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The Nonprofit Integrity Act of 2004

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The Nonprofit Integrity Act of 2004 (“NIA”), signed into law by Gov. Schwarzenegger on September 29, 2004, became effective on January 1, 2005. NIA represents California’s legislative reforms to strengthen the accountability and oversight of charitable organizations and commercial solicitation campaigns conducted on behalf of charitable organizations.

Background

High profile corporate governance and accounting scandals at Enron, WorldCom and other companies led to passage of the Sarbanes-Oxley Act of 2002 (“SOX”), described by some commentators as the single most important piece of legislation affecting corporate governance, financial disclosure and the public accounting practice since the 1930s. The initial objective of SOX was to improve the accountability of managers to shareholders and thereby restore public confidence in the public markets.

Scandals in the nonprofit sector also received considerable media attention and prompted state and federal legislators to seek reforms to improve the accountability of directors and trustees to the public. In California, Attorney General Bill Lockyer cited two scandals in particular that prompted his reform package eventually carried in the legislature by Sen. Byron Sher (D) as SB 1262, The Nonprofit Integrity Act of 2004.

The first scandal involved PipeVine, an organization established by, and closely linked to, the United Way of the Bay Area. PipeVine was designed as a fee-based donation processing agency that handled money raised in workplace campaigns and routed the money to thousands of designated charities. PipeVine failed to properly process the donations and the designated charitable recipients reportedly ended up about \$19 million short at the time PipeVine was shut down. As part of a settlement agreement, the United Way of the Bay Area agreed to pay \$13 million to make up for the shortfall.

The second scandal involved Hollywood fundraiser Aaron Tonken, who provided celebrities with millions of dollars to appear at charity fundraising events while defrauding charities to the degree of nearly \$4 million. Tonken has since been convicted, sentenced to 63 months in prison, and ordered to pay restitution.

This memorandum is intended to provide accurate information with respect to its subject matter. It does not constitute legal or professional advice, and it is not an invitation for an attorney-client relationship. If specific legal advice is sought, the reader is advised to retain the services of a competent professional.

Early drafts of the Attorney General's reform package provided for a mandatory audit with a gross revenues threshold of \$250,000, the same amount recommended by the Better Business Bureau Wise Giving Alliance in its Standards for Charity Accountability. Delegates of the California Association of Nonprofits invited to review these early drafts successfully argued that such a low threshold would subject small human services organizations to an additional expense of between \$7,000 and \$14,000 a year, which would jeopardize their abilities to provide critical services. By the time the draft legislation was introduced by Sen. Sher, the audit threshold had been raised to \$500,000. At the hearing before the Senate Judiciary Committee, and after much testimony against the bill, Sen. Sher announced that he had been persuaded that the audit costs would be an unmanageable burden for small charities and agreed, with the consent of the Attorney General's representative, to amend SB 1262 to further raise the audit threshold to \$2 million.

Who Is Impacted by NIA?

NIA applies to all charitable corporations, unincorporated associations, and trusts over which the State of California or the Attorney General has enforcement or supervisory powers, including:

- California nonprofit public benefit corporations
- California nonprofit mutual benefit corporations holding property for charitable purposes
- Foreign charitable corporations doing business in California or holding property in California for charitable purposes (subject to minimum contacts)
- Unincorporated associations holding property for charitable purposes
- Charitable trusts

Notwithstanding the foregoing, the filing, registration and reporting provisions of NIA do not apply to the following organizations:

- Educational institutions
- Religious organizations
- Hospitals
- Licensed health care service plans
- Cemeteries

Registration

Every charitable corporation, unincorporated association and trustee subject to NIA shall file with the Attorney General's Registry of Charitable Trusts a copy of the articles of incorporation, or other governing instrument, within 30 days after it initially receives property; provided, however, that a trustee is not required to register as long as the charitable interest in the trust is a future interest (e.g., CRT), but shall do so within 30 days after any charitable interest in a trust becomes a present interest. Gov. Code §12585.

The Initial Registration Checklist (available on the Attorney General’s website at <http://caag.state.ca.us/charities/forms.htm>) designed to assist charities in completing their initial registration requests the following information:

- Contact information for the organization.
- The organization’s founding document (e.g., articles of incorporation).
- The organization’s bylaws.
- Names and addresses of all directors, officers and trustees.
- The organization’s annual accounting period.
- Statement of activities in California and the date business was commenced.
- Copy of the IRS determination letter or if the IRS has yet to grant exemption, the FEIN for the organization and the date the organization applied to the IRS for exempt status.
- \$25 initial registration fee.

