



By William E. Westerbeke\*

**R**ecent corporate scandals in the for-profit and not-for-profit worlds and the subsequent passing of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”)<sup>1</sup> have led to increased attention to the oversight of directors of not-for-profit organizations (“NFPs” or singularly “NFP”).<sup>2</sup> This dramatic shift is likely to cause some people to decline board participation altogether, an unwelcome development in a not-for-profit world already confronting legislation that could increase regulation,<sup>3</sup> new allegations of fraud,<sup>4</sup> and an increase in competition for charitable funds in the aftermath of natural disasters such as Hurricane Katrina.

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, codified at 15 USC § 7217. For a discussion of Sarbanes-Oxley’s impact on not-for-profits, see, for example, ABA Coordinating Committee on Nonprofit Governance, *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley* (ABA 2005) (hereinafter *ABA Guide to Governance*); see also Board Source-Independent Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (2003), available at <http://www.boardsource.org/clientfiles/sarbanes-oxley.pdf>; Robert W. Friz & Elizabeth Virgin, *The Sarbanes-Oxley Act – Considerations for Nonprofit Health Care Organizations*, 18 *The Health Lawyer* 1 (June 2006).

2. Note that a Not-For-Profit organization can be set up as a different type of non-corporate entity such as a trust or a limited liability company.

3. While there is significant activity on the federal level to increase regulation of NFPs, California has already acted with the passing of the California Nonprofit Integrity Act of 2004, Cal SB 1262 (2004).

4. See, e.g., Fraud Section, Criminal Division, U.S. Department of Justice, *Possible Fraud Schemes: Solicitations of Donations for Victims of Hurricane Katrina*. It can be accessed online at <http://www.usdoj.gov/criminal/SpecialReport/HurricaneKatrina.htm>.



# An Illinois Not-For-Profit Directors' Compliance Checklist

Recent scandals and increased oversight are likely to cause potential directors to hesitate serving on not-for-profit boards. A carefully crafted compliance checklist can reduce the uneasiness about serving in that capacity.

Careful planning through an annual compliance checklist can help Illinois directors "cover their bases," thereby alleviating some uneasiness about serving on a board.<sup>5</sup> To fully realize this benefit, the checklist must be custom-tailored to the specific NFP it serves. A "one-size-fits-all" checklist will not even begin to cover all of the needs and issues of every type of NFP.

This article presents the basic elements of a compliance checklist derived from sources such as Sarbanes-Oxley, the Internal Revenue Service's revised Form 1023,<sup>6</sup> Illinois law, federal law, and other relevant authorities. It is crucial that practitioners research and investigate concerns specific to similar NFPs in order to complete the checklist.

The first section below discusses important considerations for the operations that is, carrying out of the exempt purposes of the NFP. Next, the article examines issues related to personnel (primarily directors, employees, and volunteers) of the NFP. The final section reviews financial reporting and financial compliance matters of importance to the NFP. Note, of course, that the information provided here is not a substitute for advice from a qualified lawyer, accountant, or other professional.

## Operations

### Organizational details and following the exempt purposes

**Organizational details.** Before undertaking his or her role, each director must review the background, history, and related details of the NFP. Has each director reviewed the organization's application for exemption (Form 1023), articles of incorporation, bylaws, and recent minutes of board meetings?

What is the history of the NFP? How was it

5. The tension between NFPs' limited resources and the increasing level of accountability for directors in the for-profit area is ripe for debate, but will not be addressed in detail in this article.

6. The Internal Revenue Service substantially revised Form 1023, Application for Recognition of Exemption (hereinafter "Form 1023") in October 2004, and then further revised Form 1023 in June 2006, to account for an increase in fees. It can be accessed online at <http://www.irs.gov/pub/irs-pdf/f1023.pdf>. Note that Form 990, Return of Organization Exempt From Income Tax, is currently undergoing potentially substantial revisions (see, e.g. Advisory Committee on Tax Exempt and Government Entities, The fifth report of recommendations (June 7, 2006), available online at <http://www.irs.gov/charities/article/0,,id=98353,00.html>).

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formed? Who was instrumental in its creation and early success? Who are the other members of the board of directors and what types of skills and experiences does each director contribute to the board?<sup>7</sup> Have important provisions of the bylaws been reviewed? What constitutes a "quorum" for voting purposes?<sup>8</sup> What is the voting percentage required to approve actions? On an ongoing basis, have there been any changes to 1) the organization of the NFP, 2) directors, or 3) officers (e.g., name, address, elections, removals, amendments to articles)? Have the minutes or resolutions reflected the above changes where appropriate?

