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Explanation of California's Nonprofit Integrity Act of 2004 (SB 1262)

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On September 29, 2004, Governor Schwarzenegger signed into law SB 1262, the Nonprofit Integrity Act of 2004. Sponsored by Attorney General Lockyer and carried by Senator Sher (D-Palo Alto), SB 1262, as it finally emerged after extensive amendments, addressed two broad areas of nonprofit activity: governance of charitable organizations and fundraising by or on behalf of charitable organizations.

The first part of this paper explains the governance provisions of the Act: the requirements for financial audits, for audit committees, for public disclosure of audited statements, and for review and approval by the board of directors of the compensation paid to the chief executive officer and the chief financial officer of the charitable organization.

The second part considers the Act's extensive charitable fundraising provisions. The Act requires charitable organizations to enter into written contracts containing mandatory terms and conditions for every charitable fundraising event where a commercial fundraiser is used. The Act requires charitable organizations to exercise control over fundraising activities conducted for them. The Act imposes on each commercial fundraiser highly detailed requirements for prompt deposit of charitable funds in a bank account in the name of, and controlled by, the beneficiary charitable organization. The Act sets forth twelve prohibited acts in the planning and execution of fundraising by the charitable organization and others, and the Act gives charitable organizations extensive rights to cancel or void contracts with commercial fundraisers and fundraising counsel.

If you are a manager or director of a California charitable organization or a foreign charitable organization conducting activities or holding property in California, we urge you to give careful attention to the Act and to the significant changes it makes in

governance and charitable fundraising rules, so your charitable organization can prepare to meet the challenges posed by the many new provisions of the Act before it becomes effective on January 1, 2005.

GOVERNANCE

Financial Audits

The Act requires certain charities to prepare annual financial statements audited by independent certified public accountants.

The charities subject to this new requirement are those charitable corporations, unincorporated associations, and charitable trusts required to file reports with the Attorney General. This includes foreign corporations doing business or holding property in California for charitable purposes.¹ On the other hand, educational institutions, hospitals, cemeteries, and religious organizations are exempt from the obligation to file reports with the Attorney General and, therefore, are not subject to either this mandatory audit requirement, or to the requirements for audit committees and for public disclosure of audited statements discussed later below.²

The mandatory audit requirement applies to some but not all charitable organizations subject to the Act. Only a charitable organization which receives or accrues in any fiscal year gross revenues of \$2 million or more must meet the audit requirement. Grant or contract income from the government is not included in the charitable organization's gross revenue so long as the governmental entity requires an accounting of those funds.

The financial audit must be performed by an independent certified public accountant in accordance with generally accepted accounting principles (GAAP). If the audit firm also performs non-audit functions for the charity, the firm and its auditors must conform to the standards for auditor independence set forth in the Government Auditing Standards issued by the Comptroller General of the U.S. (the Yellow Book, accessible online at <http://www.gao.gov/govaud/ybk01.htm>), but the Attorney General may prescribe standards for auditor independence different from those in the Yellow Book.³

Public Disclosure of Audited Statements

Audited statements (those required by the Act, as well as those prepared by charitable organizations required to file reports with the Attorney General, even if not required by the Act) must be made available for inspection by the Attorney General and the general public within nine months after the close of the fiscal year to which the

statements relate. The Act adopts the same rules for public disclosure already applicable to IRS Form 990. Thus, audited statements must be made available to the public for a period of three years, both (1) at the charitable organization's principal and any regional or district office during regular business hours, and (2) by mailing a copy to any person who so requests in person or in writing; or, alternatively, by posting the audited statements on the charitable organization's website.⁴

Audit Committees

With regard to those charities required by the Act to prepare annual audited financial statements as described above, the Act also provides that charities in corporate form – including charitable corporations incorporated outside California but required to register with California's Attorney General – must appoint an audit committee. The committee must be appointed by the board of directors.

The audit committee may include non-board members. While it may include members of the finance committee, the chair of the audit committee may not be a member of the finance committee, and members of the finance committee must constitute less than half of the audit committee.

The audit committee may not include any member of the staff, including top management, or any person who has a material financial interest in any entity doing business with the charitable organization.

If audit committee members are paid, they may not receive compensation in excess of the amounts received, if any, by members of the board of directors for service on the board.

