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Charting the Course:

Legal Help for Nonprofits in Troubled Times

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Executive Summary

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Charting the Course:
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As the recession spread worldwide in the fall of 2008, many nonprofit organizations in New York and across the United States faced major operating stresses that jeopardized their programs and disrupted their plans. As the impact of the economic downturn on the nonprofit sector deepened, an increasing number of the nation's 1.6 million nonprofit organizations[1] changed their budgets, structures, and activities to strive for stability. More than four years later, most organizations are operating with a revised set of assumptions, procedures, and partners. Decreased cash flow, exacerbated by an increased demand for services, has trapped the nonprofit sector in a constant state of financial strain. At stake is not only the viability of particular organizations and their employees, but also the millions of people who are the beneficiaries of their services.

The report, *Charting the Course*, identifies steps that nonprofit organizations can take to address the economic issues affecting the sector nationwide, while focusing on data and examples from New York City's nonprofit sector. It draws upon national and local studies for factual data about economy-related stresses affecting the nonprofit sector. It gives special attention to the experiences of human services, economic development, and community based organizations for two reasons. Those organizations often have roots in the neighborhoods where their low-income constituents live, making their safety net services vital when an economic crisis leaves millions of Americans unemployed and underemployed. Moreover, many of these organizations rely heavily on state and local government funding, so state and local government budget cuts greatly endanger their programs.

Despite an unpredictable financial outlook, there are multiple legal strategies that nonprofit organizations can pursue to minimize risks, sustain and enhance their programs, maximize their resources, and better position themselves to carry forth their charitable missions. Legal assistance can help nonprofit organizations to secure and improve five qualities critical to their ultimate success: mission, people, facilities, funds, and relationships.

At the same time, the nonprofit, legal, and government sectors should work together to identify and support practical solutions that will make the regulatory and funding environments more conducive to the smooth operation of nonprofit programs. Four areas recommended for public policy focus are to: protect and encourage advocacy by nonprofit organizations; eliminate unnecessary regulatory barriers to organizational change; rationalize and prioritize reform of government contracting; and increase access to working capital. The goal is to strengthen organizations that are so vital to the economy and the quality of life of communities in need.

I. Troubled Times: Financial Challenges for Nonprofit Organizations and Those They Serve

Funding for nonprofits is integral to program preservation. Overall, 2008 and 2009 were marked by painful revenue declines, whereas 2010 and 2011 showed some steadying, but only compared to the prior two years of major decreases. By late 2012, the "new normal" is an uncertain fundraising climate with unfilled revenue holes. Organizations that focus on human services for the poor, although numerous in number, tend to have smaller revenues, budgets and asset holdings than the nonprofit average.[2] They generally depend on charitable contributions from foundations, corporations, and individuals, plus government grants, for a majority of their revenues.[3]

A. Private Funding Overall Has Been Down

Since 2008, the three main categories of private donors – foundations, corporations, and individuals – have provided funds essential to the continuation of nonprofit programs, but limited contributions in each have negatively impacted nonprofit organizations. Data from Giving USA shows that, nationally, total charitable contributions to nonprofit organizations fell from above $300 billion in 2007 to $279 billion in 2009, and the annual percentage drops in both 2008 and 2009 were higher than in the past 50 years. With modest increases in 2010 and 2011, total contributions climbed to almost $300 billion for 2011, but less than the actual and inflation-adjusted amounts for 2007.[4] New York City surveys reflect similar trends.[5]

If history is a guide, the recession is likely to linger because private giving growth typically lags economic growth by at least a year, and it can take at least three to five years for private giving to return to pre-recession inflation-adjusted levels.[6] Charities report that the economy, including global, national, and local issues, is their greatest fundraising challenge for 2012 and beyond.[7]

Foundations: After foundation assets dropped an estimated 28 percent in 2008 in the wake of the stock market crash, total nationwide foundation giving, not including corporate foundations, fell from a $42 billion high in 2008 to $41 billion in 2009.[8] Since then the annual total has remained relatively flat. Reports from the Foundation Center[9] and Chronicle of Philanthropy[10] and anecdotes from foundations and charities show common themes. The majority of foundations: reduced their operating expenses during the economic downturn in order to preserve more funds for grant-making; reduced or leveled the number and size of their donations; and expect 2012 and 2013 foundation giving to remain flat.