**Exempt purposes.** In order to qualify the NFP under section 501(c)(3) of the Internal Revenue Code, the NFP's exempt purposes must be stated in the NFP's organizing document.<sup>9</sup> Unlike the for-profit world where directors answer to the shareholders and are measured by the organization's profit-making ability, NFP directors are measured against the success (or failure) of the pursuit of the accomplishment of the exempt purposes.

Therefore, it is important to review the NFP's activities on a regular basis to determine whether they are consistent with the exempt purposes contained in the Articles of Incorporation.<sup>10</sup> Does each activity contribute to the exempt purposes? Are any unrelated activities justified for other reasons? Are any of the components of the exempt purposes outdated or irrelevant? Do any current activities work against the components of the exempt purposes? Has each director assisted the NFP in obtaining adequate resources to carry out its exempt purposes?

### **Conflict of interest policy<sup>11</sup>**

One of the most important aspects of operating the NFP is adopting, and reviewing on an annual basis, the NFP's conflict of interest policy ("COI policy"). The revised Form 1023 places more emphasis on the COI policy. For organizations that have not adopted a COI policy, Appendix A to the instructions for Form 1023 provides a sample.<sup>12</sup> To obtain a tax exemption, an organization must either provide the COI policy or explain how alternative procedures accomplish the same result.<sup>13</sup>

Has the NFP adopted a COI policy? Has every board member and officer reviewed and signed it? Has each director,

on an annual basis, affirmed that he or she has received, read, understood, and agreed to comply with it?<sup>14</sup> Has each director also affirmed every year that he or she understands that the NFP must engage primarily in activities that accomplish one or more of its exempt purposes?<sup>15</sup> At least annually, has each director reviewed and disclosed business and family relationships between directors, officers, and highest compensated employees and any potential conflicts of interest among those relationships?<sup>16</sup>

### **Transactional review**

It is also increasingly important for a person or a committee to review all transactions above a materiality threshold, all recurring transactions falling under the threshold if suspicious and/or material, and transactions involving internal assets that have the potential for abuse (e.g., use of organization's cars, employee privileges, etc.). Also important is expense reimbursements above a material amount or involving several smaller amounts that in the aggregate are material. Those transactions, as well as all other contracts, loans, payments for services or goods, leases, or other arrangements, should be reviewed with the following questions in mind:

**Does the transaction involve disqualified persons?** A "disqualified person" essentially is an insider to the NFP.<sup>17</sup> Directors, officers, and substantial contributors to the organization are included in the list of disqualified persons.<sup>18</sup>

**Is the transaction fair?** Under Illinois law, if a transaction is fair to a corporation, the fact that the director has a conflict is not grounds for invalidating the contract.<sup>19</sup> The recurring theme of questioning in the revised Form 1023 is 1) has it been explained how the contract's terms have been (or will be) negotiated at arm's length?<sup>20</sup> and 2) has it been determined that the NFP is paying no more than fair market value?<sup>21</sup>

**Has the conflict been adequately disclosed?** Under Illinois law, the director asserting the validity of a transaction will not have the burden of proving fairness if the material facts of the transaction and the director's interest or relationship were disclosed to the board of directors or committee before approval.<sup>22</sup> If there has been a transaction where a disquali-

fied person received an excess benefit, the results will be consequential whether the organization is a private foundation (under the "self-dealing" rules)<sup>23</sup> or public charity (under the "excess benefit/intermediate sanction" rules).<sup>24</sup>

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## **Practitioners should consult personnel from NFPs similar to the ones they counsel for advice.**

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### **Insurance coverage and indemnity provisions**

A final consideration in the operations of an organization is insurance coverage. In certain cases, coverage will not be worth the high cost. However, when it is cost-worthy, insurance is important.

Is there a policy in place covering directors and officers (errors and omissions)? Damage to the NFP's property? Acts or injuries to third parties? Is there a policy (or policy rider) for any large

7. For a discussion on the "Audit Committee Financial Expert" as defined by the Securities and Exchange Commission (SEC), see *ABA Guide to Governance* at 33 (cited in note 1).

8. If not provided for in the articles of incorporation or bylaws, under Illinois law a quorum is defined as a majority of the directors then in office. General Not For Profit Corporation Act of 1986, 805 ILCS 105/108.15.

9. 26 USC § 501(c)(3); see also Form 1023, Part III, Question #1.

10. This is often referred to as the Duty of Obedience.

11. Avoiding conflicts of interest is the primary goal of the Duty of Loyalty.

12. Appendix A to the Instructions to Form 1023, available online at <http://www.irs.gov/pub/irs-pdf/i1023.pdf>.

13. The IRS requests a copy of the COI Policy (or an explanation of alternative procedures) with the filing of Form 1023. See Form 1023, Part V, Question 5 (cited in note 6).

