



Philanthropic NEWS

PROUDLY CELEBRATING 50 YEARS OF SERVICE TO THE PHILANTHROPIC COMMUNITY

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FIDUCIARY DUTIES OF NONPROFIT BOARDS POST-MADOFF

While nonprofit organizations that invested with Bernard Madoff are grieving the loss of their investments, some Attorneys General are investigating whether the directors of these nonprofits breached their fiduciary duties by investing with Madoff without adequate due diligence or skepticism.

What exactly are the fiduciary duties of board members in this post-Madoff era?

Less than two weeks after the Madoff scandal broke on December 11, 2008, Connecticut Attorney General Richard Blumenthal announced that his office was investigating whether board members of charities in Connecticut which had invested with Madoff had breached their fiduciary duty of care. In January of this year, New York Attorney General Andrew Cuomo launched an investigation into J. Ezra Merkin and his potential conflicts of interest arising from his position on nonprofit boards where he recommended investing the nonprofit's money with Madoff.

On April 6, 2009, Cuomo's investigation culminated in an official complaint filed against Merkin for, among other actions, breaching his fiduciary duty

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ENDOWMENT SPENDING DURING AN ECONOMIC CRISIS

When endowments lose money, it is important for organizations to understand their statutory spending restrictions as well as their options. This is especially true of endowments that drop below their "historic dollar value" (i.e., the total value of contributions made to the endowment fund, determined at the time the contributions were made) and thus considered to be "underwater."

The rules governing endowment fund spending differ depending primarily on the organization's state of incorporation. Most states have either adopted the Uniform Management of Institutional Funds Act ("UMIFA") or the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). Many view UPMIFA as a more modern and flexible set of endowment management rules that help institutions better cope with fluctuations in the value of their endowments.

UMIFA permits prudent expenditure of both appreciation and income. This principle replaced the old trust law concept that only income (e.g., interest and dividends) could be spent. Therefore, under UMIFA, asset growth (i.e., appreciation) and income can be spent for program purposes, subject to the rule that a fund cannot be spent below its "historic dollar value." Many states, including New York, have taken the position that organizations have an obligation to preserve the historic dollar value of their funds. Therefore, when a fund goes underwater, the organization may continue to spend income earned on the fund (e.g., interest, dividends, rent, and royalties),

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DUTIES OF NONPROFIT BOARDS

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of care. Massachusetts Attorney General Martha Coakley, on the other hand, has made public comments more sympathetic to nonprofit directors duped by Madoff, stating that her office would assume that the directors complied with their fiduciary duty and could not be expected to uncover such clever and convincing criminal behavior.

States' Attorneys General have the authority to bring actions against board members who breach their fiduciary duties, which typically include the duties of care, loyalty, and good faith. Currently, the investigations involving the Madoff scandal are focusing on the duty of care, which is the most complicated fiduciary duty. While its definition differs by state, the duty of care generally requires a director to act with the same degree of care, diligence, and skill as an ordinarily prudent person would behave in a similar position.

An ordinarily prudent person who serves on a nonprofit board must make efforts to be informed of all material facts about a situation before making a business decision on behalf of the nonprofit, and, if necessary, may be required to seek outside expertise. Depending on the particular situation, a director's obligations may change. However, if a director can show he or she made reasonable efforts to be informed, acted rationally and made decisions in good faith, the courts typically apply a standard of review known as the "business judgment rule," and do not question the decisions made by the board.

Although the burden is technically on board members to show they acted appropriately, a nonprofit organization may also establish guidelines and incorporate certain requirements into their governance policies to help directors meet their fiduciary duties. Many of the governance policies asked about in the revised Form 990 can help board members better understand and act in accordance with their fiduciary duties. Nonprofits can also support their board members by educating them as to their responsibilities as directors, as well as purchasing director and officer ("D&O") liability insurance to protect those who do act in good faith and comply with their fiduciary duties.

If you have any questions about fiduciary duties, adoption of governance policies or D&O insurance, please contact Jennifer Hu Corriggio at jennifer@perlmanandperlman.com.

ENDOWMENT SPENDING IN A CRISIS

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but it may not spend any net appreciation unless that net appreciation was appropriated for spending before the fund became underwater.

Unlike UMIFA, UPMIFA does not restrict spending based on the historic dollar value. Under UPMIFA, a charity may determine when it is appropriate to spend its funds, even if they have fallen below historic dollar value. Subject to any donor restrictions provided in the gift instrument, UPMIFA provides guidelines for an organization to consider in determining whether to spend ("appropriate") or save ("accumulate"). According to UPMIFA, the institution must consider the following seven factors: (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and, (7) the investment policy of the institution.

As of March 2009, 29 states and the District of Columbia have enacted UPMIFA (including Delaware), and 15 states have introduced legislation to adopt UPMIFA. New York is among the few states still operating under UMIFA that has not yet introduced UPMIFA legislation.

The statutory restrictions on endowment spending generally apply unless the donor gives permission to modify the endowment restrictions. Permission is typically obtained through a written agreement signed by the donor when the donation is first made, but organizations can also seek permission to modify the endowment restrictions later.

