

**Auxiliary Organizations Association**  
The California State University

**THE ROLE AND RESPONSIBILITIES OF  
AUXILIARY GOVERNING BOARDS**

By

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Auxiliary Organizations Association  
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# THE ROLE AND RESPONSIBILITIES OF AUXILIARY GOVERNING BOARDS

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## I. Purpose and Background

For three decades the *Auxiliary Organizations Association (AOA)*<sup>1</sup> has commissioned and published professional papers for its members on timely governance, compliance and management subjects.

AOA continues the series with further revisions to the 2002, 2007 and 2009 editions of this monograph, together with expansion into wider governance issues.<sup>2</sup> Its primary purpose is to compliment the *AOA baseline* Governance Training Program, and to alert and help orient new governing board members. The scope and detail of the paper should also provide a practical reference for more experienced board members, managers and staff, as well as university administrators charged with auxiliary organization oversight. This paper is not an in-depth treatise. Rather, it is a wide survey of the major, interwoven topics felt important to auxiliary organization governance.

The sections that follow address contemporary nonprofit governance concepts, legal and policy standards and requirements, and compliance approaches, coupled with valuable references and examples pertinent to auxiliary organizations operating within the California State University (CSU). Although board effectiveness and performance are important issues, they are beyond the scope of this monograph.

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<sup>1</sup> The AOA, a California public benefit nonprofit corporation, is organized to develop and foster sound relationships between members and with their customers and clients; and to provide governance and management development programs, services and publications. AOA members are auxiliary organizations serving campuses within the California State University. The AOA is *not* an auxiliary organization.

<sup>2</sup> The 2007 revision included changes in the law, regulations and system-wide policy, the addition of sections on fundraising, accountability, investing and debt instruments, and an expansion of information on meeting requirements. The 2009 revision adds summary information on trust funds, custodianship of student organization funds, the *Uniform Prudent Management of Institutional Funds Act*, as well as other minor changes to laws and regulations affecting auxiliary organizations. The 2011 revision added expanded treatment on the oversight role of the Attorney General, recent changes in the Nonprofit Public Benefit Corporation Law, and additional information on fundraising and records and reporting rules, all as an aid to compliance efforts. The 2012 revision treats records access under the *McKee Transparency Act of 2011*.

This paper does not constitute legal, accounting or other compliance advice. Auxiliary organization governance issues follow patterns, but most are quite fact and circumstance sensitive, and should, therefore, be addressed and resolved in consultation with appropriate advisors. AOA will endeavor to keep this monograph up-to-date. The analysis, conclusions and approaches in this monograph are those of the author, not the AOA or its member organizations.

## II. The Governing Body and the Organization It Serves

There are well over one-half million charitable/educational nonprofit organizations across the United States.<sup>3</sup> These entities include colleges and universities, religious groups, private foundations, symphonies, museums and other cultural organizations, hospitals, trade associations, consumer “watch-dog” and advocacy groups, social service agencies, sports leagues, and, of course, thousands of public charities (a classification that includes auxiliary organizations). They run the gamut from substantial bodies and large private institutions of higher education, to a host of small, community-based, self-help development corporations.

“Nonprofit” corporations in California likewise host diverse services for the “public benefit” and are organized under the *California Nonprofit Corporation Law*.<sup>4</sup> Nonprofits are the third major leg of the national economy, along with the private sector and government, and within the CSU, the auxiliary organizations play a critical support function to the campuses.<sup>5</sup> There are presently over ninety recognized auxiliary organizations operating in the CSU.<sup>6</sup>

The predominant feature of the nonprofit sector in the past decade has been explosive growth – not just in size – but in the *scope of services* and the demand for *competence*.<sup>7</sup> Coping with this growth is the primary reason for this monograph: it falls principally to those who govern, manage and oversee the CSU auxiliary organizations to deliver effective campus support services with a high degree of competence and accountability. An array of statutes, standards, rules and regulations, as well as system, campus and internal policies and practices apply to auxiliary organizations. If auxiliary organization boards understand their role and responsibilities, and act constructively upon them, compliance with these requirements will be greatly improved, along with the quality of support services offered.

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<sup>3</sup> These are U.S. Internal Revenue Code Section 501(c)(3) organizations according to IRS records. Every auxiliary organization operating within the CSU also functions as a nonprofit corporation.

<sup>4</sup> The Nonprofit Corporation Law is set out in *California Corporations Code*, Section 5200 *et seq.*

<sup>5</sup> CSU Board of Trustees policy declares that auxiliary organizations are “essential to the educational program of a campus and shall be so operated.” See *California Code of Regulations*, Section 42401 in Subchapter 6, Chapter 1, and Division 5 of Title 5.

<sup>6</sup> The Chancellor’s Office has an online list of the recognized auxiliary organizations operating within the CSU at <http://www.calstate.edu/FT/auxorg/AugOrgList.shtml>.

<sup>7</sup> Peter F. Drucker, *Managing for the Future: The 1990s and Beyond* (New York: Truman/Talley Books/Dutton, 1992).

An online summary on the origin and nature of *CSU* auxiliary organizations may be found at: <http://www.calstate.edu/FT/auxorg/AOBackground.shtml>.

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Appendix A to this monograph is a Selected Resource List on nonprofit and auxiliary organization governance for further study.

## **A. The Governing Board and its Authority**

### Governance Requirement

Every auxiliary organization operating on a *CSU* campus or for the *CSU* has been formed as a separate legal entity under California corporation law and authorized to function as an auxiliary under the *Education Code* and *CSU* regulations and policy. These entities are not campus departments, although they have a “linking-pin” relationship with the institution under law, regulations, policies, and by agreement(s).

California Nonprofit Corporation Law<sup>8</sup> requires each entity organizing under its provisions to be governed by a board of directors or an equivalent body called by another name. For example, some auxiliary organizations represent the campus student body, with an elected governance structure analogous more to a legislative body than a corporate board. These student body organizations are formed and operate as auxiliary organizations under separate statutory authority,<sup>9</sup> but student body organizations are also nonprofit corporations subject to other laws and regulations discussed in more detail below. Student body organizations are typically “membership organizations.” Other auxiliary organizations are structured as “non-member organizations” – the governing board being considered the “membership.”

No matter what they are called, the auxiliary organization’s governing body has a common statutory governance role, like its counterpart in the private sector: to operate a management structure in which all corporate powers are exercised by or under the board’s ultimate direction.<sup>10</sup>

### Board Powers

Directors on governing boards exercise plenary authority collectively, not individually, and such authority is commonly referred to as “corporate powers.” These powers repose under law and through the Articles of Incorporation and Bylaws of the organization, and may often be delegated as long as the delegated duties and actions are subject to the board’s review and control. Ultimate responsibility, however, resides with the board.<sup>11</sup>

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<sup>8</sup> See footnote 3.

<sup>9</sup> *California Education Code* Sections 89006, 89300 *et seq.*, and 89900 *et seq.*

<sup>10</sup> *California Corporations Code* Section 5210.

<sup>11</sup> *Ibid.*

Matters ordinarily calling for board action or approval include:

- Adopting, amending, or repealing bylaws.<sup>12</sup>
- Amending the articles of incorporation.<sup>13</sup>
- Electing directors in some nonmember organizations.<sup>14</sup>
- Filling board vacancies and removing directors in some cases.<sup>15</sup>
- Electing officers.<sup>16</sup>
- Employing the executive manager.
- Appointing and assigning duties to board committees.<sup>17</sup>
- Adopting annual budgets.
- Planning the year's programs and activities.
- Adopting corporate policies and long-term plans.
- Investing corporate funds.
- Complying with governmental reporting and taxation laws.
- Issuing reports and financial statements.
- Calling and holding special membership or board meetings.
- Deciding to seek member approval through the voting process.
- Bringing and defending legal actions on behalf of organization.
- Approving corporate borrowing or loans.<sup>18</sup>
- Approving indemnification of corporate directors, officers, and other agents.<sup>19</sup>
- Approving the mortgage or other pledge of corporate assets to secure payment or performance of contracts or obligations.<sup>20</sup>
- Approving the sale, lease, conveyance, exchange, transfer, or other disposition of corporate assets.<sup>21</sup>
- Approving mergers, reorganizations, and dissolutions.<sup>22</sup>

The manner in which the board delegates or handles these matters is frequently spelled out in a series of policy statements, and these statements are often codified in a board policy manual or similar document.

All board members must have full voting rights and proxy voting is prohibited.<sup>23</sup>

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<sup>12</sup> Ibid at Section 5150(a).

<sup>13</sup> Ibid at Section 5812.

<sup>14</sup> Ibid at Section 5310(c).

<sup>15</sup> Ibid at Sections 5221 and 5224.

<sup>16</sup> Ibid at Section 5213(b).

<sup>17</sup> Ibid at Sections 5210 and 5212(a).

<sup>18</sup> Ibid at Section 5236.

<sup>19</sup> Ibid at Section 5238(e).

<sup>20</sup> Ibid at Section 5910.

<sup>21</sup> Ibid at Section 5911.

<sup>22</sup> Ibid at Section 6011.

<sup>23</sup> Ibid at Section 5211(c).

## **B. Corporation Status**

The auxiliary organizations within the *CSU* are all incorporated entities. These corporations all fall within the public benefit classification (one of the three types of nonprofits contemplated by the Nonprofit Corporation Law).<sup>24</sup> To incorporate, the auxiliary organization files a charter (known in California as *Articles of Incorporation*), and any amendments thereto, with the Secretary of State. The *Articles* recite the general governance features of the entity, **particularly its charitable purpose and disposition of assets on dissolution**, and including the intent to organize as a nonprofit, public benefit corporation.

Such corporations are formed exclusively for charitable or public purposes and assets must be irrevocably dedicated to these purposes. If dissolved, they must distribute their assets to a qualified successor-entity. For auxiliary organizations, a qualified successor-entity is one approved by the board, the campus president, and the Board of Trustees.<sup>25</sup>

The term “nonprofit” does *not* mean that the auxiliary organization cannot make money or a profit in the performance of its authorized functions. “Nonprofit” refers to the fact that there are no stockholders, and therefore no stocks and distribution of those profits to stockholders as dividends, etc. And, indeed, there are two statutory standards auxiliary organization functions must meet: operations must be fiscally viable (with adequate reserves);<sup>26</sup> and commercial services, such as food services and bookstores, must be self-supporting.<sup>27</sup>

As separate legal corporate entities, auxiliary organizations exist and operate permanently unless formally dissolved. The permanency is unique to corporations, unlike individuals or partnerships.

The persons who serve as directors make corporate decisions collectively as a board or as a committee of the board. Thus, with the possible exception of unanimous written consent actions, corporate decision-making is viewed as a collective and deliberative process, tempered by the obligations of good faith and prudent inquiry that are the cornerstones of the directors’ fiduciary obligations to the entity they serve.

Corporate status then is one of the three structural footings of all auxiliary organizations in the *CSU*.

## **C. Status as Auxiliary Organization**

The second structural footing common to these campus-support entities is that the California Legislature has given them a statutory basis distinct from, but in addition to, their nonprofit corporate status.

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<sup>24</sup> Ibid at Sections 5100-6910. General provisions and definitions that apply to all California nonprofit corporations appear in Sections 5000-5080.

<sup>25</sup> *Cal Code of Regs, Title 5, Section 42600(b)*.

<sup>26</sup> *Cal Ed Code Section 89905*.

<sup>27</sup> Ibid at Section 89904.5.



The *California Education Code* identifies a narrow band of entities that have status as “auxiliary organizations.”<sup>28</sup> These entities include: entities designated by the Trustees; student body organizations operating under *Education Code* Section 89300; entities operating commercial services on a campus or other *CSU* property; and those entities with articles and bylaws expressing a purpose to support or benefit the *CSU* or one of its campuses, and with governing body members selected by either a *CSU* or campus official from students, faculty or staff, the Trustees or *CSU* staff.

This statutory framework for entities designated as “auxiliary organizations” gives to the *CSU* Board of Trustees the delegated authority to implement more detailed regulations. The Trustees have adopted these implementing regulations in the *California Code of Regulations*, Sections 41401-41411 and 42400-42667, in Subchapters 4 and 6, Chapter 1, at Division 5 of Title 5 – popularly known as “*Title 5*.” The Trustees have also adopted a number of resolutions that apply to auxiliary organizations.

*Title 5* regulations, in turn, delegate to the Chancellor and campus presidents a considerable degree of authority to establish operational and oversight policies and practices that apply to auxiliary organizations through Executive Orders, coded memoranda, and campus policy statements. *Title 5* also prescribes such things as: the process needed to establish a new auxiliary organization;<sup>29</sup> the functions that such entities may perform;<sup>30</sup> the affairs and fees of student body organizations;<sup>31</sup> operating agreement and lease requirements;<sup>32</sup> compensation standards;<sup>33</sup> governing body composition requirements;<sup>34</sup> and the authority of the campus president over entity budgets and programs.<sup>35</sup>

The Chancellor’s Office maintains a compilation of policies and procedures for auxiliary organizations. At present, this document appears on the *CSU* website at this URL: <http://www.calstate.edu/FT/AuxOrg/PDF0800/Compilation.shtml>.

The “compilation” is updated from time to time, but its provisions are *not* by themselves considered primary authority.<sup>36</sup> A major codification project is underway to organize, consolidate and restructure system-wide policy and practices, including requirements affecting auxiliary organizations.

