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May 2017

### Asset Transfer Considerations

Economic conditions and other challenges may cause many New York not-for-profit organizations to make tough decisions to keep necessary programs running. To raise much-needed capital, some organizations may consider selling or leasing a majority of their assets. Others who are facing insolvency may need to sell assets to avoid bankruptcy. New York State law, however, requires certain nonprofit corporations to seek the authorization of the State Attorney General and the Court prior to transferring all or substantially all of their assets.

1. When is it necessary for a nonprofit organization to get authorization prior to a transfer?
2. What constitutes a transfer of "substantially all" assets?
3. What if the underlying assets are subject to donor restrictions?
4. What does *quasi-cy pres* mean?
5. What are the mechanics of the transfer or sale of assets?
6. Are there any special considerations if the nonprofit is in severe financial distress?
7. What else should the board consider when contemplating a transfer of assets?

### Discussion Points

Below are some specific questions that the Board of a nonprofit corporation may wish to ask as it considers whether to dispose of all or substantially all of the corporation's assets.

#### **1. When is it necessary for a nonprofit organization to get authorization prior to a transfer?**

When a charitable nonprofit corporation formed under New York State law is selling, leasing, or otherwise disposing of all or substantially all of their assets, it will be required to get authorization from the New York State Attorney General (AG) or the New York State Supreme Court (the Supreme Court), with notice to the Attorney General.<sup>1</sup> A corporation may seek approval directly from the Attorney General, unless the corporation is insolvent or would become insolvent as a result of the transaction, or if the Attorney General, in his or her discretion, concludes that a court should review the petition and make a determination.<sup>2</sup> Transactions by non-charitable nonprofit corporations do not need Supreme Court or Attorney General approval.<sup>3</sup>

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<sup>1</sup> New York Not-for-Profit Corporation Law ("N-PCL") §§ 511 and 511-a.

<sup>2</sup> N-PCL § 511-a.

<sup>3</sup> Office of the Attorney General, *A Guide to Sales and Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 501-511 and Religious Corporations Law § 12 at 4*. Available online at: [https://www.charitiesnys.com/pdfs/sales\\_and\\_other\\_dispositions\\_of\\_assets.pdf](https://www.charitiesnys.com/pdfs/sales_and_other_dispositions_of_assets.pdf)

To approve the transfer, the Attorney General or the Supreme Court must find that (1) the consideration given and the transaction terms are fair and reasonable to the nonprofit corporation and (2) the transaction promotes the purposes of the corporation or the interests of its members.<sup>4</sup> Another important consideration is that the proceeds of the asset transfer must be used in a manner that is consistent with the nonprofit organization's purposes. The proceeds may not be used for the personal benefit of a director, officer, employee, member, or any other interested party.<sup>5</sup>

## **2. What constitutes a transfer of "substantially all" assets?**

There is no exact formula to determine what "substantially all" of a nonprofit's assets are. According to the AG, "There is no fixed numerical or arithmetic measure of 'all or substantially all.' Approval of the Attorney General or the Court is required when the transaction involves a large proportion of the corporation's total assets or when it may affect the ability of the corporation to carry out its purposes, regardless of the percentage of the corporation's total assets that are the subject of the transaction."<sup>6</sup>

The rule of thumb is that "substantially all" is considered to be so large a proportion of the assets that if those assets were transferred or otherwise disposed of, the disposition would change the character of the nonprofit and its activities. In some cases, the AG or the Court looks to see if a particular asset is the organization's most valuable possession. In determining the value of the asset, the AG or the Court will look to the asset's fair market value, not its depreciated value or net asset value (*i.e.*, asset value less liability).

## **3. What if the underlying assets are subject to donor restrictions?**

Many nonprofit organizations have assets whose use is restricted to specific purposes by donors. The nonprofit organization must use the restricted assets in a manner that is consistent with the directions of the donor. The AG or the Court will exert its authority to review and possibly disallow any transfer of an asset where the restrictions on an asset would not be honored or would be rendered unusable by the transaction.

Further, donor-restricted assets should not be pledged to creditors as security. The AG or the Supreme Court may find that creditors should not be allowed to seize donor-restricted assets with the aim of satisfying a lien. Allowing a creditor to gain possession of a donor-restricted asset may open the nonprofit to liability for fraudulently representing that the asset is available to the lender. Instead, the AG or the Supreme Court may seek to apply either the judicial *cy pres* or the statutory quasi-*cy pres* doctrine to the asset.

With respect to institutional funds (*i.e.*, funds donated to an organization for the purpose of making investments, rather than carrying out a programmatic purpose), there are a few ways in which a donor restriction can be lifted. The organization can seek a release or modification of the restriction from the original donor.<sup>7</sup> If the donor cannot or will not remove the restriction, the

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<sup>4</sup> N-PCL §§ 511(d) and 511-a(c).

<sup>5</sup> Office of the Attorney General, *A Guide to Sales and Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 501-511 and Religious Corporations Law § 12* at 9.