Governance

A. Audit – Gov. Code §12586(e)(1)

The audit requirement applies to every charitable corporation, unincorporated association and trustee required to file reports with the Attorney General pursuant to Gov. Code §12586 and that receives or accrues in any fiscal year gross revenues of \$2 million or more, exclusive of grants from, and contracts for services with, governmental entities for which the governmental entity requires an accounting of the funds received (each, a “\$2 Million Charity”). An audit will be required for all fiscal years ending on or after June 30, 2005.

A \$2 Million Charity must prepare annual financial statements using generally accepted accounting principles (“GAAP”).

Such financial statements must be audited by an independent CPA in conformity with generally accepted auditing standards (“GAAS”). If the auditing firm performs any nonaudit services for the charity, the firm and its auditors must adhere to the standards for auditor independence set forth in the Government Auditing Standards issued by the Comptroller General of the United States (the “Yellow Book”) or such other standards prescribed by the Attorney General.

If a charity that is required to prepare an annual audit is under the control of another organization, the controlling organization may prepare a consolidated financial statement.

The audited financial statements and notes to the statement must be made available for inspection by the Attorney General and by the public no later than 9 months after the close of the fiscal year to which the statements relate. An organization may meet the public availability requirement by (i) making audited statements available for inspection during regular business hours by any individual at its principal office or any regional or district office having 3 or more employees; and (ii) either (a) providing a copy

of the audited statements to any person who requests it without charge (other than a reasonable fee for copying and mailing costs) or (b) posting the audited statements on a freely accessible webpage that the charity establishes and maintains or having them posted as part of a database of similar documents of other exempt organizations on a freely accessible webpage established and maintained by another entity (e.g., GuideStar). The management letter is not required to be released to the public.

B. Audit Committee – Gov. Code §12586(e)(2)

The audit committee requirement applies to every \$2 Million Charity that is a corporation. The audit committee may have as few as one member and may include persons who are not members of the board of directors. The audit committee may not include any members of the staff, including the president or CEO and the treasurer or CFO, or any employees or independent contractors having the duties of such positions. According to the Attorney General’s website, the audit committee may include the president, CEO, treasurer or CFO to the extent that those persons are acting merely as officers of the board of directors rather than as members of the staff.

If the corporation has a finance committee, it must be separate from the audit committee. Finance committee members may serve on the audit committee; however, the chairperson of the audit committee may not serve on the finance committee and members of the finance committee must constitute less than half of the membership of the audit committee.

If audit committee members are paid for their service, they may not receive compensation in excess of that received by board members for their service on the board. Accordingly, if the board members are volunteers not entitled to any compensation for their service, audit committee members may not be compensated. In addition, audit committee members may not have a material financial interest in any entity doing business with the corporation.

The audit committee is subject to the board’s supervision and therefore is not a board committee to which all the authority of the board may be delegated. The audit committee has the following five duties:

1. Recommending to the board the retention and termination of the auditor.
2. Conferring with the auditor to assure its members that the financial affairs of the corporation are in order.
3. Reviewing and determining whether to accept the audit.
4. Assuring that any nonaudit services performed by the auditing firm conform to the Yellow Book standards for auditor independence.
5. Approving performance of any nonaudit services by the auditing firm.

The audit committee may negotiate the auditor’s compensation on behalf of the board. If the charity is under control of another corporation, the audit committee may be part of the board of the controlling corporation.

C. Executive Compensation – Gov. Code §12586(g)

The board of directors, an authorized committee of the board or the trustees of a charitable trust must review and approve the compensation (including benefits) of (i) the president or CEO and (ii) the treasurer or CFO to assure that it is “just and reasonable.”

This review and approval must occur:

- Initially upon the hiring of the officer.
- Whenever the term of employment, if any, of the officer is renewed or extended.
- Whenever the officer’s compensation is modified, unless such modification extends to substantially all employees.

A charity may choose to follow the procedures under Treasury Regulations §53.4958-6, which establishes a rebuttable presumption of reasonableness in the context of an excess benefit transaction:

- The compensation arrangement must be approved in advance by an authorized body composed of individuals who do not have a conflict of interest concerning the transaction.
- Prior to making its determination, the authorized body must obtain and rely upon appropriate data as to comparability.
- The authorized body must adequately and timely document the basis for its determination concurrently with making such determination.