#### **D. Tax Exemption Status**

Auxiliary organizations have a third common structural footing as “501(c)(3) tax exempt organizations.”

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<sup>28</sup> Ibid at Section 89901(a) through (f).

<sup>29</sup> *Title 5* at Section 42407.

<sup>30</sup> Ibid at Section 42500 and 42659.

<sup>31</sup> Ibid at Section 41400 *et seq.*

<sup>32</sup> Ibid at Section 42501 and 42502.

<sup>33</sup> Ibid at Section 42405.

<sup>34</sup> Ibid at Section 42602.

<sup>35</sup> Ibid at Section 42402.

<sup>36</sup> See Executive Order No. 732, dated March 6, 2000. The “Compilation” was last updated in 2002, and is due to be revised.

Just as most nonprofit organizations benefit from incorporation, auxiliary organizations benefit from the tax advantages of exempt status under California and federal law.

Every auxiliary organization has qualified and maintains status as a tax-exempt entity -- organized and operated for exempt purposes as a “public charity.”<sup>37</sup> These entities are generally exempt from federal and California tax on the income and gifts they receive, and are able to offer their donors charitable tax deductions for their contributions. To maintain this status, auxiliary organizations must adhere closely to tax law and regulations, and file periodic reports much like tax returns. Activity unrelated to the entity’s exempt purpose often requires special annual reports and can result in a tax liability on unrelated business income, and perhaps, in cases where the unrelated activity is extensive, loss of tax-exempt status. All auxiliary organizations are classified as “public charities” under IRC Section 509(a). Care should be taken to assure that an auxiliary organization is properly sub-classified as a “supporting organization” under Section 509(a).

### **E. Charitable Corporations under California Law**

There is a corollary status generally applicable to auxiliary organizations, and particularly to those functioning as the charitable solicitation and gift-receiving arm of the university: *charitable organizations* under California Law.

Each campus has designated one of its auxiliary organizations with seeking and securing private support (also known as friend and fundraising) for the university it serves. These auxiliary organizations operate under operating agreements and support service leases that authorize the fundraising function.<sup>38</sup>

Even though only certain auxiliary organizations are authorized to perform fundraising functions, under California law all auxiliary organizations are technically “charitable organizations” by virtue of their status as nonprofit public benefit corporations. Charitable corporations are held to specific solicitation, disclosure and reporting standards under the *Supervision of Trustees and Fundraisers for Charitable Purposes Act*, and “funds held for charitable purposes” are under the oversight purview of the Attorney General. The *Nonprofit Integrity Act of 2004* (the Act) set in place a number of additional operational requirements and financial standards, many of which extend to auxiliary organizations.<sup>39</sup> See Section XI for additional information on the role of the Attorney General’s Charitable Trust Section and Registry of Charitable Trusts.

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<sup>37</sup> U.S. Internal Revenue Code (IRC), Section 501(c)(3) and California Revenue & Taxation Code Section 23701d. IRC Section 509(a) describes classes of public charities (as distinct from private foundations).

<sup>38</sup> California Code of Regulations (Title 5), Section 42502 lists functions that may be performed by auxiliary organizations under appropriate agreements. Accepting donations is one of the listed functions.

<sup>39</sup> California Government Code Sections 12580-12599.7, Business and Professions Code Sections 17510 - 17510.95, and Probate Code Sections 16320 *et seq.* and 18501 *et seq.*, particularly.

The Act includes provisions relating to organization filings, registration and reporting, compensation review, control over fundraising, including misrepresentations, commercial fundraisers, fundraising counsel and commercial co-venturers, prohibited solicitation and fundraising practices, and required contract cancellation provisions.

Key governance-related provisions affecting many auxiliary organizations:

- The governing board of organizations with \$2 Million or more in gross revenues (exclusive of audited governmental grants) must establish and maintain an audit committee, and, while non-board members may be included, staff and certain officers may not serve on this committee. This committee is responsible for: independent financial auditor engagement recommendations; conferring with the auditor on financial affairs; review of audit reports; and approval of any non-audit services by the financial audit firm.
- The governing board (or a designated board committee) must review and approve executive management compensation (including benefits) at hiring and when modified to determine that it is just and reasonable.
- Solicitation campaigns involving either a commercial fundraiser or a fundraising counsel require a written agreement meeting prescribed standards and executed by an official authorized by the governing board.
- Such charitable solicitations must meet prescribed registration, management, representation and disclosure standards, including registration of both the organization and the commercial fundraiser (if used) before campaign solicitations.

Irrespective of whether an auxiliary organization is a university's authorized fundraising arm, board members and management should be broadly familiar and in compliance with not only the Act, but applicable disclosure and reporting rules for charitable organizations.<sup>40</sup> The Chancellor's Office of Systemwide Advancement has posted a comprehensive compliance manual, online at: [www.calstate.edu/UA](http://www.calstate.edu/UA).

Auxiliary organizations are under the audit-eye of a number of entities, including: the IRS, Franchise Tax Board, University Auditor, the Department of Finance and the Attorney General.

It should be evident that with these three organizational footings, auxiliary organization governance requires skill, diligence, and a keen sense of duty and stewardship.

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<sup>40</sup> See particularly, the Attorney General's "Guide for Charities." This publication is posted on the AG website.

### III. Standards of Conduct, Conflicts of Interest and Related Topics

Board members are *individually* held to statutory requirements in the exercise of their duties. Since auxiliary organizations are also nonprofit corporations, auxiliary board members must abide by self-dealing standards in the *California Nonprofit Corporation Law*. They are also subject to financial interest standards expressed in the *California Education Code* for auxiliary organization governing bodies.

#### A. California Nonprofit Corporation Law

##### The “Fiduciary” Standard (Strict and Contemporary)

The term “fiduciary” refers to one who holds a position requiring trust, confidence, and scrupulous exercise of good faith and candor. Included are those with a duty, created by a particular undertaking, to act primarily for the benefit of others relating to the undertaking with trust and confidence exercised with fairness and good faith.<sup>41</sup> There is a strict, traditional interpretation of the term generally confined to trustees.<sup>42</sup> Then there is the less strict use of the term used to describe a nonprofit director’s “fiduciary” duties: duty of care, the duty of inquiry, the duty of loyalty, and the duty to comply with investment standards.<sup>43</sup>

The strict trustee standard of duty is generally *not* imposed on directors of California nonprofit entities. In the case of auxiliary organizations serving as the trustee of charitable trusts, the traditional interpretation may well be applicable by extension to the governing board of that entity.<sup>44</sup> Thus, the fiduciary duties of auxiliary organization governing directors are not only to the entity, but also to the institution it serves, to trustors, and the general public.<sup>45</sup>

##### Duty Standards

*Duty of Care:* Directors owe a duty of due care in the performance of their governance functions.<sup>46</sup>

“The duties of a director, including duties as a member of any committee of the board upon which the director may serve...” shall be performed “in good faith, in a manner such director believes to be in the *best interests of the corporation* and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.” (*Emphasis added.*)

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<sup>41</sup> *Black’s Law Dictionary* (6<sup>th</sup> Ed 1990).

<sup>42</sup> See generally *California Probate Code* Sections 16000-16015.

<sup>43</sup> See *Guidebook for Directors of Nonprofit Corporations* (ABA, Nonprofit Corporations Committee, 1993).

<sup>44</sup> *Cal Corps Code* Section 5250.

<sup>45</sup> Auxiliary organizations are classified as “public benefit” nonprofit corporations. Citations to support this posture: *Holt v College of Osteopathic Physicians & Surgeons* (1964) 61 C2d 750, 754, 40 CR 244; *Queen of Angels Hosp. v Younger* (1977) 66 CA3d 359, 136 CR 36.

<sup>46</sup> *Cal Corps Code* Section 5231(a).

This standard is almost the same as that imposed on business corporations, but, unlike trustees under the strict fiduciary standard, nonprofit directors may delegate corporation management “to any person or persons, management company, or committee.”<sup>47</sup>

*Duty of Inquiry:* The director’s obligation to make reasonable inquiry is triggered only when circumstances suggest that further inquiry is needed. Directors may rely on information, opinions, reports, or statements, including: financial statements prepared or presented by officers or employees believed to be reliable and competent in the matters presented; by counsel and independent accountants on matters believed to be within their professional competence; and by board committees on matters charged to that committee.

*Duty of Loyalty:* A director must act in a manner that the director believes to be in the best interest of the organization and all of its members, including minority member factions, and to administer corporate powers for the common benefit – to advance and achieve the corporation’s purposes.

*Duty to Investments:* In dealing with the organization’s invested assets, directors must follow three statutory standards:

- Avoid speculation and look instead to permanent disposition of the funds, considering the probable income and the probable safety of the corporation’s capital;<sup>48</sup>
- Comply with any additional standards imposed by the corporation’s articles or bylaws or by the express terms of an instrument or agreement under which the assets were contributed;<sup>49</sup> and
- Meet the general standard of care requirements applicable to directors of public benefit corporations.<sup>50</sup>

Section IX below discusses standards relating to the management (including spending) of invested funds, including charitable assets.

### Self-Dealing Transactions

The “conflict of interest” law covering nonprofit directors does not use this term.<sup>51</sup> There are, nevertheless, strict sanctions imposed on auxiliary organization governing directors who engage in a self-dealing transaction involving the corporation the directors are serving.

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<sup>47</sup> Ibid at Section 5210.

<sup>48</sup> Ibid at Section 5240(b)(1).

<sup>49</sup> Ibid at Section 5240(b)(2).

<sup>50</sup> Ibid at Section 5240(d).

<sup>51</sup> Ibid at Section 5233.

“Self-dealing transactions” are any transactions to which the corporation is a party and in which one or more of its directors has a material financial interest, unless the transaction (1) is specifically excluded from coverage by statute<sup>52</sup> or (2) although otherwise covered by the prohibition, is approved or validated.<sup>53</sup>

A director with a material financial interest in a transaction involving the corporation served is an “interested director.” The law does not define “financial interest” or “material.”

The statutory exclusions from the “self-dealing transactions” definition include:<sup>54</sup>

- Board actions fixing compensation for directors;
- Transactions that are part of the corporation’s public or charitable purpose and that the corporation approves in good faith and without unjustified favoritism, even if one or more directors or their families benefit as part of a class of persons intended to benefit from the program; and
- Transactions of which the interested director has no actual knowledge and which do not exceed the lesser of one percent of the gross receipts of the corporation for the preceding fiscal year, or \$100,000.

The organization can engage in a self-dealing transaction if it is approved or validated, either before or after the transaction is consummated, in any one of the following ways:<sup>55</sup>

- Upon written and supported request to the Attorney General;
- Petition to the court;<sup>56</sup>
- Validation by the corporation board under specified pre-conditions;<sup>57</sup> and
- Interim approval by other authorized persons under specified pre-conditions.<sup>58</sup>

See Appendix B, Checklist for Board Approval of Transactions Involving Interested Directors (validation).

Also see Section III(B) below for “financial interest transactions” requirements specifically applicable to auxiliary organization governing board actions found in the *California Education Code*. The *Education Code* requirements appear more restrictive as to board acts and, therefore, may be considered as controlling in most cases, but,

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<sup>52</sup> Ibid Section 5233(b).

<sup>53</sup> Ibid Section 5233(d).

<sup>54</sup> Ibid Section 5233(b).

<sup>55</sup> Ibid at Section 5233(d).

<sup>56</sup> Ibid at Section 5233(d)(1).

<sup>57</sup> Ibid at Section 5233(d)(2).

<sup>58</sup> Ibid at Section 5233(d)(3), by the approving committee or person following same standards required of Board, under conditions making Board’ prior approval impractical, followed by subsequent Board ratification.

because these situations are very fact-sensitive, the self-dealing rules outlined above may be in play.

### Director Personal Liability

Given these standards, can a director avoid personal liability simply by disengaging – skip meetings, ignore reports and operations? If a director fails to take reasonable precautions that attend the duties of their corporate office, exposure to personal liability may result from injuries or losses caused by the organization.

On the other hand, so long as the director exercises reasonable diligence and care, he or she will be free from personal liability, even when poor judgment results in loss or injury to the corporation.

The relative freedom from personal liability enjoyed by nonprofit governing directors is reposed by statute:<sup>59</sup>

“There shall be no personal liability to a third party for monetary damages on the part of a volunteer director or volunteer executive officer of a nonprofit corporation...caused by the director’s or officer’s negligent act or omission in the performance of that person’s duties as a director or officer, if all the following conditions are met:

- The act or omission was within the scope of the officer or director duties;
- The director or officer acted in good faith;
- The act or omission did not involve self-dealing; and
- The act or omission was not reckless, wanton, intentional, or grossly negligent.”

Additional court procedural protections are also afforded nonprofit volunteer directors, but these have exceptions.<sup>60</sup>

Under the federal *Volunteer Protection Act of 1997*,<sup>61</sup> volunteers, including nonprofit entity directors, cannot be held liable for harm caused by the volunteer’s act or omission on behalf of the nonprofit when specified circumstances are present.<sup>62</sup>

### Indemnification

Auxiliary organizations are permitted by law to indemnify directors and officers under a strict and technical framework<sup>63</sup> as long as the entity is financially viable. The indemnity

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<sup>59</sup> Ibid at Section 5239(a).

<sup>60</sup> *Cal Code of Civil Procedure* Section 425.15.