14. Instructions to Form 1023, Appendix A, Part VI, Annual Statements (cited in note 12).

15. *Id.*

16. It is a good practice to devote an agenda item in each board meeting to ask the directors whether there are any conflicts that need to be addressed.

17. 26 USC § 4946.

18. *Id.*

19. 805 ILCS 105/108.60.

20. See, for example, Form 1023, Part V, Questions 7a, 7b, 8d, and 9d (cited in note 6).

21. See, for example, Form 1023, Part V, Questions 7a, 7b, 8c, and 9e (cited in note 6).

22. 805 ILCS 105/108.60(b)(1).

23. 26 USC § 4941.

24. 26 USC § 4958(c)(1)(A).

scale event presented or hosted by the NFP? In addition to insurance, has the board reviewed the adequacy of the protections of the indemnity provisions of the Bylaws? Has the board secured indemnity from sellers of property for environmental liabilities?<sup>25</sup>

## Personnel issues

### Excessive compensation

One of the most important issues facing NFPs is justifying the amount of compensation paid to employees. NFPs should follow the recommended practices provided in the revised Form 1023 when setting compensation.<sup>26</sup>

Will the individuals that approve compensation arrangements follow a COI policy?<sup>27</sup> Will the board approve compensation arrangements in advance of paying compensation?<sup>28</sup> Will the board document in writing the date and terms of approved compensation arrangements?<sup>29</sup> Will the board record in writing the decision made by each individual who decided or voted on compensation arrangements?<sup>30</sup> Has the board based compensation on compensation paid by similarly situated organizations for similar services, current compensation surveys compiled by independent firms, or actual written offers from similarly situated organizations?<sup>31</sup> Will the board record the information they relied on to make the decision on the compensation arrangement?<sup>32</sup>

Since this topic is high on the IRS radar,<sup>33</sup> it is strongly recommended that all directors follow the above listed steps in setting compensation.

### Employee and volunteer issues

Another layer of important issues involves employees and volunteers. It is important to fully investigate "whistle blowers" because Sarbanes-Oxley applies harsh penalties to retaliation against whistle-blowers, even if the organization is a NFP.<sup>34</sup>

Does the board have a written policy regarding the prohibition against retribution directed at whistle-blowers? Has the board investigated all warnings or reports of officer, director, or employee theft or mismanagement? Has the board fully investigated and documented all claims of misconduct, discrimination, abuse, fraud, theft, or any related claims? Do any of the employees or volunteers have any complaints? Have all complaints been reviewed and resolved?

Does the NFP have an interview and/or screening process? Are background checks required where appropriate? Have you reviewed all employee issues discovered pursuant to an employee review or brought to the board's attention? Have you followed internal policies with regard to dealing with employment issues?

### Directors

Does each director act in an informed and reasonable manner when participating in the board's decisions and oversight of the NFP's management?<sup>35</sup> Are there any express or unwritten requirements for board service? Does each director attend meetings regularly, exercise independent judgment, and review adequate information?<sup>36</sup>

How are new directors elected? What are their terms? Are there term limits? Are there any issues or potential violations of the duties of care, loyalty, or obedience?<sup>37</sup> Have directors checked to make sure any dissenting opinions at board meetings have been recorded in the minutes?

### Segregation of duties and internal controls

An important issue for any organization is the segregation of duties between certain personnel. For example, does the person who writes the checks for expense reimbursements write and approve his or her own expense reimbursement checks? Does the person who opens the mail also make the deposits in the bank? Has the board worked with the NFP's auditor to ensure there is an adequate segregation of duties and an appropriate system of internal controls?

### Financial matters

#### Soliciting funds

**Fundraising.** Does the NFP pay a professional fundraiser? Has the NFP filed fundraising forms where appropriate?<sup>38</sup> Will there be any charitable gaming? If so, have the appropriate forms been filed and gaming taxes been paid?<sup>39</sup>

**Donations, restrictions, and acknowledgments.** Does the NFP send out a letter acknowledging all contributions by a donor? Has the NFP included quid pro

quo gift language where necessary? Are there any conditions on any gifts? Are safeguards in place to monitor conditions or restrictions?

