

**NATIONAL BUSINESS INSTITUTE
Tax Exempt Organizations from Start to Finish**

ETHICAL CONSIDERATIONS FOR EO PRACTITIONERS

Michelle Huhnke
Sugar Felsenthal Grais & Hammer LLP
30 North LaSalle Street, Suite 3000
Chicago, Illinois 60602
(312) 704-2779
mhuhnke@sugarfgh.com

Relationships between a non-profit organization, its board and its donors can easily get tangled. A lawyer who remains focused on representing the organization and not its constituents will protect himself or herself from ethical questions.

This outline refers generally to the Model Rules of Professional Conduct. Effective January 1, 2010, Illinois substantially revised its Rules of Professional Conduct, which are now largely based on the current version of the Model Rules. Where Illinois does not follow the Model Rules, this divergence is highlighted.

I. Multiple Representation Issues: Who is the Client?

- A. Under the Model Rules of Professional Conduct, Rule 1.13(a) states the basic rule that identifies the client, when a lawyer works for an organization (“EO”). “A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.”

Sugar Felsenthal Grais & Hammer LLP

1. The comments note that an organization cannot act or operate except through its officers, directors, employees, and shareholders. Comment 1. In the case of an exempt organization (“EO”), this could include the members of a nonprofit corporation and the members of any committee.
 2. The comments also point out that this rule applies to organizational clients that are not organized as corporations. In the charitable setting, this could include a partnership or limited liability owned by a charity. The client is the “entity,” however organized.
- B. The lawyer must explain the identity of the client when the lawyer knows or reasonably should know that the organizations’ interests are adverse to those of the constituents with whom the lawyer is dealing. Model Rule 1.13(f).
1. Comment 10 to Rule 1.13 adds that this communication may include advice to the constituent who stands in conflict that the constituent may wish to seek independent representation.
 2. Also, the constituent should be advised that because the organization’s lawyer does not represent the constituent, their conversations may not be privileged. Rule 1.13, Comment 10.
- C. Note that representation of both the organization and a constituent can be done if it complies with the requirements of Rule 1.7. Model Rule 1.13(g) and Comment 12. If the organization’s consent is required, it must be provided by an authorized official other than the individual who will be represented. *Id.*
- D. Example: *Prentis Family Foundation, Inc. v. Barbara Ann Karmanos Cancer Inst. et al.*, 698 N.W.2d 900 (Mich. App. 2005), *app. denied*, 703 N.W.2d 816 (Mich. 2005).
1. In this case, the law firm of Honigman, Miller, Schwartz and Cohn (HMSC) represented the Barbara Ann Karmanos Cancer Institute (“Karmanos”) in connection with an endowment gift made to it by the Prentis Family Foundation (“Prentis”). Karmanos entered into a gift agreement with Prentis. Among other promises, Karmanos agreed to change its name to the “Meyer L. Prentis Comprehensive Cancer Center of Metropolitan Detroit.” The renaming did not occur.

Sugar Felsenthal Grais & Hammer LLP

2. Prentis sued HMSC for breach of fiduciary duty and because HMSC “engaged in a conflict of interest by representing multiple parties” regarding the endowment agreement.
3. The court found that HMSC had not represented Prentis together with Karmanos and dismissed HMSC from the suit.
 - (a) To find a fiduciary relationship, there must be a reasonable placement of trust, confidence and reliance in the would-be fiduciary.
 - (b) The court pointed out that when an attorney is hired to represent a corporation, the client is the corporation rather than the shareholders. The purpose of any communication with the corporation’s human agents is to represent the corporation, not the agents. 698 N.W.2d at 907.
 - (c) Prentis “failed to point to an action on HMSC’s part that might signify HMSC was representing plaintiff rather than the center.” *Id.* HMSC was the agent of Karmanos, and agency agreements do not create rights in third parties.
 - (d) In another transaction, HMSC advised the parties in writing of the identity of its client (an organization that became Karmanos) and that the other party should consider separate, independent representation. However, it apparently did not do so in this case.
4. Note the confused relations among the parties. Here, the only ground for Prentis’s charge that it was reasonable in relying on Karmanos’s law firm, was the fact that one of Prentis’s “representatives” was also a board member of Karmanos.
5. In addition, HMSC had as a prior client the individual donor who later gave his name to Karmanos. In that case, HMSC got a conflict waiver from the individual and the organization that became Karmanos.
6. In sum, over time HMSC represented a donor to Karmanos, the organization itself, and was charged with breaching its would-be representation of Prentis regarding another gift to Karmanos.

