

An act to Promote the Financial Integrity of Public Charities

Summary of Draft 1.0

Introduction

Charities need to restore the trust and confidence of donors, the public and regulators in their financial competence and integrity. Beginning with problems involving the delivery of charitable donations intended for the victims of September 11, 2001, an increasing number of cases of mismanagement and abuse of charitable assets by charity managers, officers, directors and trustees have come to light. In too many instances officers, directors and trustees are learning about financial problems within their organizations too late to address the problem in an adequate and efficient manner, and in too many instances charity leaders are pocketing assets for their own financial gain. While such abuses can be addressed in part through enhanced education of charity leaders and stepped-up enforcement measures, legislation is needed to require public charities to adopt measures that will increase their financial integrity and to hold charity leaders to clear standards of accountability.

The following legislation proposed by the Massachusetts Office of the Attorney General is intended to strengthen the public's trust in the integrity of public charities by requiring charities to monitor and certify to the accuracy of their financial reporting and encouraging them to follow accepted procedures when entering into a contract, transaction or agreement for compensation with a related party, such as one of their own officers or directors. Similar to the intent of Congress when it enacted the Sarbanes-Oxley Act corporate financial governance law shortly after the Enron and WorldCom scandals, this legislation is designed to reestablish the public's trust in public charities.

While there exist obvious differences between for-profit corporations and charitable corporations, many of the principles of good corporate governance set forth in Sarbanes-Oxley are equally applicable to public charities. Given the absence of shareholder oversight, and in light of recent abuses involving charitable assets, the requirement to employ financial controls can help ensure the integrity of charities by deterring mismanagement and misconduct and allowing the discovery of financial problems in time to fashion remedies in order to keep charities viable. In return for the tax-exempt status granted these charities by the state and federal governments and their ability to fundraise from the public, charities should follow stricter rules for fiscal soundness and transparency.

The main goal of the proposed legislation is to provide clearer standards with respect to financial oversight of and by charities' boards and directors. With respect to each provision, the proposed legislation recognizes and accommodates the differences between for-profit corporations and charitable corporations and between larger and

smaller charities. Similarly, the legislation seeks to employ existing legal standards rather than to create new requirements out of whole cloth.

The proposed legislation consists of six sections, Sections Two, Three, Four and Five being the most substantive. Section Two concerns the certification of financial reports by the principal managing officers of a public charity; Section Three concerns audit committees, procedures for complaints and whistleblower protections; Section Four concerns related party transactions and compensation, and Section Five proposes new remedies for violations and consolidates the remedy provisions in the current statute.

Section-by-Section Summary

Section 1: Definitions. This section amends Ch. 12, § 8A, which contains definitions for terms employed in Chapter 12. Chapter 12 governs the obligations of public charities and the authorities of the Attorney General with respect to public charities. The new terms are made necessary because of the new substantive provisions added to Chapter 12 by the proposed legislation.

Definitions for the following terms are added:

“compensation” (inserting definition familiar to public charities);

“disclosure controls and procedures” (inserting definition used by the Securities and Exchange Commission, with minor changes). These are controls and procedures to ensure that all of the information that the public charity must file with the Attorney General is first disclosed to management in a timely manner such that the managers are knowledgeable with respect to the substance of the information contained in the reports and documents that they submit to the Attorney General;

“internal control over financial reporting” (inserting definition used by the Securities and Exchange Commission, with minor changes). These are internal procedures overseen by the charity’s principal managing officers that ensure the reliability of the charity’s financial reporting and that financial statements are prepared in accordance with generally accepted accounting principals;

“related party” (inserting definition currently employed in Public Charities reporting requirements). A “related party” is an officer, director, trustee, or senior manager of the charity, a spouse or other close relation of such person, or an entity owned or controlled by such person.

Section 2: Certification of financial reports. Amends Ch. 12, § 8F to require that the principal managing officers of a public charity expressly certify to the accuracy of the financial reports submitted to the Attorney General and, with respect to larger public charities, to the existence and efficiency of disclosure controls and procedures and internal controls over financial reporting. Currently Section 8F requires only that principal officers verify the accuracy of such reports and documents, without any express reference to financial information. Specifically, Section 2:

Raises the annual revenue threshold that triggers the requirement to submit audited financials from \$250,000 to \$750,000. Section 2 raises from \$250,000 to \$750,000 the threshold of annual gross revenue for which a charity must file a complete audited financial statement.

Requires managing officers of smaller public charities (annual revenues below \$750,000) to expressly certify to the accuracy of the financial statements submitted to the Attorney General. Section 2 requires, for charities which receive less than \$750,000 in gross annual revenue, that, in addition to certifying the accuracy of the annual report and accompanying documents submitted to the Public Charities Division, the president or chief executive officer, and the treasurer or chief financial officer, certify that, based upon his or her knowledge, the included financial information fairly represents the charity's financial condition for the periods presented in the report and documents.

