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NONPROFIT ORGANIZATION REPORT – SUMMER 2016

Regulation, Legislation and the Evolving Standards of Governance and Fiduciary Duty[1]

The relationship between government and charity and its effect on boards of directors

In March of 2016 members of the Connecticut General Assembly proposed legislation which would have imposed a state income tax on Yale University's $25 billion endowment. The logic behind the proposal was that "universities with over $10 billion would either use their endowment to expand access to education and create innovative jobs, or would share a small percentage of their retained earnings with the state's taxpayers, so that we could accomplish these same goals." The proposal died a quick death because the logic was too thin a veneer to hide what was really going on – Connecticut is in the midst of a financial crisis and needs cash to pay its operating expenses.

In June of 1215 King John I of England met at Runnymede (south of London) with a group of English barons with whom he had been feuding over his abuses of power and exorbitant taxes. The meeting led to concessions memorialized in *Magna Carta* – a foundational document of the English and American legal systems that is discussed in high school social studies classes. One of the issues addressed in *Magna Carta* was the King's concern about land conveyances to the Church, where it would be exempt from the feudal "taxes" used to pay his kingdom's operating expenses. A compromise was reached: transfers to the Church were allowed if the transferor retained an interest in the land sufficient to satisfy the obligations in question.[2]

These two cases, 800 years apart, illustrate the underlying tension in the Anglo-American legal system between government and charitable institutions vis-à-vis the ownership and control of property dedicated to a public purpose. *Magna Carta* is germane to this topic not only because American law is based on English law, but because the 800 years between the meeting at Runnymede and the attempt to tax Yale speak for themselves – suggesting that the tension is not only baked into the relationship, but that it periodically waxes and wanes depending on economic conditions.

In this issue we will examine the law and the history of the relationship between government and charitable organizations in the United States and how the relationship impacts the duties of fiduciary governing boards. It is a timely topic because the financial tension between the two is on the rise as money gets tight at federal, state and local government levels, and because the issues created by the tension are finding their way to the boardrooms of affected nonprofits where they may force a rapid evolution of modern fiduciary governance standards.

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[1] *Regulation, Legislation and the Evolving Standards of Governance and Fiduciary Duty* is the title of a professional development training session presented on July 15, 2016, at Yale School of Management under the auspices of Commonfund Institute. The presenters were William F. Jarvis, Executive Director of Commonfund Institute, and John M. Horak, Chair of the Reid and Riege Nonprofit Organizations Practice Area. The opinions in this newsletter are those of Mr. Horak.

[2] The role of *Magna Carta* in the history of charities law is discussed in "Charitable Endowments and the Democratization of Dynasty," *Arizona Law Review*, Vol. 39, p. 873, 1997, by Professor Evelyn Brody.

We will approach this material by examining the legal principle at the root of the tension and some examples of its escalation; by taking a lesson from the history of the relationship between government and charity in the United States; and finally, by using a case study to demonstrate what our changing times will mean for boards of directors.

The root of the issue and the rising tension

The tension between government and charity exists because, since medieval times, the legal meaning of the term "charity" has included the support of ordinary public expenditures (such as the building of bridges and roads) *as well as* the care of the poor, sick or suffering (which we more commonly think of as "charity").[3]

Here's another way to say it: from the beginning the concept "charity" has included a very wide range of matters (including what to modern ears sounds "all government" in nature) such that the charitable sector evolved into a somewhat parallel, privately controlled and funded, system or method by which private persons could use their resources to address, on terms of their choice, many of the same issues as the "sovereign."[4] They are competitors of a sort – as the Runnymede and Yale examples demonstrate.

The tension is rising because the federal and many state and local governments are facing fiscal challenges as they try to satisfy the accrued obligations on their balance sheets and pay current operating expenses. The competition is direct in some cases (such as cutbacks in social service contract funding or the imposition of local real property tax on nonprofits), and indirect in other cases (such as Medicaid service mandates insufficient to cover actual costs). There is also the intermittent background chatter about limiting the charitable deduction, and the gnawing academic punditry about "nonprofits not doing enough to justify" their exemption while bemoaning "how much the deduction costs the government."[5]

The evolution of the relationship in this country – from outright hostility to partnership

In the 400 years after *Magna Carta*, the English law of charities evolved, matured and was codified in what is known as the Statute of Charitable Uses (1601) – which was the law in England's North American colonies. This statute is a high water mark in the law of charity that codified legal principles fundamental to the sector: articulating the broad definition of "charity" described above, and

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[3] "But the idea of treating the performance of these public duties as acts of charity did not come originally from the Church, nor from religious or even a moral requirement. It was an inheritance from Roman law, undoubtedly entering into England, as other parts of the Roman law did, through the Church (or rather through churchmen), but not from what we may call its religiously charitable side." *Illustrations of the Origin of Cy Pres*, Harvard Law Review Volume III, No. 2, May, 1894.

[4] To this day the Internal Revenue Code of 1986 (Section 170A) allows us to take a "charitable deduction" for contributions to our home town (to help pay for a library or even a bridge, for example), or to a local church or shelter. The Code also recognizes "lessening the burdens of government" as a charitable income tax exempt activity under Section 501(c)(3).

