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Indemnification of Trustees, Officers and Employees: What Do You Have? What Should You Have?

Article by Warren J. Casey

The chairman of the board of trustees has lunch with a prospective trustee, or the board is looking to bring in a new executive director, and the candidate asks, "What are my indemnification protections?" How do you respond?

The articles of incorporation or bylaws of most nonprofit organizations include an "indemnification" section. The indemnification section often was not given considerable thought when first included in the document, and probably was given even less as time has gone on. It is sometimes mistakenly referred to as "boilerplate."

Indemnification generally refers to an obligation of the organization to pay an ultimate liability and associated expense incurred by a trustee, officer or employee who becomes the subject of a claim and for whom indemnification under the organization's governing documents is to be provided.

Indemnification provisions are an important protection for trustees and officers and should be regularly reviewed. There are numerous questions and issues regarding to whom, and for what, indemnification should apply.

Take, for example, a situation in which one or more trustees or officers become subject to a claim that a guest of the organization was injured while on its premises. Often in such a case, third-party insurance would cover the personal injury claim; in addition, the statutes of the particular jurisdiction may expressly "exculpate" trustees and officers from liability for such a claim. But other third-party claims might not be covered by insurance or by any "exculpation," such as if an individual is accused by a third party or by a governmental agency of having engaged in some particular wrongdoing or misconduct. Whereas it is possible the organization has directors' and officers' liability insurance, more likely there exists no third-party insurance coverage or exculpation for such claim, in which case indemnification rights in favor of the trustee, officer or employee are very much at issue.

Most organizations provide for "mandatory" indemnification of trustees and officers and, more often, "discretionary" indemnification in favor of employees. That way, the board of trustees can determine whether indemnification of a particular employee (as compared with a trustee or officer) who is the subject of a claim is warranted under the circumstances. But what of an executive director? Is that person entitled to mandatory indemnification if the position of executive director is not an "officer" position under the organization's bylaws? And if indemnification is discretionary (rather than mandatory) for trustees or officers, should you, as a trustee or an officer, be concerned? These are issues to consider when reviewing the indemnification provisions of the organization's governing documents.

Further, even when indemnification protection exists, the statutes of?all jurisdictions nevertheless require the proposed

indemnitee to satisfy a particular standard of conduct -- generally, that the person acted in good faith and in a manner that he or she reasonably believed to be in (or not opposed to) the best interests of the organization and, in a criminal proceeding, that the individual had no reason to believe the conduct was unlawful. So indemnification rights are not automatic; they require, even under mandatory indemnification provisions, the individual to have met a particular standard of conduct.

In addition, indemnification is distinct from "advancement of expenses." For example, a trustee or an officer becomes subject to a particular claim, complaint or government proceeding, and at the very outset, the individual wishes to hire a lawyer to defend the claim. Indemnification rights, by themselves, typically do not apply to the expenses incurred by an individual in his or her defense, at least until there is an ultimate determination of liability on the underlying claim. This is why many indemnification provisions also include provisions for advancement of expenses. Such provisions may be mandatory or discretionary and, in any case, generally require the individual to deliver to the organization an "undertaking" to repay the organization any "advanced expenses" if it is ultimately determined that the individual is not entitled to indemnification. But an organization should be very cautious with advancement rights, because the particular circumstances of the claim, such as alleged corporate wrongdoing, might militate against mandatory advancement of expenses.

Other issues that should be considered in reviewing indemnification/provisions include:

- What types of proceedings are covered by the organization's indemnification protection? Are investigations, arbitrations and governmental proceedings covered, in addition to civil court actions and criminal court actions?
- What if the particular "proceeding" is brought *by* the individual *against* the organization?
- Do the governing documents provide indemnification protection to "former" trustees, officers or employees, after the individual has left the organization and no longer is a current trustee, officer or employee?

The key takeaway is that your organization's indemnification provisions need to be regularly reviewed and should never be considered boilerplate.

Proposed Regulations Provide Guidance on Political Activity for Social Welfare Organizations

Article by Jennifer M. Pagnillo

On Tuesday, November 26, the Internal Revenue Service and the Treasury Department released proposed new guidance that would affect Section 501(c)(4) organizations - those that are required to have social welfare as a primary purpose. Under the existing rules, such organizations are permitted to engage in an unlimited amount of lobbying and some lesser amount of political activity and are not required to disclose their donor lists, thus permitting wealthy donors to anonymously spend money to influence political campaigns.

Currently, a "facts and circumstances" test is applied to determine whether an organization engages in political activities that fall outside of social welfare. The guidance explicitly defines certain political activities as "candidate-related political activities" and thus outside the category of social welfare.