Five duties of the audit committee are spelled out in the Act. Audit committees: (1) shall recommend to the board of directors the retention and termination of the independent auditor, (2) may negotiate the compensation of the auditor on behalf of the board, (3) shall confer with the auditor to satisfy the committee members that the financial affairs of the charitable organization are in order, (4) shall review and determine whether to accept the audit, and (5) shall approve performance of any non-audit services to be provided by the auditing firm.⁵

Compensation Review

The Act provides that compensation, including benefits, of two officers (the chief executive officer and the chief financial officer) must be reviewed and approved by the board of directors or an authorized committee of a charitable corporation or

unincorporated association, or by the trustee or trustees of a charitable trust. The approving body must determine that the compensation is just and reasonable.⁶

Review and approval must occur when the officer is hired, when the term of employment of the officer is renewed or extended, and when the compensation package is modified, unless the modification applies to substantially all employees.

FUNDRAISING

Commercial Fundraiser and Fundraising Counsel: Definitions

We have included here abbreviated definitions of commercial fundraiser and fundraising counsel, even though they have been part of the law and are not newly introduced by the Act, to make more understandable our discussion of the Act below.

Commercial Fundraiser. A commercial fundraiser for charitable purposes is defined as any individual, corporation, or other legal entity who for compensation does any of the following:⁷

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

Note that commercial fundraiser does not include an employee or trustee of a charitable organization, among others.⁸

Fundraising Counsel. A fundraising counsel for charitable purposes is defined as any person who is described by all of the following:⁹

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

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

Note that fundraising counsel does not include an attorney, or an employee or trustee of a charitable organization, among others.¹⁰

Charitable Organizations: Control over Fundraising

The Act makes plain that charitable organizations must “establish and exercise control,” not only over their own fundraising activities, but over fundraising activities conducted by others for their benefit. That control must include approval of all written contracts, and the charitable organization must assure that fundraising activities are conducted without coercion of potential donors.¹¹

A charitable organization may not contract with any commercial fundraiser unless that fundraiser has registered as required with the Attorney General’s Registry of Charitable Trusts (“Registry”), nor may charity A raise funds for charity B unless charity B is registered as required.¹²

Charitable Organizations: Misrepresentations

Charitable organizations (and commercial fundraisers) may not misrepresent the purpose of the charitable organization or the nature or purpose or beneficiary of a solicitation. Misrepresentation may be established by word, by conduct, or by failure to disclose a material fact.¹³

Charitable Organizations, Commercial Fundraisers, and Fundraising Counsel: Prohibitions

The Act sets forth twelve prohibited acts and practices in the planning, conduct, or execution of any charitable solicitation or sales promotion. The prohibitions apply to, according to the Act, “regardless of injury”:¹⁴

1. Operating in violation of this Act or order of the Attorney General, or after registration is no long valid.
2. Engaging in fraud or using any unfair or deceptive act or practice that creates a likelihood of confusion or misunderstanding.

3. Using any name or any other representation that misleads a reasonable person as to the identity of the charitable beneficiary.
4. Misrepresenting or misleading anyone to believe that the beneficiary of a solicitation or sales promotion is a charitable organization when it is not.
5. Misrepresenting or misleading anyone to believe that another person sponsors, endorses, or approves a charitable solicitation or sales promotion when that person has not given consent in writing to the use of the person's name.
6. Misrepresenting or misleading anyone to believe that goods or services have endorsement, sponsorship, approval, characteristics, ingredients, uses, qualities, or benefits that they do not have, or that any person has any endorsement, sponsorship, approval, status, or affiliation that the person does not have.
7. Exploiting registration required by law to imply endorsement or approval by the Attorney General.
8. Representing that a charitable organization will receive more than the amount reasonably estimated.
9. Distributing or offering to distribute – in connection with charitable solicitations by commercial fundraisers for police, fire, and other public safety personnel – membership cards or stickers, emblems, plates, or other items that could be used for display on a motor vehicle and that suggest affiliation with or endorsement by any public safety personnel or group.
10. Soliciting for advertising related to a charitable purpose to appear in a for-profit publication without making, at the time of solicitation, these disclosures: (a) the publication is for-profit, (b) the name of the solicitor and the fact that the solicitor is a professional solicitor, and (c) the publication is not affiliated with any charitable organization.
11. Representing that any part of contributions solicited by charity A will be given to charity B unless charity B has agreed in writing prior to the solicitation to the use of its name.
12. Representing that tickets to events will be donated for use by another unless certain requirements are met to prevent abuse.