Sugar Felsenthal Grais & Hammer LLP

- E. Confusion about who is the client arises sometimes in the context of power struggles on a non-profit board. The case of *New Destiny Treatment Center, Inc.* illustrates this. An attorney and her firm, Roderick Linton L.L.P., were sued for malpractice by the New Destiny Treatment Center, a rehabilitation center for people struggling with substance abuse. The Supreme Court of Ohio overturned the judgment against the lawyer and law firm, holding that no attorney-client relationship existed between them. 950 N.E.2d 157 (Ohio 2011).
1. New Destiny's founder, Reverend Bruce Hawthorn, was under federal and state investigation for diverting the center's funds for his personal use and that of his friends and relatives.
 2. In the course of the investigation, Hawthorn invited two other ministers to join the center's board of trustees, to increase the number of independent trustees rather than family trustees.
 3. The board retained a different law firm to represent the organization in connection with the investigations.
 4. The board put Hawthorn on a leave of absence, then later removed him as President of New Destiny and extended his leave of absence.
 5. Hawthorn then retained Roderick Linton to regain or retain control of the board. A board meeting was scheduled at which neither faction could assemble a quorum. As a result no one could remove anyone else from the board. Hawthorn nonetheless changed the locks to the building and fired the board-appointed management team.
 6. Another board meeting was called at which the independent members weren't permitted to participate and were removed.
 7. As part of an action by the Attorney General, the independent directors acknowledged that Roderick Linton represented Hawthorn in his restoration, not New Destiny. On the other hand, a court-appointed receiver later formally terminated the Roderick Linton lawyer as New Destiny's counsel.
 8. New Destiny sued Roderick Linton for breaching their obligations as attorneys and negligently representing that a quorum was present at the board meeting at which the independent members had been removed.

Sugar Felsenthal Grais & Hammer LLP

9. The Supreme Court of Ohio upheld the finding that there was no attorney-client relationship between Roderick Linton and New Destiny and that New Destiny had an adversarial relationship with Roderick Linton. “The factions had separate interests, separate Boards, and separate attorneys,” the trial court had noted.
 10. The Court seemingly ignored the fact that Roderick Linton held itself out as the New Destiny counsel, which had swayed the intermediate court. The Court emphasized that Rule 1.13 requires the party hiring counsel on behalf of the corporation to have authority to do so. Hawthorn did not.
- F. A similar power struggle was reported at Feed the Children, an important antipoverty charity.
1. A lawsuit filed in 2009 showed that a “tug of war” was waged between the charity’s founder, Larry Jones, and other staff, directors and family members.
 2. To curtail the overwhelming dominance of Mr. Jones over the operation of the charity, the board had enacted rules that would have stopped anyone from taking unilateral action on the charity’s behalf.
 3. Board members planned to discuss putting Mr. Jones on sabbatical at a December, 2008 board meeting. Five such board members alleged they were removed and replaced right before the meeting.
 4. The reconstituted board fired four key staffers, including Mr. Jones’s daughter, the CFO, the COO and the internal auditor.¹
 5. This conflict got progressively uglier and more sordid, with numerous charges and counter-charges exchanged in court and in public. Mr. Jones was fired in December, 2009 upon the board’s learning that he had placed recording devices in the offices of the fired staff members after they were reinstated.
- G. Like the *Prentis*, *New Destiny* cases suggest, the inquiry “who is the client?” normally comes up because there are grounds for confusion and possible or actual conflicts of interest.

¹ *Leadership Struggle Under Way at Big National Charity, Court Battle Shows*, Grant Williams, Chronicle of Philanthropy, March 4, 2009.

Sugar Felsenthal Grais & Hammer LLP

1. Does the client relationship tempt the lawyer to act in the best interests of the non-profit's officers or board, rather than the organization itself? If the lawyer is under that sort of pressure there is often a self-dealing problem involved.
 2. The bitterness of these fights is remarkable. If the lawyer becomes involved in a political struggle, he or she should work methodically to ensure that the legal advice provided to the board is reasonable and prudent. This runs the risk of being ignored in emotional, divisive situations but lessens the risk of becoming directly involved in wrongful board action.
 3. If there is confusion about the lawyer's role, the lawyer is required to communicate the identity of the client to the parties.
- H. The question of "who is the lawyer?" can also arise if the lawyer is invited to serve on the board. Such a lawyer must determine whether the responsibilities may conflict. Rule 1.7, Comment 35. If a lawyer had been on the Feed the Children board or the New Destiny board, he might have been asked to opine on whether the removal of directors adverse to the organization's founder was proper. "If there is a material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise." *Id.*

II. Attorney-Client Confidentiality Within the Different Levels of an Organization

A. Basic Rule:

1. The rule requiring confidentiality is fairly uniform, but the exceptions from the rule vary from state to state. Model Rule 1.6(a) provides that a lawyer must keep confidential any information regarding the representation of a client unless:
 - (a) The client gives informed consent;
 - (b) Disclosure is impliedly sanctioned by the terms of the representation; or
 - (c) As permitted by an exception to the rule.

