICE AND PARTICIPATION OF LEGAL COUNSEL, ON WHAT OF THEIR DELIBERATIONS SHOULD BE CONFIDENTIAL AND WHAT SHOULD BE PUBLIC.

—ED ABLE

Freedom of Information Law (“FOIL”) requests. Our FOIL statute is similar to, but not identical to, the federal FOIA. And that has the consequence that

the business decisions was there for all to see, and I think that was the right result.

ED ABLE: I agree, Gerry. I think that's the problem. When I find that most

members and unhappy present and former employees, we wouldn't exactly be out of business, but we would've lost most of our best cases since I've been there.

ED ABLE: Um-hm, yes.

GERRY ROSENBERG: I think we are hugely dependent on disgruntlement. (LAUGHTER)

NEW FINANCIAL REGULATIONS, FOIA, AND GAPP

JESSICA DARRABY: California has just enacted the new Nonprofit Integrity Act (included on the forum CD and meeting materials). This act, newly effective, does, in part, talk about financial regulation, at least for institutions that hit the two million mark, and it seems appropriate that we at least mention it because we are here in California. So, Jim, since you're our California attorney general representative, could you share with us how this new Nonprofit Integrity Act impacts nonprofits, maybe mentioning some of the key provisions?

JIM CORDI: Well, I just happen to have a list of the key provisions on me, so. . . . (LAUGHTER)

JESSICA DARRABY: And this isn't even scripted. (LAUGHTER)

JIM CORDI: The centerpiece is a requirement that charitable organizations have audited financial statements. New York already has that, I understand; several other states do.

JESSICA DARRABY: And there's a benchmark, isn't there?

JIM CORDI: Yeah. Unfortunately, I think, for our office, we wanted a lower benchmark. It ended up at two million; I think that's way too high. What's New York's?

GERRY ROSENBERG: Two million.

JIM CORDI: It is two million? (LAUGHTER) Okay, well, then you—I don't know how you feel. Maybe you feel it's too high.

GERRY ROSENBERG: I'll come back to that. (LAUGHTER)

JIM CORDI: We think audited financial statements can be a big help in getting organizations to comply with various laws that apply to them, not the least of which are various reporting-registration and reporting laws that many of them don't seem to be too good at complying with. Another feature of the law is to require that boards do reviews of the compensation of their CEO and their CFO, and to do those at the time of hiring and when a contract is

renewed. And it's already the law in California, and everywhere, that no more than reasonable compensation may be paid. But this is a required procedure that we're hoping will get many organizations to take a serious look at the compensation of their top officers and to take steps to keep it within reasonable parameters. Most of the rest of the law deals with charitable solicitation and charitable solicitation fraud, of which we think there's an awful lot, and most regulators think there's an awful lot—particularly in the field of telephone solicitation, where, in my opinion, if you receive a call at your home from someone that says they're collecting for some charitable purpose, that the percentage chances

important impact of the law requiring generally accepted accounting principles is it doesn't apply only to those that have \$2 million or more in income and that must have certified audits—it applies to charitable organizations, whether or not they're required to have certified audits.

ED ABLE: Ah, good point. There is one problem with that that I should point out, for those who are interested in that subject. Many of the generally accepted accounting principles are adopted—well, they're all adopted by something called FASB, the Financial Accounting Standards Board. The problem with that is, particularly for the nonprofits, they have established a number of principles in

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are very high that they're a fraud, and let the giver beware is really an important rule there.

JESSICA DARRABY: Now, something you raised which I thought was interesting about charitable fundraising is whether these organizations that keep financial records must do so according to GAAP, the generally accepted accounting principles. Is that statutory in California? And I'd like to know what—how it is in New York.

JIM CORDI: It is statutory in California if your organization solicits money from the public; they have to keep records according to generally accepted accounting principles. Yes.

ED ABLE: But even if you did not have that law—and I may be corrected on this by one of our accounting professionals, Jessica—I think in order to get a clean audit, you have to be complying with GAAP. Otherwise, you get a qualified—what is called a qualified audit. And nobody wants a qualified audit, so. . . .

JIM CORDI: I'm not an accountant, but it sounds like you're right. But the

last 10 years that have now distorted the financial statements of nonprofits in terms of recording pledges as actually realized income, the consolidation of having to record, as earned income, prepaid income or grant funds that have not yet been satisfied. There are all sorts of things that you can look at a balance sheet now, and unless you are really educated about nonprofit finances and these rules, I don't think it provides a clear picture for anyone of the financial position of the organization. Give the entire board lessons on how to read a balance sheet and a P&L statement for a nonprofit.

