

**THE ECONOMIC CRISIS: LEGAL AND PRACTICAL
RAMIFICATIONS FOR NONPROFITS**

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BIOGRAPHICAL INFORMATION

Pamela A. Mann is the principal in the Law Offices of Pamela A. Mann, LLC, a practice concentrated in the representation of tax-exempt organization. The office is counsel to numerous public charities and private foundations and advises its clients in a wide range of governance, regulatory, tax, and general corporate matters. From 1985 to 1995, Ms. Mann was Chief of the Charities Bureau in the New York Attorney General's office, directing scores of important cases and initiatives and influencing the adoption of significant legislative changes affecting tax exempt organizations. Her diverse background includes clinical teaching at Rutgers University School of Law's Constitutional Litigation Clinic and the litigation of employment discrimination and other employment related matters at the National Employment Law Project.

Ms. Mann has been recognized in New York Magazine's Best Lawyers in New York and in Super-Lawyers Magazine in the category of lawyers specializing in Nonprofit/Charities Law. Ms. Mann was Chair of the Committee on Nonprofit Organizations of the Association of the Bar of the City of New York from 1998-2001 and has served as President and Vice-President of the National Association of State Charities Officials. She is a member of the American Law Institute, the Government Relations Committee of the Nonprofit Coordinating Committee of New York and of the Exempt Organizations Committee of the American Bar Association. She has written many articles for professional and lay publications and is a frequent lecturer on non-profit issues. She is a graduate of Oberlin College and the University of Pittsburgh School of Law. Additional information about the Law Offices of Pamela A. Mann, LLC is available at www.pamelamann.com.

I. INTRODUCTION

The global economic reversals that reached crisis proportions in the summer and fall of 2008 and continue to cast a pall over all sectors of the economy have profoundly changed the expectations and behaviors of most nonprofit organizations. From staff layoffs and furloughs to contractions in services, from huge endowment fund losses to diminishing donations and other developments too numerous to mention, nonprofit organizations must now focus on matters that, in many cases, were the province of specialists within the organization or simply ran on auto-pilot. This outline and presentation will review some of these issues. It will also discuss the strategic choices being considered by an increasing number of nonprofits, as a result of the economic downturn.

II. LEGAL NORMS FOR NONPROFIT INVESTMENT CONDUCT

A. Overview

1. What must the board of directors consider in determining and monitoring a nonprofit's investments? What standard of conduct is legally required?
2. If investment duties are delegated to professionals, what is the board's obligation? What is its liability?
3. How should these standards be applied to huge losses in invested assets? To a charity whose assets were invested with Bernard Madoff?

B. The board's investment authority and the relevant standards of conduct

1. New York Not-for-Profit Corporation Law ("N-PCL") §512 generally permits the board to invest the organization's funds without restriction and suggests a number of investment vehicles, including "an institutional fund, . . . real or personal property, whether or not it produces a current return including mortgages, stocks, bonds, debentures, and other securities of profit or not-for-

profit corporations, shares in or obligations of associations, partnerships, or individuals, and obligations of any government or subdivision or instrumentality thereof.”

N-PCL §512 specifically permits the board to invest all or any part of an institutional fund “in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board.”

2. The “Prudent Investor Act,” codified at Estates, Powers and Trusts Law (“EPTL”) § 11-2.3 contains the applicable principles that comprise a prudent investment plan. While not strictly applicable to directors of nonprofit organizations, it provides helpful guidance. The prudent investor standard of conduct requires that the trustee shall make and implement investment and management decisions for the entire portfolio with reasonable care, skill and caution. Compliance with the section is measured as “a standard of conduct, not outcome or performance.” In other words, poor performance of a portfolio does not mean that the fiduciary has failed to be prudent, so long as he has carefully monitored the investments and made reasonable investment decisions.