At first, grant-making during the economic downturn increased nationwide for safety net services, including food, housing assistance, financial assistance, and supportive services for low-income and disadvantaged populations. By summer 2012, foundations had given more than $521 million to 3,170 recipients in grants and program-related investments to address economic crises issues, including more than $80 million to groups providing services in New York City.[11] However, many foundations set their grant-making budgets based on a three-year rolling average value of assets, as permitted by the Internal Revenue Code ("IRC"). This means it is likely to take at least a few years of consistent market gains to offset the large asset losses in 2008 and for there to be sizeable increases in overall foundation giving.

Corporate Giving: Nationwide corporate giving, including grants from corporate foundations, peaked at more than $15 billion in 2007 and has fluctuated between approximately $13 billion and $15 billion since then.[12]

Individual Donations: After more than doubling between 1987 and 2007, individual giving nationwide fell by more than 10 percent in both 2008 and 2009, before increasing modestly in 2010 and 2011, to $217 billion in 2011, according to estimates by Giving USA.[13] Community based and other small and nonreligious organizations generally rely on individual gifts from appeals, events, online giving, and other methods to help diversify their funding, but such gifts are often a more modest part of their budget than foundation and government grants. Charities and donors report that donor uncertainty about the economy is a leading reason for reduced or flat levels of individual giving.

B. Public Funding Is Precarious

As the nonprofit sector has taken on more responsibility in recent decades for safety net and other human services, it has increasingly relied on public funding streams – in the form of contracts and grants from federal, state, and local government agencies – to support community programs. New York City human services groups are particularly reliant on government contracts. In a 2009 Baruch College study, 70 percent reported getting more than 40 percent of their operating funds from public sources, and 44 percent reported getting more than 80 percent from public sources.[14] However, since 2008 strains on government budgets have caused large actual or threatened cuts in public funding, and the prospects for the future are grim.

State and Local Government Funding: Challenges are created by both dollars and contract procedures. States and localities, including in New York, have made numerous budget cuts that affect nonprofit organizations, notwithstanding the essential services that these organizations provide. Even when government officials ultimately reject or restore proposed budget cuts in a particular program area, nonprofit organizations lose ground. Substantial resources are redirected toward fighting procurement battles, including time and money, that otherwise could be spent on direct programs or issue advocacy.

In New York, the state government had more than 22,000 active contracts with nonprofit organizations that totaled $16.8 billion as of October 2011, according to the State Comptroller. The state relies significantly on nonprofit organizations to provide a range of needed services through these contracts, including workforce development, human services, and health clinics. The number of grants and contracts has declined in recent years as a result of fewer legislative initiatives, multi-year contracting, budget cuts, and the expiration of funding from the American Recovery and Reinvestment Act ("ARRA").[15]

Moreover, the nonprofit sector has long endured a wide range of difficulties with the state and local government contracting process as a condition of receiving public funding. Sometimes nonprofit groups will enter contracts and grants even though they have little or no ability to negotiate specific terms. Other times the funding will not sufficiently cover the costs of delivering services, or providers will not get paid until long after they incur costs due to the structure of the contract or processing delays. During the economic downturn, the extent and negative impact of delayed contract approvals, delayed reimbursements, and mid-contract funding cuts has been more significant. Contract problems contributed to salary freezes, staff layoffs, and cuts in vital services.[16]

Federal Government Funding: While some nonprofit organizations regularly receive federal funding, the main recession-related change has been the federal economic stimulus package. Government reports show that ARRA money was used to create or retain almost 26,000 jobs in New York City for the first quarter of calendar year 2011 and 3,367 jobs during the first quarter of calendar year 2012, including, but not limited to, nonprofit sector jobs.[17] However, ARRA funding was temporary and has mostly ended.

C. Other Revenue Sources Have Not Filled the Holes

Fee Income: Because fee income includes both direct payments and third-party payments such as Medicaid, it is difficult to generalize about the economic downturn's impact on fee income. More nonprofit organizations considered adding or increasing fees for their services, but this may be an impractical route if individual clients are poor, of limited means, or thrifty because of the weak economy.