<sup>61</sup> 42 *USC* Sections 14501-05.

<sup>62</sup> Ibid at Section 14503(a): acting within duty scope; required license or certificate possessed; no willful or criminal misconduct, gross negligence, etc., and not caused by operated vehicle.

<sup>63</sup> *Cal Corps Code* Section 5238.

scope includes “any threatened, pending or completed action or proceeding, whether civil, criminal, administrative or investigative,”<sup>64</sup> and, although this appears to extend to all legal threats asserted against a director for which the director might be forced to retain counsel or otherwise incur personal expenses, this statutory indemnity power is dependent upon a number of factors, such as: the nature of the proceedings; their outcome; the director’s conduct in the matter complained of; and approval of the indemnification by the corporation, the Attorney General, or the court or jurisdiction in the matter.

### Board Authority, Delegation and Required Officers

All activities and affairs of the corporation must be conducted and all corporate powers exercised by or under the direction of the governing board. The board may delegate management of corporate activities to any person, persons, or committee, however composed, as long as the board retains ultimate direction.<sup>65</sup>

Certain actions cannot be delegated<sup>66</sup> including (as it relates to auxiliary organizations):

- Action requiring membership approval;
- Filling vacancies on the board, or on a committee authorized to act for the board;
- Setting board or committee member compensation;
- Amending or repealing Bylaws or any resolution with terms requiring board action to amend or repeal;
- Appointment of committees or members thereof; and
- Approval of any self-dealing transaction, except under statutory procedures.

Recent changes to the law have also clarified which officers are required for a nonprofit public benefit corporation: a board chair or president, or both; a secretary, and a treasurer or chief financial officer, or both. The secretary and CFO or treasurer may not serve concurrently as president or chair.<sup>67</sup>

### Committees

The governing board may establish by resolution sub-boards or committees to perform a range of operational functions and which serve at the pleasure of the board. Each committee must include two or more board members. It is common for the Bylaws to provide for any sub-board or committee that has the authority to act on behalf of the

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<sup>64</sup> Ibid at Section 5238(a).

<sup>65</sup> Ibid at Section 5210.

<sup>66</sup> Ibid at Section 5212(a).

<sup>67</sup> Ibid at Section 5213(a).



board, as well as the scope and circumstances of such authority. Only Board members may serve on such a committee.<sup>68</sup>

On the other hand, committees with delegated authority to manage operational aspects of the organization may include non-board members. The governing board retains ultimate authority over functions delegated to a committee.<sup>69</sup>

Auxiliary organizations that have or expect to have gross revenue of \$2 million should include an audit committee provision in the Bylaws. The chair/president and treasurer/CFO are not eligible to be on the audit committee.<sup>70</sup>

### Compensation Reviews and Approval

Statutory compensation review and approval requirements apply to auxiliary organizations. Such compensation must not exceed what is fair and reasonable to the organization. Excessive payments are a violation of the law,<sup>71</sup> and under IRS standards open up exposure to *intermediate sanctions* for excess compensation,<sup>72</sup> and potentially the revocation of tax-exempt status.<sup>73</sup> The test for determining reasonableness is adequate documentation obtained and relied upon concurrently with the compensation decision, for example: comparability with similar entities and positions; independent surveys; similar services within the area; and actual written job offers from other similar entities for the person in question.<sup>74</sup>

The board may delegate the review to a compensation committee, and the committee charge should be expressed in the Bylaws.

## **B. California Education Code**

There are concomitant “financial interest” requirements for auxiliary governing boards in the *Education Code*. These are expressed in more strict terms than the nonprofit corporation law standards and, therefore, typically apply to auxiliary board actions. The *Education Code* (at Section 89006) also sets conflict-of-interest standards for auxiliary organization employees.

### Financial Interest Conflicts

Except in certain circumstances, a director must avoid *transactions of the board* in which the director has a financial interest.<sup>75</sup> The term includes contracts approved by the governing body. To do so is “misconduct in office” and the transaction breaching this prohibition is void, unless it meets a qualified two-element validation test:<sup>76</sup>

- Is the transaction just and reasonable as to the auxiliary *when approved*; and

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<sup>68</sup> Ibid at Section 5212(a).

<sup>69</sup> Ibid at Section 5210.

<sup>70</sup> *Cal Gov't Code* Section 12586(e) and FAQ 13, AG website – <http://ag.ca.gov/charities/faq.php>.

<sup>71</sup> Ibid at Section 12586(g) and *Cal Corps Code* Section 5235.

<sup>72</sup> *Internal Revenue Code* Section 4958.

<sup>73</sup> *Treas Reg* Section 53.4958(f)(1).

<sup>74</sup> Ibid at Section 53.4958-4(b).

<sup>75</sup> *Cal Ed Code* Section 89906.

<sup>76</sup> Ibid Section 89907.

- Was the financial interest disclosed or known to the board and noted in the meeting minutes, followed by a favorable, good faith board vote sufficient for the action without including the interested director(s)?

But wait! There are several *circumstance exceptions* to the application of the above test, any one of which revives the prohibition. Here they are:

- The transaction is directly between the interested director(s) and the auxiliary.<sup>77</sup>
- The transaction is between the auxiliary and a partnership or unincorporated association in which a director(s) holds an ownership, partnership or other proprietary interest.<sup>78</sup>
- The transaction is between the auxiliary and a corporation in which the interested director(s) owns or directly or indirectly holds more than a five percent of the outstanding common stock.<sup>79</sup>
- The director(s) fails to disclose to the board the financial interest in the transaction at a public meeting, then influences or attempts to influence one or more board members in entering into the transaction.<sup>80</sup>

The *Education Code* financial interest standard for Board actions boils down to this:

The following board transactions are specifically deemed *impermissible*:

- Any transaction, other than an employment contract, directly between the organization and a Board member.
- Any transactions between the organization and a partnership or unincorporated association in which a Board member is a partner, or owner, or holder, directly or indirectly, of a proprietorship interest.
- Any transaction between the organization and a for-profit corporation in which the organization's Board member is the owner or holder, directly or indirectly, of five percent or more of the outstanding common stock.

On the other hand, the following transactions are *permissible* if the Board follows the prescribed procedure (see below):

- Transactions between the organization and a for-profit corporation in which a Board member is the owner or holder, directly or indirectly, of less than five percent of the outstanding common stock.

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<sup>77</sup> Ibid Section 89908(a).

<sup>78</sup> Ibid Section 89908(b).

<sup>79</sup> Ibid Section 89908(c).

<sup>80</sup> Ibid Section 89908(d).

- Transactions between the organization and a for-profit corporation on whose governing body a Board member serves as a director and owner or holder, directly or indirectly, of less than five percent of the outstanding common stock.
- Transactions between the organization and a nonprofit corporation on whose governing body a Board member serves as a director.

### Board Deliberations and Actions under Financial Interest Circumstances

Under the *Education Code* standards, the following procedure should be observed: any Board member with a financial interest in a proposed *permissible board transaction* shall promptly disclose to the Board the nature and scope of that interest, and thereupon be recused from participating in any deliberations or actions by the Board on that matter. The Board meeting minutes shall note the disclosure and recusal. The Board shall then make a determination whether or not the proposed transaction is just and reasonable for the organization at that time and under the circumstances of the disclosure. If so, the Board may then authorize, approve, or ratify the transaction in good faith by a vote sufficient for the purpose of the action without counting the vote(s) of such financially interested Board member(s).

Upon the disclosure to the Board by any financially interested Board member in a proposed *impermissible* transaction, no action to approve, authorize or ratify the transaction shall be taken, and the meeting minutes shall note the circumstances attending the matter.

### Using Non-Public Board Information

It is also unlawful for a director to use *non-public* information obtained through board membership for personal pecuniary gain. It matters not if that gain happens after the director has left the board.<sup>81</sup>

## **IV. Meeting Requirements**

### **A. Background on Open Meeting Laws**

There are four major *Open Meeting* statutes in California. Only two are intended for auxiliary organizations: the *Gloria Romero Open Meetings Act of 2000*<sup>82</sup> and the so-called *Seymour Act*.<sup>83</sup> The *Ralph M. Brown Act 2001*<sup>84</sup> and the *Bagley-Keene Open Meeting Act*<sup>85</sup> are the other open meeting laws, but they are for state or local governing bodies, such as state or county boards, cities and special districts, and certain nonprofit entities created by public agencies – but, *not* auxiliary organizations. The next time some uninformed person berates your board at a meeting for violating the *Brown Act*,

<sup>81</sup> Ibid Section 89909. The term “non-public” refers to auxiliary or other information not generally available to the public.

<sup>82</sup> Ibid Section 89305 *et seq.*

<sup>83</sup> Ibid Section 89920 *et seq.* State Senator Seymour authored these provisions without formal attribution to him, but it is handy in this monograph to refer to the provisions in this manner.

<sup>84</sup> *Cal Government Code* Sections 54950-54962.

<sup>85</sup> Ibid Sections 11120-11132.

you should be clear on the open meeting law that does apply to your organization, and familiar with its main attributes. This section should help.

[Special Note: The more lenient board/committee meeting notice provisions in the Nonprofit Public Benefit Corporation Law<sup>86</sup> cannot be applied to auxiliary organizations. Under well-settled statutory interpretation principles, the more restrictive *Education Code* requirements relating to public notice, time periods, and the like, prevail. However, to the extent teleconferencing and other electronic methods stated in the *Corporations Code* are consistent with the *Education Code* opening meeting rules, those methods can be used.]

Between *Romero* and *Seymour*, which statute applies to which auxiliary? Here is the test: if the auxiliary organization has been formed or is operating as a *student body organization* under *Education Code* Section 89300 *et seq.*, the *Romero Act* applies; otherwise *Seymour* governs.

The main features of both *Romero* and *Seymour* deal with: conducting meetings; notice requirements and exceptions; when a governing board may conduct business absent public access; and violation consequences.

## **B. Open Meeting Requirements and Exceptions**

Appendix C compares the key provisions of *Romero* and *Seymour* to which governing bodies must comply. Under certain circumstances, a board may meet in closed session. Board members should stress with management that the applicable requirements be closely followed, and directors and officers should *individually* have a familiarity with the requirements.

## **C. Minimum Meeting Standards**

There is an *Education Code* requirement that each auxiliary organization governing board must have at least one business meeting each fiscal year.<sup>87</sup> This minimum standard should not be confused with the more relaxed board meeting standard in the *California Nonprofit Public Benefit Corporation Law*<sup>88</sup> requiring a meeting each year in which directors are to be elected at that meeting. Even for urgency matters requiring Board action, a meeting is required.<sup>89</sup>

Orientation programs for board members should present at least an overview of open meeting law requirements and compliance practices.

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<sup>86</sup> See *Cal Corp Code* Section 5211.

<sup>87</sup> Section 89903(b). The Chancellor's Office has indicated that additional guidance on this minimum standard may be instituted to assure that prudent investment and similar board decisions are timely.

<sup>88</sup> *California Corporations Code*, Section 5510(b).

<sup>89</sup> *Cal Ed Code* Sections 89305.1, 89306.5, and 89920-23.

## V. Keeping and Disclosing Records

### A. Public Access to Records

California public policy favors access to government records. The *California Public Records Act* (CPRA)<sup>90</sup> is strong testimony to this bias. It is modeled upon the federal disclosure laws known at the *Freedom of Information Act* (FOIA).<sup>91</sup>

A corollary document-access issue can arise because of the close relationship between the university and the auxiliary: does the public -- student body, faculty or staff, or general citizenry -- have a concomitant right to the files and records of an auxiliary organization, and does the CPRA apply?

In California State University, Fresno Foundation, Inc. v. Superior Court,<sup>92</sup> the California Court of Appeals reviewed the role and relationship of a CSU auxiliary organization under the Education Code, FOIA and CPRA definitions, and both California and other case law. The court concluded, "...a non-governmental auxiliary organization is not a 'state agency' for purposes of the CPRA. The words 'state body' and 'state agency' simply do not include a non-governmental auxiliary organization."<sup>93</sup>

Effective January 2012, access to auxiliary organization records will be subject to *The Richard McKee Transparency Act of 2011*.<sup>94</sup> The McKee Act parallels in scope and in certain details the CPRA, including exclusions typically tied to State agency records.<sup>95</sup> A summary of the major provisions follows.

Public access to records extends to those used, owned, or maintained by an auxiliary in a way "balanced by the need to protect the individual privacy rights of donors and volunteers, to protect an auxiliary organization's fiduciary interests."<sup>96</sup>

Records accessible to the public upon request must be available within a reasonable time for inspection and to copy during office hours under specific requirements and exceptions, and include "any identifiable writing"<sup>97</sup> containing information relating to the conduct of the auxiliary organization.<sup>98</sup>

Once a record has been disclosed pursuant to an Act request, it constitutes a waiver of exemption.<sup>99</sup>

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<sup>90</sup> The CPRA is codified in the *California Government Code*, Section 6250 *et seq.*

<sup>91</sup> The FOIA (5 U.S.C. §55 *et seq.*) was enacted to ensure public access to vital information about the governmental conduct of its business.

<sup>92</sup> 90 Cal. App. 4<sup>th</sup> 810 and 108 Cal. Rptr. 2d 870 (2001).

<sup>93</sup> *Opinion*, F037383, dated July 16, 2001, at page 17.