Sugar Felsenthal Grais & Hammer LLP

2. Under the Model Rule 1.6(b), a lawyer may but is not required to reveal confidential information in a few circumstances. Along with uncontroversial reasons, like the need to establish or refute a claim in a controversy with the client, there are three more controversial grounds for revealing client information:
 - (a) To prevent reasonably certain death or substantial bodily harm. In Illinois, this information must be revealed; communicating it is not optional. Illinois Rule 1.6(b). The Illinois comments give the example of a lawyer who becomes aware that his client intends to dump toxins that will result in imminent harm to local residents.
 - (b) To prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.
 - (c) To prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.
3. Comment 7 to Model Rule 1.6 points out that a client can prevent a disclosure by refraining from the wrongful conduct. If the fraud or crime has already occurred, Model Rule 1.6(b)(3) authorizes disclosure where harm to the victim can be moderated.

B. Additional Confidentiality Considerations for EO Counsel:

1. The attorney who learns of wrongdoing on the part of an officer or employee of the organization must "proceed as is reasonably necessary in the best interests of the organization." Model Rule 1.13(b).
2. What wrongdoing qualifies? Model Rule 1.13(b) is triggered if an officer, employee or other associate an EO is acting, or intends to act, or refuses to act:
 - (a) In a matter related to the representation

Sugar Felsenthal Grais & Hammer LLP

- (b) That is a violation of a legal obligation to the organization OR is a crime, fraud or other violation of law that might be imputed to the organization, and
 - (c) That is likely to result in substantial injury to the organization.
- 3. How should the lawyer “proceed” in such a situation? Unless the lawyer believes it is not in the organization’s best interests, the lawyer should refer the situation to higher authorities in the organization, including the highest authority if warranted.
- 4. What may the lawyer reveal?
 - (a) The lawyer may reveal client confidences as permitted under Model Rule 1.6.
 - (b) The lawyer representing an organization may also reveal additional information under Model Rule 1.13(c). The lawyer may disclose information relating to the representation if:
 - (i) The lawyer took action as required by Model Rule 1.13,
 - (ii) The highest authority in the organization that can act on the matter refuses to cure it,
 - (iii) The act is “clearly a crime or fraud,” and
 - (iv) the lawyer reasonably believes that the crime or fraud is reasonably certain to result in substantial injury to the organization.
 - (c) The lawyer’s disclosures must be limited to those the lawyer believes reasonably necessary to avoid substantial injury to the organization.

C. Internal Investigations:

- 1. Model Rule 1.13(c) does not apply if the lawyer is retained by the organization to investigate an alleged crime, fraud or other legal violation, or to defend the organization or one of its officers, employees, or other constituents against a claim arising out of an alleged crime, fraud or other violation of law. Model Rule 1.13(d).

Sugar Felsenthal Grais & Hammer LLP

- (a) In other words, did the organization hire the lawyer to investigate a crime, fraud, or violation or defend an employee against such charges? If so, the lawyer does not have the right to disclose anything beyond what is authorized by Model Rule 1.6, or required by Illinois Rule 1.6.
 - (b) The purpose here is to provide organizations with the ability to conduct a vigorous internal investigation without fears of a breach of confidentiality.
2. In carrying out an internal investigation, the lawyer should follow Model Rule 1.13's stricture to identify the client. When interviewing EO employees, the lawyer should tell the employee that the organization is the client, not the employee. Information and statements provided by the employee are not privileged as between the attorney and the employee. Neither the lawyer nor the employee can prevent the transmission of that information to management. See Comment 10.

III. Confidentiality vs. Disclosure to the IRS

- A. Rule 4.1(a) states that in the course of representing a client, a lawyer shall not knowingly make a false statement of material fact or law to a third person.
- B. Rule 4.1(b) reiterates that a lawyer must not fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client, unless disclosure is prohibited by Rule 1.6.
- C. A practitioner's ethical obligations in dealing with the IRS are also governed by Circular 230, which appears in the Code of Federal Regulations. It sets out practitioners' duties and restrictions when practicing before the IRS.
- D. Circular 230 first requires practitioners to respond to information requests. 31 C.F.R. § 10.20(a)(1). A practitioner must supply records, information in response to a proper and lawful request by an authorized officer or employee of the IRS.
 - 1. If, however, the practitioner believes "in good faith and on reasonable grounds that the records or information are privileged," the practitioner need not supply them.