Investment Income and Cash Reserves: Investment income is a small portion of the revenue stream for most small and community-based nonprofit organizations. In Nonprofit Finance Fund annual surveys for 2008 through 2011, at least 57 percent of respondents reported having 90 days or less of cash on hand and at least 9 percent had none going into the next year.[18]

Cash reserves and investments are notable during difficult financial times in two additional respects. First, organizations with cash reserves and other investments may be able to use them as a short-term strategy to fund programs instead of scaling back staff or services. Second, a reduction in investment income can create budgetary holes if the organization had been supporting programs in pre-recession years with investment income.

D. Communities Need Nonprofit Organizations to Deliver Critical Services

Nonprofit programs are needed and wanted. The prolonged weak economy has caused substantial financial and personal hardship to persons who depend on the nonprofit sector, particularly the unemployed and underemployed, senior citizens, and mentally ill. The majority of nonprofit organizations have experienced strong demand for their services since the start of the recession, followed by overwhelming demand increases in 2010 and 2011, especially for those that identify as providing lifeline services. Meanwhile, reductions in government programs and funding means nongovernmental entities must fill a growing void. As a major contributor to the nation's economy, the nonprofit sector can supplement community resources and strengthen neighborhoods during difficult financial times in ways that the government sector does not.

II. Legal Help: Strategies to Manage Risk and Preserve Programs

Nonprofit organizations have responded to the economic downturn in multiple ways, reflecting the creativity, passion, and diverse governance approaches that infuse the nonprofit sector. Their coping strategies affect mission, people, facilities, funds, and relationships. The relevant legal principles are largely the same irrespective of the economy, but troubled financial times can make the legal stakes higher and the use of legal strategies more urgent.

Investing in legal assistance can help nonprofit managers to pursue opportunities and structure operations in a manner that best achieves the organization's mission. Ideally, the result is positive: more and better services to those in need. The law provides a framework for nonprofit organizations to engage and supervise workers, enter transactions and agreements with other parties, secure and share information, obtain funding, and protect valuable assets.

Simultaneously, the legal system creates rights for those who are aggrieved. Legal risk management includes anticipating and preventing situations that might lead to a lawsuit, loss of a key contract or staff members, negative regulatory action, conflict with vendors and creditors, or other damage to the organization. In these situations, the result is preventative: less harm to the organization means more resources are available for charitable activities.

III. Mission

A. Mission-Oriented Programs and Services

The charitable mission of a nonprofit organization creates an inspirational, value-based agenda for what services the organization will offer, who it will target for services, what activities it will pursue, and how services are to be delivered.

As mission-driven entities, most nonprofit organizations sought to get through the initial months of the economic downturn without cutting programs, but by mid-2009 at least a third to one-half of the sector found it necessary to reduce at least some services. Retrenchment continued into 2010 and 2011.[19] Some of this program reduction helped to free resources for more mission-critical services. Despite revenue challenges, a majority of nonprofit organizations, nationwide and in New York, particularly those serving low-income populations, maintained or expanded their core services to meet evolving client needs.

B. Legal Strategies Related to Mission

The legal source of the charitable mission is the corporate purposes clause set forth in the Certificate of Incorporation. Legally, the corporate purposes may be broader, but not narrower, than the mission, purposes, and activities actually pursued. During weak economic times, hard choices about which programs to eliminate, scale back, continue, or expand can implicate the organization's mission, corporate purposes, and board governance procedures.

Ensure Active Board Oversight of Fiscal Health: The fiduciary responsibilities of directors and officers of a not-for-profit corporation include monitoring and managing finances. The duties of care, loyalty, and obedience each call on directors and officers to engage in fiscal oversight. The economic downturn is a basis for more active involvement. This includes, for example, reviewing financial statements more often, requesting additional financial documents, budgeting conservatively, modifying budgets, making contingency plans, and asking more questions. In addition, it may be prudent for board members and board committees to meet more frequently than when finances are stable. With lawyers to help fine-tune governance practices, nonprofit managers are better able to keep expenses and debts in line with fiscal realities while keeping sight of their organization's mission.

Reaffirm Mission and Maintain Core Programs that Further the Mission: The corporate purposes clause of the Certificate of Incorporation typically refers to serving certain clients, providing certain types of services, and a geographic territory. Many organizations also adopt a "mission statement" that explains why the organization exists and what it seeks to accomplish. A mission statement is not a legal document, but it has marketing and management value and helps to ensure that people involved with the organization understand the mission.

