

California's Nonprofit Integrity Act of 2004

Spring 2006

Rosemary E. Fei

This outline presents a general statement of the Nonprofit Integrity Act of 2004 and related rules, for educational purposes. This outline should not be construed as legal advice, or substituted for consultation with qualified legal counsel concerning application of the law to specific facts.

On September 29, 2004, Governor Schwarzenegger signed into law S.B. 1262, the Nonprofit Integrity Act of 2004 (the "NIA" or the "Act"). It became effective on January 1, 2005. The NIA, as it finally emerged after extensive amendments, addresses two broad areas of nonprofit activity: governance of charitable organizations, and fundraising by or on behalf of charitable organizations.

This outline explains the governance provisions of the Act: the requirements for financial audits, for audit committees, for public disclosure of audited statements, and for review and approval by the Board of Directors of the compensation paid to the chief executive officer and the chief financial officer of the charitable organization. It also discusses some of the Act's extensive charitable fundraising provisions.

I. Governance Provisions

The NIA was passed in the wake of corporate scandals, such as Enron and WorldCom, that revealed the highly questionable financial practices of some of the nation's largest corporations. It was intended in part to be an analog to the federal Sarbanes-Oxley Act of 2002, which addresses the financial accountability of for-profit corporations. As such, the Act focuses on the financial practices and governance of nonprofit organizations in an effort to ensure that adequate accountability exists.

A. Mandatory Financial Audits

1. Audit requirement.

The NIA requires certain charities¹ to have their financial statements audited, on an annual basis, by an independent certified public accountant.

Only a charitable organization with annual gross revenues of \$2 million or more is subject to the audit requirement. Grant or contract income from the government is not included in gross revenue so long as the governmental entity requires an accounting of those funds. The Attorney General interprets the term “gross revenues” in the NIA to be the same as “total revenue” used by the IRS on line 12 of Form 990 and line 12 column (a) of Form 990-PF. Note that this figure includes the value of non-cash contributions.

The financial audit must be performed by an independent certified public accountant in accordance with generally-accepted accounting principles (GAAP). If the audit firm also performs non-audit functions for the charity, the firm and its auditors must conform to the standards for auditor independence set forth in the Government Auditing Standards issued by the Comptroller General of the U.S., but the Attorney General may prescribe different standards.² The Attorney General’s office has interpreted the mandatory audit provisions of the NIA to apply to all fiscal years ending on or after June 30, 2005.

2. Audit committee.

With regard to those charities required by the NIA to prepare annual audited financial statements as described above, the NIA also provides that charities in corporate form must appoint an audit committee.³ The committee must be appointed by the Board of Directors.

Unlike other committees exercising Board authority under California’s nonprofit corporate law, the audit committee may include non-Board members, and may consist of a single person. While it may include members of the finance committee, the chair of the audit committee may not be a member of the finance committee, and members of the finance committee must constitute less than half of the audit committee.

¹ The term “charities”, as used in this discussion and understood by the California Attorney General, includes all nonprofit public benefit corporations, regardless of whether they are exempt under Section 501(c)(3), 501(c)(4) or non-exempt.

² Gov. Code §12586(e)(1).

³ For transition purposes, the Attorney General’s office indicated that for charities that expected to exceed the \$2 million gross revenue threshold, the audit committee should have been appointed on January 1, 2005, or as soon as the Board of Directors met thereafter, and in no event later than the end of the first quarter of 2005.

The audit committee may not include any member of the staff, including top management, whether paid or volunteer, or any person who has a material financial interest in any entity doing business with the charitable organization. Staff members may be invited to attend an audit committee meeting, but may not be members of the committee.

If audit committee members are paid, they may not receive compensation in excess of the amounts received, if any, by members of the Board of Directors for service on the Board. Yet the Attorney General has interpreted this provision to permit audit committee members to be paid as directors and then also as audit committee members, so long as their audit committee pay does not exceed their pay as directors.

Five duties of the audit committee are spelled out in the Act. Audit committees:

- (a) shall recommend to the Board of Directors the retention and termination of the independent auditor;
- (b) may negotiate the compensation of the auditor on behalf of the Board;
- (c) shall confer with the auditor to satisfy the committee members that the financial affairs of the charitable organization are in order;
- (d) shall review and determine whether to accept the audit; and
- (e) shall approve performance of any non-audit services to be provided by the auditing firm.⁴

3. Public disclosure.

Audited statements (those required by the NIA, as well as those prepared for charitable organizations required to file reports with the Attorney General, even though not required by the NIA) must be made available for inspection by the Attorney General and the general public within nine months after the close of the fiscal year to which the statements relate. Unlike Form 990, no extensions of this deadline are available. The Attorney General has indicated that the public disclosure requirement covers all financial statements and the notes thereto, but not any management letter issued to the charity by the auditor, and do not apply to audited financial statements pre-dating the effectiveness of the NIA.