<sup>94</sup> *Cal Ed Code* Section 89913-19 (SB 20, 2011-12 Leg. Session)

<sup>95</sup> *Ibid* at Section 89915.5 cross-walks to disclosure exemptions in *Govt Code* Sections 6254 and 6255, inclusive.

<sup>96</sup> *Ibid* at Section 89913(d).

<sup>97</sup> Defined in Section 89913.5(b) as "any handwriting, typewriting, printing, photostating, photographing, transmitting by electronic mail or facsimile, and every other means of recording upon any tangible thing, any form of communication or representation, including, but not limited to, letters, words, pictures, sounds, or symbols, or combinations thereof, an any record thereby created, regardless of the manner in which the record has been stored."

<sup>98</sup> *Ibid* at Section 89914.

<sup>99</sup> *Ibid* at Section 89918.

The *Act* includes several information request processing standards, as well as judicial remedies.<sup>100</sup>

Trade secrets are not disclosable.<sup>101</sup> There is a disclosure “public interest balancing” provision in the *Act* that permits the auxiliary organization to assess and demonstrate that the public’s interest in nondisclosure clearly outweighs the public’s interest in disclosure.<sup>102</sup> Finally, an *Act* provision provides a limited disclosure exemption for donor information.<sup>103</sup>

Handling *Act* records requests should be a coordinated effort between the University and the auxiliary organization. Auxiliary organization governing boards should develop and adopt comprehensive Records Retention Policies, and management should be conversant in records redaction techniques.

Before leaving this statutory information disclosure issue, it should be observed that auxiliary organizations are subject to disclosure requirements under Federal tax rules.<sup>104</sup> As an entity determined by the U.S. Internal Revenue Service to be exempt from corporate income tax (so-called “exempt organizations”),<sup>105</sup> an auxiliary organization must provide the public, upon request, a copy of its exempt organization application,<sup>106</sup> and most portions of its annual tax information returns.<sup>107</sup>

Auxiliary boards should consider adopting policy that brings appropriate definition to what the entity considers to be public and proprietary or confidential information.

## **B. Other Significant Records and Reporting Requirements**

Federal. The major federal records and reporting rules for auxiliary organizations stem from their tax-exempt organization status. That status required the filing of a detailed application to the U.S. Internal Revenue Service (Form 1023). IRS regulations now require the Form 1023 filing to be made available to the public

Auxiliary organizations also file annual tax returns (IRS Form 990 and 990T for business income tax). There are public disclosure rules that apply to these reports as well.

A redesigned Form 990 now includes expanded questions and schedules seeking more information on the operations of tax-exempt entities. **The proper responses to these questions and schedules is critical, but auxiliary boards and management should be alert to the connection between what the IRS considers important regulatory**

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<sup>100</sup> Ibid at Section 89917.

<sup>101</sup> Ibid at Section 89916.5.

<sup>102</sup> Ibid at Section 89915.5.

<sup>103</sup> Ibid at Section 89916.

<sup>104</sup> *Taxpayer Bill of Rights 2* and IRS Notice 88-120, 1988-2 C.B. 454.

<sup>105</sup> See Section II (D) above at page 6.

<sup>106</sup> IRS Form 1023, “Application for Recognition of Exemption under IRC Section 501(c)(3).”

<sup>107</sup> IRS Form 990, “Return of Organization Exempt From Income Tax.”

**standards as reflected in the form and its instructions, and the compliance requirements for charitable organizations under California statutes and regulations. See below and Appendix D.**

Auxiliary organizations serving as the recipient of gifts are also required to file the IRS Form 8282 Donee Information Return for specified types of donations.

State. The tax-exempt status application in California is Franchise Tax Board Form 3500A. This form, along with the IRS Form 1023 filing documents, and the tax-exemption determination letter should be considered permanent corporate records.

Auxiliary organizations also file with the Franchise Tax Board an annual information return, the FTB Form 199.

There are sanctions on officers, directors, employees, and agents of a corporation when required reports are either false or not filed,<sup>108</sup> and the Attorney General has the authority to intervene to compel reporting compliance.<sup>109</sup>

Additional reporting requirements include the following:

- Annual report to members and governing board within 120 days after close of the fiscal year (accompanied by the independent audit opinion/report, and report on certain types of loans, indemnifications, and self-dealing transactions);<sup>110</sup>
- Biennial Statement (Form SI-100) to Secretary of State (the organization must also must file when changing the agent for service of process);
- Annual reports to the Attorney General's Registry of Charitable Trusts<sup>111</sup> –
  - Registration/Renewal Fee Report (Form RRF-1) filed by the 15<sup>th</sup> day of the fifth month after close of the accounting period; and
  - Corporation's annual report, including IRS Form 990 plus all applicable schedules (including Schedule B with donor names), filed within the period required for RRF-1.

Note: The Registry of Charitable Trusts must also be provided:

- A copy of Articles of Incorporation or any certificate of amendment thereto when filing with the Secretary of State;<sup>112</sup> and
- Advance written notice of any merger<sup>113</sup> or transfer of all or substantially all of the corporation's assets.<sup>114</sup> See Section XIE below.

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<sup>108</sup> *Cal Corps Code* Section 6215(a).

<sup>109</sup> *Ibid* at Section 6216.

<sup>110</sup> *Ibid* at Section 6321.

<sup>111</sup> *Cal Gov't Code* Section 12586(b); *Cal Code of Regs, Title 11* Section 305.

<sup>112</sup> *Cal Corps Code* Sections 5120(d) and 5817.

**The reporting standards summarized above are higher than those sought by the IRS in Form 990 filings. See Appendix D for a “crosswalk” analysis.**

Each auxiliary organization must keep a current original or copy of its Articles of Incorporation and Bylaws at its principal office.<sup>115</sup> Additionally, the following corporate records are required:<sup>116</sup>

- Adequate and correct books and records of account;<sup>117</sup>
- A record of its members, including each name, address, and membership class; and
- Minutes of the proceedings of its members, governing board, and board committees.

CSU. Each auxiliary organization must have an annual financial audit by a certified public accountant under procedures established by the Chancellor. The audited financial report must be published widely and be made available to the public.<sup>118</sup>

Auxiliary organizations are required to maintain adequate records and prepare periodic operations and financial reports required by the Board of Trustees.<sup>119</sup> Records must be open and available to the Board of Trustees and the Department of Finance.<sup>120</sup>

Any unauthorized acts, such as material fraud or misuse of funds involving an auxiliary organization must be reported under specific procedures.<sup>121</sup>

Special periodic system-wide reports, such as campus gift and externally sponsored program results, typically include auxiliary organization transactions.

## **VI. Loyalty Owed to Organization or Constituency?**

Trustee regulations<sup>122</sup> set out a composition framework for auxiliary organization governing boards.

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<sup>113</sup> Ibid at Section 6010(b).

<sup>114</sup> Ibid at Section 5913.

<sup>115</sup> Ibid at Section 5160.

<sup>116</sup> Ibid at Section 6320(a).

<sup>117</sup> Records adequate to document all revenues and disbursements must be retained for at least the ten-year statute of limitations period.

<sup>118</sup> *Cal Ed Code* Section 89900(a).

<sup>119</sup> *Title 5* Section 42404(a).

<sup>120</sup> Ibid at Section 42404(b).

<sup>121</sup> Executive Orders 813 and 821.

<sup>122</sup> Ibid at Section 42602.



Student body organizations must “consist primarily of students, with a representative of the campus president to advise on policy and to provide liaison between the student governing board and the president of the campus.”<sup>123</sup>

Most if not all student body auxiliary organizations elect governing body members through a system affording representation to constituent groups or institution academic units (such as departments, schools or colleges). Students are qualified to stand for election to the board under organization bylaws that typically require status within such units or interest groups.

For auxiliary organizations other than student body organizations the composition requirement is different and tied to a date-triggering mechanism.

Non-student body auxiliary organizations “operating on April 1, 1969, may continue the composition of their governing board of directors existing at that time.”<sup>124</sup> Those entities making “a substantial change” in their governing board’s composition, and any [non-student body] auxiliary organization established after that date, shall have a governing board consisting of a voting membership from the following categories:

- (A) Administration and staff
- (B) Faculty
- (C) Non-campus personnel
- (D) Students.

Auxiliary organization governing bodies must be large enough to handle these composition requirements, if they apply.<sup>125</sup>

Student body organizations have an historic connection to the “governmental model” of structure. This model often includes the three branches: executive, legislative and judicial. The “corporate model” of organizational structure may be an emerging trend for these entities, but many articles and bylaws retain the “representative” form for qualifying and electing governing body members – more often referring to the body as the board of directors. This vestige, coupled with the “composition categories” required for other auxiliary boards, frequently leads uninitiated directors to conclude they owe a duty to a constituency, rather than to the organization.

Composition requirements in Trustee regulations do *not* mean that directors “represent” or hold an allegiance to a category or constituency that elected or qualified them for board membership. The purpose of the composition categories is to help assure that governing board deliberations and action are informed by perspectives likely to emanate from those categories. A close look at even the “governmental model” of organization structure reveals where the duty of a legislative “representative” truly resides.

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<sup>123</sup> Ibid at 42602(a).

<sup>124</sup> Ibid at 42602(b).

<sup>125</sup> Ibid at Section 42602(c).

A national, state or local candidate for an elected legislative-type office may indeed represent one or more constituencies (geographical, political or interest group). But once elected, the legal and moral duty of the official is owed to the public entity and its governing body.

Recall also that auxiliary organizations are incorporated under California nonprofit corporation laws.<sup>126</sup> Board members first owe a duty to the corporation under duty-of-care and loyalty standards expressed in the California Nonprofit Corporation Law.<sup>127</sup>

The duty owed by an auxiliary organization board member is a practical one. Board matters will or may significantly affect a constituency or composition category of a director. The director must certainly articulate and weigh that impact, and attempt a good faith balance that is best for the organization.

## **VII. Management, the University, Customers, Clientele or Constituents**

A successful auxiliary board recognizes and understands key relationships that need to be established and nurtured. Some of these relationships are unique to public higher education and the nonprofit sector, while others are quite common.

### **A. Board – Management Relations**

Governing boards typically delegate considerable authority to management to operate the organization on a day-to-day basis. In the nonprofit or “independent” sector, the relationship between the board and management is only slightly akin to the private sector. In the corporate world, management leadership needs to be crisp and nimble, with the board in an oversight role. The governance balance struck in nonprofit governance is somewhat different. The nonprofit board typically plays a more active role – indeed, the relationship between board and manager is often described as a partnership. This balance for auxiliary organization boards and managers is more complex, since the campus president and the designated oversight officer must be factored in.

Auxiliary organizations in good standing<sup>128</sup> within the *CSU* are *separate* but *related* to the institutions they serve. This dynamic triggers the need for very discerning relationship protocols. These arrangements need to respect the prerogatives and role of the board, the operational effectiveness of management, and the critical oversight responsibilities held by the campus president, the Chancellor and the Trustees.

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<sup>126</sup> See Section II (B) above.

<sup>127</sup> *Cal Corps Code* Section 5231(a). See also discussion of director duty standards at Section III (A).

<sup>128</sup> *Title 5* Section 42406 requires the Chancellor to maintain a current list of organizations “in good standing.” The alternate term, “officially recognized auxiliary organizations” is used in Executive Order No. 698 and in other directives.

## **B. Setting Policy and Accountability Standards**

### Policy vs. Procedures

One primary responsibility of an auxiliary board is to establish formal policies within which the entity functions. Of course, the functions should be those authorized in Title 5 for auxiliary organizations<sup>129</sup> and specified in appropriate operating agreements and support service leases.<sup>130</sup> The term “policy” is frequently misunderstood or confused with operational “procedures” and “practices.”

Simply put, policy is formal guidance needed to manage, coordinate and execute actions and activity throughout an organization – whether in the private, public or nonprofit sectors. When effectively deployed, policy statements help focus attention and resources on high priority matters – aligning and merging efforts within and for the organization to achieve its purpose and vision. Policy provides the operational framework within which the entity functions.

Procedures and practices, on the other hand, are the operational *processes* within the organization required to implement policy. Operating practices can be formal or rather informal, specific to a department or unit, or applicable across the entire organization. If policy is “what” the organization does, then its procedures are “how” it carries out those policies.

What’s unique about auxiliary board policy-making? It is the operational context in which these entities must function. For, while the auxiliary organization is indeed a separate legal entity with important corporate prerogatives and statutory powers, it has as its sole corporate purpose service in support of the institution’s mission. Furthermore, its “good standing” status with the Trustees through the Chancellor rests upon a high degree of conformance within system-wide and institution policies that apply to auxiliary organizations, and auxiliary board policy statements must synchronize with them. To strengthen this “test-of-relatedness” the auxiliary in good standing agrees to this conformity in the operating agreements and support service leases for the functions required of the auxiliary by the institution.<sup>131</sup>

### Accountability Standards

Setting and reviewing accountability standards is another important governance responsibility. Auxiliary organizations are principally in the “business” of service and stewardship. This calls for a higher standard of duty by the board and in management performance.<sup>132</sup> The board should be clear with itself and with management on sound business practices, including internal controls and compliance policies and procedures. These should be well documented, monitored and brought up-to-date on a regular basis.

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<sup>129</sup> Ibid at Section 42500(a).

<sup>130</sup> Ibid at Sections 42501-2 and 42601.

<sup>131</sup> Ibid at Section 42502(l)-(m).

