Session 305

A Legal Primer for Nonprofits and Professional Associations (Part I)

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A Liability Overview for Associations and Nonprofits.

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I. Introduction, Scope, Limits, and Disclaimers

A. A review of examples of the kinds of liability that associations can accrue by virtue of their own activities and those of their affiliates and members.

1. Direct liabilities - what the entity itself did.

2. Derivative liabilities - what others allegedly did for it.

3. Excludes labor and employment and intellectual property cases.

B. Session is illustrative of four different kinds of liabilities. It is not exhaustive, either as to types of exposure or examples of cases.

1. Standard setting, policy making, evaluation offering activities - general tort liability

2. Certification and information sharing activities - antitrust liability

3. Attempts at risk spreading - "name plate" cases

4. Ordinary but expensive cases - misconduct of employees and volunteers

C. Gratitude to ACCA members who shared information in response to my request and to Jerald Jacobs, Jenner & Block, Washington, D.C. - general counsel to the American Society of Association Executives.

D. Some Resources -

1. *Association Law Handbook*, Jerald Jacobs, ASAE, Washington, D.C. 1996

2. *Legal Risk Management for Associations*, Jerald Jacobs and David Ogden, APA, Washington D.C. 1995

3. Non Profit Risk Management Center - www.nonprofitrisk.org (many useful publications and a newsletter geared to the nonprofit community.). Washington, D.C. 202-785-3891

4. American Society of Association Executives - www.asaenet.org (many useful resources on line and through publications). Washington, D.C. 202-626-2723

II. Basic Approach to Risk Management

A. The processes by which a person or organization -

1. Anticipates, evaluates, prioritizes, and plans for occurrences, accidents, and incidents in the course of one's activities; and

2. Attempts to prevent or mitigate those possibilities; and

3. Creates a structure for responding effectively to those possibilities.

B. "Risk is a part of life."

1. Selling that reality to management.

2. Importance of involvement of legal function in a team approach that includes management, insurance, public relations, and "technical" people.

C. Post - Policy Syndrome and its adverse consequences: tendency to ignore a matter after it has been committed to a written policy.

1. Need to rethink and revise policies based on experience.

2. Need to train operating staff periodically.

D. When in doubt, do the right thing. - Has both procedural (fairness) and substantive (truthfulness) attributes.

III. General Liability in Tort for Association Activities

Associations that offer opinions, collect and disseminate information, offer ratings and reviews, serve as a clearinghouse for information risk general tort liability.

A. Case illustration - The Motion Picture Association of American rates films. Plaintiffs sued the Association after their son was shot by a 13 year old who had just viewed (without parents and without permission) the R-rated "Dead Presidents." Association prevailed as court found NO duty to plaintiff. Court held that the benefits of rating system flow to the parents of young person who saw the movie unaccompanied by an adult, not to "society at large" including plaintiffs' decedent. *Delgado v. American Multi-Cinema,* 85 Cal. Rptr. 2d 838 (Cal. App. 1999)

Query-What result when plaintiffs sue parents of shooter, who, in turn, implead the Association?

B. Procedural issues. Personal jurisdiction over an out-of-state association.

1. The activities must be "purposefully directed" at the forum state, to provide "minimum contacts" such that the assertion of jurisdiction comports with due process standards of justice and fair play. *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 471-72 (1985).

2. If the lawsuit arises directly out of association's conduct in the forum state, that may be sufficient. Mere association with the forum is not enough.

a. Allegations of conspiracy between Association and resident member insufficient based solely on effects. Association must target its actions in such a way that jurisdiction to answer for its conduct is foreseeable. *National Industrial Sand Ass'n v. Gibson,* 897 S.W. 2d 769, 773 (Tx. 1995)

b. Petitioning the government on behalf of resident members is not enough to warrant jurisdiction for action based on alleged inadequacy of standards.

3. General jurisdiction requires "systematic and continuous contact" - *Skinner v. Flymo, Inc.* 505 A.2d 616 (Pa. Super. 1986):

   (a) High percentage of association members resident in state (5-10%)

   (b) Substantial dues income from resident members. ($40,000)

   (c) Large sums of money earned by association publications and other activities in state ($500,000).