The Attorney General has stated that the NIA rules for public disclosure of audited statements are the same as those applicable to public disclosure of federal tax returns by tax-exempt organizations. Thus, audited statements must be made available to the public for a period of three years, both (a) at the charitable organization's principal and any regional or district office during regular business hours, and (b) by mailing a copy to any person who so

⁴ Gov. Code §12586(e)(2).

requests in person or in writing; or, alternatively, by posting the audited statements on the charitable organization's website.⁵

B. Mandatory Compensation Review

1. What is required?

The compensation, including benefits, of the President or CEO and the Treasurer or CFO of the charitable organization must be reviewed and approved by the Board of Directors or a Board committee.⁶ The charity may not avoid the compensation review requirement by giving that person a different job title, but anyone with either of those titles is subject to the required compensation review, regardless of job description. Review and approval must occur when the officer is hired, when the term of employment of the officer is renewed or extended, and when the compensation package is modified, unless the modification applies to substantially all employees. The California Attorney General takes the position that this compensation review requirement extends to situations where the functions of the CFO are performed by an independent contractor rather than an employee, or otherwise contracted out by the charity.

2. What standard is applied?

The approving body must determine that the compensation is just and reasonable.⁷ That test is usually met by a showing that the compensation is comparable to that paid by similar organizations for similar services. The three most common methods used to address the comparability standard are: (a) a tailor-made salary survey for the charity done by a management firm (the cost of such a survey usually ranges between \$5,000 and \$15,000); (b) reliance on an off-the-shelf survey such as the annual compensation survey of grantmakers by the Council on Foundations in Washington, D.C. and the annual compensation and benefits survey of California nonprofits by the Center for Nonprofit Management in Los Angeles; and (c) independent research of the range of compensation paid by comparable charities based on information contained in publicly available tax-return information available on www.guidestar.org. Many charities use one or more of those sources to establish a comparable range of compensation and benefits and then rely on the annual performance review to determine exactly where a particular officer might fit within that range.

3. What about compensation of other officers or employees?

Federal and state laws other than the NIA require that members of the Board of Directors have a continuing duty to avoid paying excessive compensation, and the NIA does not

⁵ Treas. Regs §§301.6104(d)-1(a) and (d)-2; Gov. Code §12586(e)(1).

⁶ For transition purposes, the Attorney General's office has indicated that, for officers in place on the effective date of the NIA, the initial review of compensation should have occurred as soon after January 1, 2005, as was reasonably possible.

⁷ Gov. Code §12586(g).

supercede them, but the NIA only applies to the President or CEO and Treasurer or CFO, even if other officers are more highly compensated.

C. Coverage

1. General rule.

The charities subject to the NIA's mandatory audit requirement, the audit committee requirement, and the public disclosure rules, are those charitable corporations, unincorporated associations, and charitable trusts who are required to register and file reports with the California Attorney General. Initial registration is required within 30 days after a charity first receives any assets, including money and any other form of real or personal property. Registration may be accomplished by a letter to the Attorney General's office with required information listed or attached; a list of the required information may be found at http://caag.state.ca.us/charities/forms/charitable/reg_form_checklist_05.pdf.

2. Exemptions.

Charities that are exempt from the requirement to file reports with the California Attorney General include:

- educational institutions (public and private schools, colleges, and universities),
- hospitals,
- cemeteries, and
- religious organizations.⁸

However, exemption only applies to the mandatory audit, audit committee and public disclosure requirements of the NIA; there are no exemptions to the mandatory compensation review and fundraising provisions (discussed below) of the NIA.

II. Fundraising Provisions

In addition to financial accountability, the Act also focuses on fundraising practices as an area of historical abuse. The NIA requires charitable organizations to enter into written contracts containing mandatory terms and conditions for every charitable fundraising event where a commercial fundraiser is used. It also requires charitable organizations to exercise control over fundraising activities conducted for them. A discussion of all of these provisions is beyond the scope of this outline, as many of the requirements fall upon the fundraisers themselves, rather than the charitable organization. Nevertheless, a basic understanding of these

⁸ Gov. Code §12583.

provisions is essential for all organizations that work with outside development professionals or fundraisers.

A. Commercial Fundraiser and Fundraising Counsel: Definitions

The Act contains many provisions that apply to “commercial fundraisers” and “fundraising counsel” and not to charities, but many of which affect charities’ interactions with them.

