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Preventing and Investigating Fraud, Embezzlement, and Charitable Asset Diversion: What's a Nonprofit Board to Do?

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I) Increasing Scrutiny of Fraud, Embezzlement, and Charitable Asset Diversion in the Nonprofit Sector

A) The *Washington Post's* Investigation, "Inside the Hidden World of Thefts, Scams and Phantom Purchases at the Nation's Nonprofits"

On October 26, 2013, the *Washington Post* reported that from 2008 through 2012, over 1,000 nonprofit organizations disclosed hundreds of millions of dollars in losses attributed to theft, fraud, embezzlement, and other unauthorized uses of funds and organizational assets. According to a study cited by the *Post*, nonprofits and religious organizations suffer one-sixth of all major embezzlements, second only to the financial services industry.

While the numbers are shocking, the reasons nonprofits can be susceptible to fraud and embezzlement are easy to surmise. Many begin as under-resourced volunteer-run organizations with a focus on mission rather than strong administrative practices. As agencies established for public benefit, nonprofits assume that the people who work for them, especially senior management, share their philanthropic goals. Nonprofits often are more trusting of employees, and frequently have less stringent financial controls than their for-profit counterparts.

Unfortunately, nonprofit employees are as vulnerable as anyone else to economic distress, including personal financial difficulties, overspending, and even gambling and other addictive behaviors. Nonprofit employees who engage in fraud often rationalize their unlawful conduct. Such rationalizations can include perceived injustices in compensation or treatment compared to their peers at for-profit enterprises; unhappiness over denied promotions, requested raises, or the absence of similar benefits; and that the employees are "borrowing" from the organization with the plan to fully return the money to the organization at a later date. In addition, high-level employees at nonprofit organizations and their close associates have significant access to the organization's funds and financial records, causing them to believe not only that they can commit the fraud and embezzlement but also that they can successfully conceal their conduct from outside scrutiny.

Examples are easy to find. Only last week, a former executive director of a nonprofit symphony was arraigned in Northern California on charges of embezzlement, grand theft, forgery, identity theft and tax evasion following the discovery of a loss of $500,000 -- an amount comprising nearly all of the organization's operating funds and endowment. The executive director was accused of siphoning off money from the nonprofit's accounts beginning shortly after he was hired in 2010. He allegedly wrote numerous checks to himself, including duplicate payroll checks, using some of the money to pay his credit card debts. He also was suspected of taking out an unauthorized $25,000 loan on behalf of the symphony and forging the signature of two board members on several of the checks. At the time, the board didn't have controls in place to monitor the accounts. "We very much trusted him," the board chair is reported to have said.[1]

Many nonprofits try to handle instances of fraud or embezzlement quietly to avoid unwanted attention and embarrassment. That is no longer an option for 501(c)(3) organizations that file Form 990 information returns. In 2008, the Internal Revenue Service implemented additional regulations designed to enable the public to more easily evaluate how effectively larger nonprofits manage their money. Tax-exempt organizations with gross receipts greater than or equal to $200,000, or whose assets are greater than or equal to $500,000, must report "any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft." Specifically, these organizations are now required to publicly disclose any embezzlement or theft that exceeds $250,000, 5% of the organization's gross receipts, or 5% of its total assets.[2]

Charitable asset diversion in any amount, regardless of whether reportable on Form 990, is serious. Embezzlement in particular can damage donor trust and agency reputation, undermining a nonprofit's good work. In extreme cases, it can lead to the revocation of tax exempt status and even personal liability for directors.

B) The Regulatory Backdrop

In California, oversight of nonprofit activities falls under the jurisdiction of the California Attorney General, who is authorized to protect charitable assets for their intended use and ensure that the charitable donations are not misapplied and squandered through fraud or other means. Under the authority to protect charitable assets, the California Attorney General requires all registered charities to annually report whether they have experienced theft, embezzlement, diversion or misuse of the organization's charitable property or funds in any amount in the past year. State prosecutors may elect to bring charges under California Penal Code Section 503-515, which defines embezzlement as "the fraudulent appropriation of property by a person to whom it has been entrusted."

Most California nonprofits that receive charitable assets must register with the Attorney General through the Registry of Charitable Trusts. The IRS and Franchise Tax Board have co-extensive jurisdiction over California nonprofit organizations that have been granted tax exempt status under federal and California law, respectively, and can levy penalties or excise taxes, or revoke tax exempt status altogether where a significant diversion of assets is involved.

If the nonprofit receives federal funding, it may face scrutiny by the granting agency's Office of Inspector General (OIG). Besides performing traditional audit work, the OIGs—and sometimes, the FBI—work hand-in-hand with federal prosecutors at the Department of Justice in Washington, DC, and the U.S. Attorneys' Offices across the country, to investigate fraud and embezzlement at nonprofit organizations. Federal prosecutors may elect to bring charges under, among other applicable federal statutes, 18 U.S.C. § 641, which makes it a crime to steal money from the United States or any department or agency thereof, and 18 U.S.C. § 1341, which makes it a crime to devise a scheme to defraud another of property or money with the use of interstate wire communications.

C) The Role of the Board of Directors

Instances of fraud and embezzlement strike at the heart of an organization's ability to raise funds and affect its mission. As one nonprofit official quoted by the *Washington Post* explained, "[p]eople give their money and expect integrity. And when the integrity goes out the window, it just hurts everybody. It hurts the community, it hurts the organization, everything. It's just tragic." Directors of nonprofit corporations are charged with the important responsibilities of conducting and overseeing the management of the corporation's affairs. While the day-to-day operations of a nonprofit can be and often are delegated to staff, the directors maintain the ultimate authority over all corporate activities.

State law and judicial decisions impose upon directors the fiduciary duties of care and loyalty regarding the corporations they serve. In California, these duties are detailed in Section 5231(a) of the Corporations Code:

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

A nonprofit director who observes the duties of care and loyalty is generally insulated from personal liability. However, the board's actions must be taken in good faith with that diligence, care and skill which an ordinary prudent person would exercise under similar circumstances.

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[1] *"Former Peninsula Symphony director jailed on embezzlement charges,"* San Jose Mercury News, March 4, 2014.

[2] In addition, asset diversions (in any amount) by a charity's insider—including, but not limited to, a charity's founders, members of its governing body, officers, senior employees, persons with financial oversight responsibilities or anyone in a position to exert significant influence on the charity—must also

be reported. Called “excess benefit transactions,” these sorts of charitable asset diversions occur whenever such insiders (or, as referred to by the IRS, “disqualified persons”) receive some kind of economic benefit from the nonprofit organization that exceeds the value of the benefit they provide to the organization. The Internal Revenue Code Regulations state in Section 53.4968.4(c) that “in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services.” Thus, embezzlement by a disqualified person is an automatic excess benefit transaction—and as such, it must be reported.

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