   (d) Repeated association meetings or symposia in state (4 meetings).

   Factors are balanced and the thresholds appear low (factors sufficient to trigger jurisdiction in parentheses).

C. Substantive issues.

Associations are bound to the same level of care and reasonableness in their actions as are any other kind or class of activity. Issue however is when the action of the association triggers either direct or derivative liability in tort. Three examples -

1. Setting standards and offering policy, guidance, or recommendations.

   Cases seem to divide around the degree to which association's work is binding versus advisory, intended to convey a sense of certitude to the consuming public, and was, in fact, relied upon to their detriment.

   a. Negligence cases will turn on question of whether a duty was owed to consumer or end user. That issue, in turn, reflects degree of control delegated to association by members. *Compare Snyder v. American Association of Blood Banks,* 676 A.2d 1036 (N.J. 1996) (duty) *with Meyers v. Donnatacci,* 531 A.2d 398 (N.J. Super. 1987) (no duty). *See also, King v. National Spa and Pool Institute,* 570 So.2d 612 (Ala. 1990).

Cases alleging the inadequacy of existing standards are easier to maintain (*Snyder*) than those alleging failure to warn (*Meyers*).

b. Product certification is a special problem.

i. What does the "certification" convey to user? *Duffin v. Crater Farms,* 895 P.2d 1195 (Idaho 1995)(liability when intended to convey reliability to consumer).

ii. Was there reliance? *Collins v. American Optometric Ass'n*, 693 F.2d 636 (7th Cir. 1982)(plaintiff could not identify any AOA advertisement or product).

c. In determining whether a product certifier should have liability, courts have divided based largely on the identity of the parties and the nature of the injuries. Real persons suffering physical injury may recover from the certifier, while corporations suffering economic harm may not. *Compare Hanberry v. Hearst Corp*., 81 Cal. Rptr. 519 (Cal. App. 1969)(recovery) *with Benco Plastics v. Westinghouse Corp.*, 387 F. Supp. 772 (E.D. Tenn. 1974)(no recovery on misrepresentation theory, dispute over causation).

In *Benco*, the court summarized policy considerations relevant to the liability considerations: "(1) the degree of closeness between the injured party and the endorser, (2) the nature of the plaintiff's injury, (3) the causal connection between the plaintiff's injury and the endorser's representation, (4) the evidence of reliance on the endorser's representations, (5) the moral culpability attached to the endorser's conduct, (6) the policy of preventing future harm, and (7) the nature of the endorser's business." 387 F. Supp. at 786.

2. Defamation - a false or misleading statement to a third party about some person, product, service, or entity, absent a privilege for the communication.

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a. Common in employment/reference disputes.

b. Extends to association especially through its publications, public statements, newsletters, or opinion letters.

c. Corporate defamation - growing area of potential liability wherein some organization alleges it was defamed ("former" member, competitor, antagonist in public policy arena, etc.). *Metastorm, Inc. v. Gartner Group,* 28 F. Supp.2d 665 (D.D.C. 1998) (action against information technology reporter).

d. May have a qualified privilege to engage in communications within the organization for purposes of promoting members' common interest in activity (standard setting, code enforcement, etc.). Want to assure no fair inference of ill motive. Limit sensitive statements to those who need to know.

3. Action in concert with or on account of member, including efforts to place liability for an action that was taken by a local or regional affiliate.

a. Failing to advise of risks or dangers in an action -- does the Association assume obligation to its member to make such information available? *Friedman v. F.E. Myers Co.,* 706 F.Supp. 376, 382-83 (E.D. Pa. 1989) (although associations had issued "public information releases," it was under no duty to do so). *Compare Arnstein v. Manufacturing Chemists Ass'n*, 414 F.Supp. 12, 14 (E.D. Pa. 1976) (association had activities in recommending safety procedures and had special research program, sufficient to state claim for relief and allow discovery). Cases also illustrate difference noted above (§ C,1,a) between "failure to warn" and "negligent standards".