For example, preexisting law requires that a commercial fundraiser for charitable purposes must register with the Registry. The Act adds the requirement that before beginning any charitable solicitation, a commercial fundraiser must also file a notice with the Registry setting forth information identifying the fundraiser and the charitable organization, the fundraising methods to be used, the dates when fundraising will begin and end under the contract, and identifying information about the person responsible for directing and supervising the work of the fundraiser. The notice must be filed not less than 10 days before the beginning of each solicitation campaign, event, or service, except for solicitations to aid victims of emergency hardship or disasters, in which case the notice must be filed not later than when the solicitation begins.⁹ Similar requirements apply to fundraising counsel. The NIA also now requires commercial fundraisers to maintain detailed records, including a list of required information, for ten years after a solicitation campaign ends.¹⁰

In general, nearly all external development consultants or professional fundraisers who receive a fee from a charity will fall into one category or the other.¹¹

⁹ Gov. Code §12599.6(h).

¹⁰ Gov. Code §12599.7.

¹¹ **Commercial Fundraiser.** A commercial fundraiser for charitable purposes is defined as any individual, corporation, or other legal entity who, for compensation, does any of the following (Gov. Code §12599):

1. Solicits funds, assets, or property in California for charitable purposes.
2. As a result of a solicitation of funds, assets, or property in California for charitable purposes, receives or controls funds, assets, or property solicited for charitable purposes.
3. Employs, procures, or engages any compensated person to solicit or control funds, assets, or property for charitable purposes.

Note that a commercial fundraiser does not include an employee or trustee of a charitable organization, among others. Gov. Code §12599(a).

Fundraising Counsel. A fundraising counsel for charitable purposes is defined as any person who is described by all of the following (Gov. Code §12599.1):

1. For compensation plans, manages, advises, counsels, consults, or prepares material for, or with respect to, the solicitation in California of funds, assets, or property for charitable purposes.
2. Does not solicit funds, assets, or property for charitable purposes.
3. Does not receive or control funds, assets, or property solicited for charitable purposes in California.

B. Charitable Organizations: Control Over Fundraising

The Act makes plain that charitable organizations must “establish and exercise control,” not only over their own fundraising activities, but over fundraising activities conducted by others for their benefit. That control must include approval of all written contracts, and the charitable organization must assure that fundraising activities are conducted without coercion of potential donors.¹²

A charitable organization may not contract with any commercial fundraiser unless that fundraiser has registered as required with the Attorney General’s Registry of Charitable Trusts (“Registry”),¹³ nor may any charity raise funds for another charity unless the second charity is registered as required.¹⁴

C. Misrepresentations

Charitable organizations may not misrepresent their purposes or the nature, purpose, or beneficiary of a solicitation. Misrepresentation may be established by word, by conduct, or by failure to disclose a material fact.¹⁵ The Act sets forth twelve prohibited acts and practices in the planning, conduct, or execution of any charitable solicitation or sales promotion.¹⁶ The prohibitions apply, according to the Act, “regardless of injury.”¹⁷

-
4. Does not employ, procure, or engage any compensated person to solicit, receive, or control funds, assets, or property for charitable purposes.

Note that fundraising counsel does not include an attorney, or an employee or trustee of a charitable organization, among others. Gov. Code §12599.1(b).

¹² Gov. Code §12599.6(b).

¹³ Gov. Code §12599.6(c).

¹⁴ Gov. Code §12599.6(d).

¹⁵ Gov. Code §12599.6(a).

¹⁶ They are:

1. Any operation in violation of the NIA, the Attorney General’s regulations or orders, or making solicitations after registration has expired or been suspended or revoked;
2. Unfair or deceptive acts or fraudulent conduct;
3. Using any name or symbol that falsely suggests a contribution is for a particular charitable organization;
4. Misrepresenting that a contribution is for a charitable organization or will be used for a charitable purpose;
5. Misrepresenting that a person sponsors, endorses or approves a charitable solicitation when that person has not given written consent to that use of the person’s name;
6. Misrepresenting that goods or services or persons have endorsements, characteristics, or affiliations they do not have;
7. Misleading anyone to believe that registration constitutes an endorsement or approval by the Attorney General;
8. Representing that a charity will receive more than actual estimated net proceeds to the charity;

D. Contract Requirements

The Act requires that a commercial fundraiser and a charitable organization must enter into a written contract for each solicitation campaign, event, or service.¹⁸ The contract must be signed by an authorized contracting officer for the commercial fundraiser and by an official authorized to sign by the charitable organization's governing body. The mandatory provisions of the contract, which may be inspected by the Attorney General, include:

