REID AND RIEGE, P.C.
COUNSELLORS AT LAW

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NONPROFIT ORGANIZATION REPORT – WINTER 2014

TWO TIMELY TOPICS

In this issue we will discuss two topics. The first concerns pending changes in the way auditors present endowment funds on nonprofit financial statements. While this subject may sound overly technical, its implications are significant and it behooves nonprofits and their donors to understand the issue. Second, we will discuss a recent jury verdict finding the directors and officers of a failed nonprofit personally liable to the nonprofit's unpaid vendors. This case is interesting because the jury parsed the difference between *negligent* board conduct (no liability) and *reckless* board conduct ($5,750,000 of liability).

Topic One: Endowments, Accountants, and Nonprofit Financial Statements. Charitable organizations are in part a product of the private property rights of the donors who contribute to them. In this regard the law permits donors to impose restrictions on how the charities use their donations. We are concerned today with those restrictions requiring the charity to hold donated assets as a perpetual endowment fund, with only the earnings to be used to support operations. For example: In 1970 Mrs. Gloria Gotrocks leaves $100,000 to Yale University as a "permanent endowment with the earnings to be used for general support of the university." While gifts of this type are now commonplace, they have never been free of *controversy* or *complexity*.

The *controversy* can be traced to thirteenth century England and attempts by the Crown (notably Edward I, known as "Longshanks" to his subjects) to limit the amount of land (the principal form of wealth at the time) given to charities where it would be free from feudal dues (taxes). It took centuries, but English law evolved to permit donors to "restrain" their property in perpetuity by giving it to charities to be held as a permanent income producing asset, all of which was codified in the Statute of Charitable Uses of 1601 during the reign of Elizabeth I. Interestingly, while American law is based on English precedents, the early states shared some of the same concerns as Longshanks, and many resisted the accumulation of charitable assets. It was not until an 1833 decision of the United States Supreme Court that these English legal principles were firmly planted in American soil.

The *complexity* erupted with commercial developments in the last century – notably the shift from land as the principal source of wealth to assets such as stock, bonds, and the other investments available in today's financial markets. Land is an easy and safe asset – it is *tangible*, it yields rents or saleable products, its value changes gradually, and it is not traded frequently. On the other hand, stocks and bonds are *intangibles*; they can evaporate entirely in a bankruptcy, their value changes daily, and they can be bought and sold with a click of a mouse.

The developments discussed in the previous paragraph presented both legal and accounting questions for charitable endowments. The principal legal question was this: how do you graft the centuries-old concept of perpetuity onto assets which by their nature (and unlike the land under our feet) are not? To be precise, as a matter of law, what portion of these intangible, volatile, and ephemeral assets is the perpetual part that the board of directors cannot allow management to spend (the corpus or principal)?[1] The accounting question was this: how is the perpetual portion presented on a charity's audited financial statements?[2]

The legal question was addressed in a 1973 statute (the Uniform Management of Institutional Funds Act). The term "uniform" is in the title because the Act was prepared by an organization named the Uniform Law Commission – which proposes legislation for adoption by the states on matters where uniformity is appropriate. This statute answered the "perpetuity" question directly by stating that the "historic dollar value" of the donor's gift (its value on the date donated – Mrs. Gotrocks' $100,000) is the permanent portion which an institution could not spend. The accounting work was easy because financial statement presentation follows the law, and the $100,000 would be reflected on Yale's financial statements under the heading ***permanently restricted assets*** (which means what it says). While some folks saw this approach as "untidy" (see the next paragraph),[3] it gave boards and their professional advisors the benefit and security of a fixed point to which their spending decisions and advice could be tethered.

However, in the period between 1973 and 2007 the Uniform Law Commission concluded that the untidy features of the 1973 statute (footnote 3) were problematic enough to justify a different approach.[4] The result was a new statute (the Uniform ***Prudent*** Management of Institutional Funds Act or UPMIFA) which abolished the fixed dollar standard for identification of the perpetual portion, and replaced it with… well… we're not really sure…. And therein lies the problem and the financial statement conundrum that is our topic. Let us put it this way: the 1973 law's fixed reference point acted as a leash on the fiduciary spending discretion of governing boards; whereas the 2007 statute eliminated the fixed limit and gave boards almost total discretion on the question – albeit with what UPMIFA supporters refer to as an enhanced fiduciary reminder that directors need to keep perpetuity in mind when they spend. In the Commission's own words: "The Act directs the charity to focus on the purposes and needs of the charity rather than on the purposes and perpetual nature of the fund."

So, what did the accounting profession do after UPMIFA became the law? Over the emphatic written objections of the Uniform Commission, the Financial Accounting Standards Board (FASB) decided to continue to require nonprofits to identify a class of ***permanently restricted assets*** on their financial statements, but in lieu of the fixed dollar standard FASB said it was up to nonprofit boards and their lawyers to decide how much to put in that class. As a practical matter, and to the continuing chagrin of the

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[1] Think about Mrs. Gotrocks' 1970 gift of $100,000 to Yale, invested prudently in a portfolio of stocks and bonds. The initial $100,000 could depreciate below $100,000 in a bad market, or appreciate above $100, 000 in a good market. Over a long period time, of course, the investment should appreciate such that, for example, in 2014 it may be worth $200,000. So, given these iterations, the question is what is the perpetual portion of her gift? *While we do not have the space to discuss donor intent, many donors we have represented fully expected (intended) that the institution (Yale in our example) actually would have taken steps to increase the permanently restricted portion of their gifts to account for inflation.*

[2] Financial statements are vitally important. They are like an X-ray that illuminates the inner financial condition of an organization. Board members, governmental funders, lenders, suppliers of goods and services, donors and regulators all rely upon them, and the reliance can be a basis of litigation if they are not correct or are misleading.