b. Civil conspiracy requires affirmative action - intent to injure inferred from allegations of association publishing false and misleading information on hazard. *Friedman v. Myers Co., supra* at 384.

c. Agency allegations to establish vicarious liability in national association depends on control, supervision, and training, not just common name. *Wilson v. Boy Scouts of America*, 989 F.2d 953, 959 (8th Cir. 1993). *See* section V, *infra.*

IV. Antitrust Exposure for Association Activities

Trade and professional associations, by definition, are composed of competitors in the ordinary marketplace. The sharing of information (especially about costs and prices), the setting of standards and policies (especially when resolving internal industry disputes), and providing evaluations (especially in reacting to new products or ideas) all can trigger antitrust exposure if anti-competitive.

A. Texas Charitable Annuities Litigation - aimed as a class at all members for price-fixing. Filed against any member who had a representative on the Board (about 25), such as the Southern Baptist Convention, Northwestern University, Lutheran Church-Missouri Synod, and Salvation Army.

1. American Council on Gift Annuities did offer information on rates of return, believing that competition among charities should occur on content and activities, not on rate of return.

2. Expensive, vexacious, and harassing - discovery and pre-trial proceedings. Defendants with no connection to the underlying claim held in over their vigorous objection.

3. Two national legislative fixes and some state fixes to solve the case. *See Ozee v. American Council on Gift Annuities,* 143 F.3d 937 (5th Cir. 1998) (summarizing history and legislative action).

B. Associations and non-profits are subject to the antitrust laws and to trade regulation. *California Dental Ass'n v. FTC,* 119 S.Ct. 1604 (1999), *American Society of Mechanical Engineers v. Hydrolevel Corp.,* 456 U.S. 556, 577 (1982) (rejecting "nonprofit" defense).

1. Antitrust laws apply to associations, even if they are composed of licensed professionals. *Goldfarb v. Virginia State Bar,* 421 U.S. 773, 786-88 (1975).

2. Can be enforced even if they might restrain actions that, in another context, might have First Amendment protections. *National Association of Professional Engineers v. United States,* 435 U.S. 679-98 (1978).

C. Actions subject to scrutiny are especially vulnerable if they tend to affect price (raising, lowering stabilizing), profit margins, costs, market shares, and the like.

1. Gathering and disseminating industry information, research, advancements, trends, and improvements, when done fairly without any intent to restrain competition is legitimate. *Compare Maple Flooring Ass'n v. United States,* 268 U.S. 563, 583-85 (1925) (valid) *with American Column v. United States,* 257 U.S. 377, 397-99 (1921) (sharing of information aimed at manipulating price, invalid).

2. Actions of agents and committees, aimed at stifling competition or targeting competitors, attributed to association. *Am. Soc. of Mech. Engs. v. Hydrolevel, supra* ("safety" evaluation of new product performed by competitor).

3. Association standard setting is important activity but should not be used to create barriers to markets, mislead customers or users, or restrict competition. *E.g., National Macaroni Mftrs Ass'n v. FTC,* 345 F.2d 24, (7th Cir. 1965).

D. *Noerr-Pennington* Doctrine - No antitrust liability for joint efforts, legitimately designed, to lobby government for or against legislative action. *Eastern Railroad Presidents' Conference v. Noerr Motor Freight,* 365 U.S. 127, 137-38 (1961); *UMW v. Pennington,* 381 U.S. 657, 670 (1965). The law forbids restraints of trade, not of political activity.

1. Attempts to use government process to restrain trade are a sham, not entitled to protection. *California Motor Transport v. Trucking Unlimited,* 404 U.S. 508 (1972).

2. Attempts to influence private standards - setting body, not entitled to protection. *Allied Tube & Conduit v. Indian Head, Inc.,* 486 U.S. 492 (1988).

3. Protection limited to legislative action, not to government procurement process, or administrative or regulatory functions.

E. Price Reporting Programs - One commentator suggest these nine guidelines to mitigate the possibility of antitrust exposure:

(a) The independence of each reporting participant in the program to change their prices must remain inviolate.