Commercial Fundraisers

Gov. Code §12599(a) defines “commercial fundraiser for charitable purposes” (“Commercial Fundraiser”) as any individual, corporation, unincorporated association or other legal entity who for compensation does any of the following:

- Solicits funds, assets, or property (“Funds”) in California for charitable purposes.
- As a result of a solicitation of Funds in California for charitable purposes, receives or controls the Funds for charitable purposes.
- Employs, procures or engages any compensated person to solicit, receive or control Funds for charitable purposes.

Notwithstanding the foregoing, an employee or trustee of a charitable organization is not a Commercial Fundraiser.

A. Notification of Attorney General Before Solicitation Campaign – Gov. Code §12599(h)

The Commercial Fundraiser shall file a notice with the Registry of Charitable Trusts (i) not less than 10 working days prior to the start of a solicitation campaign, event

or service; or (ii) not later than the start of a solicitation to aid victims of emergency hardship or disasters. The notice (Form CT-10CF, available at <http://caag.state.ca.us/charities/forms.htm>) sets forth the following information:

- Contact information of the Commercial Fundraiser.
- Contact information of the contracting charity.
- The fundraising methods to be used.
- Projected dates of performance of the contract.
- Contact information of the person responsible for directing and supervising the work of the Commercial Fundraiser under the contract.

B. Written Contract with Charitable Organization – Gov. Code §12599(i)

The Commercial Fundraiser and the charity to receive services performed by the Commercial Fundraiser must enter into a written contract signed by an authorized representative of each party and available for inspection by the Attorney General. Such contract must contain the following provisions:

1. Legal name and address of the charity unless it is exempt from registration.
2. Statement of the charitable purpose for which the solicitation campaign, event or service is being conducted.
3. Statement of the respective obligations of the Commercial Fundraiser and the charity.
4. If the Commercial Fundraiser is to be paid a fixed fee, a statement of the fee to be paid to the Commercial Fundraiser and a good faith estimate of what percentage the fee will constitute of the total contributions received; and a statement of the assumptions, which are based upon all of the relevant facts known to the Commercial Fundraiser regarding the solicitation, upon which the estimate is based.
5. If the Commercial Fundraiser is to be paid a percentage fee, a statement of the percentage of the total contributions received that will be remitted to or retained by the charity, or, if the solicitation involves the sale of goods, services or admissions to a fundraising event, the percentage of the purchase price that will be remitted to the charity.
6. Effective and termination dates of the contract, and the date solicitation activity in California is to commence.
7. Provision that requires that each contribution in the control or custody of the Commercial Fundraiser in its entirety and within five working days of its receipt either:
 - a. Be deposited in an account at a bank or other federally insured financial institution that is solely in the name of the charity and over which the charity has sole control of withdrawals.
 - b. Be delivered to the charity.
8. Statement that the charity exercises control and approval over the content and frequency of any solicitation.
9. If the Commercial Fundraiser proposes to make any payment to any person or entity to secure any person's attendance at, or sponsorship, approval or

- endorsement of, a charity fundraising event, the maximum dollar amount of those payments shall be set forth in the contract.
10. Provision that the charity has the right to cancel the contract without cost, penalty or liability for a period of 10 days following the execution date; that cancellation may be made by serving written notice on the Commercial Fundraiser; and that, if mailed by certified mail, return receipt requested, cancellation shall be deemed effective upon the expiration of five days after the date of mailing.
 11. Provision that, following the initial 10-day cancellation period, the charity may terminate the contract by giving 30 days' written notice; that if mailed by certified mail, return receipt requested, service shall be deemed effective upon the expiration of five days after the date of mailing; and that, in the event of termination by this provision, the charity shall be liable for services provided by the Fundraising Counsel up to 30 days after the effective service of the notice.
 12. Provision that, following the initial 10-day cancellation period, the charity may terminate the contract at any time upon written notice, without payment or compensation of any kind to the Commercial Fundraiser, if the Commercial Fundraiser or its agents, employees or representatives:
 - a. Make any material misrepresentations in the course of solicitations or with respect to the charity;
 - b. Are found by the charity to have been convicted of a crime arising from the conduct of a solicitation for a charity or charitable purpose punishable as a misdemeanor or felony; or
 - c. Otherwise conduct fundraising activities in a manner that causes or could cause public disparagement of the charity's good name or good will.

C. Recordkeeping of Solicitation Campaign Records for 10 Years –
Gov. Code §12599.7(a)

A Commercial Fundraiser must maintain during each solicitation campaign and for not less than 10 years following the completion of each solicitation campaign records that contain the following information, which shall be made available for inspection upon demand by the Attorney General:

- The date and amount of each contribution.
- The name and address of each noncash contributor.
- The name and address of each employee or agent involved.
- Record of all revenue received and expenses incurred in the course of the solicitation campaign.
- For each account into which the Commercial Fundraiser deposited revenue from the solicitation campaign, the account number and name and location of the bank or other financial institution in which the account was maintained.