Sugar Felsenthal Graiss & Hammer LLP

2. This exception for privilege coordinates with Model Rule 1.6, which generally prohibits disclosure of client information. Comment 13, which addresses a governmental entity's order that a lawyer supply client information, states: "Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law."
- E. If the lawyer does not have or control the records or information requested, the lawyer must tell the IRS officer or employee any information the lawyer has about who has custody of the records. The lawyer must make reasonable inquiry of the client about who has the records. The lawyer is not required to verify any such information supplied by the client. 31 C.F.R § 10.20(a)(2).
 - F. A lawyer also may not interfere with any proper effort by the IRS to obtain records or information, again unless the practitioner believes reasonably and in good faith that the information is privileged. *Id.* at § 10.20(c).
 - G. A lawyer who learns that his or her client has made an error or omission on a return or other document filed, or that the client has not complied with the tax code, must advise the client of the error, omission or noncompliance. The practitioner must also give the client advice about the consequences of the mistake or noncompliance. *Id.* at § 10.21.
 - H. The lawyer must exercise diligence in preparing or assisting with the preparation of returns or other documents relating to tax matters. This means that the lawyer must verify the correctness of these filings.
 1. The lawyer must also verify the correctness of his or her statements to (i) the IRS or Treasury Department representatives, and (ii) the client regarding any tax matter. *Id.* at § 10.22(a).
 2. In performing due diligence, the lawyer is entitled to rely on the workproduct of another person whom the lawyer engaged, supervised, trained, and evaluated with reasonable care. *Id.* at § 10.22(b).
 - I. Though not strictly related to confidentiality, bear in mind the standards for taking positions before the IRS. As of August 2, 2011, a lawyer must not willfully, recklessly, or through gross incompetence sign a return or a claim for refund that

Sugar Felsenthal Graiss & Hammer LLP

the practitioner knows or reasonably should know contains a position that (i) lacks a reasonable basis; (ii) is an unreasonable position as described in section 6694(a)(2) of the Internal Revenue code (Code); or (iii) is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code. *Id.* at § 10.34(a).

1. An unreasonable position is one that is not (i) a position supported by substantial authority, or (ii) a disclosed position that is supported by a reasonable basis, or (iii) a tax shelter or a reportable transaction that it is reasonable to believe would more likely than not succeed on the merits. IRC §6694(a)(2).
- J. The lawyer also must not advise the client to take such a position or prepare a portion of a tax return that includes such a position. *Id.* at § 10.34(a).
- K. As to a document other than a return, a practitioner may not advise a client to take a position on unless the position is not frivolous. 31 C.F.R. § 10.34(b)(1).
- L. Representations made to the IRS naturally arise in the context of preparing or reviewing its annual Form 990. They may also arise if the IRS investigates the organization, either in a single-issue examination or a broader examination of the organization's exempt status.
- M. Representations to the IRS may also arise in the context of fundraising, though this is less likely for EO counsel. A 2008 survey by the Giving Institute and released at the annual meeting of the Association of Fundraising Professionals concluded that 50% of EO leaders had witnessed ethical breaches in fundraising practices. Among the lapses reported was backdating donations, so that a donor could take a deduction in the prior tax year.

IV. Self-Dealing Situations

- A. Advising the board or officers about whether a transaction raises self-dealing concerns is a common task for an EO lawyer. Self-dealing by an officer, board member or other party can raise problems under state law and under federal tax law. Two major Code sections impose excise taxes intended to prevent or ensure the fairness of a self-dealing act.

Sugar Felsenthal Grais & Hammer LLP

- B. Definition of Self-Dealing. Conflicts of interests can easily arise between the organization and its officers, directors, employees, and donors who may directly or indirectly enter into business or financial transactions with the EO.
1. The conflict of interest is material if a director, officer, or employee holds a director or indirect interest that might affect or might reasonably be seen to affect the director's officer's or employee's judgment or conduct.
 2. Self-dealing does not always arise from self-interest. Sometimes a board member or officer who truly intends to help the organization wishes to do so by offering a certain deal. Common examples are:
 - (a) A related party who offers space to the organization at a fair market or reduced rent.
 - (b) A board member who provides his or her professional expertise – investment or legal advice, for example – to the organization.
 - (c) These examples are not necessarily forbidden; however, in the context of private foundations, almost all transactions between insiders and the private foundation are prohibited under tax law. This means that the foundation often cannot enter into transactions with people most likely to help it, unless the transaction is free to the foundation. For example, a private foundation may receive an interest-free loan from an insider.
- C. Other Examples:
1. A member of the EO's board is employed by, participates in the management of, serves on the board of, or owns an interest in a company that does business with the EO.
 - (a) Rothko Case. The litigation in the estate of Mark Rothko revealed one of the most notorious self-dealing cases in legal history. *In re Rothko*, 372 N.E.2d 291 (N.Y. 1977).
 - (i) Mark Rothko named Bernard J. Reis (an unlicensed lawyer who drafted the Will), Theodoros Stamos (another artist) and Morton Levine as the executors of his estate.
 - (ii) Rothko left his estate was left to the Rothko Foundation, of which Reis, Stamos and Levine were directors.