Under the proposed guidelines, "candidate-related political activity" includes the following:

1. Communications

    - Communications that expressly advocate for a clearly identified political candidate or candidates of a political party.
    - Communications that are made within 60 days of a general election (or within 30 days of a primary election) and clearly identify a candidate or political party.
    - Communications expenditures that must be reported to the Federal Election Commission.

2. Grants and Contributions

    - Any contribution that is recognized under campaign finance law as a reportable contribution.
    - Grants to Section 527 political organizations and other tax-exempt organizations that conduct candidate-related political activities (note that a grantor can rely on a written certification from a grantee stating that it does not engage in, and will not use grant funds for, candidate-related political activity).

3. Activities Closely Related to Elections or Candidates

    - Voter registration drives and "get out the vote" drives.
    - Distribution of any material prepared by or on behalf of a candidate or by a Section 527 political organization.
    - Preparation or distribution of voter guides that refer to candidates (or, in a general election, to political parties).
    - Holding an event within 60 days of a general election (or within 30 days of a primary election) at which a candidate appears as part of the program.

Although the proposed guidance does not go so far as to attempt to define how much political activity an organization may engage in without endangering its tax-exempt status, comments are requested as to this issue.

This is the strongest effort to date to curb the political activities of such social welfare organizations, issued in response to the need for more definitive guidance in light of the recent scandal at the IRS whereby officials targeted certain exemption applications for social welfare groups. However, the proposed rules are first subject to a 90-day period for public comments, followed by hearings, additional review and an implementation period, which makes it unlikely that final regulations will be issued any time soon.

New Personnel File Requirements for Connecticut Employers

Article by Daniel L. Schwartz

On October 1, amendments to the Connecticut Personnel Files Law went into effect, imposing new requirements on Connecticut employers, including nonprofit organizations, with respect to (a) providing current and former employees with access to their personnel files; (b) notifying employees of discipline and termination documents; and (c) informing employees of their right to submit rebuttals to any performance, disciplinary or termination documents.

Under the amended Personnel Files Law, an employer must provide a current employee with the right to inspect and copy his/her personnel file within seven days of the employer's receipt of such a request. Employers must provide former employees a copy of their personnel file within 10 days if the employee has submitted the request within one year of his/her separation from employment.

The amendments also require an employer to provide an employee with a copy of "any documentation of any disciplinary action imposed on that employee" within one business day after the date the discipline is imposed. If the employee is terminated, the employer must "immediately provide" a copy of "any documented notice of that employee's termination of employment."

Furthermore, with respect to any documented disciplinary action, notice of termination or performance evaluation, employers now must include a written notice stating in "clear and conspicuous language" that if the employee disagrees with any information contained therein, the employee may submit a written statement explaining his/her position. The employee's statement then must be maintained in his/her personnel file.

Finally, the amendments also increase the civil penalties that the Connecticut Department of Labor may impose for violations of the Personnel Files Law. Employers that fail to comply with this law could face a $500 civil penalty for a first violation and a $1,000 civil penalty for each subsequent violation. Even after these amendments, however, the Personnel Files Law does not permit employees to sue their employers directly for such violations. Instead, such complaints must be pursued through the Connecticut Department of Labor.

Form 990 Schedule K: Difficult Even for Accountants

Article by Linda L. D'Onofrio

The accountants or accounting firms hired by nonprofits typically handle nonprofit tax returns -- Form 990 and Form 990-T -- completely and efficiently. But Form 990's Schedule K: Supplemental Information on Tax-Exempt Bonds often stumps even the best accountants at the best accounting firms. Accountants often send the schedule back to the nonprofit, asking the person responsible for the nonprofit's bond issues to complete it. The language of and questions asked on the schedule presume a complete understanding of the tax law and vocabulary of tax-exempt bond financing, which is a highly specialized and esoteric area most accountants have not studied, and of all relevant information about the organization's bond issues.

Complicating matters is the fact that the instructions accompanying Schedule K are not completely clear; the language for one section may appear to conflict with or contradict the language of another section. Reliance on the information provided in

a prior year's Schedule K also may not be helpful, because both the information sought and the manner of the request have changed since the first Schedule K was added to Form 990 in 2010. In addition, new questions have been added more recently regarding both whether the nonprofit has developed written procedures to ensure compliance with the tax law affecting the exemption of interest on its bonds and whether the nonprofit has written procedures ensuring that violations of relevant tax rules have been "remediated" pursuant to certain Treasury regulations. These questions are designed by the Internal Revenue Service to require ongoing familiarity by the nonprofit with the tax law governing its bonds; the questions also require the nonprofit to monitor both the use and investment of bond proceeds before their expenditure and the use of facilities financed with bond proceeds. At numerous seminars discussing tax-exempt bonds, IRS and Treasury officials have indicated they review Schedule Ks as part of their process in deciding whether to audit certain bond issues.