1. A statement of the charitable purpose of the fundraising activity.
 2. A statement of the "respective obligations" of the commercial fundraiser and the charitable organization.
 3. If the commercial fundraiser is to be paid a fixed fee, a statement of the fee and a good faith estimate of what percentage the fee will be of total contributions, disclosing the assumptions on which the estimate is based, which must reflect all relevant facts known to the commercial fundraiser.
 4. If the commercial fundraiser is to be paid a percentage fee, a statement of the percentage of total contributions that will be remitted to or retained by the charitable organization or, if the sale of goods is involved, the percentage of the sales price remitted to or retained by the charitable organization. In determining the percentage, the commercial fundraiser's fee, as well as any other amounts the charitable organization is required to pay as fundraising costs, must be subtracted from contributions and sales receipts received.
 5. The starting and ending dates of the contract and the date solicitation activity will begin in California.
 6. A provision requiring the commercial fundraiser to handle contributions in accordance with the Act's detailed requirements on the deposit or delivery of funds to the charity, including that all contributions received by the commercial fundraiser either be
-
9. Distributing items that can be used for display on a motor vehicle that suggests an affiliation with or endorsement by any public safety personnel or group;
 10. Soliciting advertisements to appear in a for-profit publication that do or might relate to a charitable purpose, without disclosing that the publication's for-profit status and other required information;
 11. Representing that any contributions solicited will be given to another charity without prior written consent from that charity for such use of its name; and
 12. Representing that event tickets will be donated to charity unless (a) there are written commitments from charities to accept a specific number of donated tickets, and (b) the total number of donated tickets does not exceed either total commitments to accept tickets from charities, or the total capacity of the event site.

¹⁷ Gov. Code §12599.6(f).

¹⁸ This outline does not distinguish between contracts with commercial fundraisers and fundraising counsel. Because the requirements with respect to commercial fundraisers are slightly more onerous, this outline focuses on those requirements.

personally delivered to the charity, or deposited into a bank account controlled by the charity, within 5 working days.

7. A statement that the charitable organization shall exercise control and approval over the content and frequency of any solicitation.
8. If the commercial fundraiser proposes to pay any person or legal entity, in cash or in kind, to attend, sponsor, approve, or endorse a charity event, the maximum dollar amount of those payments must be stated.
9. A provision allowing the charitable organization to cancel the contract without cost, penalty, or liability for a period of 10 days after signing, by giving written notice in a specified manner. Any funds collected by the commercial fundraiser after notice of cancellation must be held in trust for the benefit of the charitable organization without deduction for costs or expenses.
10. A provision permitting the charitable organization to terminate the contract on 30 days' written notice to the commercial fundraiser, effective five days after the notice is mailed. The charitable organization remains liable for the commercial fundraiser's services during the 30-day period.
11. A provision providing that, after the initial 10-day cancellation period, the charitable organization may terminate the contract at any time by giving written notice, without payment of any kind to the commercial fundraiser, if (a) the commercial fundraiser makes material misrepresentations in solicitations or about the charitable organization, (b) the charitable organization learns that the commercial fundraiser or its agents have been convicted of a crime punishable as a misdemeanor or felony, arising from charitable solicitation, or (c) the commercial fundraiser otherwise conducts fundraising activities that cause or could cause "public disparagement of the charitable organization's good name or good will."¹⁹

Whenever a charitable organization cancels a contract, it must mail a duplicate copy of the notice of cancellation to the Registry.²⁰ Contract cancellation rights are statutory, entirely apart from the terms of any contract. Thus, even if contracts fail to spell out the required rights of cancellation, the Act provides that charitable organizations nevertheless have those rights by law.²¹ The Act also provides that charitable organizations may void contracts with commercial fundraisers or fundraising counsel if they are not properly registered.²²

¹⁹ Gov. Code §12599(i).

²⁰ Gov. Code §12599(d).

²¹ Gov. Code §12599.3(b), (c), (e), (f), (g).

²² Gov. Code §12599.3(a)

III. Impact of the NIA on Non-California Charities: Doing Business in California

Charities required to file reports with the Attorney General, and thus subject to the mandatory audit requirement, the audit committee requirement, and the public disclosure rules, include foreign corporations (those formed under the laws of other states) doing business or holding property in California for charitable purposes.²³ Examples of doing business in California by foreign corporations include:

- Soliciting donations in California by mail, by ads in publications, or by any other means from outside of California.
- Holding Board meetings of the charitable corporation in California.
- Maintaining an office in California of the charitable corporation.
- Conducting charitable programs in California or having officers or employees who work here.