Requires managing officers of larger public charities (annual revenues above \$750,000) to expressly certify, not only to the accuracy of the financial statements submitted to the Attorney General, but that the officers have established disclosure controls and internal controls over financial reporting. Section 2 requires, for charities that receive gross annual revenue of over \$750,000, that, in addition to verifying the accuracy of the annual report and accompanying documents submitted to the Public Charities Division, the president or chief executive officer, and the treasurer or chief financial officer certify, based upon his or her knowledge, that, among other items:

- 1) the officers designed, established and maintained disclosure controls and procedures to ensure that material information relating to the public charity is made known to the signing officers;
- 2) designed and instituted the internal financial controls needed to provide reasonable assurances regarding the reliability of financial reporting and the preparation of financial statements in accordance with Generally Accepted Accounting Practices;
- 3) evaluated the effectiveness of the disclosure controls; and

- 4) disclosed, to the audit committee and the charity's auditors, material deficiencies in the internal financial controls and any fraud perpetrated by a trustee, director, manager or employee.

Section 3: Audit committees; procedures for complaints; whistleblower protections. Adds a new section to Ch. 12 that:

Requires large public charities (annual revenues over \$750,000) to establish an audit committee comprised of independent members of the board. This section requires any public charity that receives more than \$750,000 in annual gross revenue to designate an audit committee consisting of three or more directors/trustees.

Requires the audit committee to oversee the charity's independent certified public accountant. This section requires audit committee to be directly responsible for overseeing the charity's public accountant, and requires the public accountant to report directly to the auditing committee and to the entire board.

Audit committees must establish procedures to accept complaints about financial matters, including complaints from anonymous sources within the charity. This section requires audit committees to establish procedures for receiving and resolving complaints about financial matters, and for receiving confidential and anonymous concerns from employees, directors or trustees about illegal or improper financial matters.

Audit committees must forward all complaints to the Attorney General, as well as an annual summary of how the charity resolved the complaints. This section requires audit committees to forward all these complaints and concerns to the Attorney General, as well as to forward (annually or upon demand) to the Attorney General a description of measures taken by the charity to address each complaint and concern. This provision specifies that none of these forwarded documents shall be considered public records under G.L. Ch. 66 § 10.

Prohibits public charities from retaliating against any employee, officer, director or trustee who submits a complaint to the audit committee, the Attorney General, or any other governmental entity. This section specifies that, to receive these protections, the complainant must have submitted her complaint in good faith and in the reasonable belief that the charity had engaged or was engaging in illegal or improper conduct.

Section 4: Related party transactions. Adds a new section to Ch. 12 that essentially incorporates, into Massachusetts law, some of the standards established by the intermediate sanctions provisions of the Internal Revenue Code. The section imposes a presumption that a related party transaction (except for certain private foundation

transactions) -- the entering into of a contract, other transactions, or agreement for compensation between the public charity and a related party -- is fair and reasonable if certain procedural protections are in evidence. The section also provides that any related party contract, transaction or agreement for compensation may be voided by the Attorney General in a lawsuit should the public charity fail to establish a presumption that a related party transaction is fair and reasonable, to otherwise establish that the contract, etc., is fair and reasonable, or that by voiding or modifying the contract, transaction or compensation agreement the charity is in a worse off position than were it not voided or modified.

Establishes presumption that a related party contract, transaction or agreement for compensation is fair and reasonable if each of the following factors is satisfied:

- 1) Approval, by a 2/3 vote, of all members entitled to vote on the applicable board or committee, excluding the votes of related directors/ officers/ trustees;
- 2) The material facts of the deal and the director/officer/trustee's interest were disclosed in good faith or otherwise known to all members of the applicable board/committee entitled to vote;
- 3) The board/committee obtained and relied upon appropriate comparability data prior to approving the deal and provided the data to voting members;
- 4) The board/committee adequately documented the basis for the approval at the time of approval, including the terms of the deal, the members present and voting, the comparability data and a description of how it was obtained.

Provides for modification or voidance of a related party contract, transaction or agreement for compensation should public charity fail to establish presumption or otherwise establish that contract, transaction or compensation is fair and reasonable or that charity is worse off after contract, transaction or compensation agreement is voided or modified.

Requires compensation of officers, directors and trustees be established through at least a majority vote and requires that such compensation be fair and reasonable. Requires that compensation of trustees/directors for serving as trustees/directors or on any committee shall be fixed by majority vote of the trustees/entire board. Such compensation shall be fair and reasonable.

Restricts those who can vote on compensation for directors or trustees for services they provide the charity (other than the service they provide as directors or

Office of Massachusetts Attorney General Tom Reilly
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trustees). This provision limits the persons who can fix the compensation of trustees/directors/officers for serving in capacities other than their capacity as trustee/director/officer to directors or trustees who are not compensated by the charity in a capacity other than their capacity as a board member or trustee.

Section 5: Remedies for violations. Section 5 adds a new section to Ch. 12 that culls from the existing remedy provisions of Chapter 12 a comprehensive list of civil remedies that the Attorney General may seek upon determining the existence of a violation of an existing section of Chapter 12 or one of the new sections added by this proposed legislation. This remedies section is available in addition to the existing remedies set forth in Chapter 12, which are not altered.

Section 6: Consistency with other provisions. Section 6 of the legislation makes certain changes to the current text of Chapter 12 so that it conforms to the changes made as a result of this proposed legislation.