### Budgeting, investing, and distributing funds

**Budgeting and investments.** Does each director actively participate in budgeting, reviewing financial statements, and forecasting? Has the NFP made any jeopardizing investments?<sup>40</sup> Does the NFP have any excess business holdings?<sup>41</sup>

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For private foundations, the consequence of these items is an excise tax as

25. See, e.g., John M. McDonough, *Not-For-Profit Corporations* § 4-8 (ICLE 2004).

26. Form 1023, Part V, Question 4 (cited in note 6).

27. *Id.* at Question 4(a).

28. *Id.* at Question 4(b).

29. *Id.* at Question 4(c).

30. *Id.* at Question 4(d).

31. *Id.* at Question 4(e).

32. *Id.* at Question 4(f).

33. See, e.g., *Compensation Issues for Exempt Organizations*, IRS Phone Forum (May 17-18, 2006), available online at [http://www.irs.gov/pub/irs-tege/phone\\_forum\\_5\\_2006.pdf](http://www.irs.gov/pub/irs-tege/phone_forum_5_2006.pdf).

34. Sarbanes-Oxley, Title VIII, Section 806, 68 Fed. Reg. 31, 860 (2003), 29 CFR pt. 1980.

35. Committee on Nonprofit Corporations, *Guidebook for Directors of Nonprofit Corporations* § 2 at 19 (ABA 2d ed. 2002).

36. *Id.* at 19-22.

37. A thorough analysis of directors' duties under Illinois law is beyond the scope of this article. See, e.g., McDonough, *Not For-Profit Corporations* § 4-1, et seq. (cited in note 25).

38. See Illinois Attorney General's Office Form IFC, Report of Individual Fundraising Campaign, online at <http://www.illinoisattorneygeneral.gov/charities/formife.pdf>.

39. For a brief summary of charity gaming license types, forms, and fees, see the Illinois Department of Revenue's Charity Gaming webpage, online at <http://www.revenue.state.il.us/CharityGaming/index.htm>; see also Illinois Department of Revenue's Charitable Games Tax webpage, online at <http://www.revenue.state.il.us/Businesses/TaxInformation/Gaming/charitable.htm>.

40. 26 USC § 4944.

41. 26 USC § 4943. Private Foundations may hold up to 20% of a particular corporation's voting stock; beyond 20% is considered a taxable excess business holding.

well as a penalty for noncompliance. In addition, has the NFP paid the excise tax on net investment income?<sup>42</sup> Even though public charities do not have the same restrictions, they should keep an eye on the type, risk, and excess business holdings of the NFP's investments.

**Expenditures.** If the NFP is considered a private foundation, has it made any taxable expenditures?<sup>43</sup> Have the directors reviewed all purchases by the NFP above a material amount or involving several smaller transactions that in the aggregate are material? Have the directors reviewed expense reimbursements above a material amount or involving several smaller amounts that in the aggregate are material?

**Grants, loans, and distributions.** It is important to review grants, loans, and other distributions to outside organizations. How does each distribution further the NFP's exempt purposes?<sup>44</sup> Does the NFP keep adequate records for each distribution?<sup>45</sup> Does it require an application form or grant proposal?<sup>46</sup> Does it have procedures, including periodic reports, for oversight of distributions to assure the distributions are used to further its exempt purposes?<sup>47</sup> If the NFP is considered a private foundation, has it made the required annual distributions?<sup>48</sup>

### Financial reporting matters and filings

**Record-keeping.** Does each director have a general knowledge of the books and records of the NFP? Are the records and accounts accurate? If an audit is not performed, is there an adequate review of the performance of the NFP's bookkeeper?

**Tax returns and annual reports.** Has each director reviewed the NFP's tax returns and contacted the preparer if there are any questions?<sup>49</sup> Does the NFP have unrelated business income subject to tax (UBIT)? Does the NFP engage in (and report) any lobbying?

Has someone, other than the person in charge of payroll, verified that all withholdings are deducted and forwarded to state and federal authorities?<sup>50</sup> Has the NFP filed state and federal employment tax (and related) returns?<sup>51</sup> Has it paid sales or use taxes and filed the appropriate forms, where an exemption is not available? Has it paid property taxes, where an exemption is not available? Filed annual reports with the

Illinois Attorney General's Office<sup>52</sup> and the Secretary of State?

**Auditing issues and document retention policy.** When necessary, has there been an audit by a certified public accountant? Is the opinion "unqualified"? If not, investigate further.

Does the NFP have the resources to form an audit committee?<sup>53</sup> What level of financial expert will the board recruit (or does it have)?<sup>54</sup> Are all personnel aware of the penalties, mandated by Sarbanes-Oxley, for destruction or alteration of documents?<sup>55</sup> Is there a written policy in place for addressing document retention and destruction?