In defining the scope of careful monitoring and the facts and circumstances supporting a reasonable decision, EPTL § 11-2.3(3) states a number of important considerations for the prudent investor. Below is a summary of these general principles:

- To pursue an overall investment strategy to enable appropriate present and future expenditure needs, in accordance with risk and return objectives reasonably suited to the entire portfolio; and
- To consider the size of the portfolio and the nature and duration of the fiduciary relationship as well as general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions, and the role of each investment in the expected total return of the portfolio overall; and

- To diversify the assets unless the trustee reasonably determines it is not appropriate under the purposes and terms of the governing instrument.

EPTL § 11-2.3(4) further authorizes a trustee to invest in any type of investment consistent with the principles discussed above, similar to N-PCL §512, stating explicitly that “no investment is inherently prudent or impudent for purposes of the prudent investor standard”.

3. N-PCL § 717 articulates the board’s standard of care, both generally and as it relates to investments. Section 717(a) states that “directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions.” With respect to investment-related decisions, “a governing board shall consider among other relevant considerations the long and short term needs of the corporation in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.”

C. The board’s authority to delegate investment of its assets

N-PCL §514 provides that the board may, unless otherwise specified in “the applicable gift instrument,” delegate management of the corporation’s investments to a committee of the board, the officers or employees or to “contract with independent investment advisors, investment counsel or managers, banks, or trust companies” to act in place of the board when making investment decisions.

The board must, however, exercise the standard of care required by N-PCL §717 when selecting the persons to whom authority is delegated or contracted. If the delegation or contract is made properly, the board is relieved of all liability for the investment and reinvestment, and any related acts or omissions, of the organization’s funds. (However, this delegation does not absolve the board of responsibility to assure that restricted funds

are expended in a manner consistent with applicable restrictions; this subject is discussed below.)

D. Application of these principles in the face of astronomical losses

In 2008 and the first quarter of 2009, the Dow Jones industrial average and virtually all other financial indexes fell in value precipitously, from a high of over 11,000 to a low, in March 2009, of below 7,000, with the S & P Industrials posting losses of roughly 50% during that time period. University endowments lost nearly a quarter of their worth and some of the largest funds posted losses of 35% and more. The invested assets of private foundations plummeted in value, causing cut-backs in grant-making. Faced with these dire circumstances, nonprofit boards anxiously reassessed the prudence of their conduct.

1. If the board has followed a reasonable investment policy, has monitored investments consistently, and has considered the factors listed above, it has discharged its legal duties.

2. The fact that an organization's investments have fallen significantly in value should not subject the directors to liability for breach of the duty of care. The measure of prudence is process, not performance.

3. Diversification, once the gold standard of prudent investor pedagogy, failed completely to stave off the effects of the crisis. Diversified portfolios fared no better than un-diversified portfolios in the economic downturn. All types of investments experienced unprecedented losses.

4. Astronomical losses may place new demands on the board in determining a reasonable investment strategy going forward, but, given the complete absence of reliable expert opinion and the extreme volatility of the market, it is doubtful that any strategy would be judged imprudent, whatever its content and/or performance.

5. Where investment authority has been prudently delegated, the board has no legal liability for losses.

E. Application of these principles where assets were invested in Madoff securities or Madoff feeder funds

After forty years as an increasingly successful and prominent investment manager, Bernard L. Madoff pled guilty in March 2009 to 11 felony counts in connection a complex Ponzi scheme in which investors lost approximately \$65 billion. Among the scores of individuals and institutions that were victims of this scheme – either as a result of direct investment in Bernard L. Madoff Investment Securities or in other “feeder funds” whose assets were forwarded to Madoff’s firm -- were many universities, large public charities, and both large and small private foundations.

1. Bernie Madoff, J. Ezra Merkin, and others involved in his schemes were directors of numerous charities that invested in Madoff securities or feeder funds. See, e.g., People v. J. Ezra Merkin and Gabriel Capital Corporation (Supreme Court New York County April 2009). As relates to the N-PCL, Merkin is charged in that action with breach of fiduciary duty, failing to disclose relevant facts, failing to make diligent inquiry into the risks of investing with Madoff, and failing to disclose conflicts of interest in investments made by nonprofits in other funds where he had a financial interest. He has since agreed to step down from running these investment funds in a partial settlement with the Attorney General’s office.