Sugar Felsenthal Grais & Hammer LLP

- (iii) Reis was a director, secretary and treasurer of Marlborough Gallery NY, which took on representation of Stamos after Rothko's death. Both Reis and Stamos were paid as employees of Marlborough.
 - (iv) Immediately following Rothko's death, the co-executors disposed of all his works in two highly preferential contracts with Marlborough.
 - (v) The court unwound the contracts. In addition to recovering hundreds of paintings, the court found Reis and Stamos jointly and severally liable for more than \$9.25 million. Levine was liable for almost \$6.5 million. Marlborough was also fined \$3 million for selling paintings in violation of an injunction.
 - (vi) Within a few years after the central litigation ended, a single Rothko sold at auction for \$1.8 million. This was the total price for which the co-executors sold 100 paintings to Marlborough.
- 2. An EO board member, officer or agent receives a commission or compensation for a transaction that the EO enters into.
 - 3. Excessive compensation, discussed below, paid to an EO representative.
 - 4. A transactional opportunity: obtaining an interest in property that the EO may purchase.
 - 5. A loan between an EO and a board member, officer, employee or donor. Recent IRS studies have suggested that this is a common practice. As a result, it is the subject of further IRS scrutiny.
 - 6. Using the EO's property or assets for noncharitable purposes.
 - 7. An insider's receiving a gift from the a company doing business with the EO.
- D. *William Robertson, et al. v. Trustees of Princeton University, et al.*
- 1. This case was a multi-year litigation regarding enforcement of donor intent over a charitable gift fund. Settlement occurred in 2008.

Sugar Felsenthal Grais & Hammer LLP

2. The gift fund was the Robertson Foundation, a “Type I” supporting organization under the Internal Revenue Code. This means that the Robertson Foundation was under the direct control of Princeton University.
3. The Robertson Foundation was funded in 1961 to improve the graduate programs of the Woodrow Wilson School of Public and International Affairs and aid students in forging careers in public service.
4. Members of the Robertson family, the heirs to the A&P grocery store fortune, objected to the operation of the Robertson Foundation. They interpreted its relevant governing documents to require distributions to support careers in public service only. They objected that the Foundation was supporting graduate programs for individuals who would succeed to careers in investment banking and other for-profit businesses.
5. The Robertson family used the assets of the Banbury Fund, another charity founded by their parents, to pay the legal fees.
 - (a) According to an expert witness for the Robertsons, the law firm of Milbank Tweed had provided a legal opinion stating that payment of the fees was a legitimate charitable purpose of the Banbury Fund.
 - (b) This expert said that the Milbank Tweed lawyers relied on two IRS rulings stating that payment of board members’ legal fees by a charity is appropriate, if the board members have successfully sued to ensure that the organizations were carrying out their charitable missions. Viewed in this light, the Robertsons were essentially carrying on a shareholder derivative suit.
 - (c) A letter from one of the founders of the Banbury Fund to its board stated that the “Banbury Fund is specifically dedicated to support the purpose of the Robertson Foundation.”
6. Critical commentators responded that using foundation assets to satisfy the personal obligations of an insider is self-dealing, under state law and federal tax law, discussed below. The Director of the National Committee for Responsive Philanthropy called the payments by the Banbury Fund “yet another egregious example of people abusing philanthropy for personal gain.”

Sugar Felsenthal Grais & Hammer LLP

7. Moreover, the payments were not reimbursements as in the IRS rulings. The lawsuit by the Robertsons was fairly unsuccessful, if at all.
 - (a) The parties were in court for more than six years.
 - (b) Each side spent more than \$40 million in attorneys' fees. Critics (and Princeton) charged that the availability of the Banbury Fund to pay attorneys' fees enabled the Robertsons to follow a scorched-earth litigation policy.
 - (c) At the commencement of the litigation, the Robertson Foundation was worth just less than \$900 million. At the end, in the midst of the 2008 financial crisis, its assets had fallen to \$700 million.
 - (d) The Banbury Fund was nearly wiped out by the attorneys' fees.
 - (e) The Robertson Family settled for about \$100 million. Of this, \$40 million went to the Banbury Fund. Fifty million was used to establish a new private foundation for the family to control. The Robertson Foundation was dissolved and the family gave up influence over the remaining funds at Princeton. The remaining amount paid by Princeton appeared to be interest on periodic payments. Effectively, the Robertsons received 10 percent, which was an early settlement offer by Princeton.
- E. The non-profit media frequently reports on investigations of self-dealing. Among other recent stories:
 1. The Fiesta Bowl CEO was recently fired after an internal investigation alleged use of Fiesta Bowl funds for trips for Arizona politicians, a lavish birthday party for the CEO, and a visit to a Phoenix strip club.
 - (a) According to the internal investigation, the charity's leaders also urged employees to make political contributions. The employees were then reimbursed with fake bonuses.
 2. Three whistleblowers at Western University of Health Sciences were fired in the early 2000s. Among other issues, they raised the following complaints:

Sugar Felsenthal Graiss & Hammer LLP

- (a) The University had a practice, which they ultimately terminated, of extending loans to executives against unused vacation time. These “salary advances” totaled hundreds of thousands of dollars over an eleven-year period.
 - (b) The loans to the president and founder totaled just less than \$110,000 in 12 loans over 11 years.
 - (c) The president and other senior executives were accused of using university money and staff to provide domestic help, perform maintenance, and run personal errands.
 - (d) Family members of the founder were allegedly hired at higher-than-market salaries.
3. The Hershey School and School Trust have recently attracted attention last year and then again in June. Recent acquisitions include a golf course and “Pumpkin World,” which seems to be a roadside nursery and farmstand. Most recently, the Hershey School proposed to purchase the world’s largest chocolate factory for redevelopment into condos, retail stores, a hotel and a retirement community.
- (a) The factory is a Hershey factory that is being shut down as production shifts to newer facilities.
 - (b) According to a Philadelphia Inquirer article, the project would cost the charity tens of millions of dollars, possibly \$100 million.²
 - (c) The purpose is the beautification and redevelopment of Hershey, Pennsylvania, but the charity’s core purpose is the education of poor children throughout the United States.
 - (d) One of the firms retained to develop a revitalization plan for Hershey in recent years was a group partially owned by the son-in-law of the chairman of the Hershey School. Fees to that group totaled \$290,000 in 2010.

² *Hershey School Seeks to Develop Chocolate Factory*, by Bob Fernandez, Philadelphia Inquirer Staff Writer. June 19, 2011, Philly.com.

Sugar Felsenthal Grais & Hammer LLP

- (e) The chairman, LeRoy Zimmerman, has also been under scrutiny as his compensation for serving as chair of the Hershey School was reportedly \$500,000. A company spokesman later stated that this fee is a total for service on several Hershey boards, including chairing Hershey Entertainment.³
- (f) LeRoy Zimmerman is a former attorney general of Pennsylvania. His successor lifted rules that would have limited Mr. Zimmerman to serving on a single Hershey Board.⁴
- (g) These conflicts of interest could ultimately be determined harmless. Nonetheless the story emphasizes the dangers of serving too many masters.

F. State Law

1. State law regularly permits self-dealing transactions if there is a showing of fairness.
2. Under Illinois law, a transaction that is fair will not be invalidated simply because a director is directly or indirectly a party.
 - (a) In a contest, the party asserting the validity of the transaction will have the burden of showing fairness.
 - (b) The burden switches, however, if there was disclosure of the material facts of the transaction and the director's interest in it. If the transaction was authorized or approved by the affirmative votes of a majority of all disinterested directors, then the party challenging the transaction will have the burden of proving unfairness.
 - (c) This is also true if there was full disclosure and the vote of board authorized the transaction without counting the vote of any interested director. 805 ILCS 105/108.60.

³ *Prominent Hershey Trustee Paid \$500,000 a Year for Board Service*, Chronicle of Philanthropy. July 20, 2011.

⁴ *Id.*

Sugar Felsenthal Grais & Hammer LLP

G. Federal Tax Law

1. For private foundations, self-dealing acts are subject to an excise tax meant to prohibit self-dealing activities rather than raise revenue.
 - (a) A 10% tax is imposed on the self-dealer, and this is increased to 200% of the amount involved if the act of self-dealing is not corrected within the “taxable period.” That is generally the date on which the first-tier tax is imposed or a notice of deficiency is imposed on the first-tier tax.
 - (b) A 5% tax is imposed on any foundation manager who knowingly involves himself or herself in an act of self-dealing. This increases to 50% if not corrected. There is, however, an overall limit of \$20,000 on each of the 5% first-tier tax and the 50% second-tier tax.
 - (c) Self-dealing acts include a sale, exchange or lease between a private foundation and an insider, or “disqualified person;” payment of compensation to an insider other than for personal services, a private foundation’s lending money to an insider, an insider’s lending money to a private foundation other than interest-free, and most provisions of goods and services between insiders and the private foundation.
 - (d) Note that in the Rothko case, the state-law damages for breach of fiduciary duty were not the worst judgments against those co-executors and directors. The IRS levied self-dealing excise taxes against Reis for more than \$18 million and Stamos for more than \$19 million. *See, e.g., Estate of Reis v. Comm’r*, 87 T.C. 1016 (1986); *Stamos v. Comm’r*, 87 T.C. 1451 (1986).
2. For public charities, there is no absolute prohibition against transactions between insiders and the public charity. However, section 4958 of the Code taxes “excess benefit transactions.” In other words, transactions must be for fair market value.
 - (a) This Code provision imposes a 25% tax on the disqualified person and a 10% on knowing participation by management. The tax on the disqualified person increases to 200% if correction is not made.

Sugar Felsenthal Grais & Hammer LLP

- (b) Treasury Regulations provide a safe harbor that the board of directors may use to avoid a determination that a proposed transaction constitutes an excess benefit.