(b) No reporting plan should be compulsory, coercive, or obligatory.

(c) Associations should refrain from sponsoring or preparing suggested manufacturers' retail price lists.

(d) All price changes should first be reported to customers, then to competitors.

(e) General price information should be available to all on proportionately equal terms.

(f) Reporting should not be unduly specific and detailed.

(g) Discussion of prices at association meetings should be avoided, before, during, and after such assemblages.

(h) The program's purpose should dispel unlawful inferences.

(i) Care should be exercised even as to use of recent past prices."

George Webster, *The Law of Associations*, § 10.02 [3], p. 10-18 (rev. 1988).

F. *See* Jerald Jacobs, *Association Law Handbook*, Section III "Association Antitrust," pp. 230-368 (3d ed. 1996).

V. Risk Spreading - Claims by persons injured by one employee or volunteer answerable to a local or regional member, affiliated with a national entity.

A. "Nameplate" cases - "All of these defendants have "Lutheran" or "Red Cross" or "Boys Scouts" or [INSERT YOUR ORGANIZATION] in their names. They must have been acting in concert, usually through the national association, to do some unspeakably expensive thing to the plaintiff."

1. Broad definition of association - (1) group whose members share a common purpose and (2) when it functions under a common name under circumstances where fairness requires the group to be recognized as a legal entity.

2. Has the group ever asserted group rights? Filed briefs, provided testimony, responded in its own broad name. *Coscarart v. Major League Baseball,* 1996 WL 400988 (N.D. Cal.)

3. Jurisdictionally, an association has citizenship everywhere its members have citizenship. *United Steel Workers of America v. Bouligny*, 382 U.S. 145 (1965). Still, membership alone does not trigger jurisdiction for "out of state" association. *National Industrial Sand Ass'n v. Gibson,* 897 S.W.2d 769 (Tex. 1995).

B. Examples of claims -

1. Conspiracy - a meeting of the minds of two or more members (or a local and a regional member or the national association) to do an unlawful act or a lawful act in an unlawful way.

2. Failure of Standards and Policy - usually alleged to be non-existent or inadequate, but pervasive through the association, now called a "joint venture."

C. Examples of Cases -

1. General Tort liability - against the perpetrator, the local supervisor, regional chapter, and a national association.

   a. Targeted as providing a forum in which to discuss "cover-up" of problem including a decision not to report.

   b. Defenses include failure to state a claim, no duty to claimant (only to members), First Amendment.

   c. Underlying claim went to jury. *Doe v. Diocese of Dallas*.

2. Breach of Contract - against the other party to the contract, affiliated regional corporation, and entire alleged "association."

   a. Mission statement says act of one is the act of everyone. All members and components process loyalty and adherence to mission statement.

   b. Underlying claim settled after court refuses motion for summary judgement. *Barr v. United Methodist Church*, 153 Cal. Rptr. 322 (1979).

3. Products Liability - against all six manufacturers of certain explosives and their trade association. Alleged that makers of explosives knew of particular risk to children through trade association activities, and delegated industry-wide safety and standards action to the association. Survived motion to dismiss. *Hall v. DuPont,* 345 F.Supp.353 (E.D.N.Y. 1972).

Court said - "Factors which must be explored to determine both the existence of joint control of risk and appropriate remedies (if any) include the size and composition of the trade association's membership, its announced and actual objectives in the field of safety, its internal procedures of decision-making on this issue, the nature of its information-gathering system with regard to accidents, the safety program and its implementation by the association and member manufacturers, and any other activities by the association and its members (such as legislative lobbying) with regard to safety at the time in question." *Id*. at 376.

D. Approaches to directive liability.

1. Kinds of liability assertions

a. Corporate authority - where in the structure of the "association" is this risk in fact located?

i. Articles of incorporation and by laws.

ii. Mission statements and management policy manuals.

iii. Actual corporate control is important. *Wilson v. Boy Scouts of America, supra* (citing cases).

b. Situational responsibilities - the tendency of some groups (and their leaders) (especially community - based non-profit/charities) to act, even in the absence of authority, to respond to a problem. Can create liability notwithstanding absence of authority such as through ratification.