Commercial Fundraisers: Constructive Trustee

The Act makes all commercial fundraisers constructive trustees as to all funds collected pursuant to solicitations for charitable purposes, and it requires the fundraiser to account to the Attorney General for all funds. The Act subjects the fundraiser to the Attorney General's supervision and enforcement over charitable funds to the same extent as a trustee for charitable purposes.¹⁵

Commercial Fundraisers: Notice to Attorney General

Current law requires that a commercial fundraiser for charitable purposes must register with the Registry. The Act adds the requirement that before beginning any charitable solicitation, a commercial fundraiser must also file a notice with the Registry setting forth information identifying the fundraiser and the charitable organization, the fundraising methods to be used, the dates when fundraising will begin and end under the contract, and identifying information about the person responsible for directing and supervising the work of the fundraiser.

The notice must be filed not less than 10 days before the beginning of each solicitation campaign, event, or service, except for solicitations to aid victims of emergency hardship or disasters, in which case the notice must be filed not later than when the solicitation begins.¹⁶

Commercial Fundraisers: Misrepresentations

Commercial fundraisers (and charitable organizations) may not misrepresent the purpose of the charitable organization or the nature, purpose, or beneficiary of a solicitation. Misrepresentation may be established by word, conduct, or failure to disclose a material fact.¹⁷

Commercial Fundraisers: Deposit of Contributions

For each contribution in the control or custody of a commercial fundraiser, the Act requires the fundraiser, within five working days of receipt, (1) to deposit the contribution in an account in a bank or other federally-insured financial institution solely in the name of the charitable organization and over which the beneficiary charitable organization has the sole right of withdrawal, or (2) to deliver the contribution to the charitable organization in person, by Express Mail, or by another method providing for overnight delivery.¹⁸

Commercial Fundraisers: Contracts with Charitable Organizations

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

1. A statement of the charitable purpose of the fundraiser.
2. A statement of the "respective obligations" of the commercial fundraiser and the charitable organization.
3. If the fundraiser is to be paid a fixed fee, the contract must state the fee and provide a good faith estimate of what percentage the fee will be of total contributions, disclosing the assumptions on which the estimate is based, which must reflect all relevant facts known to the fundraiser.
4. If the fundraiser is to be paid a percentage fee, a statement of the percentage of total contributions that will be remitted to or retained by the charitable organization or, if the sale of goods is involved, the percentage of the sales price remitted to or retained by the charitable organization. In determining the percentage, the fundraiser's fee, as well as any other amounts the charitable organization is required to pay as fundraising costs, must be subtracted from contributions and sales receipts received.
5. The starting and ending dates of the contract and the date solicitation activity will begin in California.
6. The contract must require the fundraiser to handle contributions in accordance with the Act's requirements (discussed above) on the deposit or delivery of funds to the charity.
7. A statement that the charitable organization shall exercise control and approval over the content and frequency of any solicitation.
8. If the fundraiser proposes to pay any person or legal entity, in cash or in kind, to attend, sponsor, approve, or endorse a charity event, the maximum dollar amount of those payments must be stated.

The contract must also contain three distinct provisions relating to cancellation of the contract. *First*, the contract must allow the charitable organization to

cancel the contract without cost, penalty, or liability for a period of 10 days after signing, by giving written notice in a specified manner. Any funds collected by the fundraiser after notice of cancellation shall be held in trust for the benefit of the charitable organization without deduction for costs or expenses. *Second*, the contract must permit a charitable organization to terminate the contract on 30 days' written notice to the fundraiser, effective five days after the notice is mailed. The charitable organization remains liable for the fundraiser's services during the 30-day period. *Third*, the contract must provide that, after the initial 10-day cancellation period, the charitable organization may terminate the contract at any time by giving written notice, without payment of any kind to the fundraiser, if (1) the fundraiser makes material misrepresentations in solicitations or about the charitable organization, (2) the charitable organization learns that the fundraiser or its agents have been convicted of a crime punishable as a misdemeanor or felony, arising from charitable solicitation, or (3) the fundraiser otherwise conducts fundraising activities that cause or could cause "public disparagement of the charitable organization's good name or good will."¹⁹

Commercial Fundraisers: Prohibitions

A commercial fundraiser for charitable purposes may not solicit in California on behalf of a charitable organization unless the organization has registered with the Registry or is exempt from such registration.²⁰

No person may act as a commercial fundraiser if that person (or any officer or director of that person's business or any person with a controlling interest in the business or any person employed or paid to solicit funds by the fundraiser) has been convicted in state or federal court of a crime, punishable as a misdemeanor or felony, arising from the conduct of charitable solicitation.²¹