<sup>132</sup> There can be a policy tension for a multi-function auxiliary between “fiscally viable” services and the “due diligence” required over grant or gifted assets held for the institution, or between the “compensation comparability” standard (*Title 5, Sec. 42405(a)*) and the need to meet the “self-supporting” standard for commercial operations (*Ed Code Sec. 89905*).

Successful service organizations pride themselves on measures of quality, responsiveness, integrity and value. These measures should be woven into all auxiliary program and activity objectives – objectives that can, in turn, assist the board in judging management’s performance.

### **C. Operating Agreements/Leases**

Merely because the Trustees have declared enumerated functions that auxiliary organizations can provide<sup>133</sup> does not give a particular auxiliary the right or privilege to undertake one or more of those functions. The Trustees also require that an auxiliary enter into an appropriate operating agreement for those functions<sup>134</sup> to include specified provisions.<sup>135</sup> If *CSU* property or facilities are to be used to perform any function, then a lease or license is required.<sup>136</sup>

### **D. Trustees and University Oversight**

State, system and institution oversight is another unique feature of auxiliary organization governance. Auxiliaries may be separate legal entities, but each exists to supplement, support or enhance the institution served.

There is a legal interpretation maxim that holds less specific statutes on the same subject to be subordinate to more specific ones. This is the case with the oversight framework expressed in the *Education Code* and in *Title 5*. The State Legislature authorized auxiliary organizations to operate within the *CSU* on a limited basis, with a delegation of authority to the Board of Trustees. In turn, the Trustees established a more detailed operational framework and relationship standards under the delegated authority of the Chancellor and the campus presidents.

The public policy behind this “oversight context” secures needed flexibility by auxiliary organizations,<sup>137</sup> while appropriate and prudent safeguards are in place.<sup>138</sup> There is considerable wisdom in the tension between “flexibility” and “oversight.” It is doubtful either the general public or even the State Legislature would recognize the separateness of the *CSU* or campus from an out-of-step auxiliary organization.

The true challenge for the policymakers is to carefully discern between oversight requirements that help rather than hinder flexible and viable auxiliary services to the campuses.

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<sup>133</sup> *Title 5* Section 42500(a) and inferentially 42659.

<sup>134</sup> *Ibid* Section 42501.

<sup>135</sup> *Ibid* Section 42502.

<sup>136</sup> *Ibid* Section 42601 citing *Cal Ed Code* Section 89046.

<sup>137</sup> *Ibid*, Section 42401 is a declaration of policy by the Trustees that lists the objectives to be served by auxiliary organizations, including “fiscal and management procedures to provide campus instructional and service aids not otherwise available; effective operations and elimination of undue difficulty that would otherwise arise, and the effective coordination of auxiliary activities under sound business practices.”

<sup>138</sup> *Ibid* at Sections 42400-2, 42408, and 42500-3.

## VIII. Risk Responsibility

Governing boards have an important role in managing risks posed by auxiliary operations in support of the served institution. Risk responsibility does not fall solely to management.

There are several dimensions to risk responsibility at the governance level.

First, and fundamentally, the board should consistently exercise its essential governance functions, and be receiving and evaluating reports and information clearly demonstrating that management is attending to day-to-day operations and the risk exposures from those services and activities. Also, auxiliary legal counsel should, as a sustaining function, be advising both the Board and management on the legal requirements for the organization, and on pending major litigation.

Next, the board should set risk management policy and standards covering all auxiliary operations.

Finally, the board should require and be familiar with a periodic, documented inventory and evaluation of the risks to which the auxiliary is normally exposed.

Appendix E is a list of Typical Governing Board Questions Concerning an Organization Risk and Insurance.

### A. Essential Governance Functions

The governing board serves important functions that by their nature and significance mitigate risk. As distinct from for-profit boards, non-profits, in general and auxiliary organization boards in particular, are not focused on enhancing shareholder values. They are committed to the service mission of the organization and with stewardship over assets.

These boards:

- Select, advise, evaluate, and, if need be, replace executive management;
- Establish and review strategic directions, approve specific objectives and set accountability standards;
- Ensure, to the extent possible, that the resources needed to accomplish those objectives and standards are at hand;
- Monitor management performance to established standards;
- Ensure that the organization operates responsibly (ethically) as well as effectively; and

- Establish and carry out an effective board-level governance system, involving the officers, committees and counsel.

Thus, a crucial first step toward corporate risk responsibility is *engaged* governance. Interestingly, there is little in either the *Education Code* or *Title 5* on this point. As discussed above, the *Education Code* sets governance limits on self-dealing, meetings, elections, fees and funds. *Title 5* replicates and details more of the same, and sets auxiliary board composition, permissible functions, fiscal administration, debt requirements, and external oversight, records, succession, and employee compensation requirements.

The Chancellor has issued executive orders covering an array of auxiliary *operational* issues, yet little of this direction deals directly with the essential *governance* functions of an auxiliary organization. Fortunately, the *Nonprofit Corporations Law* addresses these important governance responsibilities. Auxiliary organizations are incorporated under this statutory scheme and are, therefore, subject to its provisions.<sup>139</sup>

## **B. Setting Risk Management Policy and Standards**

The auxiliary board policy-making should extend to risk management. Such policy guidance should be designed to reduce or eliminate losses to which the organization may be exposed through a process of risk identification and evaluation, and appropriate risk management actions.

The scope of a comprehensive risk management policy statement should include: appropriate background, authority, and purpose provisions; a general policy statement on risk responsibility; more specific policy provisions on limited loss retention, insurance acquisition, and cooperative programs; and policy implementation provisions, including the role of management, risk management standards, and risk management program practices.

Any auxiliary risk management policy should be consistent with corresponding system and campus policy and practices that relate to auxiliary organization functions.<sup>140</sup>

The *AOA Website* periodically posts sample policy statements, including those covering risk management and responsibility.

Once adopted, the risk management policy should be periodically reviewed by the board and management to assure the provisions are up-to-date and relevant to contemporary operations and exposures.

## **C. Periodic Risk Cataloging and Assessments**

An important part of risk responsibility at the governance level is assuring that the auxiliary organization is aware of the risk at hand or under consideration. The board

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<sup>139</sup> See discussion of governance powers in Section II (A), and standards of conduct in Section III.

<sup>140</sup> For present system-wide policy and practices, see Executive Orders 715 and 849.

should require that management establish an appropriate risk assessment process and periodic risk cataloging system.

Again, the AOA has developed a model risk assessment checklist that could serve as a template for most auxiliary operations of functions.

Try online at: [http://www.foundation.sdsu.edu/aoa/resources/risk\\_mgmt/doc205.pdf](http://www.foundation.sdsu.edu/aoa/resources/risk_mgmt/doc205.pdf).

The assessment process and cataloging system should be reevaluated from time to time.

## **IX. Managing and Spending Invested Funds (including Charitable Assets)**

### **A. Policy Comes First, then Oversight – An Overview**

Auxiliary governing boards carry the responsibility for developing, implementing and periodically evaluating policies over invested assets.<sup>141</sup>

The idle funds of student organizations and unions are held in trust funds (which are pooled for investment) and overseen by the Chancellor's Office, but under the custodianship of the campus president or a designee.

For organizations with significant invested assets, portfolio policy and oversight is an undertaking of profound consequences, and managing these funds should be of singular importance by board members. Effective investment management requires the close collaboration between the board and management, and with investment counsel and portfolio managers. The effort must be a sustaining one, but it starts with the clear and complete articulation of the organization's policies *in formal statements* that include provisions governing the expenditure, investment, and use of such assets.

What investments standards apply to which assets under investment? California law is far from settled on this question. As discussed in Section IIIA, there are fairly clear "duty to investments" standards to which governing board members are held. Those standards do not apparently apply to "assets which are directly related to the corporation's public or charitable programs."<sup>142</sup> Such assets presumably include idle operational funds that are held temporarily in an interest-bearing account. The management (and investment) of operational funds<sup>143</sup> are likely subject to the more general "good faith and prudent" standards discussed in this paper.

There is a bit of a disconnect between California nonprofit corporation law and trust law over investment management standards, so auxiliary organizations with sizable invested assets attempt to comply with both sets of laws.

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<sup>141</sup> Exemplars for developing auxiliary organization investment policies, together with guidelines on endowment practices are posted by the Chancellor's Office at: [www.calstate.edu/investment\\_policy/](http://www.calstate.edu/investment_policy/).

<sup>142</sup> *Cal Corps Code* Section 5240(a).

<sup>143</sup> Also termed "program-related assets" under the *Uniform Prudent Management of Institutional Funds Act*. See Section IXB below.

For the purposes of this section, the term “institutional funds” refers to all assets that are held by an auxiliary organization from private or corporate donations to advance the charitable purpose(s) for which the organization was formed. These assets often come with various labels, none apparently accepted with any standardization or well-defined meanings. These included “endowment funds,” “quasi-endowments,” “annual funds,” or “capital funds.” These terms are often found in policies and are intended to convey different spending restrictions or uses to which the assets are dedicated. California laws over this area are of little help, since they rarely use such labels, and can carry somewhat different meanings.

Institutional funds do not include those funds used directly for the operations of the organization. How revenue from sources other than donations (commercial operations, earned indirect costs from externally-sponsored projects, or income from other activities related to corporate purposes) is invested and spent involves other more general standards discussed below. If the asset was donated, then the higher, more specific standards seem to apply.

The balance of this section describes, in summary, distinctions important to managing and investing institutional funds. Section B summarizes statutory standards applicable to this topic.

“True endowment” typically refers to a permanent fund whose principle is to be preserved in perpetuity, as conditioned by the donor(s) of the funds. Restrictions on the expenditure of the principle earnings may or may not be imposed by the donor, but the law requires adherence to any such conditions if the funds have been accepted by the organization (acting as a trustee under the law).<sup>144</sup> Such restrictions on an endowed fund are critical, since any subsequent contributions by others to the same fund take on the same primary fund characteristics, together with any earnings use restrictions.

“Term endowment” is a term used to set restrictions on the expenditure of fund principle or earnings for a fixed term (or when a specified event occurs).

“Quasi endowment” funds are those unrestricted assets (gifts, or surplus operating funds) the organization itself places under voluntary restrictions similar to a true or term endowment. Subsequent additions to such a fund take on the characteristics of that quasi endowment.

It is important to discern between endowment-type funds and those considered non-endowed, since only endowed funds are resources for the future of ongoing organization programs. So-called “annual funds” are generally available in full for current needs. There may be donor-designations on the uses to which some funds may be put. “Capital funds” are typically for new or replacement facilities or equipment, but the term is loosely applied in many cases to describe major new projects.

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<sup>144</sup> *Cal Probate Code* Section 16000.



## B. Statutory Requirements

As California nonprofit public benefit corporations, auxiliary organizations are subject to a number of statutory requirements set out in the *Nonprofit Public Benefit Corporation Law*<sup>145</sup> and some of the laws applicable to trusts in *California Probate Code*<sup>146</sup> governing the expenditure and investment of donated funds.<sup>147</sup>

There is solid statutory basis and case law precedent for the proposition that all charitable corporation (auxiliary organizations included) assets are considered to be in charitable trust by virtue of the organization's chartered purpose(s).<sup>148</sup> Unfortunately, there is some discordance when attempting to apply *Nonprofit Corporation Law*<sup>149</sup> and the *Trust Law*<sup>150</sup> to how funds should be managed for investment and use.

The most prudent approach is to attempt to comply with the provisions of both laws – at least stake out a documented and supportable path or fork taken!

### UPMIFA (Managing and Spending Institutional Funds).<sup>151</sup>

There is fairly clear statutory intent that certain charitable funds held by auxiliary organizations should be governed by the *Uniform Prudent Management of Institutional Funds Act* (UPMIFA).<sup>152</sup> UPMIFA sets standards for spending and investing of so-called “institutional funds” and includes special provisions for the expenditure of “endowment funds,” and for modifying restrictions on institutional funds. Also, UPMIFA standards and practices can be subject to the intent of the donor as expressed in a gift instrument.<sup>153</sup>

Under the Act, an “institutional fund” is a fund held by an institution exclusively for charitable purposes.<sup>154</sup> An “endowment fund” is defined as “an institutional fund, or any part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis.”<sup>155</sup> A “gift instrument” is a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.<sup>156</sup>

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<sup>145</sup> *Cal Corps Code* Section 5240 *et seq.*

<sup>146</sup> Sections 15000-19403.

<sup>147</sup> Nonprofit corporations are excluded from the *Uniform Prudent Investor Act* (UPIA) in *Probate Code* Sections 16045-16054.

<sup>148</sup> *Cal Bus & P C Code* Section 17510.8.

<sup>149</sup> *Cal Corps Code* Sections 5000 – 10841.

<sup>150</sup> *Cal Probate Code* Sections 15000 – 19403.

<sup>151</sup> First promulgated by the National Conference of Commissioners on Uniform State Laws in 1972, UMIFA was first adopted in California in the mid-70s, and its application expanded in 1990. The Act has recently been revised by the National Conference as the *Uniform Prudent Management of Institutional Funds Act* (UPMIFA), and enacted in California with some expanded refinements. See SB 1329, Statutes 2008, Chapter 715, and codified in *Cal Probate Code* Section 18501 *et seq.*

<sup>152</sup> *Ibid*, Sections 18501 – 18510. Section 18502(d) and (f) define the term “institution” to include auxiliary organization holding institutional funds.