V. Excessive Compensation

- A. The problem of charities paying excessive compensation to officers, directors, trustees and key employees was highlighted in the 1990s by various scandals. The IRS took a special interest.
- B. In 1996, Congress enacted section 4958, described above. Excessive compensation paid to insiders is a an excess benefit transaction, and the self-dealer and any other EO manager who knowingly cooperates in paying the excessive compensation will be exposed to the excise taxes detailed above.
- C. A board seeking to establish fairness may meet a three-prong safe harbor established under the Treasury Regulations.⁵ If the board meets the following requirements, then the board has established a rebuttable presumption that the compensation paid is not excessive. An IRS Exempt Organization Executive Compensation Compliance Project commenced in 2004 found that of the organizations studied, 51% of them tried to comply with all three prongs in order to claim the protection of the rebuttable presumption.
 - 1. The compensation is reviewed and approved by an independent governing body. The 2004 Compliance Project found that in that study, 95% of disqualified persons recused themselves from discussion and approval of their own compensation.
 - 2. The board commissions comparability studies and relies on that data in determining compensation. The 2004 Compliance Project found that 54% of the EOs studied commissioned these studies in determining compensation. Of the EOs that did so, 97% gathered information about EOs of similar type and size. Also, 97% of those organizations set the compensation at hand within the range of the commissioned data.
 - 3. The board adequately documents its decisionmaking process.

⁵ Treas. Reg. § 53.4958-6.

Sugar Felsenthal Grais & Hammer LLP

- D. As discussed earlier, Form 990 was redesigned to emphasize and investigate governance issues. Compensation of various persons must be reported, including that of officers, directors, trustees, employees, and highly-compensated employees and independent contractors. The form also asks whether the board obtained compensation studies in setting compensation.
- E. Despite the enactment of section 4958 and the transparency that the revised Form 990 serves, the IRS and state attorneys general are staying busy policing compensation.
1. Payments to the most highly compensation nonprofit leaders and other executives continue to attract controversy. Compensation listed in the Chronicle of Philanthropy's 2008 survey led to a Forbes article criticizing "Nonprofit Millionaires" and "saintly salaries."⁶ The most highly paid EO employee is a Columbia University professor of dermatology, who was paid more than \$5 million in 2009 – which is more than 5 times what is paid to the university president.⁷ Critics respond that looking at executive compensation alone is not an adequate way to judge a nonprofit.
 2. In one recent example, the New Jersey attorney general sued the Stevens Institute of Technology of excessive spending on the personal needs of executives (among other problems, including financial mismanagement and breach of fiduciary duty).
 - (a) One committee of the board allegedly buried a compensation analysis by an independent consultant, which had concluded that the president's compensation was excessive.
 - (b) Again, low-interest loans were used as a compensation tool.
 - (c) The school's auditors allegedly quit due to the high risk posed to the auditing firm by the school's practices. According to the attorney general, another board committee buried letters from the auditors warning the school of this.
 - (d) The suit forced the president's resignation, and the board agreed to new, sweeping changes to the governance structure.⁸

⁶ *Nonprofit Millionaires*, by Amy Bell, Forbes.com, December 17, 2009.

⁷ Chronicle of Philanthropy, Executive Compensation Data, www.philanthropy.com.

⁸ *A Cautionary Tale for Nonprofit Boards*, by Kevin B. Scott, The Chronicle of Philanthropy, November 28, 2010.

Sugar Felsenthal Grais & Hammer LLP

- F. In the private foundation setting, a recent analysis by the Chronicle of Philanthropy found that 38 of the 50 wealthiest foundations pay their directors. The aggregate figure for these 38 foundations exceeds \$11 million.
1. According to this analysis, very few charities pay their boards.⁹
 2. The practice of paying foundation directors raises questions because of the fundraising struggles that so many charities are suffering through since 2008.
 3. Critics charge that demographically, individuals serving on such boards have no need for compensation. They say that there is no proven link between board payments and quality of service. Foundations who pay their boards respond that the payments are necessary to compensate board members for their time and attract capable individuals to manage large endowments.
- G. When advising charities and other EOs about executive compensation, lawyers should focus on the board's obtaining useful salary data. Compensation studies are available, but the board should scrutinize how the study is done.
1. The board itself can investigate appropriate performance goals for executives and practices at similarly-situated organizations.
 2. The board can also review whether the executives' compensation is reasonable in light of what is paid to other employees and more junior executives.
 3. The board – not the officers – should hire any compensation specialists.
 4. The board should make sure that section 4958 requirements are met by documenting its decision.
 5. When discussing these matters, the board members should feel free to be thorough. The tendency of board meetings to be tightly scripted should not be followed in this area.

⁹ *Most of America's 50 Richest Funds Pay Their Board Members*, The Chronicle of Philanthropy, July 24, 2011.

