

Frequently Asked Question

**Legal And Ethical Issues**

**Legal Issues**

• **Introduction**

Legal issues are important as nonprofits seek to be in compliance with federal, state and local statutes. While many nonprofits are very small, they nevertheless must be aware of the law and follow it as it pertains to their situation. Clearly nonprofits with substantial resources have more legal requirements than a small volunteer nonprofit with no staff or budget.

A recent listing of legal and financial documents by the St. Luke's Health Initiative of Phoenix shows how substantial those requirements can be for nonprofits in the state of Arizona:

- IRS Form 990 (Federal)
- IRS Pension Report Form (Federal)
- IRS Tax Deferred Annuities (Federal)
- Arizona Corporation Commission Annual Report (State)
- Arizona Fundraising Forms (when applicable) (State)
- Arizona State Withholding (State)
- Department of Economic Security (Unemployment - State)
- Worker's Compensation (State)
- County Property Tax Exemption (Local)
- Tax Depositories (Federal)
- W-2 and 1099 Forms (Federal and State)
- Local Fundraising Permits (Local)

• **How do I find what our legal requirements are?**

Each state has an administrative unit that is responsible for the incorporation of nonprofits. Most states lodge legal authority in their Secretary of State's office. In the state of Arizona the government entity is the Corporation Commission. It has an excellent Web site that explains the laws and regulations: <http://www.cc.state.az.us/>

It is also important to be familiar with federal statutes. The primary federal statutes governing nonprofits are Internal Revenue Service statutes regulating the formation of 501 (tax exempt corporations). Such federal designations also form the basis for state and local laws regarding sales tax exemption, as well as local property tax exemptions. It should be noted that some states (including Arizona) do not exempt nonprofits (with a few exceptions) from sales and use taxes.

• **Should we retain legal counsel?**

Larger nonprofits (budgets of \$1 million plus) often have a formal relationship with a law firm. Many of the larger law firms have developed subspecialties in the arena of

- nonprofit law. Another common source of legal counsel has been volunteer attorneys on an organization's board, but care needs to be taken regarding conflict of interest (ethics). Legal counsel should be retained if there are any questions of compliance with the law.
- **What is the Board of Directors' responsibility?**  
Oversight of the organization's compliance always falls to the board. It should have policies in place that provide for an annual compliance check by the appropriate board committee and reported to the board. Of course, good policies are worthless if they are not followed.
- **How does a volunteer board put together good policies?**  
If the agency has specialists such as a Chief Financial Officer, Human Resources Director and Professional Development Director, the board often asks those staff to put together draft policies. These requirements are a substantive argument for an organization, regardless of size, belonging to a professional association. Many local organizations belong to a national entity that develops model policies for use by local nonprofits. Other national associations such as the Alliance for Children and Families have collected substantial resources for their members.
- **Would it be helpful to be "accredited?"**  
Some accreditations provide excellent assurance for boards relative to legal and ethical compliance. The three major bodies for health and human services are:
  - The Joint Commission (JACHO) – Healthcare organizations – <http://www.jointcommission.org/>
  - Council on Accreditation (COA) – Human service organizations – <http://www.coanet.org>
  - Commission on Accreditation of Rehabilitation Facilities (CARF) – Residential organizations – <http://www.carf.org/>

Each examines their members' policies and compliance on a three or four year cycle. As the nonprofit sector experiences increased regulation, this part of the association membership often pays for itself.

- **What would be a good resource for an overview of Code of Ethics for nonprofits?**  
We would suggest the "Statement of Values and Code of Ethics for Charitable and Philanthropic Organizations" published by the Independent Sector. This is a rich resource for general standards as well as reference to national and state organizations providing standards. Available online: <http://www.independentsector.org/issues/accountability/standards2.html>.
- **What are the ethical issues relative to fundraising (resource development)?**  
The ethical standards for fundraising are well developed and recognized nationally. They are also treated within the FAQ portion of our Web site regarding "Resource Development." It should be emphasized that a nonprofit is operated as a "public trust" and as such is particularly vulnerable to persons (staff and volunteers) abusing the

organization with often a fatal loss of trust. It is, therefore, crucial for the board to understand the ethical standards and insist upon adherence.