<sup>153</sup> *Ibid*, Sections 18503(a), 18504(a) and 18505(a).

<sup>154</sup> *Ibid*, Section 18502(e).

<sup>155</sup> *Ibid*, Section 18502(b). The key aspect to this definition is that such funds may not be currently spent in their entirety.

<sup>156</sup> *Ibid*, Section 18502(c).

The organization's ("institution" under the Act)<sup>157</sup> governing board is responsible for the management of "institutional funds."<sup>158</sup> Governing board members must administer these *invested* funds with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity" would use.<sup>159</sup> In managing and investing such funds all the following factors, if relevant, must be considered in context with the whole portfolio:<sup>160</sup>

- General economic conditions;
- The possible effect of inflation or deflation;
- The expected tax consequences, if any, of investment decisions or strategies;
- The role that each investment or course of action plays with the overall investment portfolio of the fund;
- The expected total return from income and the appreciation of investments;
- Other resources of the institution;
- The needs of the institution and the fund to make distributions and preserve capital; and
- An asset's special relationship or special value, if any, to the charitable purposes of the institution.<sup>161</sup>

Institutional fund investment management may be delegated on a prudent and structured basis either to officers, committees, employees or agents, including investment counsel, or through contracts with compensated independent investment advisers, investment counsel or managers, banks, or trust companies with appropriate decision-making authority.<sup>162</sup>

### Investing and Spending Endowment Funds

Except as may be limited by the gift instrument, institutional funds under UPMIFA:

- May be invested and reinvested in any kind of property, or type of investment, consistent with UPMIFA standards;<sup>163</sup> retained or disposed of within a

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<sup>157</sup> Ibid, Section 18502(d) and (f).

<sup>158</sup> Ibid, Section 18503(f) referring to nonprofit director duty and liability standards in *Cal Corps Code* Section 5240. See page 9 above.

<sup>159</sup> Ibid, Section 18503(b), and review board member duty standards relating to investments on page 9 above. Note that the duty of investment care spelled out in *Cal Corps Code* Section 5240 is harmonized with the UPMIFA standard of care. See *Cal Corps Code* Section 5240(e).

<sup>160</sup> Ibid, Section 18503(e)(2).

<sup>161</sup> Ibid, Section 18503(e)(1)(A-H).

<sup>162</sup> Ibid, Sections 18505(a)-(e).

<sup>163</sup> Ibid, Section 18503(e)(3).

reasonable period of time after receiving property based upon UPMIFA standards;<sup>164</sup> and, be pooled with other institutional funds for management and investment purposes.<sup>165</sup>

- Shall be subject to a diversified investment portfolio, unless special circumstances relating to the fund's purpose are otherwise better served.<sup>166</sup>

The UPMIFA endowment fund appropriation and accumulation standards give the institution good faith and prudent discretion (subject to gift instrument terms otherwise), considering the following factors:

- The duration and preservation of the endowment fund;
- The purposes of the institution and the endowment fund;
- General economic conditions;
- The possible effect of inflation or deflation;
- The expected total return from income and the appreciation of investments;
- Other resources of the institution; and
- The investment policy of the institution.<sup>167</sup>

#### Modifying or Releasing Use or Investment Restrictions

UPMIFA also includes processes through which an institution may release or modify, in whole or in part, restrictions over an institutional fund relating to its management, investment or purpose.<sup>168</sup>

#### Investing and Spending Other Funds

There are, as has been mentioned, other idle organizational assets that should be properly invested, even though they arguably fall outside UPMIFA. The investment standards governing these funds are more general, keeping in mind that there is statutory authority for the position that such assets should also be considered *in charitable trust* given the corporate purpose(s) of the organization.

There has already been reference to the statutory duty-standards, including to investments.<sup>169</sup> See Section IIIA above.

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<sup>164</sup> Ibid, Section 18503(e)(5).

<sup>165</sup> Ibid, Section 18503(d).

<sup>166</sup> Ibid, Section 18503(e)(4).

<sup>167</sup> Ibid, Section 18504(a)(1-7).

<sup>168</sup> Ibid, Section 18506.

<sup>169</sup> *Cal Corps Code* Section 5231(a).

Additionally, CSU guidance on investments should inform board members. A 1977 Board of Trustees resolution urges auxiliary boards to include a social responsibility provision in investment policies.<sup>170</sup> Auxiliary organizations may, under current system-wide practices, invest idle funds in State investment vehicles. Funds of student body organizations are held by the university under *Education Code* custodianship requirements.<sup>171</sup>

Finally, Board members should be aware of the “Business Best Practice Guidelines” issued by the Chancellor’s Office regarding investments. These guidelines seek “to protect and properly account for investments and investment income in accordance with source restrictions and other requirements,” and include five (5) action standards dealing with investment policy, segregation of duties, recording of investment income, safekeeping physical assets, and reconciliation and reviews.<sup>172</sup>

## X. Fundraising Requirements

There is a broad and complex system of required fundraising practices at the national, state, and local levels, in addition to CSU requirements. The scope of this section is limited to the essential compliance principles and concepts. See Appendix A resources for further study.

### A. Federal

There are strict disclosure and substantiation requirements under Federal statutes and regulations on charitable organizations that solicit and accept deductible gifts.

Income tax deductions are disallowed for charitable gifts of \$250 or more without a timely written receipt from the donee to the donor.<sup>173</sup> Special substantiation and reporting rules apply to vehicle gifts.<sup>174</sup>

Donee organizations receiving or seeking contributions involving a *quid pro quo* for the donors must satisfy additional – and separate -- disclosure requirements.<sup>175</sup>

While there are monetary penalties for disclosure and substantiation noncompliance, the more effective enforcement lever is the possible loss of the donor’s income tax deduction on the contribution.

### B. State & Local

General. California law regulates charitable solicitations,<sup>176</sup> and some cities and counties have local registration, permitting and financial disclosure ordinances.<sup>177</sup>

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<sup>170</sup> RFIN 7-78-6.

<sup>171</sup> *Cal Ed Code* Section 89300 *et seq.*, and Title 5, Section 41409.

<sup>172</sup> See “Compilation” at Section 8.9, online: [www.calstate.edu/FT/AuxOrg/PDF0800/Compilation.shtml](http://www.calstate.edu/FT/AuxOrg/PDF0800/Compilation.shtml).

<sup>173</sup> *U.S. Internal Revenue Code* Section 170(f)(8).

<sup>174</sup> *Ibid* at Section 170(f)(12).

<sup>175</sup> *Ibid* at Section 6115

<sup>176</sup> *Cal Bus & Prof Code* Sections 17510-17510.9.

<sup>177</sup> *Ibid* at Section 17510.7 regarding required consistency for local laws with State law.

Disclosures Required. Charitable organizations (including auxiliary organizations) are subject to “solicitation for charitable purposes” disclosure requirements<sup>178</sup>, including both the timing and form thereof.<sup>179</sup>

In certain instances, an annual filing (Form CT-694) with the Registry of Charitable Trusts is required to disclose financial information about fundraising efforts, if the organization:<sup>180</sup>

- Collected more than 50% of annual income and received more than \$1 million from California donors in prior calendar year; and
- Spent more than 25% of annual income in specified operational expenses.

The completed CT-694 is a public document subject to review and request rules.<sup>181</sup>

Unlawful Acts and Practices. Charitable organizations and commercial fundraisers may not misrepresent the purpose of the organization or the nature, purpose, or beneficiary of a solicitation, either through words, conduct, or failure to disclose a material fact.<sup>182</sup> There are enumerated prohibited acts, regardless of injury, in the planning, conduct, or execution of any solicitation or charitable sales promotion.<sup>183</sup>

Violation of state disclosure rules may result in civil and criminal penalties and remedies.<sup>184</sup>

Use of Commercial Fundraisers and Fundraising Counsel. There are strict disclosure, registration, and written contract requirements in the use of commercial fundraisers and fundraising counsel by a charitable organization, including:

- Commercial fundraisers are subject to specific registration, reporting, deposit, fee and records requirements;<sup>185</sup>
- Both the charitable organization and any fundraising professionals must be registered prior to the commencement of any solicitation activity, including both direct solicitation, or the planning or consultation services provided by fundraising counsel;<sup>186</sup> and

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<sup>178</sup> Ibid at Sections 17510.2(a) and 17510.3(a).

<sup>179</sup> Ibid at Sections 17510.3(a) and 17510.4.

<sup>180</sup> Ibid at Section 17510.9(a).

<sup>181</sup> Ibid at Section 17510.9(c).

<sup>182</sup> *Cal Gov't Code* Section 12599.6(a).

<sup>183</sup> Ibid at Section 12599.6(f).

<sup>184</sup> *Cal Bus & Prof Code* Section 17536; and the Attorney General may file action for violation of the *Supervision of Trustees and Fundraisers for Charitable Purposes Act* (*Cal Gov't Code* Section 12580-12599.7).

<sup>185</sup> *Cal Gov't Code* Sections 12599-12599.7

<sup>186</sup> Ibid at Sections 12585 and 12599.6(c).

- Charitable organizations must enter into a written contract for each solicitation, campaign, event, or service employing a commercial fundraiser, and such contracts must include mandatory provisions, and be available for inspection by the Attorney General.<sup>187</sup> Model contracts are posted on the Registry of Charitable Trusts website.

Special Fundraising Events. Any plans for special fundraising activities, including solicitations for vehicles, aircraft or vessels, bingo or similar games, raffles or other controlled games, should include a thorough review of the regulatory framework for such activities.

### **C. CSU**

The Board of Trustees has designated “gifts, bequests, devices, endowments, trusts and similar funds” as an essential function appropriately performed by qualified auxiliary organizations.<sup>188</sup> Serving this function requires the organization to be in good standing, with an operating agreement in effect authorizing that specific function.<sup>189</sup>

Only a “grant, contract, bequest, trust, or gift” conditioned that it may be used only for purposes consistent with policies of the Board of Trustees, may be accepted by an auxiliary organization.<sup>190</sup> In implementation of this standard, the Chancellor has established policies and practices.<sup>191</sup>

Valuable policy and best practices guidance for auxiliary organizations responsible for the campus fundraising function can be found at:

<https://www.calstate.edu/universityadvancement/intranet/policies-procedures/index.shtml>

## **XI. Role of the Attorney General**

### **A. Oversight Responsibility**

The California Attorney General exercises continuing and extensive supervision responsibility over charitable organizations (including auxiliary organizations) under both common law and a comprehensive statutory framework.<sup>192</sup> This oversight extends to organization registration and reporting, and audit/investigation of, and intervention with charitable solicitation practices and how charitable assets are managed and spent.

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<sup>187</sup> Ibid at Section 12599(i).

<sup>188</sup> *Cal Code of Regs Title 5 Section 42500(a)(10)*.

<sup>189</sup> Ibid at Sections 42406 and 42501.

<sup>190</sup> *Cal Ed Code Section 89903*. Also see *Title 5 Section 42500(b)* providing that such gifts shall be accepted, maintained and used in accordance with policies, rules, and regulations of the Board of Trustees.

<sup>191</sup> Executive Orders 276, 440, 676, and 1052.

<sup>192</sup> The *Supervision of Trustees and Fundraisers for Charitable Purposes Act*, *Cal Gov't Code Section 12580 et seq.*, the *Cal. Corps Code Sections 5233, 5250, 5913, 6324, and 6510-11*; *Cal. Bus & Prof Code Sections 17200 and 17500 et seq.*; and *Cal. Probate Code Sections 16320 et seq.* and 18501 *et seq.*, for example.

## **B. Organization**

The Charitable Trust Section consists of two coordinated operations:

- The *Registry of Charitable Trusts* manages the registration and annual reporting functions. The *Registry* also receives and reviews notices of transactions required to be filed by charitable organizations. See below.
- The *Legal and Audit Unit* is the enforcement arm of the Charitable Trust Section, handling investigations, audits, and civil litigation. See below.

## **C. Registration and Reporting**

Initial registration (Form CT-1) with the *Registry* is required within thirty (30) days of when a new charitable organization receives assets. Annual reporting to the *Registry* is typically done through the filing of the Form RRF-1 and the IRS Form 990.

## **D. Audit and Intervention Authority**

The focus of the enforcement function (investigations, audits and civil litigation) is on the mismanagement and diversion of charitable assets and fundraising malpractice, relying on multiple jurisdiction sources, and developed from report filings and complaints received.

## **E. Transactions Requiring AG Notice or Consent**

Certain transactions of a charitable organization require notice to, or in certain cases consent by the Charitable Trusts Section, including (as it relates to auxiliary organizations):

- Voluntary dissolution;
- Merger;
- Sale or disposition of all or substantially all assets;
- Conversion of public benefit corporation to another form;
- Self-dealing transactions; and
- Loans to directors or officers.

## **F. Common Investigation Issues**

The Charitable Trusts Section encounters the following problems on a frequent basis:

- Self-dealing transactions;
- Prohibited Loans;
- Loss of charitable assets through speculative investments;

- Excessive compensation and other remunerations (salaries and benefits, travel and entertainment, legal and other professional fees);
- Sale, transfer or conversion of assets;
- Illegal use of charitable funds;
- Diversion of charitable trust funds from intended purposes; and
- False or misleading solicitation of charitable donations.

## **XII. Borrowing**

### **A. General**

Nonprofit corporations have the power to incur indebtedness, subject to restrictions in their articles of incorporation or bylaws.