2. It seems unlikely that directors without inside knowledge and who were not receiving management fees from these investments would be found to have breached their fiduciary duty in investing with Madoff or a feeder fund. Madoff has admitted that he misled investors in all reports concerning the funds they entrusted to him and that, in most cases, the funds were never invested at all but, rather, were used to pay expenses of the criminal enterprise or were siphoned to Madoff’s personal accounts.

3. Charities that invested in Madoff’s company directly and filed a claim in the bankruptcy proceedings will be entitled to receive up to \$500,000 from the SIPC insurance fund, as well as a

proportionate share of assets recovered by Irving H. Picard, the trustee in bankruptcy. On the other side of the coin, the trustee is seeking recovery from some investors of monies they withdrew from the Madoff accounts that exceeds the amounts they invested. Whether any charities will have potential “clawback” liability remains to be seen.

4. Was delegation of investment authority to Madoff’s funds imprudent? Should his unverifiable and “too good to be true” positive results have been a red flag that led boards to ask more questions?

A study by the National Committee for Responsive Philanthropy of the private foundations that lost 30-100% of their assets to Madoff’s scheme suggests a correlation between small, homogeneous boards and large losses. Does this show that boards with less diversity of point-of-view and/or experience are more likely to be scammed?

5. Some lessons learned: if it doesn’t make sense, keep asking questions. Do not be intimidated by the technical jargon of investment advisors.

Many sophisticated investors stayed away from Madoff – in the charity context and otherwise – on the grounds that they could not verify his claims of consistent, high returns on investments. It appears that, at least in some cases, boards were dissuaded from asking hard questions because they were impressed with Madoff’s reputation and with the other prominent institutions that invested with him.

III. ENDOWMENT FUNDS AND OTHER RESTRICTED FUNDS

A. Restricted Funds Generally

1. N-PCL § 513(b) requires that the board of a nonprofit corporation apply all assets received by the corporation “to the purposes specified in the gift instrument and to the payment of the reasonable and proper expenses of administration of such assets.”

2. Binding restrictions arise from directions by donors that are stated or inferred from the “gift instrument” related to the funds. The term “Gift Instrument” is defined in N-PCL § 102(a)(14) as “a will, deed, grant, conveyance, agreement, memorandum, court order, writing or other governing document (including any institutional solicitations from which an institutional fund resulted) under which property is transferred to or acquired by a corporation as an institutional fund.”

B. Types of Restricted Funds: Restricted Purpose Funds and Endowments

1. An “endowment fund” is an “institutional fund, or any part thereof, not wholly expendable by the corporation on a current basis under the specific terms of all applicable gift instruments.” N-PCL § 102(13). Generally speaking, a New York not-for-profit corporation that receives a gift to be held as an endowment cannot expend the principal or corpus of the gift; it can only spend the income. The extent to which the appreciation on the endowment’s assets may be spent, as well as the purposes for which any of the endowment’s assets may be spent, must be determined, in the first instance, by a review of the gift instrument.

2. A restricted purpose fund is one that has been donated to the organization for a particular purpose, e.g., for scholarships or the construction of a building. Both principal and income of such a fund may be spent at any time by the nonprofit, but only for the restricted purpose.

3. Some donations are endowments that are also restricted in purpose. The principal of such funds are not expendable on a current basis, and the income may only be spent for the restricted purpose.

C. Endowment Expenditure Rules

1. Expenditure of Appreciation. Traditionally, expenditure from an endowment fund was limited entirely to “income.” This caused many trustees to invest endowment funds solely in vehicles that threw off income such as interest, dividends, rents or royalties.

However, this strategy eliminated any possibility that the value of the principal would appreciate in value, causing the real value of endowed assets to decline over time, particularly during periods of high inflation.