- **What is the Donor Bill of Rights?**

### **The Donor Bill of Rights**

Philanthropy is based on voluntary action for the common good. It is a tradition of giving and sharing that is primary to the quality of life. To ensure that philanthropy merits the respect and trust of the general public, and that donors and prospective donors can have full confidence in the nonprofit organizations and causes they are asked to support, we declare that all donors have these rights:

- To be informed of the organization's mission, of the way the organization intends to use donated resources, and of its capacity to use donations effectively for their intended purposes.
- To be informed of the identity of those serving on the organization's governing board, and to expect the board to exercise prudent judgment in its stewardship responsibilities.
- To have access to the organization's most recent financial statements.
- To be assured their gifts will be used for the purposes for which they were given.
- To receive appropriate acknowledgement and recognition.
- To be assured that information about their donation is handled with respect and with confidentiality to the extent provided by law.
- To expect that all relationships with individuals representing organizations of interest to the donor will be professional in nature.
- To be informed whether those seeking donations are volunteers, employees of the organization or hired solicitors.
- To have the opportunity for their names to be deleted from mailing lists that an organization may intend to share.
- To feel free to ask questions when making a donation and to receive prompt, truthful and forthright answers.

The Donor Bill of Rights was created by: Association of Fundraising Professionals (AFP) <http://www.afpnet.org> Association for Healthcare Philanthropy (AHP) <http://www.ahp.org/> Council for Advancement and Support of Education (CASE) <http://www.case.org/> Giving Institute: Leading Consultants to Nonprofits <http://www.givinginstitute.org/>.

- **Where can we find the most comprehensive assistance regarding ethics and philanthropy (fundraising)?**

The Association of Fundraising Professionals (AFP) has been the standard bearer for this critical part of nonprofits for over 40 years. Its Web site (<http://www.afpnet.org/>) has a major section devoted to ethics and standards. A substantial portion of those standards are quoted below.

### **Code of Ethical Principles and Standards**

- **Ethical Principles**

The Association of Fundraising Professionals (AFP) exists to foster the development and

growth of fundraising professionals and the profession, to promote high ethical behavior in the fundraising profession and to preserve and enhance philanthropy and volunteerism.

Members of AFP are motivated by an inner drive to improve the quality of life through the causes they serve. They serve the ideal of philanthropy, are committed to the preservation and enhancement of volunteerism; and hold stewardship of these concepts as the overriding direction of their professional life. They recognize their responsibility to ensure that needed resources are vigorously and ethically sought and that the intent of the donor is honestly fulfilled.

To these ends, AFP members, both individual and business, embrace certain values that they strive to uphold in performing their responsibilities for generating philanthropic support. AFP business members strive to promote and protect the work and mission of their client organizations.

**AFP members, both individual and business, aspire to:**

- Practice their profession with integrity, honesty, truthfulness and adherence to the absolute obligation to safeguard the public trust
- Act according to the highest goals and visions of their organizations, professions, clients and consciences
- Put philanthropic mission above personal gain;
- Inspire others through their own sense of dedication and high purpose
- Improve their professional knowledge and skills, so that their performance will better serve others
- Demonstrate concern for the interests and well-being of individuals affected by their actions
- Value the privacy, freedom of choice and interests of all those affected by their actions
- Foster cultural diversity and pluralistic values and treat all people with dignity and respect
- Affirm, through personal giving, a commitment to philanthropy and its role in society
- Adhere to the spirit as well as the letter of all applicable laws and regulations
- Advocate within their organizations adherence to all applicable laws and regulations
- Avoid even the appearance of any criminal offense or professional misconduct
- Bring credit to the fundraising profession by their public demeanor
- Encourage colleagues to embrace and practice these ethical principles and standards
- Be aware of the codes of ethics promulgated by other professional organizations that serve philanthropy

• **Ethical Standards**

Furthermore, while striving to act according to the above values, AFP members, both individual and business, agree to abide (and to ensure, to the best of their ability, that all members of their staff abide) by the AFP standards. Violation of the standards may subject the member to

disciplinary sanctions, including expulsion, as provided in the AFP Ethics Enforcement Procedures.

