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Embezzlement from a Charity: What to Do?

Theft from a charity is, fortunately, rare. But it happens, perhaps more in tougher economic times. From the charity's perspective, the question is what to do when the theft is discovered. As fiduciaries of the charity, its Board must take these situations very seriously, and carefully consider how best to protect the charity's interests. Every situation is different, but here are some common or necessary steps:

- › **Investigate the transaction.** The charity's Board should make a reasonable inquiry into the theft. "Reasonable" will depend on the circumstances, including how large the theft was and the probability that other funds or assets were taken. At the very least, the Board should learn how much the charity has lost and understand how the theft occurred. Sometimes, the charity needs to hire a forensic accountant to help. The Board should document its investigation and decisions, in case a government agency or lawsuit requires the Board to show that it made reasonable investigative efforts. If the individual was employed by the charity, employment counsel should also be consulted.
- › **Decide whether to report to the police.** The Board must weigh the benefits and risks to the charity of reporting the theft to police. Among other considerations, the California Attorney General prefers that charities report misappropriations to the police, and not doing so may raise questions if the Attorney General investigates. A police report may be required for insurance purposes. One downside to the charity of reporting to the police may include possible negative publicity. Again, the Board should document its decision and reasons.
- › **Make reasonable efforts to recover the money.** The Board should make reasonable efforts to recover the funds stolen. "Reasonable" will depend on the circumstances, such as how much money was taken, the likelihood and costs of recovery, and other factors. Once again, document the Board's decision about how to proceed and why it is in the charity's best interests to take (or not take) each step. At the very least, the charity should request repayment in writing; at the other extreme, the charity could file a civil suit against the thief.
- › **Prevent recurrence.** Perhaps most critically, the Board's duty of care requires that it take steps to prevent recurrence. This will also depend on the particular situation. It often means working with the charity's accountants to determine how internal controls should be improved, and increased Board or Committee oversight of the charity's budget and finances. Regulators may be particularly interested in how a charity has improved its operations and processes.
- › **Report to the California Attorney General.** A charity who reports to the California Attorney General will have to report the diversion of funds on the charity's **Form RRF-1**.

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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- › **Report to the IRS.** Depending on who stole the funds, a public charity may have to report the fraud to the IRS as a Section 4958 excess benefit transaction on its **Form 990**, and a private foundation may have to report the fraud as Section 4941 self-dealing on its **Form 990-PF**. These statutes impose various taxes on the embezzler (and in some instances, charity management), which can increase if the funds are not returned within a certain time period. Regardless, the charity must work with its accountants to make sure the funds taken (and returned, if so) are reported properly.

Dealing with charity theft is difficult for everyone involved. Prevention is easier than the cure!