2. Defenses - *Ponessi v. American Gold Star Mothers,* 725 F. Supp. 201 (S.D.N.Y. 1989) (citing cases)

a. Clarity in organization documents about allocating authority.

b. Separate incorporation of operational elements (Breach of Corporate veil). *Owens v. American Nat'l Red Cross,* 673 F. Supp. 1156 (D. Conn. 1987)

c. Consistency in responding to claims outside authority of national/regional entity.

3. In context of religious entities, see Chopko, "Ascending Liability of Religious Entities for the Actions of Others," 17 Am. J. Trial Adv. 289 (1993) (summarizing cases illustrating how liability claims are made and defended).

VI. A Special Case - Sexual misconduct of volunteers, employees, and others attributed to the community-based nonprofit.

A. Types of claims.

1. Negligent Selection - probative information in the background of an individual was available and not obtained. *See Focke v. United States,* 597 F. Supp. 1325, 1345-46 (D.Kan 1982).

a. Must be probative on misconduct in question, not on some other issue (alcoholism, financial problems)

b. Reference checks, criminal background checks (especially in education), and other follow-up.

c. Failure to give a truthful evaluation - the proverbial rock and hard place.

2. Negligent Supervision - probative information in the action of an individual was available and ignored or not addressed. *Andrews v. United States,* 548 F. Supp. 603, 611 (D.S.C. 1982).

a. Most common type of claim.

b. Most difficult to defend. *Scott v. Blanchett High School,* 747 P.2d 1124 (Wash. App. 1987).

3. Respondeat superior - usually the conduct is found outside the scope of duty. *Compare Moseley v. 2nd New St. Paul's Baptist Church,* 534 A.2d 346 (Md. App. 1987) *with Lyon v. Carey,* 533 F.2d 649 (D.C. Cir. 1976).

    a. New trend in the cases (Oregon and Canada) rejects a bright line approach and moves towards broader definition of motivation. *Fearing v. Bucher,* 328 Or.367, 977 P.2d 1163 (1999).

    b. In newer cases, courts ask whether a portion of the activities of the perpetrator were, in fact, authorized by the employer (e.g., intimate custodial contact).

4. Failure to Warn - is these a special relationship that triggers the responsibility? *Miller v. Everett*, 576 So.2d 1162 (La. App. 1991). Is there a special target of the person's attention? *Tarasoff v. Board of Regents,* 551 P.2d 334 (Cal.1976). Is there a special, at risk population? *Eiseman v. State of New York,* 489 N.Y.S. 2d 957 (N.Y. App. 1985).

5. Fiduciary duty - new use of mission statements and community service documents to create institutional fiduciary duty. *Martinelli v. Diocese of Bridgeport,* 10 F. Supp.2d 138 (D.Conn. 1998) (on appeal).

6. Harassment - Although the bar is set high, there is the possibility of federal claims against institutional aid recipients. *Davis v. Monroe County Bd. of Educ.,* 119 S.Ct. 1661 (1999) (Title IX private action).

B. Dealing with claims

1. Need for clear, written policies - communicated to staff and volunteers, understood to have no tolerance of misconduct, and forming the basis for training.

2. Public must understand organization's commitment to combat misconduct.

3. Create atmosphere in which persons victimized will feel they can be heard, believed, and understood.

4. Deal truthfully (as possible) with allegations.

   a. Single spokesperson.

   b. Balancing disclosure with privacy.

5. Deal effectively with the accused - removal from position, medical intervention, assistance.

6. Follow the law.

   a. Notify insurers.

   b. Notify authorities if required.