- **Member Obligations**

- Members shall not engage in activities that harm the members' organizations, clients or profession.
- Members shall not engage in activities that conflict with their fiduciary, ethical and legal obligations to their organizations, clients or profession.
- Members shall effectively disclose all potential and actual conflicts of interest; such disclosure does not preclude or imply ethical impropriety.
- Members shall not exploit any relationship with a donor, prospect, volunteer, client or employee for the benefit of the members or the members' organizations.
- Members shall comply with all applicable local, state, provincial and federal civil and criminal laws.
- Members recognize their individual boundaries of competence and are forthcoming and truthful about their professional experience and qualifications and will represent their achievements accurately and without exaggeration.
- Members shall present and supply products and/or services honestly and without misrepresentation and will clearly identify the details of those products, such as availability of the products and/or services and other factors that may affect the suitability of the products and/or services for donors, clients or nonprofit organizations.
- Members shall establish the nature and purpose of any contractual relationship at the outset and will be responsive and available to organizations and their employing organizations before, during and after any sale of materials and/or services. Members will comply with all fair and reasonable obligations created by the contract.
- Members shall refrain from knowingly infringing the intellectual property rights of other parties at all times. Members shall address and rectify any inadvertent infringement that may occur.
- Members shall protect the confidentiality of all privileged information relating to the provider/client relationships.
- Members shall refrain from any activity designed to disparage competitors untruthfully.

- **Solicitation and Use of Philanthropic Funds**

- Members shall take care to ensure that all solicitation and communication materials are accurate and correctly reflect their organizations' mission and use of solicited funds.
- Members shall take care to ensure that donors receive informed, accurate and ethical advice about the value and tax implications of contributions.
- Members shall take care to ensure that contributions are used in accordance with donors' intentions.
- Members shall take care to ensure proper stewardship of all revenue sources, including timely reports on the use and management of such funds.

- Members shall obtain explicit consent by donors before altering the conditions of financial transactions.
- **Presentation of Information**
  - Members shall not disclose privileged or confidential information to unauthorized parties.
  - Members shall adhere to the principle that all donor and prospect information created by, or on behalf of, an organization or a client is the property of that organization or client and shall not be transferred or utilized except on behalf of that organization or client.
  - Members shall give donors and clients the opportunity to have their names removed from lists that are sold to, rented to or exchanged with other organizations.
  - Members shall, when stating fundraising results, use accurate and consistent accounting methods that conform to the appropriate guidelines adopted by the American Institute of Certified Public Accountants (AICPA)\* for the type of organization involved.

\* In countries outside of the United States, comparable authority should be utilized.

- **Compensation and Contracts**
  - Members shall not accept compensation or enter into a contract that is based on a percentage of contributions; nor shall members accept finder's fees or contingent fees. Business members must refrain from receiving compensation from third parties derived from products or services for a client without disclosing that third-party compensation to the client (for example, volume rebates from vendors to business members).
  - Members may accept performance-based compensation, such as bonuses, provided such bonuses are in accord with prevailing practices within the members' own organizations and are not based on a percentage of contributions.
  - Members shall neither offer nor accept payments or special considerations for the purpose of influencing the selection of products or services.
  - Members shall not pay finder's fees, commissions or percentage compensation based on contributions, and shall take care to discourage their organizations from making such payments.

Any member receiving funds on behalf of a donor or client must meet the legal requirements for the disbursement of those funds. Any interest or income earned on the funds should be fully disclosed.

## **Human Resource Legal Issues**

- **How important are human resources compliance issues?**  
In this arena the nonprofit is an employer and it is subject to the same laws as for-profits. Therefore it is critical to garner the resources necessary to meet numerous legal

requirements, many of which are designed to protect the employee. The following sections are also included in the Human Resource Issues FAQ on our Web site.

- **What is “At-will” employment?**

Many employers will state that all staff are “at-will” employees. This is a legal concept that asserts that employees are free to terminate employment at any time and the organization has the right to terminate at any time, with or without notice, for any reason not prohibited by law.

All states, except Montana, adhere to this legal definition of employment with some important exceptions. There are three major exceptions and Arizona recognizes all three: Public policy exceptions – a person cannot be fired if such action violates state public policy or state or federal statute. This primarily refers to discrimination – race, color, religion, sex, national origin, and age or handicap status. Other reasons are employee refusal to commit illegal acts, family or medical leave, not following the organization’s own termination procedures.