<sup>6</sup> *Id* at 4.

<sup>7</sup> N-PCL § 555(a).

organization may petition the Supreme Court to do so if the restriction is impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund.<sup>8</sup> The Supreme Court may also use the *cy pres* or quasi-*cy pres* standard to modify the restriction in a manner that is consistent with the purposes set out in the original gift.<sup>9</sup> If the donor-restricted asset is a fund less than \$100,000 and more than twenty years old, the restriction may be released through an application to the Attorney General without court approval or donor consent.<sup>10</sup>

#### **4. What does quasi-*cy pres* mean?**

The quasi-*cy pres* doctrine requires that a nonprofit's assets be used for purposes that are substantially similar to the purposes for which the assets were given. If those purposes become impossible or impracticable, the N-PCL sets the procedures to follow to seek relief. When evaluating a proposed asset transfer, the court will review whether the transfer meets the quasi-*cy pres* standard by looking at five aspects of the transfer: (1) whether the assets were received through public solicitation or under the specific dictates of a trust or will; (2) what the nonprofit corporation's certificate of incorporation states that its purposes and powers are; (3) what services and activities the nonprofit corporation actually provides; (4) what the activities and purposes are of the entity that will receive the assets; and (5) the reasons why the board recommends the asset transfer.

Thus when contemplating an asset transfer, a Board must consider not only how the nonprofit's purposes and activities are promoted by the transfer, but also how the assets will be used to continue those purposes and activities after the transfer is complete.

#### **5. What are the mechanics of the transfer or sale of assets?**

A nonprofit corporation must take several steps to gain approval for the asset transfer. The process of obtaining approval may require significant time and cost, which should be taken into consideration when negotiating the terms of the transfer with a proposed buyer or transferee.

##### *Step 1: Obtain an Appraisal of the Assets*

Although an appraisal of the assets is not explicitly required by statute, a petition without an appraisal may be rejected by the Supreme Court or the AG because an appraisal is usually necessary to determine whether the terms of the transaction are fair and reasonable. In some cases, the nonprofit corporation may be able to use audited financial statements or published stock prices. The appraisal should be prepared by a professional appraiser who is completely independent from both the buyer and seller.

##### *Step 2: Obtain Board and Membership Approval*

If the nonprofit has voting members, the board must adopt a resolution recommending the transaction and submit the resolution to the members entitled to vote.<sup>11</sup> The resolution must specify the terms and conditions of the proposed transaction, including the consideration to be received by the nonprofit corporation and the eventual disposition to be made of such

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<sup>8</sup> N-PCL § 555(b).

<sup>9</sup> N-PCL § 555(c).

<sup>10</sup> N-PCL § 555(d).

<sup>11</sup> N-PCL § 510(a)(1).

consideration, together with a statement addressing whether the dissolution of the corporation is contemplated thereafter.<sup>12</sup> Once the voting members receive this information the transactions must be approved by 2/3 of the nonprofit's membership at an annual or special meeting of the members.

If the organization does not have members entitled to vote on the transaction, the transaction must be approved by at least a 2/3 affirmative vote of the entire Board.<sup>13</sup> If the Board is comprised of 21 or more directors, a majority affirmative vote of the entire Board will satisfy the requirement. If the transaction involves a transfer of assets to a director or officer, the director's or officer's interest in the transaction must be fully disclosed to the Board and the voting members and the transaction must be approved by the affirmative vote of "disinterested directors" (*i.e.*, those directors who will not directly or indirectly receive any benefit from the transaction). Such an "interested person" transaction would also need to satisfy federal tax law procedures known as the excess benefit transaction approval procedures, which parallel state "related party transaction" rules.<sup>14</sup>

### Step 3: Draft the Petition

If the organization is a charitable nonprofit, it must draft a petition for submission to the AG or to the Supreme Court that details the terms of the transaction and places the transaction in the context of the nonprofit's overall activities.<sup>15</sup> Once drafted, the petition must be "verified" by a notary that the petitioner has sworn to regarding the accuracy of the petition's contents under the penalty of perjury.

If the proposed transaction requires approvals by government agencies (such as the NYS Department of Health, NYS Education Department, etc.), such approvals must be obtained and annexed to the petition.<sup>16</sup> Furthermore, if the organization is delinquent in its required filings with the AG, the organization will have to make its registration and reports current before it can receive authorization for the transaction.<sup>17</sup>

### Step 4a: Submit the Petition to the Supreme and Have a Hearing on the Petition

If the petition is filed with the court, the petition should be filed with the supreme court of the judicial district or county court in the county where either (i) the nonprofit has its office or (ii) the principal place where the mission of the nonprofit is to be carried out.<sup>18</sup> Upon receipt of the petition, the Court shall direct that at least 15 days' notice<sup>19</sup> be given to the AG and any other interested person (as determined in the Court's discretion) setting the time and place for a hearing for the application. If the corporation is insolvent, all of its creditors must be given notice of the hearing.<sup>20</sup>

If the Supreme Court is satisfied that the consideration and terms of the proposed transaction are fair and reasonable to the corporation and that the purposes of corporation or the

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<sup>12</sup> *Id.*

<sup>13</sup> N-PCL § 510(a)(2).