7. A team approach works best - management, legal, medical, public relations.

8. Follow-up: It-ain't over, 'til it's over.

C. Other considerations.

1. Balancing concern for victim with defense of litigation.

2. What about the possible false claim?

3. Serial problems - a group/association will judged not by the best response, but by the worst response.

4. The media is not interested in the truth.

VII. Conclusion and Discussion

PENDING ISSUES FOR NONPROFIT ORGANIZATIONS

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I. INTERMEDIATE SANCTIONS

A. Coverage

1. The proposed IRS regulations implement a statute that was passed in 1996. The provisions apply only to Section 501(c)(3) entities (that is, a nonprofit schools, hospitals and similar publicly supported educational, charitable or healthcare entities) and Section 501(c)(4) social welfare organizations, whether or not the organization has sought tax exempt status from the IRS.

2. Basic Rule: When a disqualified person engages in an excess benefit transaction with an entity described above, both the "disqualified person" and any "organizational manager" who knowingly participates in the transaction can be liable for excise taxes.

3. Under the proposed regulations, a disqualified person who receives an excess benefit from a transaction is liable for a tax equal to 25% of the excess benefit. However, if the excess benefit is not corrected within the "taxable period," the disqualified person is then liable for a tax of 200% of the excess benefit. For these purposes, "taxable period" is defined as the period beginning on the date the transaction occurs and ending on the earlier of the date of mailing a notice of deficiency for the 25% tax or the date on which the 25% tax is assessed.

4. Under the proposed regulations, each organization manager who participates in the excess benefit transaction, knowing that it was such a transaction (unless such participation was not willful and was due to reasonable cause), is liable for a tax equal to 10% of the excess benefit, not to exceed an aggregate amount of $10,000 with respect to any one excess benefit transaction.

B. Basic Terms and Concepts

1. "Disqualified persons" include:

a. Voting members of the entity's governing body.

b. The president, chief executive officer and chief operating officer.

c. The treasurer and chief financial officer.

d. Persons with a material financial interest in a provider-sponsored organization (such as health care joint ventures under IRC 501(o)).

e. Family members (spouse, ancestors, siblings, descendants, and their spouses), depending on the circumstances.

f. Entities in which a disqualified person directly or indirectly holds a 35% interest.

g. Depending on the circumstances, the term also might include a substantial contributor, a person whose compensation is based on the entity's revenues that he/she controls, a person who has control over a significant portion of expenditures, a person with managerial authority or who serves as a key advisor to someone with such authority, an officer of a subsidiary (whether taxable or not) that provides revenues to the parent, or a person who has a controlling interest in a corporation, partnership or trust that is a disqualified person.

h. Factors that indicate a person might not be a disqualified person include the following: the person has taken a vow of poverty; the person is an independent contractor (attorney, accountant, etc.) that receives no benefits from the entity other than fees; or the person is a donor, provided any benefits he/she receives are the same as are offered to other donors who make comparable donations.

2. "Excess benefit transaction" consists of any transaction in which the entity provides the "disqualified person" an economic benefit whose value is greater than the consideration the entity receives in return.

This could include payments for services to donors (or, more likely and thus more problematic, their corporations), compensation to managers, revenues shared with disqualified persons (such as revenues shared with doctors by hospitals or other medical organizations), etc.

3. "Organizational manager" includes any officer, director or trustee of the entity, as well as any other individual, regardless of title, who has similar responsibilities or who serves on a safe harbor committee (such as a compensation committee, etc.). As with disqualified persons, organization managers do not include independent contractors (such as attorneys, accountants, etc.).

4. A revenue sharing transaction may constitute an excess benefit transaction if, at any point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the accomplishment of the organization's exempt purpose. Examples of revenue sharing might include a share of income paid to university athletic coaches, a percentage of income paid to doctors at a hospital or clinic, etc.

C. Safe Harbor Processes

1. The safe harbor processes outlined in the draft regulations anticipate that compensation, revenue-sharing and similar arrangements will be reviewed and approved by an entirely independent board or committee (that is, a board or committee that has no member who himself/herself has a conflict of interest, either directly or because of family members, controlled corporations, etc.).

2. The approving body should receive objective data, including comparable data on salaries or transactions and, where appropriate, expert advice (such as compensation surveys conducted by third parties, trade association data on compensation levels and or typical costs of certain types of transactions, and advice from accountants and counsel).