**Other filings.** Has the NFP registered with the Illinois Attorney General's Office?<sup>56</sup> Has it filed the appropriate state-level forms with the attorney general of every other state where filing is required?<sup>57</sup> Has it filed certificates of authority in every jurisdiction where it transacts business? Has it filed all state-level annual reports?

Are the following available for public inspection: application for exemption, Form 1023; articles of incorporation; and all tax returns and state filings?<sup>58</sup> Are any local permits required for any activities of the NFP? Has the NFP applied for special mailing rates afforded NFPs?<sup>59</sup>

If the NFP plans to dissolve, have the directors completed the following: drafted a resolution to dissolve the NFP; filed and received tax clearance from the appropriate authorities; made arrangements to have the assets distributed pursuant to the organizing documents (i.e., to another 501(c)(3)); and filed for dissolution at the Secretary of State?

### Conclusion

Building an annual checklist is easier with the basic elements provided in this article. The next step depends on an analysis of the characteristics of the target organization. Practitioners should consult personnel from similar NFPs for advice on some of the items they address on a regular basis.

Once the organization-specific items are added, the checklist is ready to be implemented. If the checklist is used on a regular basis, such as during the annual meeting, it is more likely to fulfill its purpose – reducing uneasiness about board participation. ■

42. 26 USC § 4940. Private foundations must pay

a 2% Excise Tax on Net Investment Income ("NII"). However, this tax can be reduced to 1% if the private foundation meets certain distribution requirements. 26 USC § 4940(e). NII is the sum of gross investment income (income from interest, dividends, rents, and/or royalties) and net capital gains incurred from the sale of appreciated capital assets. 26 USC § 4940(c).

43. 26 USC § 4945. Some taxable expenditure examples include: grants to influence legislation; grants to a nonexempt organization; or grants for a noncharitable purpose.

44. Form 1023, Part VIII, Question 13a (cited in note 6).

45. Id at Question 13e.

46. Id at Question 13f.

47. Id at Question 13g.

48. Private foundations must distribute annually an amount equal to its Minimum Investment Return ("MIR"). 26 USC § 4942. A Private Foundation's MIR is 5% of the Private Foundation's net investment assets.

49. For a list of the types of Forms 990, see Instructions to Form 1023, at 5 (cited in note 12). For more detailed explanations, see the instructions specific to each form.

50. If nothing else, all directors should follow-up to make certain that amounts withheld from employees' wages are actually being paid over to the appropriate governmental entities. The Internal Revenue Service can and will take action for recovery of lost withholdings against directors of NFPs.

51. The directors should consult with the NFP's accountant or payroll service to be certain that they are filing Forms 941 (Federal Employment Tax Return), Form IL-941 (Illinois Employment Tax Return), and Form UI-3/40 (Illinois Department of Employment Security's Employer's Contribution and Wage Report). As long as confidentiality is preserved, the directors should ask the accountant or payroll service to forward copies of the forms for review at board meetings.

52. Form AG990-IL, Illinois Charitable Organization Annual Report, must be filed with the Attorney General's Office within 6 months after the NFP's fiscal year end and can be accessed online at <http://www.illinoisattorneygeneral.gov/charities/ag990-annualreport.pdf>.

53. See *ABA Guide to Governance* 28-34 (cited in note 1).

54. For a discussion on the "Audit Committee Financial Expert" as defined by the Securities and Exchange Commission (SEC), see *ABA Guide to Governance* at 33 (cited in note 1).

55. Sarbanes-Oxley, Title VII, Section 802 (cited in note 34).

56. Charities must register with the Illinois Attorney General's Office using Form CO-1, Charitable Organization Registration Statement. Form CO-1 can be accessed over the internet at: <http://www.illinoisattorneygeneral.gov/charities/co-1form.pdf>. Form CO-2, Charitable Organization Financial Information Form is also required with the initial registration and can be accessed online at <http://www.illinoisattorneygeneral.gov/charities/co-2form.pdf>.

57. In some states, solicitations of a certain amount of donations among the state's residents can cause a NFP to be subject to registration with that state's Attorney General's office, even if the solicitations are over the internet. Please refer to each specific state's Attorney General's office for applicable restrictions.

58. A list of the items that are required to be open to public inspection (e.g., exemption letter, Form 1023, IRS correspondence) as well as a list of items that do not have to be open for public inspection (e.g., contributors' names and addresses; user fee check) can be found in the Instructions to Form 1023. Instructions to Form 1023, at 5 (cited in note 12).

59. See United States Postal Service Publication 417, Nonprofit Standard Mail Eligibility, online at <http://pc.usps.gov/cpin/ftp/pubs/Pub417/Pub417.pdf>.