Because many, if not most, nonprofit organizations are unfamiliar with the changes and complexities inherent in the tax law affecting their bonds, nonprofit organizations required to file Schedule K are well advised to seek assistance from their counsel or other advisers familiar with their tax-exempt bond issues and with current tax law in the area. In addition, nonprofits may wish to seek assistance in developing the written procedures asked about in the schedule. Attorneys at Day Pitney have assisted many nonprofits with both Schedule K and the development of these written procedures to ensure post-issuance compliance with all relevant tax requirements and to allow the nonprofit to favorably answer the questions on Schedule K.

New York's Non-Profit Revitalization Act of 2013: What You Need to Know

Article by Brooke Pollak

In the first major overhaul of New York's Non-Profit Corporation Law since 1970, in June the New York State Legislature passed the Non-Profit Revitalization Act of 2013 (the "Act"). The drafters of this piece of legislation were motivated by a desire to (i) modernize and ease the administrative burdens associated with both setting up and running a nonprofit corporation in New York state, and (ii) strengthen and streamline corporate governance, oversight and accountability.

The Act has many components and will affect both individuals interested in establishing new nonprofit corporations in New York and individuals who are already running nonprofit corporations or charitable trusts in New York. Some provisions will affect foreign nonprofit corporations that register to conduct charitable solicitations in New York.

Existing New York nonprofit corporations and charitable trusts will be affected in the following ways:

1. The Act will require every nonprofit to adopt a conflict of interest policy.
2. The Act will require nonprofits with 20 or more employees and more than $1 million in annual revenues to adopt a whistleblower policy.
3. The Act will raise the gross revenue thresholds that trigger both an independent CPA audit and an independent CPA's review of a nonprofit's financial statements.
4. While significant corporate events (such as exchanges, mergers and changes of purpose) currently require court approval followed by attorney general review, under the Act these events will require only attorney general review.
5. Depending on the number of directors in the nonprofit, the Act may change the vote required to approve certain real estate transactions from a two-thirds vote to a majority vote.

6. The Act will expand the disclosure requirement in related-party transactions to include "key employees" in addition to officers and directors. In addition, the Act will require the board to consider alternatives to any related-party transaction.
7. The Act will prohibit employees from serving as chair of the board of directors (or in any officer position with similar authority, regardless of title). This provision will not take effect until July 1, 2015.
8. The Act will allow board members to meet board procedures via electronic means such as facsimile or e-mail, and for board members to attend meetings via video conference or Skype.
9. The Act will prohibit an employee from being present during the discussion and decision-making process concerning his or her own compensation.

If the Act becomes law, most of the provisions will become effective July 1, 2014. As of this publishing, the Act had not been signed into law by Governor Cuomo. The Act will require thorough review by officers and directors of New York nonprofits, and the above highlights only some aspects of the Act. Please contact Day Pitney for assistance in understanding how the Act will affect your New York nonprofit.

A Shift in the New Jersey Affordable Housing Landscape?

Article by Craig M. Gianetti

The New Jersey affordable housing world received some much-needed guidance on the status of the Council on Affordable Housing's (COAH) Third Round regulations, which used a "growth share" methodology to calculate municipal affordable housing obligations.

On September 26, the New Jersey Supreme Court upheld the invalidation of COAH's Third Round regulations in *In re Adoption of N.J.A.C. 5:96 & 5:97 by N.J. Council on Affordable Housing*. Rather than invalidate the regulations and the growth share methodology on constitutional grounds (as the Appellate Division did), the court held the regulations violated the New Jersey Fair Housing Act, which requires municipal affordable housing obligations to be based on "regional need." The court ordered COAH to adopt new regulations based on the Second Round methodology (as opposed to growth share) within five months.

The key part of the decision, however, was not the court's holding on that specific issue but its invitation to the Legislature to step back into the affordable housing arena. The court noted that *Mount Laurel* decisions "should not be viewed as a constitutional straight jacket [sic] to legislative innovation" in creating a methodology to ensure towns provide their fair share of affordable housing.

Though the decision is a step toward clarifying the uncertainty over affordable housing, it by no means resolves the issue. Many people expect COAH will *not* adopt new regulations within five months. Further, it seems inevitable that the Legislature will reenter the affordable housing world. Since the court did not provide any real guidance as to what would be constitutionally acceptable, whatever legislation is adopted would likely result in further litigation.

Lastly, and separate from this decision, Fair Share Housing Center's appeal of the state's attempted seizure of municipal affordable housing trust fund money remains pending before the Appellate Division. Notwithstanding this appeal, the clock is still ticking on towns to spend affordable housing trust fund money within four years of collection; otherwise, it is subject to possible seizure by the state.

Though this battle over COAH's growth share methodology has concluded, the war over affordable housing continues.