Auxiliary organizations have come to rely with increasing scope and frequency on borrowing for major projects through loans, bond issues or similar debt instruments. Financing arrangements can be complex and often represent long-term and consequential demands on operating assets.

While it is beyond the scope of this monograph to delve into the many aspects of nonprofit corporation/auxiliary organization project financing vehicles, it should be clearly understood that Board members must exercise the duty of due care analyzed in Section III above when considering and acting on such obligations.

Among the certain nonprofits that have the ability to borrow on a tax-exempt basis, auxiliary organizations have a credible history of such financing structures. However, under a system-wide policy framework, major capital project debt financing by auxiliary organizations has been relatively focused on a singular approach.

### **B. System-wide Revenue Board Program (SRB)**

For the past several years the CSU has evolved a comprehensive financing and debt management policy,<sup>193</sup> together with implementing practices that include the financing needs and activities of auxiliary organizations.

Executive Order No, 994 details the practices to be followed by a university and an auxiliary organization to utilize the SRB or other “alternative financing activities.” See: [www.calstate.edu/EO/](http://www.calstate.edu/EO/) (index to all Executive Orders).

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<sup>193</sup> Trustees CSU Policy for Financing Activities, Resolution RFIN 03-02-02. This resolution appears as Attachment B to Executive Order No. 994, dated October 23, 2006.



## ***APPENDIX***

***A Selected References on Governance***

***B Board Approval of Transaction with Interested Director -- Checklist***

***C Open Meeting Law Requirements for Auxiliary Organizations***

***D Redesigned IRS Form 990 "Crosswalk" to California Charities Law***

***E Typical Governing Board Questions on Risk and Insurance***

## SELECTED REFERENCES ON GOVERNANCE

- A. *Auxiliary Organization Standards of Conduct and Commitment: A Policy Development Guide*, AOA Monograph, 2009
- B. *CSU Auxiliary Organizations & Affiliated Nonprofit Entities – The Supervision of Trustees and Fundraisers for Charitable Purposes Act & Charitable Solicitation Compliance Manual*, Finestone & Richter, 2008
- C. *Governance for Nonprofits: A Summary of Organizational Governance Issues & Principles for Directors of Nonprofit Organizations*, Society of Corporate Secretaries & Governance Professionals, August 2008
- D. *Guidebook for Directors of Nonprofit Corporations*, American Bar Association, 2003
- E. *Nonprofit Governance & Management – Executive’s Guide*, Futter, 2002
- F. *Principles of Good Governance & Ethical Practice: A Guide for Charities & Foundations*, Independent Sector, October 2007
- G. Charitable Trusts Section California Attorney General website:  
<http://ag.ca.gov/charities/>
- H. *Board Fundamentals: Understanding Roles in Nonprofit Governance*, 2d Edition, BoardSource.
- J. *Advising California Nonprofit Corporations*, California CEB
- K. Tax Information for Charities & Other Non-Profits, IRS website:  
<http://www.irs.gov/charities/>
- L. CSU Chancellor’s Executive Order No. 1059, *Utilization of Campus Auxiliary Organizations*, June 6, 2011.

## **Board Approval of Transactions With Interested Directors**

### ***CHECKLIST***

#### **Before the Board Meeting:**

- Identify interested director's material financial interest and ascertain whether the proposed transaction falls within any exceptions (pre-conditions).
- Gather material facts for disclosure to the Board about the proposed transaction and the director's interest.
- Appointed disinterested person or committee to investigate possible reasonable alternatives for report to the Board.

#### **At the Board Meeting:**

- Disclose all material facts about the proposed transaction and the director's interest.
- Hear report by disinterested person or committee on possible alternatives.
- Have Board find and resolve the following, by vote of majority of directors then in office, without counting vote of interested directors (each director's vote or abstention should be recorded in Minutes):
  - ✓ That the proposed transaction is in the corporation's best interests and for the corporation's own benefit;
  - ✓ That the proposed transaction is fair and reasonable to the corporation; and
  - ✓ That, after reasonable investigation, the Board has found that the corporation cannot obtain a more advantageous arrangement with reasonable efforts under the circumstances.
- Have the Board approve the proposed transaction, by a vote of a majority of directors then in office, excluding the vote of the interested director (record each director's vote or abstention).

#### **After the Board Meeting:**

- Prepare Meeting Minutes, particularly –
  - ✓ Full disclosure to the Board;
  - ✓ Investigation and report to the Board;
  - ✓ Findings of the Board (in Resolution); and
  - ✓ Board approval of the transaction, including vote of each director.

# OPEN MEETING LAW REQUIREMENTS

*Applicable to Auxiliary Organizations:  
A Comparison Summary Chart*

Requirement	<b>Romero Act</b> (Student Body Organizations)	<b>Seymour</b> (Other Auxiliary Organizations)
<b>Coverage</b>	<p>Governing body (“legislative body”) of student body organizations formed or operating under <i>Cal Ed Code § 89300</i>;</p> <p style="text-align: center;">[§89305.1(b)(A)(i)]</p> <p>Governing body of statewide student organization representing CSU students or CSU campus student body organization governing bodies.</p> <p style="text-align: center;">[§89305.1(b)(A)(ii)]</p>	<p>Governing board of an auxiliary organization formed under <i>Cal Ed Code §89900 et seq.</i> except student body organizations.</p> <p style="text-align: center;">[§89920]</p>
<b>Sub-Bodies</b>	<p>Any commission, committee, board, sub-board, or other board created by charter, resolution, or governing body formal action, excluding “advisory committee.”</p> <p style="text-align: center;">[§89305.1(b)(A)(iii)]</p>	<p>Provisions apply to any sub-board of the auxiliary organization governing board.</p> <p style="text-align: center;">[§89920]</p>
<b>Meeting Defined</b>	<p>Congregation of majority membership of governing body or sub-body at same time and place to hear, discuss, or deliberate on item within its purview.</p> <p style="text-align: center;">[§89305.1(b)(B)]</p> <p>“Meeting” does <i>not</i> include:</p> <ul style="list-style-type: none"> <li>• Individual contacts/conversations between a governing body or sub-body member and another person; or</li> <li>• A governing board or sub-body majority attending a noticed public meeting of another governing body or entity, a public conference on general public interest issues, or a purely social or ceremonial occasion, as long as they do not discuss among themselves specific business within its purview.</li> </ul> <p style="text-align: center;">[§89305.1(b)(B)(i), (ii) &amp; (iii)]</p>	<p>Provisions do not define the term “meeting.” In general, a meeting is a gathering of a quorum of a body, no matter how informal, where business is discussed or transacted. (<i>61 Ops. Cal. Atty. Gen. 220 (1978).</i>)</p>
<b>Secret Ballots &amp; Semi-closed Meetings</b>	<p>Secret ballots are prohibited.</p> <p style="text-align: center;">[§89305.1(e)]</p> <p>See Note A below on semi-closed meetings.</p>	<p>See Note A below.</p>

Requirement	<b>Romero Act</b> (Student Body Organizations)	<b>Seymour</b> (Other Auxiliary Organizations)
<b>Public Participation at Meetings</b>	<p>Any person may upon request obtain meeting agenda/documents packet. Request process is defined.</p> <p style="text-align: center;">[§89305.7]</p> <p>Every regular meeting agenda shall include opportunity for public to directly address governing body on any item affecting campus or statewide higher education. No action may be taken on such item unless it duly appeared on meeting agenda. Exceptions where a prior sub-body has met and afforded public input.</p> <p style="text-align: center;">[§89306(a)(1)(2)]</p> <p>Special meeting notices shall provide for public comment to governing body or sub-body on meeting agenda items.</p> <p style="text-align: center;">[§89306(a)(3)]</p> <p>Reasonable meeting regulations may limit public participation time limitations on any one agenda item and for each person.</p> <p style="text-align: center;">[§89306(b)]</p> <p>Governing body or sub-body may not prohibit public criticism of body and/or organization.</p> <p style="text-align: center;">[§89306(c)]</p> <p>No meeting shall be held in a facility that prohibits admittance of anyone in a classification protected by law or not free to attain entrance.</p> <p style="text-align: center;">[§89307.2(a)]</p> <p>Meeting notices, agenda, announcements or other required reports need not name any tortuous sexual conduct or child abuse victim or alleged victim unless the person's name has been publicly disclosed.</p> <p style="text-align: center;">[§89307.2(b)]</p>	<p>Any individual or medium shall upon written request receive a meeting notice one week before the meeting date. Meeting notice requests shall be valid for one year unless a renewal request is filed.</p> <p style="text-align: center;">[§89921]</p> <p>All persons are permitted to attend governing or sub-board meetings, unless otherwise provided by these provisions.</p> <p style="text-align: center;">[§89920]</p> <p>No governing or sub-board shall take action on any issue until that issue has been publicly posted for at least one week.</p> <p style="text-align: center;">[§89924]</p>
<b>Notice of Regular Meetings</b>	<p>Governing body or sub-body must annually set time and location(s) for holding regular meetings.</p> <p style="text-align: center;">[§89305.5(a)]</p> <p>A notice and agenda shall be posted in an accessible public place at least 72 hours before each regular governing or sub-body meeting. The agenda must include a general description of each meeting agenda item.</p> <p style="text-align: center;">[§89305.5(b)(1)]</p>	<p>Any individual or medium shall upon written request receive a meeting notice one week before the meeting date. Meeting notice requests shall be valid for one year unless a renewal request is filed.</p> <p>Governing or sub-boards must annually set time and location for holding regular meetings.</p> <p style="text-align: center;">[§89921]</p> <p>Governing or sub-boards shall at least one week before a regular meeting date give written notice of the meeting.</p> <p style="text-align: center;">[§89924]</p>

<b>Requirement</b>	<b><i>Romero Act</i></b> (Student Body Organizations)	<b><i>Seymour</i></b> (Other Auxiliary Organizations)
<b>Notice of Special Meetings</b>	<p>Written call and notice to each governing or sub-body member and requesting local media at least 24 hours before special meeting called by presiding officer or body majority. Notice must include meeting time, location and agenda.</p> <p>Written call and notice to body members may be dispensed with by filed written waivers before meeting or as to members actually present when meeting convenes.</p> <p style="text-align: center;">[§89306.5(a)]</p> <p>Special meeting call and notice shall also be posted in accessible public location.</p> <p style="text-align: center;">[§89306.5(b)]</p>	<p>Written call and notice (delivered personally or by mail) to each governing or sub-board member and requesting individuals and media, or persons directly affected by the meeting, at least 24 hours before meeting noting time, place and business to be conducted.</p> <p>Notice may be waived in writing by director(s) filed with clerk or secretary before or at special meeting; and is deemed waived by presence at meeting</p> <p style="text-align: center;">[§89922]</p>
<b>Notice of Emergency Meetings</b>	<p>For defined “emergency situations” governing body may dispense with 24-hour notice and posting requirement.</p> <p>1-hour telephone notice to local requesting media required unless service out, then as soon after meeting as possible.</p> <p style="text-align: center;">[§89306.5(c) &amp; (d)]</p> <p>Emergency meetings may not be held in closed session.</p> <p style="text-align: center;">[§89306.5(e)]</p> <p>Otherwise, emergency meetings subject to special meeting notice requirements.</p> <p style="text-align: center;">[§89306.5(f)]</p> <p>Emergency meeting Minutes, with actions taken and roll call votes, together with list of those notified or attempted to notify, shall be posted in a public place as soon as possible after meeting and for at least 10 days.</p> <p style="text-align: center;">[§89306.5(g)]</p>	<p>No “emergency meeting” notice provision, but under “special meeting” provision (see above), the 24 hour notice requirement may be waived by directors under specified circumstances.</p> <p style="text-align: center;">[§89922]</p>
<b>Notice of Sub-Body Meetings</b>	<p>Same as apply to the governing body.</p> <p style="text-align: center;">[§89305.1(b)(1)(A)(iii)]</p>	<p>Same as apply to the governing board.</p> <p style="text-align: center;">[§89921]</p>

Requirement	<b>Romero Act</b> (Student Body Organizations)	<b>Seymour</b> (Other Auxiliary Organizations)
<b>Notice of Closed Sessions</b>  <i>General:</i>    <i>Liability Claim or Pending Litigation:</i>	<p>Prior to any closed session, the governing or sub-body shall disclose in open meeting, the item(s) to be discussed in closed session by reference to agenda listing.</p> <p style="text-align: center;">[§89307(f)(1)]</p> <p>Through the meeting agenda or by public announcement, the governing or sub-body must identify any closed session to be held, together with the statutory provision authorizing the session. In liability claim or litigation circumstances, either the title of the closed session matter shall also be identified, or a statement included that to do so would thwart service of process or pending settlement negotiations favorable to the organization.</p> <p style="text-align: center;">[§89307(b)(7)]</p>	<p>The governing or sub-board meeting notice and agenda should include reference to any closed session to be held, together with the authority for holding such a session.</p> <p style="text-align: center;">[§89923-24]</p>
<b>Closed Session</b> [Exception to open meeting requirements]	<p>A host of specific exceptions to open meeting requirements are afforded governing or sub-bodies.</p> <p style="text-align: center;">[§89307]</p>	<p>Provisions briefly identify specific matters that may be considered and in some cases acted upon in closed session.</p> <p style="text-align: center;">[§89923]</p>
<b>Basic Requirements</b>	<p>See above for closed session notice requirements.</p> <p>All closed session circumstances must be expressly authorized under the Act.</p> <p style="text-align: center;">[§89307(a)]</p> <p>Only matters stated in open meeting as being the subject of a closed session shall be considered in that closed session.</p> <p style="text-align: center;">[§89307(f)(1)]</p> <p>After closed session, governing or sub-board must reconvene into open session prior to adjournment and make any required disclosures on closed session action(s).</p> <p style="text-align: center;">[§89307(f)(2)]</p>	<p>Only closed session matters expressly enumerated are authorized.</p> <p style="text-align: center;">[§89923]</p>
<b>Real Property Transactions</b>	<p>May be used to advise negotiator on price &amp; terms when property &amp; parties are identified in advance.</p> <p style="text-align: center;">[§89307(a)(1)]</p>	<p>No provision, unless transaction could be classified as an investment decision where public discussion could have a negative impact on the organization's financial situation. See below.</p>