Note that “doing business” does not generally include merely making grants to grantees in California or maintaining financial accounts or investments in an office of a financial institution in California.

As noted above, there are no exemptions to the compensation review and fundraising provisions of the NIA, and the view of the California Attorney General is that these provisions do apply to foreign corporations doing business in California, although it is unclear whether or how the Attorney General would or could assert that jurisdiction to enforce the NIA.

IV. Concluding Observations

A. Coverage of the NIA.

Relatively few charities are subject to the mandatory financial audit. The threshold—the requirement that the charity must have annual gross revenues of \$2 million or more—will exclude the vast majority. Not only does that threshold exclude the small charity with modest gross revenues, it may also exclude the charity with substantial assets. For example, most grantmaking foundations with assets of \$50 million will not have gross revenues even close to \$2 million because gross revenues consist only of contributions, commercial income, investment income, and capital gains. Most grantmaking foundations generate cash for their minimum payout and operating expenses by selling stock; only the gain portion on stock sales is counted as part of gross revenues. In addition, most human service organizations will be not be

²³ Gov. Code §12582.1. It is not clear whether the Attorney General would assert jurisdiction and application of the NIA to out-of-state charities that do not operate in corporate form (i.e., unincorporated associations and trusts), based on their doing business in California.

covered because grant and contract income from the government is excluded from the gross revenues calculation so long as the government requires an accounting of those funds.

In addition to the high dollar threshold, the audit requirements reach an even narrower group of charities because they apply only to those charities required to file reports with the Attorney General. Exempted from filing with the California Attorney General—and thereby exempted from the NIA audit requirements—are colleges and universities, private schools, other educational institutions, hospitals, and religious organizations. The Attorney General’s position, however, is that all of those excluded organizations are subject to the mandatory compensation review and fundraising practices requirements of the NIA.

B. Attorney General Response.

The manner in which the Charitable Trust Section of the Attorney General’s office has responded to enactment of the NIA is unprecedented. The website of the Attorney General’s office (www.caag.state.ca.us/charities/faq.htm) now contains detailed guidance to the NIA in the form of a narrative guide as well as many helpful FAQs which are updated and expanded, as needed. Also, the top officials of the Charitable Trust Section have launched statewide education and training efforts where these officials meet with representatives of charities and their advisers and respond to e-mail requests for guidance on the NIA.

C. Evolving Standards.

This past spring, the *New York Times* carried an article about AIG (American International Group) and the downfall of its CEO, Maurice (Hank) Greenberg. The authors wrote “How could a man who ruled for almost 40 years see his legacy slip away in a matter of days over events that, at another time, might have been dismissed as immaterial....” Their answer was that the CEO was a throwback to another era – “an executive working in a business world still shaken by the corporate scandals of recent years, but who failed to recognize the swirl of change engulfing him.”²⁴

The NIA is likely to be amended as the Attorney General gains experience in interpreting and enforcing it; other forms and sources of nonprofit accountability are likely to develop, legislative and otherwise—changes in the Internal Revenue Code and other federal laws affecting nonprofits are imminent in Congress. The charitable sector, inside California and out, may be experiencing the period of greatest structural legal change since the creation of private foundations in 1969. The only way a Board of Directors or any individual director or officer can be sure to avoid being engulfed by this “swirl of change” in standards of nonprofit governance is to understand that charities are increasingly expected by the public to take the highest road. Compliance with the letter of the current law—or even the spirit of that law—may no longer be sufficient when the law changes. The public looks to charities to act as moral agents, and focussing too much on today’s legal requirements may be short-sighted. Directors and officers

²⁴ Jenny Anderson and Kurt Eichenwald, “Insurer Ex-Chief Is Called Target of Stock Inquiry,” *New York Times*, Section A, page 1 (May 6, 2005).

of charities may instead need to seek and follow the highest ethical standards appropriate to their organization's structure and mission. To do otherwise in today's environment of intense scrutiny and change, risks that the charity's reputation will be damaged, its respect in the community diminished, and its ability to fulfill its mission imperiled.

V. Further Resources

The NIA is newly enacted, and continues to be subject to active interpretation by the California Attorney General, who is charged with its enforcement. It is also possible that amendments to the NIA may be made in future years. For up-to-date information on regulations and answers to frequently-asked questions, consult www.caag.state.ca.us/charities/faq.htm. Another good resource is CompassPoint, at www.compasspoint.org; the California Association of Nonprofits closely monitors legislative developments affecting nonprofits, at www.canonprofits.org.