Commercial Fundraisers: Record Retention

Commercial fundraisers must maintain, for at least 10 years, two categories of records: (1) solicitation campaign records, including donor information, revenue and expense data, the names and addresses of employees, and the name and number of each bank or other account in which funds were deposited by the fundraiser, and (2) ticket sale records for charitable events, including the number of tickets purchased and donated by each contributor and a list of all organizations receiving donated tickets for use by others.²²

Fundraising Counsel: Notice to Attorney General

Current law requires that fundraising counsel must register with the Registry. The Act adds a requirement that before performing any services for a charitable organization, fundraising counsel must also file a notice with the Registry, not less than 10 working days before services start. The notice must include the name and address of fundraising counsel and of the charitable organization, and the dates when the performance of services begins and ends.²³

Fundraising Counsel: Contracts with Charitable Organizations

The Act also makes clear that there must be a written contract between the fundraising counsel and the charitable organization for each service to be performed. The contract must be signed by the authorized contracting officer for fundraising counsel and by an official who is authorized to sign by the governing body of the charitable organization.²⁴ Current law sets forth extensive provisions that must be included in the contract.²⁵

The contract must also contain two distinct provisions relating to cancellation of the contract. *First*, the contract must allow the charitable organization to cancel the contract without cost, penalty, or liability for the first 10 days after signing, by giving written notice in a specified manner. *Second*, the contract must permit the charitable organization to terminate the contract on 30 days' written notice to fundraising counsel. The notice is effective five days after the date of mailing; termination is effective 30 days after that. The charitable organization is liable for the services of fundraising counsel up to the effective date of termination.²⁶

Charitable Organizations: Right to Cancel or Void Contracts with Commercial Fundraisers or Fundraising Counsel

Contract cancellation rights of charitable organizations are addressed twice in the Act. First, they appear as mandatory provisions of contracts between charitable organizations and commercial fundraisers or fundraising counsel, as discussed earlier. Second, they appear as separate rights, entirely apart from the terms of any contract. Thus, even if contracts fail to spell out the required rights of cancellation, the Act provides that charitable organizations nevertheless have those rights by law.²⁷ The Act also provides that charitable organizations may void contracts with commercial fundraisers or fundraising counsel if they are not properly registered.²⁸ Finally, whenever a charitable organization cancels a contract, it must mail a duplicate copy of the notice of cancellation to the Registry.²⁹

Commercial Fundraisers and Fundraising Counsel: Registration Requirements

Similarly, the Act addresses registration with the Registry from three distinct perspectives: (1) as a requirement of commercial fundraisers and fundraising counsel,³⁰ (2) as a prohibition on charitable organizations, barring them from contracting with a commercial fundraiser or fundraising counsel if not registered as required,³¹ and (3) as a remedy for charitable organizations, allowing them to void contracts with commercial fundraisers and fundraising counsel if not properly registered, as we discussed above.³²

NOTES

¹ Gov. Code §12582.1.

² Gov. Code §12583.

³ Gov. Code §12586(e)(1).

⁴ Treas. Regs. §§301.6104(d)-1(a) and (d)-2; Gov. Code §12586(e)(1).

⁵ Gov. Code §12586(e)(2).

⁶ Gov. Code §12586(g).

⁷ Gov. Code §12599.

⁸ Gov. Code §12599(a).

⁹ Gov. Code §12599.1.

¹⁰ Gov. Code §12599.1(b).

¹¹ Gov. Code §12599.6(b).

¹² Gov. Code §12599.6(c), (d).

¹³ Gov. Code §12599.6(a).

¹⁴ Gov. Code §12599.6(f).

¹⁵ Gov. Code §12599(g).

¹⁶ Gov. Code §12599(h).

¹⁷ Gov. Code §12599.6(a).

¹⁸ Gov. Code §12599.6(e).

¹⁹ Gov. Code §12599(i).

²⁰ Gov. Code §12599(m).

²¹ Gov. Code §12599(l).

²² Gov. Code §12599.7(a), (b).

²³ Gov. Code §12599.1(e).

²⁴ Gov. Code §12599.1(f).

²⁵ Gov. Code §12599.1(d).

²⁶ Gov. Code §12599.1(f)(8),(9).

²⁷ Gov. Code §12599.3(b), (c), (e), (f), (g).

²⁸ Gov. Code §12599.3(a).

²⁹ Gov. Code §12599(d).

³⁰ Gov. Code §§12599(m) and 12599.1(c).

³¹ Gov. Code §12599.6(c).

³² Gov. Code §12599.3(a).