Implied contract exceptions – a person cannot be fired if there is an implied contract. This is often very difficult to prove.

Covenant of good faith and fair dealing exceptions –This is the most significant departure from traditional “at-will” policy. It has been determined by some courts that the employer’s personnel decisions are subject to a “just cause” standard or that terminations made in bad faith or motivated by malice are prohibited.

Many nonprofits have had painful lessons after complaints have been lodged for wrongful termination. It is important for the organization to know the law and to be prudent in its termination of employees.

- **What is the difference between exempt and nonexempt employees?**

The simplest answer is that exempt employees are paid a salary for a specified period of time regardless of the number of hours worked. Generally professional, management and other types of skilled jobs are classified as exempt.

Unskilled or entry-level jobs are usually classified as non-exempt. Non-exempt jobs usually get a wage, or an amount of money per hour. Non-exempt jobs are also paid over-time, that is, extra pay for hours worked over 40 hours a week or on certain days of the week or on holidays.

Nonprofits seeking to stabilize costs are tempted to make as many employees exempt as possible. Regulations regarding such a determination have become more stringent therefore the organization must carefully evaluate each position.

- **What is the difference between staff and independent contractors?**

Nonprofits have liked to utilize persons as independent contractors thereby forgoing payroll and benefits considerations. Such people are also not subject to the personnel

policies and practices including termination issues discussed above. However, in the past two decades the Internal Revenue Service has tightened the allowable conditions for utilizing this option. Each organization must know the criteria and apply the test before utilizing contractual relations in lieu of compensation.

- **What are “intermediate sanctions?”**

There are IRS penalties that apply to “excess benefit” transactions between a nonprofit and a disqualified person. Excess benefit means any transaction that exceeds fair market value such as compensation. A “disqualified” person is anyone holding substantial influence for the nonprofit for the preceding five years. The tax consequences are quite onerous and this can include a board member if he or she is found culpable. Intermediate sanctions apply to the overwhelming majority of nonprofits 501(c)3 and 501(c)4, excluding private foundations. A board must fulfill three requirements to successfully navigate into a “safe harbor.”

- Approve the transaction with the interested person not present or voting.
- Obtain and review comparability data
- Document the basis for the decision

## Summary

The legal and ethical issues for nonprofits fill books. The existing body of statutes and ethical standards provide excellent guidance for nonprofits of any size. As indicated earlier, this sector of society has a special place in families and communities and it is a public trust. This academic center dedicated to this sector stands ready to provide information and assistance to nonprofits so that they may fulfill that trust.

## Related Resources

### What additional resources are available to nonprofits regarding legal and ethical issues?

- The ASU Lodestar Center provides board training through a multi-module program that focuses on these legal and ethical arenas in the life of a nonprofit. Contact our Sr. Program Coordinator at or 602-496-0500.
- Corporation Commission of Arizona: <http://www.cc.state.az.us/>
- The Joint Commission (JACHO) – Healthcare organizations: <http://www.jointcommission.org/>
- Council on Accreditation (COA) – Human service organizations: <http://www.coanet.org>
- Commission on Accreditation of Rehabilitation Facilities (CARF) – Residential organizations: <http://www.carf.org/>
- Association of Fundraising Professionals (AFP): <http://www.afpnet.org>
- Association for Healthcare Philanthropy (AHP): <http://www.ahp.org/>
- Council for Advancement and Support of Education (CASE): <http://www.case.org/>
- Giving Institute: Leading Consultants to Non-Profits: <http://www.givinginstitute.org/>
- Independent Sector: <http://www.independentsector.org/>

*(This list of questions regarding Legal and Ethical Issues has been developed by the many persons and organizations seeking assistance from the Lodestar Center. We invite you to add*



*your questions and reactions through the "[Ask the Nonprofit Specialists](#)" section of the Center's Web site so that we might improve and expand these FAQ.)*

Please note that websites frequently change and while we endeavor to keep links current, some might not work. When you encounter such a problem you can help us by sending an e-mail to [robert.duea@asu.edu](mailto:robert.duea@asu.edu) so that we might investigate and make changes to our information and links.

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