D. Commercial Fundraisers' Obligations When Fundraising –
Gov. Code §12599.6(a) and (e)

1. A Commercial Fundraiser shall not misrepresent the charity's purpose or the nature or purpose or beneficiary of a solicitation, whether by words, conduct, or failure to disclose a material fact.
2. Each contribution in the control of a Charitable Fundraiser must in its entirety and within 5 working days of receipt:
 - a. Be deposited in an account at a bank or other federally insured financial institution that is solely in the name of the charity and over which the charity has sole control of withdrawals.
 - b. Be delivered to the charity.

Fundraising Counsel

Gov. Code §12599.1(a) defines "fundraising counsel for charitable purposes" ("Fundraising Counsel") as any individual, corporation, unincorporated association or other legal entity who is described by all of the following:

- For compensation plans, manages, advises, counsels, consults, or prepares material for, or with respect to, the solicitation in California of Funds for charitable purposes ("Fundraising Counsel Activities").
- Does not solicit Funds for charitable purposes.
- Does not receive or control Funds solicited for charitable purposes in California.
- Does not employ, procure or engage any compensated person to solicit, receive or control Funds for charitable purposes.

Notwithstanding the foregoing, none of the following persons are Fundraising Counsel:

- An attorney, investment counselor or banker engaged in the giving or legal, investment or financial advice.
- An employee or trustee of a charitable organization.
- A person whose total annual gross compensation for performing any Fundraising Counsel Activities does not exceed \$25,000.

A. Notification of Attorney General Before Solicitation Campaign –
Gov. Code §12599.1(e)

The Fundraising Counsel must file a notice with the Registry of Charitable Trusts (i) not less than 10 working days prior to the start of the performance of any service for a charity by Fundraising Counsel; or (ii) not later than the start of a solicitation to aid victims of emergency hardship or disasters. The notice (Form CT-11CF, available at <http://caag.state.ca.us/charities/forms.htm>) sets forth the following information:

- Contact information of the Fundraising Counsel.
- Contact information of the contracting charity.

- Projected dates of performance of the contract.
- Contact information of the person responsible for directing and supervising the work of the Fundraising Counsel under the contract.

B. Written Contract with Charitable Organization – Gov. Code §12599.1(f)

The Fundraising Counsel and the charity to receive services performed by the Fundraising Counsel must enter into a written contact signed by an authorized representative of each party and available for inspection by the Attorney General. Such contract must contain the following provisions:

1. Legal name and address of the charity unless it is exempt from registration.
2. Statement of the charitable purpose for which the solicitation campaign is being conducted.
3. Statement of the respective obligations of the Fundraising Counsel and the charity.
4. Statement of the fees and other compensation, including commissions and property, that will be paid to the Fundraising Counsel.
5. Effective and termination dates of the contract, and the date solicitation services in California will commence.
6. Statement that the Fundraising Counsel will not at any time solicit funds, assets or property for charitable purposes, receive or control Funds solicited for charitable purposes, or employ any compensated person to solicit, receive or control Funds for charitable purposes.
7. Statement that the charity exercises control and approval over the content and frequency of any solicitation.
8. Provision that the charity has the right to cancel the contract without cost, penalty or liability for a period of 10 days following the execution date; that cancellation may be made by serving written notice on the Fundraising Counsel; and that, if mailed by certified mail, return receipt requested, cancellation shall be deemed effective upon the expiration of five days after the date of mailing.
9. Provision that, following the initial 10-day cancellation period, the charity may terminate the contract by giving 30 days' written notice; that if mailed by certified mail, return receipt requested, service shall be deemed effective upon the expiration of five days after the date of mailing; and that, in the event of termination by this provision, the charity shall be liable for services provided by the Fundraising Counsel to the effective date of the termination.

Charity's Right to Void or Cancel Contracts with Commercial Fundraisers of Fundraising Counsel

A. Voidable Contract with Unregistered Commercial Fundraiser or Fundraising Counsel – Gov. Code §12599.3(a)

A charity has the right to void a contract between itself and a Commercial Fundraiser or Fundraising Counsel which has not registered with the Registry of Charitable Trusts prior to the start of the solicitation.

B. Cancelable Contract with Commercial Fundraiser or Fundraising Counsel – Gov. Code §12599.3(b), (f) and (g)

A charity has a right to cancel the contract with a Commercial Fundraiser or Fundraising Counsel without cost, penalty or liability for a period of 10 days following the execution date, and such right cannot be waived.