<sup>14</sup> N-PCL § 715.

<sup>15</sup> N-PCL § 510(a)(3).

<sup>16</sup> Office of the Attorney General, *A Guide to Sales and Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 501-511 and Religious Corporations Law § 12 at 14.*

<sup>17</sup> Office of the Attorney General, *A Guide to Sales and Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 501-511 and Religious Corporations Law § 12 at 13-14.*

<sup>18</sup> N-PCL § 510(a)(3) and 511(a).

<sup>19</sup> The Court may shorten this time period to fewer than 15 days upon a showing of good cause. N-PCL § 511(b).

<sup>20</sup> N-PCL § 511(c).

interests of the members will be promoted, it may authorize the asset transfer and issue a signed order directing the transaction to occur.<sup>21</sup>

*Step 4b: Submit the Petition to the AG*

Alternatively, in lieu of obtaining Supreme Court approval, the corporation may submit the petition to the AG for approval unless the corporation is insolvent, or would become insolvent as a result of the proposed transaction, in which case notice to all creditors and a petition to the Supreme Court would be required.<sup>22</sup> Additionally, the AG may determine in his or her discretion that the court should instead review and make a determination regarding the petition.<sup>23</sup> The AG may, in his or her discretion, direct the corporation to provide notice of the petition to any interested person, in which case the corporation must provide a certification to the AG that such notice was provided.<sup>24</sup>

If the AG is satisfied that the consideration and terms of the proposed transaction are fair and reasonable to the corporation and that the purposes of corporation or the interests of the members will be promoted, the AG may authorize the asset transfer and direct the disposition of the assets as described in the petition.<sup>25</sup> At any time, including if the AG does not approve the proposed transaction, or if the AG determines that court review is appropriate, the corporation may seek court approval as described in Step 4a above.<sup>26</sup>

*Step 5: Receive Authorization for the Transaction*

Whether through a court-issued signed order or from an authorization from the AG, once approved, the nonprofit corporation may proceed with the transaction. Note that if the transaction involves real estate, the title company or others may require a copy of the order or authorization as a condition precedent to closing.

**6. Are there any special considerations if the nonprofit is in severe financial distress?**

Even if a nonprofit is insolvent or is in severe financial distress, it cannot transfer all or substantially all of its assets without considering the statutory requirements of the N-PCL. If a transfer of all the nonprofit's assets is the only way to preserve the mission of a nonprofit in financial distress or to avoid bankruptcy, then the nonprofit will have to make that case in its petition. Courts prefer that a distressed nonprofit transfer its assets to an organization that provides similar services or has similar purposes rather than filing for bankruptcy. If the distressed nonprofit cannot find a suitable organization to purchase or assume the assets, a change in the nonprofit's mission through a sale of its assets will only be approved if it can demonstrate that it has carefully considered alternatives that would preserve its mission, but was unable to find a viable alternative.

If the nonprofit is insolvent, the process of obtaining the court's approval will also require additional time. As noted, creditors of a distressed nonprofit must be given notice of the proceedings and the opportunity to appear and explain why the transfer should not be approved.<sup>27</sup> If the nonprofit has already sought protection from its creditors under the federal bankruptcy laws, a sale of the nonprofit's assets may be permitted pursuant to a plan of reorganization or liquidation.

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<sup>21</sup> N-PCL § 511(d).

<sup>22</sup> N-PCL § 511-a(a).

<sup>23</sup> *Id.*

<sup>24</sup> N-PCL § 511-a(b).

<sup>25</sup> N-PCL § 511-a(c).

<sup>26</sup> N-PCL § 511-a(d).

<sup>27</sup> N-PCL §511(c).

In these cases, in addition to complying with federal bankruptcy law, the sale must also comply with all the requirements of a typical transfer of assets by any charitable nonprofit corporation under New York law. Additionally, as stated above, if the nonprofit is insolvent, the petition can only be made to the court, not to the AG alone.<sup>28</sup>

## **7. What else should the Board consider when contemplating a transfer of assets?**

Directors of nonprofits are generally not held personally liable for approving an asset transfer, if the decision to enter into the transaction is made in good faith, involves no conflict of interest, and the director makes an effort to understand the terms of the transaction. If not, an action may be brought against a director to account for his/her conduct in neglecting to fulfill his/her duties. In addition, the transaction may be set aside by the court and injunction may be obtained to prevent the transaction from occurring. For this reason, it is imperative that a director fully disclose any potential interest in a proposed transaction before seeking the approval of the Board, the members, the court or the AG.

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<sup>28</sup> N-PCL §511-a.