The Uniform Management of Institutional Funds Act (“UMIFA”) was drafted to address this issue; New York enacted a statute patterned after UMIFA in 1978. (See N-PCL § § 512-522) Pursuant to N-PCL § 513(c), the board “may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized (with respect to all assets) and unrealized (with respect only to readily marketable assets), in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established in section 717 (Duty of directors and officers).”

“Historic dollar value” is defined as “the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund.” The “determination of historic dollar value made in good faith by the corporation is conclusive.” NPCL § 102(16).

2. Impact of Uniform Prudent Management of Institutional Funds Act (“UPMIFA”). The National Conference of Commissioners on Uniform State Laws adopted a major revision of UMIFA in 2006. Since that time, 43 states and the District of Columbia have adopted UPMIFA; the legislation has been introduced in the New York State Legislature, but it is not clear when it will be passed.

UPMIFA eliminates the concept of “historic dollar value” and allows organizations to appropriate for expenditure or expend as much of the principal as it deems prudent and consistent with the restricted purposes of the endowment fund. For organizations whose endowment funds are “under water,” *i.e.*, where current market value is below historic dollar value, UPMIFA would give those organizations the flexibility to expend some of the principal

of their endowment funds if they determined that such expenditure was prudent.

For organizations doing business in New York but incorporated in one of the states that has passed UPMIFA, it appears that the law of the state of incorporation would apply. The proper resolution of the choice-of-law question presented, however, is not entirely clear. N-PCL § 1301 allows foreign corporations that have obtained authority to do business in New York to “conduct in this state any activities which may be conducted lawfully in this state by a domestic corporation.” As discussed above, it would be a violation of the N-PCL for a domestic corporation to expend endowment principal, once the value of the fund is below historic value. Moreover, the State of New York has an interest in having all corporations operating within its borders be subject to the same legal principles with respect to investment activity, a greater interest, arguably, than the state of incorporation. On the other hand, N-PCL § 1320 contains a list of provisions of the N-PCL applicable to foreign corporations, and the UMIFA provisions are not part of this list.

3. Expenditure of Income. Regardless of the current value of an endowment fund, income earned by that fund is always expendable. Even if the value of the fund is below its historic value, income remains available as a source of revenue for the organization. Of course, if, in reliance on the UMIFA principles cited above, organizations have invested primarily in vehicles that do not throw off income but, rather, are intended to grow in value, there may be no income to expend.

D. Modification of Restrictions

1. N-PCL § 522 specifies methods by which the board of directors of a not-for-profit organization may release certain restrictions on a corporation’s use of an institutional fund. Under § 522(a), if the board obtains the written consent of the donor, it may “release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.” Alternatively, if the donor has died or is otherwise unavailable or cannot be identified, the board may seek court approval for the release of use restrictions, on notice to the

Attorney General, for release of restrictions that are “obsolete, inappropriate or impractical. A release under this paragraph (b) may not change an endowment fund to a fund that is not an endowment fund.” N-PCL § 522(b).

2, Cy pres. In order to change an endowment fund to a fund that is not an endowment fund, a not-for-profit organization must seek relief pursuant to Estates, Powers, and Trusts Law § 8.1-1, the statutory codification of the common law doctrine of cy pres. See, e.g., In re Estate of Othmer, 12 Misc. 3d 414 (N.Y. Cty Surrogate’s Court 2006). There are three preconditions to application of this doctrine, pursuant to which the court will lift the restriction and fashion a remedy that adheres to the donor’s original intent as closely as possible. The gift must be charitable in nature; the donor must have demonstrated a general charitable intent, and the party seeking the modification must show “that circumstances have changed subsequent to the gift that render literal compliance with the restrictions impossible or impracticable. *Id.* at 309.

E. Restricted Gifts in a Time of Financial Crisis

1. Organizations with restricted assets have faced particular challenges in dealing with the recent market downturn. As unrestricted assets decreased in value and/or donations declined as a result of the crisis, nonprofits may find themselves cutting programs or staff while they maintain funds that cannot be spent, due to donor restrictions.