Sugar Felsenthal Grais & Hammer LLP

VI. When Must the Lawyer Withdraw?

- A. Model Rule 1.16 provides rules that mandate a lawyer's withdrawal and that permit withdrawal.
- B. Withdrawal is required, among other reasons, if "the representation will result in violation of the rules of professional conduct or other law." Rule 1.16(a)(1).
 - 1. Based upon the single example of mandatory withdrawal provided in the Comment to Rule 1.16, this rule refers to the lawyer's committing a violation of the RPC or committing a legal violation.
 - 2. According to the Comment, a "lawyer ordinarily must decline or withdraw from representation if the client demands that the lawyer engage in conduct that is illegal or violates the Rules of Professional Conduct or other law. The lawyer is not obliged to decline or withdraw simply because the client suggests such a course of conduct; a client may make such a suggestion in the hope that a lawyer will not be constrained by a professional obligation." Comment 2, Rule 1.16.
 - 3. The lawyer must also withdraw if fired or if the lawyer's mental or physical condition impairs his or her ability to represent the client. Rule 1.16(a)(2) and (a)(3).
- C. Withdrawal is permitted if any of the following occur:
 - 1. Withdrawal can be accomplished without material adverse effect on the interests of the client.
 - 2. The client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent. The Comment notes that it is not necessary in this case that the lawyer's services further the conduct. The lawyer is not required to be associated with such a client. Comment 7, Rule 1.16.
 - 3. The client has used the lawyer's services to perpetrate a crime or fraud. The Comment states that if the lawyer's services were misused in the past, the lawyer may withdraw even at the client's detriment. *Id.*

Sugar Felsenthal Graiss & Hammer LLP

4. The client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement.
 5. The client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled.
 6. The representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client.
 7. Other good cause for withdrawal exists. Model Rule 1.16(b).
- D. Comment 29 to Model Rule 1.7 advises that there are times when common representation fails. The conflicts in the representation may grow too difficult to resolve. This may require the lawyer to withdraw from representing one or more – even all – of the parties. “The result can be additional cost, embarrassment and recrimination.”
- E. In the case of either mandatory or permissive withdrawal, the lawyer must follow any applicable law regarding notice to court. If the court directs the lawyer not to withdraw, the lawyer must continue the representation despite having reason for quitting. Model Rule 1.16(c).
- F. The case of *In the Matter of Greene* provides one dramatic nonprofit example. 638 S.E.2d 677 (S.C. 2006).
1. Rev. Johnny Cabe was convicted of 26 counts of wire fraud and money laundering, in connection with running a Ponzi scheme disguised as an evangelical ministry known as “HIM.”
 2. Rev. Cabe involved David B. Greene, a lawyer whose father was also an evangelical minister. Mr. Greene became a “steward” for HIM, finding other individuals to contribute to HIM. Mr. Greene was also a donor, giving \$50,000 to a related organization, HISway.
 3. In 1998, the Secret Service was investigating HIM and the organization's bank accounts were frozen.
 4. At a meeting in which Mr. Greene was asked and agreed to serve as criminal attorney for both Cabe and HIM, Mr. Greene was also asked by

Sugar Felsenthal Grais & Hammer LLP

Cabe and other HIM representatives to “act as escrow agent” for HIM by using his client funds account.

5. According to others at the meeting, they asked Mr. Greene to use his client funds account because it was an account that could not be frozen by the government. The stated purpose was to pay out individuals who were owed “re-gifts” and to admit others who “wanted to get in on” HIM’s purported investments.
6. Mr. Greene deposited more than \$450,000 into his client funds account, including another \$50,000 payment from himself. At least three victims testified that they believed or were told that their money would be safe because it was being deposited into a lawyer’s account.
7. Mr. Greene did not withdraw until seven months later, when he realized that Rev. Cabe was not going to cooperate with the federal investigation. At that point, most of the money in the client account had been paid out to various individuals at the direction of Cabe and other HIM representatives.
8. A full disciplinary panel found Mr. Greene guilty of numerous ethics violations, including S.C. Rule of Professional Conduct 1.16(b), which is identical to the Model Rule. The Supreme Court of South Carolina imposed the recommended sanctions against Mr. Greene, but did not find he violated Rule 1.16(b).
 - (a) How can a rule permitting withdrawal be violated? Was the panel suggesting Mr. Greene didn’t have reasonable grounds for withdrawal?
 - (b) Didn’t Mr. Greene violate Rule 1.16(a) by accepting the representation and furthering a fraud by his own acts? At the time he provided the use of his account, he knew about the federal investigation and the frozen HIM accounts. There was testimony at the disciplinary hearing that Mr. Greene tended toward particular gullibility.



Sugar Felsenthal Graiss & Hammer LLP

The information described herein is of a general nature, based on information currently available, and should not be relied upon to make planning, purchase, sale, or exchange decisions without seeking personal professional advice.

CIRCULAR 230 DISCLOSURE: Pursuant to the regulations governing practice before the Internal Revenue Service, any tax advice contained in this communication is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Further, any tax advice contained in this communication is not intended or written to support the promotion or marketing of the matter or transaction addressed by such tax advice.