As the recession became an ongoing challenge, many boards of directors turned to their organization's purposes clause and mission statement for planning guidance. Difficult decisions about which programs to maintain or cut are better informed through an assessment of how core those programs are to mission. If an under-funded program is core to the mission, the organization's leadership can try to reprioritize fundraising or reduce expenses in order to retain the program. At the same time, scaling back on non-core programs can free up dollars and staff for more mission-critical services. Making these determinations requires a review of the corporate purposes as well as the finances.

Amend Corporate Purposes: For some organizations, the recession has created opportunities to serve a different client constituency, pursue programs shed by other entities, acquire facilities in a more favorable real estate market, or otherwise switch direction. A not-for-profit corporation must go through the legal process of amending its Certificate of Incorporation if this document does not appropriately encompass the new purposes, powers, and activities. In New York, a not-for-profit corporation that seeks to amend its corporate purposes or powers in the Certificate of Incorporation must obtain approval from the state supreme court after notifying the New York Attorney General of its proposed change.[20]

Clarify Corporate Bylaws: Many decisions prompted by economic challenges, such as cutting or adding programs, budgeting, budget modifications, and borrowing money, are appropriate for board review and approval. A second foundational document, the Bylaws, sets forth the procedures by which the directors, officers, and any members are to follow when making significant decisions and changes, such as an amendment of corporate purposes. With quality legal help, nonprofit organizations can ensure that their organizational documents are in order and sufficient to support their charitable mission.

IV. People

A. Personnel Are the Greatest Asset and Greatest Expense

Only people can transform mission into results. Staff salaries and benefits are a major expense for the overwhelming majority of nonprofit organizations. Proper personnel management increases workforce productivity and decreases the risk of liability.

The economic downturn has caused all types of nonprofit organizations to reexamine their staffing arrangements. Salary freezes and hiring freezes were among the most popular 2008 and 2009 tactics to reduce personnel costs in a weakened economy, as nonprofit organizations sought to retain current staff. By 2010 layoffs became unavoidable for more organizations. The human services industry experienced a larger percentage of layoffs than the national average. Other common cost control steps include unfilled vacancies, furloughs, job sharing, reduced staff hours, reduced benefits, and decreased professional development. These strategies continued during 2011 and 2012, requiring many nonprofit managers and their staff to try to meet services demand despite reduced, flat, or uncertain staffing.

B. Legal Considerations Affecting the Employment Relationship and Layoffs

Labor and employment law issues can arise as employers try to trim and moderate workforce costs. In New York and many other states, the law presumes that employment is "at will," terminable by the employer or the employee at any time for any lawful reason, absent a contrary employment agreement or collective bargaining. This legal doctrine permits employers to terminate, modify the work hours, or otherwise change the job status of an at will employee without cause.[21] Employers and their attorneys should review the language of employment applications, hire letters, employee handbooks, and performance reviews to check that they do not unintentionally limit the employer's right to terminate or change an employee's job status.

At the same time, federal, state, and local discrimination laws extend to virtually every aspect of the employment relationship, including hiring, reassignments, job classification, leave time, and termination. When making staff changes aimed to reduce costs, nonprofit organizations should take steps to maintain neutrality with respect to protected classes, have a sound business reason for selecting the affected employees, reasonably accommodate religious beliefs and disabilities, and contemporaneously document the rationale and process for decisions.

Layoffs: Organizations that carefully plan and execute a layoff, also known as a reduction in force or RIF, can minimize their potential liability. Legal counsel can review applicable personnel policies, the termination process, and the organization's plans for paying salary and benefits to terminated workers. An attorney can suggest steps that the organization might take to ensure that a RIF does not have a "disparate impact" on members of a protected class. Moreover, legal counsel can prepare termination notices, including those required under Worker Adjustment and Retraining Notice Acts,[22] and provide guidance on the pros and cons of paying salary or benefits beyond required amounts in exchange for a "release" from the terminated employee. Organizations should have an attorney represent them in threatened or actual litigation related to layoffs.