2. Boards that expend restricted assets in violation of donor restrictions face possible liability, since one aspect of their duty to the corporation is to expend restricted assets in a manner consistent with donor restrictions. See N-PCL § 513(b). Under N-PCL § 720(a)(1)(A), an action may be brought against a director or officer who violates his duty to manage the corporation’s assets seeking an order compelling the director or officer to account in the case where there has been “neglect of, or failure to perform, or other violations of [the defendant’s] duties in the management and disposition of corporate assets committed to his charge. However, the business judgment rule, applicable to New York not-for-profit corporations, creates a bar to judicial inquiry into actions of

corporate directors taken in good faith. Consumers Union of U.S. v. New York, 5 N.Y.3d 327 (2005), following Auerbach v. Bennett, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 925 (1979)(business judgment rule applicable to for-profit corporations).

3. Organizations may not wish to seek relief from restrictions from a living donor out of concern that the donor will be reluctant to make future gifts thereafter. Where donor modification of restrictions is not feasible, organizations may be unwilling or unable to expend the funds necessary to seek a court order lifting the restriction.

4. Other apparent solutions are legally defective. For example, many organizations use their restricted funds as collateral for a loan or line of credit to fund their general operations, believing that, since the restricted funds are not being expended, they are acting legally. This is considered a violation of the restrictions, however, because, if the organization defaults on the loan, the lender is entitled to seize the fund, at which point the restriction will be violated.

IV. BANKRUPTCY AND/OR DISSOLUTION

A. Selected Issues

1. In what circumstances should an organization file for reorganization in bankruptcy?

2. If an organization is insolvent and also wishes to end its corporate existence, is dissolution a better remedy than bankruptcy?

3. To what extent are restricted assets available for satisfaction of creditors in bankruptcy?

B, Bankruptcy as a remedy for nonprofits

1. Nonprofits that become insolvent are entitled to file a petition for reorganization under Chapter 11 of the Bankruptcy

Code. 11 U.S.C. § 541(a) (2005). (They are not subject to involuntary bankruptcy.) The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 contains provisions specifically tailored to nonprofits filing bankruptcy petitions; for example, Section 541(f) authorizes the Attorney General of the State in which the organization is incorporated, was formed, or does business” to appear as a party in the bankruptcy proceeding of a nonprofit organization.

2. As with any other bankrupt in reorganization, Chapter 11 allows a charity to satisfy its creditors pursuant to a “work out” plan and to emerge from bankruptcy with a clean slate. Conversely, an organization that determines it should end its corporate existence as a result of insolvency will not achieve that result in bankruptcy.

3. Bankruptcy’s primary focus and goal, marshalling assets for the benefit of creditors, often conflicts with the general law of charities, whose focus is the preservation of assets for the public purpose determined by the donor. See, generally, Evelyn Brody, “The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future,” 29 Seton Hall Legislative Journal 471 (2005).

4. Generally, restricted assets – whether endowment funds or restricted purpose funds – will not be considered part of the bankruptcy estate available to creditors. Instead, the bankruptcy court will refer the disposition of such assets to a state court, where the principles of cy pres can be applied or will make its own determination based on those principles. See, e.g., In re Bishop College, 151 B.R. 394 (Bankr. N.D. Tex. 1993); Freme v. Maher, 480 A. 2d. 783 (Me. 1984).

C. Dissolution for insolvent nonprofits

1. Articles 10 and 11 of the N-PCL, governing so-called “non-judicial” and judicial dissolution, contain procedures for the resolution of the claims of creditors under court supervision as well as explicit requirements that restricted funds be redirected to other nonprofits that agree to use them in the manner specified by their donors.

2. The filing of a dissolution petition, unlike a bankruptcy petition, does not protect the organization from collection actions brought by its creditors. While N-PCL § 1102(a)(1)(A) provides for the presentation of a petition for judicial dissolution where “[t]he assets of the corporation are not sufficient to discharge its liabilities,” the state court forum will generally be less sympathetic to the debtor charity than the bankruptcy court.