3. Documentation should describe the terms of the transaction, date of approval, individuals who were present during the discussion and/or vote, the source and substance of data relied upon, actions taken and, if the approved compensation or transaction deviates from the comparables, the reason for the discrepancy. Minutes and other records must be ready by the subsequent meeting of the approving body.

D. Possible Problems and Solutions:

1. Are in-house attorneys and accountants "independent" enough? Whether or not they are, what insurance, indemnifications or other protections do they need (and can they properly obtain) in the event the advice they give turns out to be wrong?

2. May a for-profit corporation indemnify its officers who sit on nonprofit boards and become subject to proposed penalties for a disqualified transaction? Does it matter if the corporate officer's position on the nonprofit board was at the behest of the corporation? Even if not at the behest of the corporation, does it help if the corporation derives benefits from the officer's service on the nonprofit board, or might that be more of a liability than a benefit, especially if the alleged transaction comes under scrutiny by the very fact that the transaction allegedly benefits the corporation?

3. Who should advise a corporate officer with respect to his/her service on a nonprofit board?

4. What legal opinions should be obtained? More specifically, when, from whom, and covering what?

E. See Sample Resolution (attached)

II. REVENUE SHARING/"GAINSHARING"

A. OIG Ruling

1. Special Advisory Bulletin, Office of the Inspector General (OIG) of the Department of Human and Health Service (HHS), July 8, 1999 (www/dhhs.gov/progorg/oig/frdalrt/gainsh).

2. "Gainsharing" arrangements are intended to share with physicians some of the "gains" from reducing hospital overhead, but now have been held contrary to Section 1128A9(b)(1) of the Social Security Act.

3. Per the Special Advisory Bulletin: "While the OIG recognizes that appropriately structured gainsharing arrangements may offer significant benefits where there is no adverse impact on the quality of care received by patients, section 1128A(b)(1) of the Act clearly prohibits such arrangements. Moreover, regulatory relief from the [civil money penalties] prohibition will require statutory authorization."

4. Note: This is a much narrower result than the IRS has allowed, albeit under a different statutory scheme.

a. IRS private letter rulings have held: benefits to physicians must "constitute a lawful activity" and there must be no private inurement.

b. IRS Revenue Ruling 69-383: a compensation plan does not result in private inurement if three requirements are satisfied:

(i) The compensation plan is not inconsistent with the organization's tax-exempt status, such as being merely a device to distribute profits to principals.

(ii) The compensation plan is the result of arm's length bargaining.

(iii) The compensation plan results in reasonable compensation.

c. Pursuant to Revenue Ruling 97-21, recruitment incentives must:

(i) Bear a reasonable relationship to the accomplishment of the organization's tax-exempt purposes.

(ii) Not result in inurement of net earnings of the hospital to a private shareholder or individual.

(iii) Not cause the hospital to be operated for the benefit of a private interest rather than a public interest.

(iv) Not constitute a substantial unlawful activity.

d. For intermediate sanctions, the IRS is willing to find a revenue sharing arrangement to be permissible so long as total compensation is reasonable and benefits received by the employee are proportional to those received by the organization.

5. Notwithstanding the foregoing, under the OIG ruling, "any hospital incentive plan that encourages physicians through payments to reduce or limit clinical services directly or indirectly violates the Act."

B. The Redlands case

1. Redlands Surgical Services v. Commissioner, 1135 T.C. No. 3; No. 11025-97X (July 19, 1999).

2. Redlands Hospital's nonprofit parent formed the for-profit Redlands Health Services which, together with the for-profit SCA Surgery Centers, Inc., owned as general partners a for-profit entity known as Redlands Surgical Services.

3. Judge Michael B. Thornton found that the structure conferred an impermissible private benefit when it ceded effective control to private parties, with the result that the entity is not operated exclusively for exempt, charitable purposes, as required by Section 501(c)(3); see Church of Scientology v. Commissioner, 823 F.2d 1310, 1315 (9th Cir. 1987) affg. 82 T.C. 381 (1984). See also est of Hawaii v. Commissioner, 71 T.C. 1067 (1979).