Following the 10-day cancellation period, the charity may terminate a contract with a Commercial Fundraiser or Fundraising Counsel by giving 30 days' written notice. If mailed, service of notice must be by certified mail, return receipt requested, and service shall be deemed effective upon the expiration of five days from the date of mailing. The charity shall be liable for service provided by the Commercial Fundraiser or Fundraising Counsel up to 30 days after the effective service of the notice.

Following the 10-day cancellation period, the charity may terminate a contract with a Commercial Fundraiser or Fundraising Counsel at any time upon written notice, without payment or compensation of any kind to the Commercial Fundraiser or Fundraising Counsel, if the Commercial Fundraiser or Fundraising Counsel, or their agents, employees or representatives:

- Make any material misrepresentations in the course of solicitations or with respect to the charity;
- Are found by the charity to have been convicted of a crime arising from the conduct of a solicitation for a charity or charitable purpose punishable as a misdemeanor or felony; or
- Otherwise conduct fundraising activities in a manner that causes or could cause public disparagement of the charity's good name or good will.

Charity's Obligations When Fundraising

Gov. Code §12599.6(a), (b), (c) and (d)

1. A charity shall not misrepresent its purpose or the nature or purpose or beneficiary of a solicitation, whether by words, conduct, or failure to disclose a material fact.
2. A charity must "establish and exercise control" over its fundraising activities conducted for its benefit, including approval of all written contracts and agreement, and must assure that fundraising activities are conducted without coercion.

3. A charity shall not enter into any contract or agreement with, or employ, any unregistered Commercial Fundraiser or Fundraising Counsel unless such Commercial Fundraiser or Fundraising Counsel agrees to register prior to the start of any solicitation.
4. A charity shall not enter into any contract or agreement with, or raise any funds for, any charity required to be registered unless that charity is registered or agrees to register prior to the start of the solicitation.

The Twelve Prohibitions

Gov. Code §12599.6(f)

NIA prohibits the following twelve acts and practices in the planning, conduct or execution of any solicitation or charitable sales promotion, regardless of whether any injury is suffered:

1. Operating in violation of the Act or regulations or orders of the Attorney General, or soliciting contributions after the solicitor's registration has expired or has been suspended or revoked.
2. Using any unfair or deceptive acts or practices, or engaging in any fraudulent conduct that creates a likelihood of confusion or misunderstanding.
3. Using any name, symbol, emblem, statement or other material that falsely suggests or implies to a reasonable person that the contribution is to or for the benefit of a particular charity.
4. Misrepresenting or misleading anyone to believe that a charitable solicitation or sales promotion is being conducted for a charity or that the proceeds of such solicitation or promotion will be used for charitable purposes when that is not the fact.
5. Misrepresenting or misleading anyone to believe that any other person sponsors, endorses or approves a charitable solicitation or sales promotion when that person has not given written consent to the use of the person's name for such purposes.
6. Misrepresenting or misleading anyone to believe that a good or service has endorsement, sponsorship, approval, characteristics, benefits or qualities that it does not have, or that a person has endorsement, sponsorship, approval, status or affiliation that such person does not have.
7. Misrepresenting or misleading anyone to believe that registration with the Registry of Charitable Trusts constitutes an endorsement or approval by the Attorney General.
8. Representing that a charity will receive an amount greater than the actual net proceeds reasonably estimated to be retained by the charity for its use.
9. With respect to solicitations by commercial fundraisers for charitable purposes on behalf of public safety personnel, offering or distributing any honorary membership cards or any 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 to appear in a for-profit publication that could reasonably be construed to relate to any charitable purpose without making

the following disclosures at the time of solicitation and in writing prior to receipt of money for the sale:

- a. The publication is a for-profit, commercial enterprise.
 - b. The name of the solicitor and the fact that the solicitor is a professional solicitor.
 - c. The publication is not affiliated with or sponsored by any charity.
11. Representing that any part of the contributions solicited by a charity will be given to another charity unless an authorized officer, director or trustee of the other charity has consented in writing to use of such charity's name prior to the solicitation.
12. Representing that tickets to events will be donated for use by another unless the following requirements have been met:
- a. The charity or commercial fundraiser has written commitments from charities stating that they will accept donated tickets and specifying the number of tickets they are willing to accept.
 - b. The donated tickets will not, when combined with other ticket donations, exceed either the number of ticket commitments received from charities or the total attendance capacity of the event site.