JIM CORDI: Well, maybe that's good. (LAUGHTER) One other thing I'd like to mention is, under California's new law, Nonprofit Integrity Act—I don't know about laws of other states—the charitable organization that hires a professional fundraiser is actually responsible, under the statute, for what the fundraiser does and what the fundraiser says to people that they're trying to collect money from. So, it becomes incumbent upon the nonprofit and its management to look

over the shoulder of their professional fundraisers, to approve their solicitation scripts, to approve their mailings that they send out, and to, I think, have some sort of a systematic approach.

DUE DILIGENCE

JESSICA DARRABY: So, to just kind of close this segment of our discussion, there's something in the art world, in the art business, called due diligence. And it's a concept that evolved about 20 or 30 years ago and has taken on new dimensions because of these regulations and international treaties covering cultural property—antiquities, artifacts, and so on. And the question is, how much diligence is due because it could be never-ending. You could put scholars on these things for years and they might still debate them and so on. So as these cases come down, we're finding practical ways to make connections, and one of those practical ways you should know, as an audience, are [sic] these international reporting agencies. So, there are ways now for boards to assure that their curatorial staff and their research staff are making these efforts at due diligence to at least have a record in place of what the institution attempted to do to try to locate the owner of these artworks. And while the courts are still grappling, again, with another bright line—where do we divide it, where is diligence due?

ED ABLE: The American Association of Museums has recently published two new books on provenance research that has evolved—it's a state-of-the-art thing. It's far beyond anything that was ever available before. And that was really precipitated by this big controversy over antiquities and the Nazi era because once the fall of the Soviet Union, the archives available to researchers vastly expanded. [In the past, boards] never questioned the provenance. They left it to the curator to do that provenance research and trusted they had done it well. That era is gone, and I think acquisitions committees and the senior management of the institution are now not allowing curators the kind of free reign that they had before.

COMPENSATION

JESSICA DARRABY: It's hard to have a discussion like this with [two Chiefs of Charity from the California and New York offices] of attorneys general here

and the former CEO of the American Association of Museums without discussing the Getty Report, which came out [October 2006]. Jim Cordi may not be able to give us details of what he did on the report, or even if he's one of the authors, and we completely respect that, but his office did conduct the investiga-

comparable organizations make, and if you make a decision about the compensation of your executive that's rationally based on those surveys and the advice of the consultant, and your decision process is free of conflict of interest—that is, the people whose salaries are being set aren't part of the salary-setting

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tion. So, I ask again, all you who have read the report, what kind of roadmap does this offer boards?

JIM CORDI: Well, boards have to control management, and particularly the extravagant spending of management is one lesson that I hope would be learned. But that lesson has to be learned over and over again, it seems, because things like this are not that unusual.

JESSICA DARRABY: Could you flesh out the California statute, where there is a problem of excessive compensation in the nonprofit work, whereas you can pay in the for-profit world multimillion-dollar contracts for services?

JIM CORDI: Well, there is a statute that says reasonable compensation shall be paid. That's probably no different than legal principles that would apply, at least in theory, in the for-profit world, where if you're dealing with, you know, spending the shareholders' money of a for-profit company, you're not supposed to be extravagant with that either. The problem is, what does that mean—"reasonable compensation"? And what it means to the IRS is, I think, if you go through the exercise of hiring consultants who show you comparables of what—do surveys and determine what comparable officers and directors of

process—and you document the process that you went through, you're going to be pretty safe.

JESSICA DARRABY: Could you explain to the audience the difference between the attorney general's investigation of private and confidential information, and this notion of public record facts and how it plays into the report and how it plays into your investigation?

JIM CORDI: Well, we have a statute in California that says if the attorney general does an investigation and obtains information from the private books and records of individuals or private corporations that the attorney general may not reveal that information except in a court proceeding. Now, that was incompatible in many ways with even doing a public report on the Getty investigation, but Getty is so important and of such interest that we decided to do a public report using the information that was publicly available—the only information that we could use. And a lot of that was developed by the *Los Angeles Times* in its series of articles. So, that's what we did; we wanted to do a public report because there was great interest and it's an important subject, but we're hamstrung in what information we can reveal in that report.

GERRY ROSENBERG: May I give the New York perspective on this? First of all, the statutory scheme that was just described for California is exactly mirrored in New York and is not terribly different from IRS standards, which are, of course, applicable nationally. The problem that we haven't mentioned is the problem of the charismatic, terribly strong, powerful figure—the runaway CEO. And this problem is not limited to the art world.

ED ABLE: Oh, God, no.

GERRY ROSENBERG: And it's not limited to any other segment of the nonprofit world. And you have the issue of the supine board that basically takes its instructions from its chief employee, and no matter how many comp surveys you have, no matter how much other data you put in the files, there's still a question of who's really in charge. There's only so much a state regulator can do, and that's really to make sure that the paper record is sufficient and that the comps support the decision. But boards need spines—and if they don't have it, the CEO is going to get what he or she wants. And that's really

discontinue certain practices and to undertake certain reforms or paybacks or restitution. That document is public, and what it then does is it invites FOIL requests, which we get flooded with, and that then, in many ways, opens up the whole question of what was the body of evidence on which this was based, and then we have our FOIL disputes. So, I think a good deal more of what we investigate ultimately gets into the public domain, if it's a matter of interest.