[3] The alleged untidy features were these: (1) an institution had to stop spending from an endowment fund (at least temporarily) if it depreciated below historic dollar value; (2) historical dollar value was an arbitrary number based on things such as the date of death of a donor; and (3) after a long period of time historic dollar value became meaningless.

[4] The Commission's official commentary to UPMIFA refers to the three items in footnote 3 as the basis for the change. Candidly, we think these items are much too slender a reed upon which to base what the Commission did in UPMIFA, and we suspect that the large institutions behind the Commission's actions found these to be inconveniences that created some work that they simply did not want to deal with.

Commission, our accountant friends tell us that the boards of their nonprofit clients have continued to use the fixed historic dollar value for this purpose even though it is not in UPMIFA.

We are writing about this because there is a project underway at FASB to rethink the matter and possibly to promulgate in 2014 new asset classifications and protocols for dealing with the issue. We participated actively in discussions with FASB personnel and state Attorneys General in the aftermath of UPMIFA, supported the retention of the permanent asset class, and have advised our clients to use the fixed historic dollar value on their financial statements. We offer the following thoughts to FASB as it contemplates what it will do next:

1. If the 1973 statute was untidy, UPMIFA may have created a real mess. While it may not be easy to apply the centuries old concept of perpetuity to modern investment portfolios, the decision to leave so much authority to the discretion of governing boards is a move worthy of Longshanks – a usurpation of greater control over these assets. Moreover, while this approach may be suitable for institutions such as Yale (which have unlimited access to professional resources), the same is not true for a vast number of institutions which would benefit from a clearer legal standard (See Topic Two).

2. The law supports the creation of endowments because they are intended to outlive the corporate institutions holding them. If an institution fails (and they frequently do), the endowment (or what's left of it) will be transferred to a successor institution with the approval of the courts. In this sense there can be a subtle but pernicious conflict of interest facing board members seeking current operating income to sustain a weak institution, while balancing a concurrent fiduciary obligation to keep the fund around in perpetuity for the needs of future generations. At times it may be more prudent for a board to enhance the size of the perpetual part of its funds and to shut down a faltering institution so that more will be available in the hands of a healthy successor.

3. We are very cynical about the degree to which UPMIFA relies on the discretion of boards to preserve funds in perpetuity. Having litigated fiduciary cases, we have seen how easy it is for boards to create reasons to justify (rationalize) spending decisions. For example, if Mrs. Gotrocks had given her $100,000 to a small college that then started to fail, could its board spend her fund down to $1.00 if it could make the case that the decision was based on an expectation of increased enrollments in future years (but which never happens)?

4. We have other thoughts (see footnote 4), but because we are running out of room let us close by suggesting that the concept of perpetuity makes more of a statement about the human condition than it does about corporate governance. It is a declaration that people will *always* need charitable assistance, and that we ought not rob people not yet born of funds set aside for them by farsighted donors.

Topic Two: Officers and Board Members Personally Liable. The court decision we mentioned in the opening paragraph illustrates just how badly directors and officers can behave – and provides some additional context for the above discussion about the disparity in the quality of governing boards. The litigation was brought by the unpaid creditors (vendors and suppliers) of a failed nonprofit nursing home against individual *officers* (management) and members of the board of directors. A jury awarded a total of $5,750,000 in damages to the creditors, including $350,000 in punitive damages (extra punishment) against two officers and five of the directors. The gist of the case was that the failure of the officers and directors to fulfill their duties was causally connected to the losses suffered when the nonprofit ran out money and was unable to pay its bills. While the case involved complex facts and legal theories, we believe there are a few straightforward "takeaways" for readers to note:

1. The court looked at the officers (management) and the directors separately in recognition of the fact that they have separate and different obligations to the organization and to each other, and should have a somewhat arms length relationship. The takeaway: Boards and the managers they oversee should not get too cozy.

2. The principal defense (excuse) offered by the directors was reminiscent of Sergeant Schultz in the 1960s sitcom *Hogan's Heroes,* famous for the line "I see nothing!" In other words, the directors said they did not see the problems because they relied upon what management told them. The jury was instructed that if they found that this conduct was negligent the directors would not be liable, but that if they concluded that it was reckless there would be liability. The jury (average citizens and not judges) concluded that the directors' behavior as evidenced during the trial (see point 3) was reckless and assessed damages accordingly. The takeaway: Board members have an *active* and not a *passive* role to play – they are not mere rubber stamps.

3. Readers who have not lived through litigation should note that opposing counsel subpoenaed minutes, financial statements (see Topic One above), notes, emails and letters by and among directors and officers, and took oral testimony – to reconstruct for the benefit of the jury who did what and when – or who failed to do what prudence requires. The takeaway: Other than attorney client communications, almost everything you do or fail to do will be discovered.

4. Not everyone was equally culpable. Two of the directors were exonerated, and only five of the board members were subject to punitive damages. The takeaway: If you are at a board meeting and disagree with a course of conduct, make sure the minutes reflect your opposition and negative vote.

5. One has to wonder what would have happened if Mrs. Gotrocks had given her $100,000 endowment to this entity and for these officers and directors to manage. In the exercise of their discretion how much of her gift would have been left to find a place in another viable home for the elderly? The takeaway: State Attorneys General responsible for the protection of charitable endowments should keep an eye on what FASB does (and keep donor intent in mind as well)!

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

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