<b>Requirement</b>	<b>Romero Act</b> (Student Body Organizations)	<b>Seymour</b> (Other Auxiliary Organizations)
<b>Liability Claim or Pending Litigation</b>	Express definition of pending litigation, including process for implementation. This exception is the exclusive application of the attorney-client privilege to closed session.  [§89307(b)]	May be used to consider matters relating to litigation.  [§89923]
<b>Facility or Public Services Threats</b>	May be used to meet with law enforcement representatives on matters posing public services and/or facilities security threat.  [§89307(c)(1)]	No provision.
<b>Employees</b>	May be used to consider employee appointment, performance evaluation, discipline or dismissal.  [§89307(c)(1)]  “Employee” includes an officer, independent contractor functioning as an officer, or an employee, but not elected official, governing or sub-board member, or other independent contractor.  [§89307(c)(4)]	May be used to consider matters relating to the appointment, employment, performance evaluation, or dismissal of an employee. “Employee” does not include a person elected or appointed to an office.  [§89923]
<b>Quasi-Judicial Deliberations</b>	May be used to hear complaints or charges brought against an employee by another person or employee, unless the employee requests a public session.  [§89307(c)(1)]	May be used to hear complaints or charges brought against an employee by another person or employee, unless the employee requests a public hearing.  [§89923]
<b>Labor Negotiations</b>	May be used to advise representative on negotiations with employees.  [§89307(e)(1)]	May be used to consider matters relating to collective bargaining.  [§89923]
<b>Investments</b>	No provisions.	Upon favorable majority vote, governing or sub-board may discuss investments where public a public discussion could have a negative impact on the organization’s financial situation. The final decision must be made in open session.  [§89923]
<b>Public Records &amp; Confidentiality Privileges</b>	None specified in Act.	No provisions.
<b>Remedies</b>	None specified in Act.	None specified.



<b>Requirement</b>	<b><i>Romero Act</i></b> (Student Body Organizations)	<b><i>Seymour</i></b> (Other Auxiliary Organizations)
<b>Violations</b>	Misdemeanor sanctions against any governing or sub-body member attending meeting when “action taken” with knowledge of violation of open meeting law requirements.  [§89307.4]	Misdemeanor sanctions against any governing or sub-board member attending meeting when “action taken” with knowledge of open meeting law violations.  [§89927]

- A. The California Attorney General has issued a series of consistent written opinions relating to secret ballots and semi-closed meetings by local and state governing bodies under both the *Ralph M. Brown Act* and *Bagley-Keene Act*. These appear analogous to the public policy purposes of *Romero* and *Seymour* and are of some predictive value in judging requirements for auxiliary organization governing boards. These opinions concluded that meetings could not be “semi-closed” where only certain interested members of the public were given access to the meeting.

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# **The Redesigned IRS Form 990 and California Charitable Organization Laws**

## **I. Background**

When the Internal Revenue Service revised Information Return of Tax-Exempt Organization (Form 990) it expanded its questions fields and schedules to better assess the tax-exempt status. The revised form seeks to improve transparency and compliance and reduce burden. It consists of the core form applicable to all filers, together with a number of detailed schedules, only some of which are applicable to filing organizations.

The new 990 includes questions about an organization's governance structure, policies, and practices, as well as additional schedules that call for information concerning the internal and external operations of the charity

The form, along with certain schedules and the instructions, also has the potential to mislead organizations about the regulatory standards to which they are held under specific provisions of California statutes and regulations. California holds charitable organizations to strict governance, management, reporting and disclosure requirements. So it is important to draw these distinctions and “crosswalk” from the federal rules to maintain tax-exempt status over to California charities law.

## **II. Crosswalk Comparative Analysis**

The IRS Form 990 changes below should prompt a California charitable organization to compare and understand California law governing the same or similar topical area.

### ***Instructions Form 990, Part VI (Governance, Management, & Disclosure)***

The instructions make clear that, although the information sought is not required under the Internal Revenue Code, the IRS believes the questions have a bearing on continued entitlement to tax-exempt status:

Even though governance, management, and disclosure policies and procedures generally are not required under the Internal Revenue Code, the IRS considers such policies and procedures generally to improve tax compliance. The absence of appropriate

policies and procedures may lead to opportunities for **excess benefit transactions**, inurement, operation for non-exempt purposes, or other activities inconsistent with exempt status. (Emphasis in original)

The IRS instructions then include, however, the following statement, which could be interpreted as allowing a charity discretion concerning how it conducts its operations—a discretion that may not exist, given specific provisions of applicable state law:

Whether a particular policy, procedure, or practice should be adopted by an organization may depend upon the organization’s size, type, and culture. Accordingly, it is important that each organization consider the governance policies and practices that are most appropriate for that organization in assuring sound operations and compliance with the tax law.

While this suggestion that a charity has wide discretion to choose among governance alternatives may be consistent with the IRS’s recognition of a lack of prescribed standards at the federal level, that discretion may not exist under applicable state law. State law may remove any discretion by imposing governance obligations applicable across the board to all charities. Or state law may prescribe obligations that are applicable to charities at certain revenue and asset levels, but not at others. In both cases, a discretion that might otherwise be allowed under federal law has been displaced by a specific state regulatory provision.

In California, the Attorney General oversees charities. The authority proceeds from the common law as well as various California statutes, including the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code, §§ 12580-12599.7), the Nonprofit Corporation Law (Corp. Code, §§ 5500-10841), and the Unfair Competition Law (Bus. & Prof. Code, §§ 17200-17210, 17500-17582). The Attorney General’s oversight authority is implemented in regulations that are set forth in title 11 of the California Code of Regulations.

This body of state law differs in some respects from federal tax law applicable to charities. More broadly, it establishes standards of conduct for charities that, as the IRS 990 instructions recognize, are “not required under the Internal Revenue Code.”

For charities incorporated or doing business in California, various lines and schedules of the new 990 can serve as a helpful checklist of charity governance issues that are of concern to both the federal and state governments. More important, they should call to mind specific standards that, while absent from federal tax law, must be followed by California charities. Set forth below are the requirements of California law that relate to the information called for by the new 990. Also set forth are the differing federal and state requirements for financial reporting.

### ***Distinctions between Financial Thresholds for Filing Reports***

The IRS requires that a nonprofit organization file some version of the 990 if its gross receipts are over \$25,000. If gross receipts are \$25,000 or below, only IRS Form 990-N (e-Postcard) need be filed.

The California Attorney General has different filing requirements for charities. Every year, all California charities, regardless of gross revenue or total assets, must file Form RRF-1, the Annual Registration Renewal Fee Report. And because the Attorney General uses the 990 as one of the reporting tools for charities, a charity may sometimes be required to file a 990 with the Attorney General even when there is no requirement that a 990 be filed with the IRS. For instance, a California public benefit corporation that is not exempt from tax under federal law must nonetheless file with the Attorney General an IRS Form 990, 990-EZ, or 990PF, as applicable, if either its annual gross revenue or its gross assets, at all times during its fiscal year, are \$25,000 or more. And even if it is below those income and asset thresholds, a California charity must file a 990 with the Attorney General in the following situations:

1. it has not filed a Form 990 for 10 years;
2. the corporation or unincorporated association was dissolved or merged, the trust was terminated or modified, all or substantially all of the assets of the corporation or trust were sold or transferred, or the corporate articles were amended to change the charitable purposes of the corporation;
3. the charitable purposes of the corporation, unincorporated association, or trust were abandoned by the directors or trustees;

4. there were any self-dealing transactions, as defined in California Corporations Code section 5233, or any transactions described in Probate Code section 16004, or any loans made by the corporation or trust to a director, officer or trustee.

***Form 990 Part VI (Governance, Management & Disclosure)***

**Section A (Governing Body and Management)**

**Line 1a (number of voting members of governing body)**

Corporations Code section 5210 provides that, subject to exceptions in the code and the articles or bylaws, all corporate powers shall be exercised by or under the ultimate direction of the board of directors. Corporations Code section 5213 provides that a corporation shall have, at a minimum, a president or chairman of the board, a secretary, and a chief financial officer, and that neither the secretary nor the chief financial officer may serve concurrently as president or chairman of the board.

**Line 1b (number of voting members that are independent)**

Corporations Code section 5227 provides that not more than 49 percent of persons serving on the board of directors may be interested persons. "Interested person" includes (1) any person currently being compensated by the corporation for services rendered to the corporation within the 12 previous months, excluding reasonable compensation paid to a director as a director, and (2) any one of a defined range of relatives of such a person.

**Line 2 (whether officers, directors, trustees, or key employees had a family or business relationship with another such person)**

Corporations Code section 5233 defines self-dealing transactions involving directors and prescribes a method for dealing with them.

**Line 3 (delegation of management duties)**

Corporations Code sections 5210, 5212, and 5231, taken together, provide for delegation of the powers of the board of directors to committees or other persons, subject to certain limitations, and prescribe a standard of care.

**Line 4 (significant changes to organizational documents)**

Corporations Code sections 5810-5820 prescribe permissible amendments to the articles of incorporation and the manner of making them.

**Lines 6-7 (organizations with members and the powers of members)**

Corporations Code sections 5310-5354 pertain to nonprofit corporations that have members and provide for the rights and obligations of members and the issuance, types, transfer, and termination of memberships.

**Line 8 (documentation of meetings of governing body and committees with authority to act for governing body)**

Corporations Code sections 5212 and 6320 provide for notice of and conduct of board meetings and the keeping of minutes of board and committee meetings.

**Line 10 (approval of Form 990 by the governing body)**

Corporations Code section 5231 prescribes the standard of care and liability of directors.

**Section B (Policies)**

**Line 12a (conflict of interest policy)**

Corporations Code sections 5231, 5233, 5236, and 5237 govern the standard of care for directors, self-dealing transactions, loans or guaranties for an obligation of a director or officer, and liability of directors.

**Line 15 (determination of compensation for officers and key employees) (Also see Part VII and Schedule J of IRS Form 990)**

Corporations Code section 5235 provides that executive compensation must be just and reasonable and prescribes liability for excessive compensation.

Government Code section 12586 requires review and approval by the board, an authorized committee of the board, or the trustee or trustees of a charitable trust, of the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to ensure that it is just and reasonable. This review and approval must take place

upon hiring, whenever the term of employment of the officer is renewed or extended, and whenever the officer's compensation is modified.

### **Section C (Disclosure)**

#### **Line 18 (manner of making IRS Forms 1023 and 990 available for inspection)**

Government Code section 12586 requires that a charity's audited financial statements be made available for public inspection.

#### ***Form 990 Part VII (Compensation)***

See reference to Corporations Code section 5235 and Government Code section 12586 above, regarding line 15 of Part VI.

In addition, Corporations Code section 5236, with certain exceptions, prohibits loans to directors and officers unless approved by the Attorney General.

## **Typical Questions from a Governing Board Concerning the Organization's Risk and Insurance**

1. What risks does the organization face?
2. Has the risk manager listed and defined those risks?
3. With respect to the exposures faced, how probable is the occurrence of a loss resulting there from?
4. What would happen to the organization's services, programs and interests if such a loss were incurred?
5. Who outside the organization would be affected by such an event?
6. Of those risks, which could be avoided by reorganizing the organization's activities?
7. Which risks could be reduced by indemnification?
8. Is the party (indemnitor) financially responsible?
9. Is the indemnification adequately documented?
10. Where relying upon insurance of third parties (e.g., owners' insurance of automobiles used in the organization's business), has the organization secured adequate information on this coverage?
11. Of risks that cannot be reorganized or indemnified, which ones can be transferred or avoided?
12. Which risks cannot be transferred or avoided?



13. What kinds of insurance policies does the organization carry?
14. Do these policies cover all insurance risks?
15. What are the dollar limits of the various policies? Are they enough? Or are any of them unnecessarily high?
16. Does the insurance cover just the organization, or does it cover parties collaterally at risk as well, such as directors, officers, employees, volunteers or third parties injured with or without fault?
17. If those policies do not cover such parties, can riders be obtained to do so?
18. Have the insurance applications been reviewed to determined:
  - a. If they were truthful and accurate when made? or
  - b. Would they be truthful and accurate if applied to the present situation?
19. Does the risk manager read and analyze each insurance policy? How often? Are the *Best's* ratings of the various insurance companies known to the risk manager? When does the governing body receive a report on the risk management program?
20. Where does the organization buy insurance? What qualifications does this source have?
21. Are the topics of the above questions contained in the bylaws or written policy adopted by the governing board? Are these provisions reviewed periodically?