4. Stated the Court: "There is no per se proscription against a nonprofit organization's entering into contracts with private parties to further its charitable purposes on mutually beneficial terms, so long as the nonprofit organization does not thereby impermissibly serve private interests."

5. The Court found several factors that indicated for-profit control, including:

    a. The partnership was not bound to put charitable purposes ahead of its economic objectives.

    b. The nonprofit entity lacked formal control (among other things, it could only name half the managing directors; could only go to arbitration in the event of a deadlock and thus could not force the satisfaction of community needs; had given up its management powers via the management contract; had delegated decision-making concerning medical matters to a "medical advisory group;" and had given up control over quality assurance via a quality assurance agreement, which had lapsed after a year).

    c. The nonprofit entity likewise lacked informal control over the surgery center's activities (among other things, the Court found nothing in the record to indicate that the nonprofit entity had the resources or ability effectively to oversee or monitor the surgery center's activities, there was no indication of any charity or indigent care being provided, and the nonprofit hospital had ceased doing all the activities now performed by the for-profit partnership).

C. Observations

1. In both the OIG and the Redlands situations, the nonprofit entity might truly benefit from the relationships under attack (among other things, the nonprofit entity would receive income streams that could be used to serve the nonprofit purposes, there is an infusion of expertise from third parties, there are built-in economic incentives to bring costs down while maintaining high quality care, etc.).

2. Unfortunately, the statues may not give sufficient leeway for these structures, and/or the specific deals may have gone too far with respect to profit motivation to the detriment of the community, charitable or other nonprofit purposes.

III. PRACTICAL ISSUES

A. Liability and Indemnification

1. Statutes.

2. D & O insurance.

3. Indemnification resolutions and agreements.

B. Best Practices

1. Compensation committee meetings and minutes.

2. Compliance procedures.

3. Documentation for revenue sharing.

C. Expertization

1. Counsel.

2. Compensation advisors.

3. Accountants.

4. Other.

SAMPLE RESOLUTION

Resolution of the Board of Directors of XYZ Nonprofit Corp. Regarding the Review of Compensation and Other Designated Transactions

WHEREAS, the Directors have been briefed on the statutes and regulations concerning "intermediate sanctions" which address, among other things, compensation, revenue sharing and bonus plans of officers and staff as well as other transactions (such as certain XYZ transactions in which officers, Directors, donors or others may have an economic interest) that may be covered by these laws ("covered transactions"); and

WHEREAS, the Directors have been apprised of proposed thresholds for the review of covered transactions, as shown in the attachment hereto [deleted];

NOW THEREFORE, BE IT RESOLVED, that the delegation of authority to the Director Committee on Compensation, as set forth in the XYZ Bylaws, is reconfirmed, it being understood that this authority includes the authority to review and act upon all forms of covered transactions, as defined above; and

RESOLVED FURTHER, that the Directors hereby ratify the thresholds for review, as set forth in the attachment hereto, and delegate to the Director Committee on Compensation the authority periodically to review and modify these and other thresholds, in compliance with applicable law; and

RESOLVED FURTHER, that the officers of XYZ shall continue to submit to the Director Committee on Compensation any covered transactions that they believe should be reviewed under applicable law or otherwise; and

RESOLVED FURTHER, that the Director Committee on Compensation may refer matters to the full Board of Directors of XYZ if they deem it appropriate to do so; and

RESOLVED FURTHER, that, subject to the foregoing and subject to other resolutions that may be adopted from time to time by the Board of Directors, actions of the Director Committee on Compensation shall be final; and

RESOLVED FURTHER, that members of the Director Committee on Compensation shall consist solely of persons who are not officers or employees of XYZ; committee members shall disqualify themselves in any matter where there may be a conflict of interest; and no person shall serve on the Director Committee on Compensation if an officer or staff member of XYZ or his or her spouse is a member of a board or committee at another entity and in that capacity reviews the compensation of XYZ Director or of the Director's spouse.