[5] For more on this point, see the Summer 2009 edition of this newsletter, *Charitable Money Is Private Money*, and the Spring 2012 edition, *Defending the Charitable Deduction*. Both are available on our website.

confirming that donors have the power and right to give property in perpetuity to charity and to impose permanent restrictions on how it is used.

However, after the American Revolution, the former colonies abandoned English law to the point, in some states, of not allowing property to be given to charity and specifically rejecting the Statute of Charitable Uses. It took 150 years after the Revolution for the law of charities to be re-established in this country,[6] and by the end of the twentieth century it reached a very favorable new high water mark, giving us the modern nonprofit sector of which we write. We have tax deductions and exemptions, nonprofits partnering with for-profits, volunteer protection statutes, tax exempt bond financing, networks of grant making private and community foundations, human service organizations, shelters, churches, and all the rest – comprising somewhere between 10 and 15 percent of the nation's gross domestic product.[7]

Our foray into American history teaches us that government and charity are competitors in only a limited sense, because government makes the rules (the law) under which the competition occurs. The charitable sector exists at the sufferance of federal and state legislators who could change the rules with enough votes. While we do not foresee a repeat of King Henry VIII's sixteenth century seizure of the Catholic monasteries in England to finance his realm, modern nonprofit fiduciaries should understand the balance of power – which cards they hold and which they do not.

A case study demonstrating what is in store for directors

Healing Hearts (not the real name) is a Connecticut human services organization that cares for the disabled. It has a $20 million budget that is funded almost entirely with government money under state contracts and Medicaid fee-for-service revenue. It has a modest $4 million endowment funded by gifts and bequests primarily from families whose members received care from Healing Hearts. Two years ago the endowment was transferred to the Healing Hearts Foundation – a separately incorporated nonprofit entity (there is some board overlap) that holds the endowment solely to support and benefit Healing Hearts.[8]

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[6] Here is a quotation from an article ("American Acceptance of Charitable Trusts") in the February 1953 edition of the *Notre Dame Law Review*: "After the American Revolution, many of our states experienced a feeling of great revulsion to laws of English derivation, and a wholesale repeal of statutes was instituted… [t]he Statute of Charitable Uses, being an English statute, thus fell victim to the axe of the legislator . . . [r]ecognizing the desirability of charitable trusts, American courts have gradually reversed their earlier attitudes. They now take the position that charities are favorites of the law and give them their full support. Our courts have run the gamut from complete rejection of charitable trusts to liberal support and encouragement."

[7] Our proposition that the "modern" law of charities is well and favorably developed is also based on uniform laws around the country that make it easier for nonprofit advisors to do their jobs. They include the Model Nonprofit Corporation Act, the Uniform Principal and Income Act, the Uniform Management of Institutional Funds Act, the Uniform Prudent Investors Act, and the Uniform Prudent Management of Institutional Funds Act. An excellent summary can be found in a May 2015 publication of Commonfund Institute *Legislating the Normative Environment: Nonprofit Governance, Sarbanes-Oxley and UPMIFA,* by William F. Jarvis, Executive Director of Commonfund Institute. It is available at https://www.commonfund.org/2015/05/19/legislating-the-normative-environment-nonprofit-governance-sarbanes-oxley-and-upmifa/.

[8] We often recommend that clients transfer endowment assets to supporting foundations to create a wall between the operating entity (and its creditors and liabilities) and the endowment.

The levels of government funding (which had been reasonably constant for years) have been shrinking precipitously, leaving Healing Hearts with a $200,000 deficit in the current fiscal year that will force lay-offs and the elimination of services to disabled clients. Healing Hearts management asks the Foundation for an extraordinary $200,000 distribution from the endowment to cover the deficit and maintain current operational and care levels. What should the board of the Foundation do?

First, on a macro level the board should recognize the human gravity of the burden they now bear. They will have to decide if disabled people will end up on the streets, and will have to answer for their decision in the community and the press. This issue goes to the very heart of what charity is all about, arises because of government's financial problems, and is a burden of the sort that many volunteer board members did not expect when they "signed up."

Second, on a micro level, the board should prepare a "to do" list, which would include, for example, (1) an endowment analysis to determine what unrestricted monies are available, (2) an analysis of the statutory prudence standard by which their decision will be judged after the fact, (3) an appraisal of management's performance (perhaps with the involvement of outside auditors) to see if the deficit exists despite good management, (4) an inquiry about the possibility of a merger, (5) an estimate of government funding levels over the next two fiscal years to see if they will stabilize, (6) an analysis of donor reaction, (7) the development of financial and operating projections looking out two or three years which consider best and worst case scenarios, and (8) many, many other items.

Let us close with this: if, as we expect, the financial tension between government and the nonprofit sector continues to increase, modern fiduciary governance standards and board members will be put to the test in a manner not foreseeable even a few years ago.[9] It will not be easy to wade through waters this rapid and deep.

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.

This issue of the Nonprofit Organization Report was written and/or edited by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment, and regulatory issues for nonprofit organizations.

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[9] Here are two other examples: Under the new Uniform Prudent Management of Institutional Funds Act boards can dip into endowment corpus or principal in ways that were unlawful a few years ago. Would the Healing Hearts Foundation board be justified in taking money out of principal in this case? Should the board of the Foundation view the $200,000 as a form of tax on its endowment – akin to the direct tax that was designed for Yale?