IRS Compliance Sale for 403(b) Plan Document Failures Ends December 31

Article by Liza J. Hecht

Earlier this year, the Internal Revenue Service's (IRS) updated Employee Plans Compliance Resolution System (EPCRS) went into effect. EPCRS provides several procedures under which employers sponsoring retirement plans, e.g., 401(k) plans and 403(b) plans, can correct errors in their retirement plans. Some errors may be corrected without formal submission to the IRS, while others may require formal application and payment of a compliance fee or payment of a negotiated sanction amount. The IRS will not disqualify a retirement plan for an error that is corrected in accordance with EPCRS.

The updated EPCRS provides employers the opportunity to fix incomplete or inaccurate 403(b) plan documents (known as "Plan Document" failures) by making a voluntary submission to the IRS. If the submission is made ***on or before December 31***, employers may pay a ***significantly reduced compliance fee***.

By way of background, effective January 1, 2009, all employers sponsoring 403(b) plans were required to adopt a written plan document containing specific terms required under the Internal Revenue Code. This requirement was generally met if the employer adopted the written 403(b) plan document no later than December 31, 2009. If on IRS audit, an entity is unable to produce evidence that it properly adopted the written plan document by December 31, 2009, it may have a "Plan Document" failure, even if the document contains all the required terms. A Plan Document failure could result in the 403(b) plan losing its tax-favored status, meaning the employees' ability to accumulate retirement savings is reduced and their current income tax liability increased.

403(b) plans can be maintained only for the benefit of employees of private 501(c)(3) organizations and public schools employees. While any employer is vulnerable to a Plan Document failure, 403(b) plans maintained by governmental entities or by employers whose plans allowed for only voluntary employee contributions are particularly vulnerable, because prior to 2009 these plans were not generally subject to the written plan document requirement.

The EPCRS compliance fee for submissions limited to the failure to timely adopt the 403(b) plan document ***is reduced by 50 percent,*** provided the submission is made ***on or before December 31***. For example, if a 403(b) plan has between 101 and 500 participants, the compliance fee for 2013 would be ***$2,500 rather than $5,000***.

Clearly, this $2,500 is a bargain when contrasted with the potential financial exposure for not correcting the Plan Document failure in 2013. First, if the voluntary submission is made after 2013, the compliance fee will double in amount. Second, if not corrected under EPCRS, the Plan Document failure could cause the employer to pay a negotiated sanction amount far in excess of $2,500. To illustrate the potential sanction, the starting point?-- assuming just one participant contributing an average of $16,000 per year and paying an effective federal tax rate of 25 percent -- is ***$12,000***. Obviously this amount increases dramatically when all participants are considered. Although the IRS will likely negotiate the sanction amount, it does not typically reduce it below the amount the employer would have paid under a voluntary EPCRS submission.

Applying for Tax-Exempt Status: The New 'Interactive' Application

Article by Jennifer M. Pagnillo

On September 27, the Internal Revenue Service published a new "interactive" Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The new interactive guide first asks prerequisite questions to ensure an organization has all of the required information to apply for tax-exempt status. Depending on how an organization answers the prerequisite questions, additional IRS forms will be generated for the organization to complete. For example, if an organization answers "yes" to the question "Have you authorized, or do you plan to authorize, an individual to represent your organization or obtain copies of documents on your behalf?" then Form 2848, Power of Attorney, will be available for the organization to download. Only after an organization has correctly answered the threshold questions can it proceed to the completion of the interactive Form 1023.

Although the interactive Form 1023 remains substantively unchanged from the current Form 1023, this new interactive form contains help buttons and pop-up boxes with examples, explanations, definitions and links to relevant IRS publications. In addition, the financial pages of the interactive form will auto-calculate totals and automatically direct an organization to any required supplemental information pages based on how it answered particular questions.

The interactive Form 1023 also provides a link to the IRS's "Top Ten Tips to shorten the application process":

10. Provide all required information on the principal officers and board of directors.
9. Ensure a director, trustee, principal officer or other authorized individual signs the Form 1023.
8. Don't forget to submit a copy of adopted bylaws, code of regulations or any other document that sets out the organization's rules of operation, but only if adopted.
7. Include all of the necessary financial data.
6. Include the month the organization's annual accounting period ends.
5. Attach all required schedules.
4. Complete all required pages.
3. Provide enough information about the organization's exempt activities to show us how it will achieve the exempt purpose.
2. Attach a complete copy of the organizing document and all amendments.
1. Include the correct User Fee.

Although the interactive Form 1023 can be completed online, it still must be printed and mailed to the IRS for filing, with all required attachments.

The IRS expects use of the interactive Form 1023 will reduce processing time, because its auto-calculating and self-populating properties will reduce the number of errors that otherwise might occur in the preparation of the form.