ED ABLE: To follow up on Gerry's comments, it's the culture of extravagance that is being created in many of these organizations. I guess the new evaluation for boards into whether something is appropriate is if the end justifies the means. That is a very slippery slope. (LAUGHTER)

DIRECTORS AND OFFICERS: DUTIES, OVERSIGHT, AND INSURANCE

JESSICA DARRABY: The first thing we learn as law students in torts is about the role of insurance as the consumer's way of indirectly financing industry error. Yet, insurance has become, actually,

larger policy than one would find in the private sector because it will cover the organization, its employees, and its board—which is a good thing. I mean, you've got that sort of package. But I think it's supposed to cover legitimate errors and omissions, not deliberate malfeasance. And I think you find those limitations in there; a lot of boards sort of relax and say, "Oh, well, you know, so we did the wrong thing or we weren't sufficiently vigilant. Our D & O insurance will cover that." No. And I think you'll find insurance companies fighting that sort of thing.

JESSICA DARRABY: So, I told you one of the things I do when I first get to a board is inquire about their financial records, and another is I inquire about insurance. And some board members respond that they have D & O or they're going to just go out and get it. How do you [chiefs from the offices of] attorneys general respond to the board member who has that response?

JIM CORDI: Well, that's kind of like a person saying, "I've got auto insurance, so I've got a license to drive recklessly." If that's your attitude, I don't know what you're doing on the board to begin with.

ED ABLE: I agree, yeah.

GERRY ROSENBERG: Well, I have a somewhat different view, which is that I want to see the boards of nonprofits get directors and officers insurance because, frankly, we have a lot of situations where the thief ran away with the money, she's judgment-proof, and now we're looking to the board to make restitution—and, whoops, they're not deep pockets. So if we're trying to protect the institution, I do want them to have D & O insurance. But D & O insurance will not protect them, and should not, cannot protect them against affirmative participation in fraud, and it may not protect them from being removed. They may be inappropriate as continuing directors or trustees of the institution. So, it seems to me that you can't have it both ways. You can have D & O insurance, which will protect the entity, and you can remove the directors who slept through the board minutes.

JESSICA DARRABY: It may be time in America for the nonprofit board to have a shakeup and a shakedown. It may well be that we have too many supine boards, or at least too many supine members on

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at the core of many of these problems. And on the public/private issue, there may be a slight divergence here; that is, many of the matters in the State of New York are settled by something called an assurance of discontinuance, which is widely misunderstood as meaning an assurance that the attorney general has discontinued his investigation. But what it really is is an assurance by the respondent that it has agreed to

an important device in the nonprofit world. What is the role of insurance in the nonprofit board?

ED ABLE: The insurers that I know that [sic] are doing underwriting on D & O for nonprofits.

JESSICA DARRABY: Directors and officers?

ED ABLE: Yes. They're quite clear, and most of them, by the way, do cover the organization itself. It's a much

the board, and that it's time to have new faces on the nonprofit boards of America. If you look at the top 50 boards in the country, by any measure, you are going to see this—in the arts, I'm speaking in the arts—you are going to almost always see the same collectors, the same patrons, and the same donors. And one of the things that impressed me about these panelists when I interviewed them and asked them about boards in general was their response that the accountable board is one that reflects the community. And by that, they did not mean just demographics, which are critically important—race, religion, color, et cetera—they meant people in the community by profession, by vocation, by avocation, by neighborhood, and that maybe we need to change the face of the American nonprofit boardroom. So, on that note, I'd like to invite the audience to question our panelists, and I'd like to thank the panelists for their excellent comments and for participating in our forum program. Thank you. (APPLAUSE, END PANEL DISCUSSION) ♦

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ENDNOTES

1. <http://west.thomson.com/productdetail/148335/13514005/productdetail.aspx>.
2. http://www.isflp.com/news/Files/Nonprofit_Integrity_Act_summary.pdf.
3. Cf. Uniform Trust Code—Section 405: Charitable Purposes, Enforcement (last revised in 2005):

“(a) A charitable trust may be created for the relief of poverty, the advancement of education or religion, the promotion of health, governmental or municipal purposes, or other purposes the achievement of which is beneficial to the community. (b) If the terms of a charitable trust do not indicate a particular charitable purpose or beneficiary, the court may select one or more charitable purposes or beneficiaries. The selection must be consistent with the settlor's intention to the extent it can be ascertained. (c) The settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust.”

4. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ204.107.

5. http://ag.ca.gov/newsalerts/cms06/06-085_0a.pdf.

6. FOIA requirements: <http://www.state.gov/m/a/ips/>.