A "last resort" option is to seek judicial release of endowment restrictions through a *cy pres* proceeding. This relief can only be sought if the donor has passed away or is otherwise unable to give permission. The Attorney General is a necessary party to such a proceeding. Judicial relief is only available if the organization can show that without the relief, the organization will fail or the intentions of the donor will be frustrated.

Organizations should carefully analyze the value of their endowment funds, which generally requires reviewing each fund set up by a particular gift instrument separately, and then determining the extent to which spending is appropriate. If you have questions regarding your organization's particular endowment fund situation, please contact any of the attorneys at the firm.

RECENTLY INTRODUCED STATE LEGISLATION

A number of states have introduced legislation that would significantly revise their respective nonprofit corporation and charitable solicitation laws, including Illinois, Mississippi, and Oklahoma. Of note, Illinois Senate Bill 1970 would amend the Solicitation for Charity Act to increase from \$150,000 to \$300,000 the contribution threshold amount required for a charitable organization to file a financial statement with the Attorney General for the preceding year. Also, Mississippi House Bill 680 and Senate Bill 2413 would make various amendments to the Mississippi Nonprofit Corporation Law, including increasing from \$4,000 to \$25,000 the annual contribution threshold requiring registration.

In addition, Iowa has introduced legislation (House Study Bill 80) that would create a private cause of action for consumer fraud violations, which would include prohibited deceptive acts in connection with solicitations of contributions for charitable purposes. The bill would allow consumers to recover damages, costs, and attorneys' fees.

Montana and Nevada have introduced legislation that would create new solicitation registration schemes. Charities are not presently required to register in those states. Under Montana House Bill 143, a registration system for charities would be established, but would not apply to charities with gross annual revenue of less than \$25,000. Similarly, Nevada Senate Bill 153 would require every charitable corporation that intends to solicit contributions in the state to file annually a registration statement and financial report with the Secretary of State.

NEW YORK AMENDS SALES TAX REQUIREMENTS FOR NONPROFITS

New York State has recently expanded the area of sales by a nonprofit organization that is subject to sales tax. Beginning in September 2008, nonprofit charitable, educational, and religious organizations were required to collect New York State sales tax on the retail sale of any tangible personal property that are made with a "degree of regularity, frequency and consistency" by remote means, such as by telephone, mail order, or over the internet. In January of this year, the sales tax was further expanded to require any exempt organization that operates a store and also makes similar retail sales by remote means to charge sales tax on sales made to New York residents regardless of the frequency of such sales. In addition, certain sales of tangible personal property by auction are now subject to

New York State sales tax if made with a degree of regularity, frequency and continuity.

Any nonprofit that is subject to New York sales tax must register with the state, and obtain a Certificate of Authority. Once registered, organizations must maintain records and submit either monthly, quarterly, or annual sales tax returns.

For further information on these recent New York sales tax changes and how it may impact your organization, please contact Cliff Perlman at cliff@perlmanandperlman.com.

UPDATE ON HYBRID ENTITIES

There have been recent legislative developments regarding for profit legal entities formed to carry on social enterprise. Michigan, Wyoming and Utah have become the latest states to recognize the limited-purpose limited liability company ("L3C"), which is an LLC whose purposes are limited to "low profit" activities that are for public rather than private purposes. An L3C can make a profit and distribute its profit to shareholders as long as creating a profit is not its primary purpose. Contributions to an L3C are not tax-deductible and the L3C is not tax-exempt, but presumably an L3C can enter into joint ventures with nonprofit organizations and receive program-related investments more easily than a conventional for-profit company. Vermont was the first state to adopt the L3C last spring, and this year Michigan enacted its law in January, followed by Wyoming in February, and Utah in March.

Last year, the State of California failed to enact a "constituency" statute that would have given companies, executives, and directors the option to include the interests of various stakeholders, in addition to shareholders, in their decision-making process without fear of shareholder retribution. The statute was permissive and not mandatory; companies could take other stakeholders' interests into account, but were not required to do so. This year, a working group of prominent California attorneys is drafting a statute that would create a new type of business entity, currently known as the "H Corporation." This entity would protect companies from shareholder lawsuits based on the company's addition of certain provisions, including a social purpose, into their organizational documents.

For more information on these various hybrid legal structures, contact Allen Bromberger at allen@perlmanandperlman.com.

UPCOMING SPEAKER EVENTS AND ANNOUNCEMENTS

CLIFF PERLMAN will be giving a presentation on May 4, 2009 at the National Breast Cancer Coalition Fund Annual Advocacy Training Conference in Washington, D.C. He will be speaking on how nonprofit organizations can engage in advocacy while still maintaining their tax-exempt status.

ALLEN BROMBERGER and **BARBARA NAGEL** will be giving a workshop on Financing Social Ventures at the Social Enterprise Alliance Summit on April 16, 2009 in New Orleans, LA.

SETH PERLMAN and **ALLEN BROMBERGER** will be attending the Social Venture Network Annual Member Gathering on April 23-26, 2009 in Itasca, IL.

PERLMAN & PERLMAN, LLP has recently joined the National Catholic Development Conference (NCDC) as a Corporate Partner. NCDC leads the Catholic development community toward excellence in the ministry of ethical fundraising through education, networking and advocacy.

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