No Good Deed Goes Unpunished: Non-profits Under Fire

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By Donald Glazier and Tara Cummins

Non-profits Under Fire

Traditionally, the most prolific claims against non-profit institutions are employment practices claims alleging discrimination, harassment or retaliatory treatment. However, as the struggling economy leaves gaping holes in governmental budgets, tax authorities have set their sights on new sources of income. As a result, non-profit entities are facing new challenges. Charitable institutions are witnessing increased scrutiny of their tax-exempt status and criticism of executive compensation schemes. In light of these developments, non-profit entities should re-examine current corporate governance and risk management strategies to ensure that growing needs are being addressed.

Loss of Tax Exemption Status

Massachusetts property tax authorities are currently in litigation with the Boston archdiocese over the applicability of property taxes for certain churches, schools and convents that are no longer actively used. Should the tax authority prevail and disallow tax exemption for the archdiocese, careful financial planning may be upended, with problematic consequences.

Recently, an Illinois hospital lost its tax-exempt status on the grounds that it did not assist a sufficient volume of charitable patients. In that case, decided before the Illinois Supreme Court, 302 patients out of 100,000 admissions were treated for free or at discounted rates. The court held that this was insufficient to merit exemption under the law, but failed to specify exactly what ratio of charitable-to-profitable care is necessary to maintain tax-free status. In the wake of the court's decision, Illinois legislators are considering how to provide more clarity on the topic. Increased statutory clarity would help the upwards of 20 Illinois healthcare institutions awaiting a ruling on their request for tax exemptions.

A change in an entity's tax-exempt status may trigger certain exclusions in non-profit management liability insurance forms. Should the government initiate litigation against an entity regarding its exemption, coverage for defending the action may be jeopardized. Whether the issue is framed in terms of open versus closed institutions or in terms of charitable volume, the potential to upset established fiscal strategy is real. A careful review of policy language is imperative given increased scrutiny and unsettled specifics.

Executive Compensation

After a decade of corporate scandals and fiscal mismanagement, financial reforms require public companies to disclose more expansive and detailed information on the components and derivation of senior management's total compensation packages. The same sort of heightened review has been turned toward non-profit institutions. Specifically, the IRS, as part of the Treasury Department, has revamped the non-profit tax form (Form 990), which contains a specific schedule on compensation-related information for officers, directors and other highly paid individuals.

It remains to be seen what may happen regarding executive compensation on the federal level. In some states, as part of the larger charity care debate, the issue is already front and center. A number of State Attorneys General have looked closely at this issue and most recently, in New Hampshire, the Attorney General has started looking at compensation for top executives in that state's not-for-profit hospitals. More than 20 New Hampshire hospitals have agreed to provide information about executive pay to the Attorney General's Division of Charitable Trusts. If, after their review, the attorney general concludes that the pay is too high, he could initiate litigation to bar the payment or seek a court-ordered adjustment to the pay.

Part of the Attorney General's focus, in this case, will be on whether the hospital board met its duties in reviewing executive compensation. Drawing from issued guidelines, the Attorney General's office indicates that hospital board members are responsible for reviewing and approving salary levels, as well as examining how the salary level was determined. Failing to comply with those duties could result in an action by the Attorney General.

The compensation debate is not exclusive to healthcare institutions; directors of non-profits in other industry sectors have faced increasing inquiries. Recently a director of a non-profit housing agency was criticized for her $685,000 compensation package, which was reportedly three times higher than other local non-profit housing development corporations.

The issue of tax-exempt status can create uncertainty and potential claims that should be considered when reviewing insurance protections put in place. While typically taxes are not a covered loss, other types of claims against hospital management arising from the entity's tax status may receive coverage under a Directors' and Officers' liability policy. For example, any entity which issues tax-exempt bonds could have a claim made against it and its directors or officers if that status is lost. Bondholders could, in that case, allege misrepresentation in connection with the offering of the debt.

Class Action Litigation

On another front, new federal requirements may revitalize the charity care class action litigation previously led by now jailed attorney Richard Scruggs. Scruggs filed numerous class action claims across the county asserting that defendant hospitals had used their tax-exempt status to reap large surpluses and spent those dollars on everything except helping their uninsured patients pay for healthcare services. The charity-care class actions failed to gain traction in the Federal courts. However, with the new statutorily-mandated inquiries contained in the Patient Protection and Affordable Care Act, Scruggs' followers may look at whether this cause of action makes sense pursuing in earnest again.

Responding to Changing Risks

The focus on charity tax exemptions and executive compensation illustrates the dynamic nature of liability exposures. Whether an organization is a hospital, a condominium board, an advocacy group, a social group or any manner of charitable non-profit, these changes must be addressed from a risk management standpoint to assure that insurance protections are enhanced to respond to changing risks. To assure insurance protections respond as expected, it is important to work with a broker who proactively looks at client's risks against the background of an ever-changing risk environment. Integro looks at the risk horizon and works hard to assure its clients' insurance protections meet the risks of today.

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About Integro

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