



# REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT - FALL 2008

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## The Nonprofit Katrina Winning the game (surviving the storm) with bunts and singles

The collapse of world financial markets and impending recession are collectively spinning into a storm of major proportions for the nonprofit sector – foreshadowing an ugly double whammy of diminished resources and increased demand. The dust is rising so rapidly that it may be a fool's errand to hazard a guess as to where it will finally settle – but that risk won't stop us from offering a few suggestions and observations.

There certainly will be increased pressure on management with respect to ordinary course of business items such as cash flow and expense management. Boards of directors should consider asking management to prepare an assessment of likely cash and expense challenges over the next 12-24 months in an effort to anticipate and plan for bumps in the road. There are business techniques that might be worth considering – such as asking for better price and extended payment terms from vendors, while simultaneously trying to collect accounts receivable (or other payments) more quickly. In our experience a polite request for assistance rarely does any harm.

Asset protection planning is also something to consider – especially with respect to charitable investments/endowments. Asset protection planning is legal if it is done in the right way and at the right time. The technique we have used most often involves spinning off investment/endowment assets into a separate supporting foundation. The by-laws and certificate of incorporation of the foundation must be structured carefully to walk a fine line – making sure the foundation is answerable to the operating entity while simultaneously keeping the foundation's assets out of reach of the operating entity's creditors. For example, a nonprofit school or hospital could create a supporting foundation which would (i) obtain Section 501(c)(3) status, (ii) hold legal title to the assets to be protected and (iii) have as its sole purpose the provision of financial support to the school or hospital. Thought could also be given, for similar reasons, to transferring real estate into a Section 501(c)(2) title holding company.

Nonprofits with cash needs should avoid the temptation to use donor restricted assets which are held as a “true endowment” (not expendable at all), or for purposes different from those earmarked by the donor. We know of a current case in which the administration of a Connecticut educational organization tried to divert surpluses from a donor restricted fund to pay for other programs the administration wanted to fund. Adherence to donor intent is a sacrosanct principle in the law of charities – and in the above case the institution's use of funds is under review by the Office of the Attorney General. Be especially wary of using donor restricted funds to pay operating expenses (trade creditors).

In a worst case scenario nonprofit insolvencies and bankruptcies are possible. We have led nonprofits through out-of court or “informal” workouts with creditors and formal Chapter 11 Bankruptcy filings. A Chapter 11 bankruptcy is not a liquidation – but one in which the court is asked to provide relief from creditors so that the entity can be reorganized and preserved. Nonprofits in this position have issues unique to their exempt status and assets, and if your organization is suffering sustained and accumulating operating deficits you should be proactive and get out ahead of the situation before planning options are foreclosed.

We expect that troubled economic times will increase the pressures to merge – for the ostensible purpose of spreading overhead costs, creating synergies, avoiding duplication and the like. Many of the members of our practice group started their careers as business lawyers, and “acquisitions and mergers” of for-profit businesses were a common task. Having said this, it never ceases to amaze us how much

more **difficult it is to get nonprofits to merge** – even in situations in which the business/operational enhancements are obvious. In our experience this is because nonprofit boards and staff hold their mission very close to their hearts – and just don't believe that the “other guys” across town will “do it” quite as well. We have seen mergers work only in those cases in which there were committed strong leaders on both boards who had the political acumen to win over board members, management and staff. **We have also witnessed recalcitrant minority board factions do their best to derail mergers** – using techniques as unseemly as press leaks and harassing telephone calls to get their way.

**Endowed nonprofits in states (like Connecticut) that have adopted the Uniform Prudent Management of Institutional Funds Act** already had a lot of work to do because of the August 6, 2008 publication by the Financial Accounting Standards Board of Position Paper 117-1. Under FAS 117-1 boards have to **adopt resolutions to address the reclassification of assets from the “unrestricted class” into the “temporarily restricted” class** – mindful of the effects that doing so could have on lenders (loan covenants) and other outside parties. These same boards will now need to retool investment and spending policies to take into account market circumstances, and will have to adopt a policy (in consultation with their auditors) about what to do with “underwater” funds (endowment funds that have depreciated below their dollar value at the time received).

The governing boards of **Colleges and Universities** may be forced to do some strategic thinking about the future of their “industry.” Declining stock prices have simultaneously cut a wide swath through the value of endowments and of parents' college savings – not a pretty picture when held against the backdrop of the **tuition “sticker shock”** of the past several years. Will the current economic circumstances do for higher education what four dollar per gallon gasoline did for SUV's – precipitating strategic changes in the way higher education services are delivered? On top of all of these problems, the IRS recently announced that it was sending **“compliance questionnaires”** to 400 colleges and universities to collect data on a wide variety of issues, such as how these institutions classify and report trade or business activities, invest and use endowment funds and set the compensation of certain highly paid individuals.

Finally, we generally counsel clients facing a potential financial crisis that they will have a better chance of riding out the storm if they **focus on many small things that are relatively easy to do, rather than hoping or reaching out for a miracle**. Human nature being what it is, it is not abnormal to dream about the unexpected receipt in the mail one day of an anonymous unrestricted multi-million dollar gift to tide you over. On the other hand, the cumulative effect of many “smaller” things (improved cash management, expense curtailments, bank loans, asking donors to “un-restrict” all or a part of a gift and the like) may be enough to get you over the finish line. **In other words, as nice as it is to win a ball game with homeruns, the cumulative effects of bunts and singles can work as well even if the process takes a bit more work, time and planning.**

*The Reid and Riege Nonprofit Organizations 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 by John M. (Jack) Horak, Chair of the Nonprofit Organization Practice Group at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment, and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel. For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Jack Horak at 860-240-1077 or [jhorak@reidandriege.com](mailto:jhorak@reidandriege.com), or other members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at [www.reidandriege.com](http://www.reidandriege.com).*