Classification of Remaining Workers: Following a reduction in force, management or the board of directors may expect remaining employees to work longer hours to absorb the work load of those who have been laid off. Federal and state wage and hour laws set forth standards for employers to pay minimum wages and overtime pay.[23] A detailed body of law controls whether a particular employee is "exempt" or "non-exempt" from these requirements, often necessitating an attorney to review the detailed job duties of a particular employee before rendering advice on an individual employee's status. Misclassification of an employee as exempt rather than non-exempt can result in the employer's liability for payment of back wages as well as penalties and liability for back taxes on such wages.

C. Legal Strategies to Control Labor Costs by Means Other Than Layoffs

Historically, many employers and employees have viewed salary and benefits as sacrosanct. During a rough economy, expectations can change. In recent years, as an alternative to layoffs, many nonprofit organizations spread out personnel expense reductions among multiple workers in an effort to retain trained staff, build worker loyalty, and avoid termination-related payments. However, weathering the economic storm together can become impractical after an extended period without significant reductions in personnel costs. Nonprofit organizations have several legal options.

Freeze or Reduce Pay: One direct way to control labor costs is to freeze or reduce pay. Legally, the analysis is relatively straightforward. In the absence of employment contracts or collective bargaining agreements, employers can freeze pay, cut salaries, eliminate bonuses (unless already promised), or otherwise cut compensation for at will employees. Reductions in compensation must be prospective. Minimum wage laws must be followed.

Reduce Work Hours and Implement Furloughs: Employers may tie a reduction in compensation to a corresponding reduction in work. Popular forms of reduced work hours include changing an hourly employee's work schedule, changing an employee's status from full-time to part-time, shortening the organization's workweek, implementing a partial furlough, or temporarily closing an entire worksite. The pertinent legal issues will vary depending on the particular employee's exempt or non-exempt status and the nature of the job change.

Reduce Benefit Packages: The majority of nonprofit organizations have not significantly reduced employee benefits in recent years, except by increasing cost sharing for health care. An attorney can help the organization examine how to reduce benefit packages legally without unduly cutting back on benefits most important to the current staff.

Pay Taxes When Due: A pitfall to avoid is the failure of employers to withhold payroll taxes from employee paychecks and then promptly remit the withheld taxes, along with employer side taxes, to state and federal taxing authorities. Nonprofit organizations that are struggling with cash flow may be tempted to delay remitting these payments, but the negative impact of failing to pay withholding taxes can be severe for the organization and its directors.

Reassign Employees: For employees who welcome the change, a reassignment can be a professional development opportunity. However, if employees are unwilling or unable to accept a reassignment, there are possible legal ramifications. The employer's obligations to a reassigned employee will depend on the facts, including whether the reassignment is effectively a termination of the employee's existing job.

Engage Temporary or Nontraditional Paid Workers: Some nonprofit organizations have reduced workforce costs by eliminating or reducing their reliance on contract workers, consultants, or other types of independent contractors. Independent contractors enter a written contract with the organization to provide services with significant autonomy and very limited supervision from the organization. An attorney can assist with contract reviews and amendments.

Others may be tempted to engage more independent contractors instead of employees based on the belief that independent contractors cost less because they do not receive employee benefits. Whether a worker should be classified as an employee or an independent contractor involves a fact-specific legal analysis. Taxing and labor authorities may require payment of back taxes, related penalties, and interest if an employer misclassifies an employee as an independent contractor without a good faith basis.

Rely More on Volunteers: Volunteers can increase the capacity of nonprofit organizations seeking to carry out their programs during times of limited or reduced financial resources. Volunteers, unlike employees, do not receive and do not expect to receive wages or compensation for their services. They may receive small cash awards, stipends, non-cash benefits, and reimbursements under limited circumstances.[24]

As nonprofit organizations rely more heavily on volunteers, they should take steps to minimize their risk of liability if a volunteer injures a third party while providing services on behalf of the organization. Legal counsel can create volunteer policies and provide guidance about background checks, the appropriate scope of activities for volunteers, client confidentiality procedures, insurance coverage, and ways to terminate a problematic volunteer arrangement.

Legal counsel also can help nonprofit organizations to clarify the volunteer relationship so as to avoid missteps that might convert a volunteer into an employee. Volunteer policies or a code of conduct should set forth the volunteer's role. An unpaid worker is more likely to be a volunteer than an employee if he or she intends to donate time to benefit the organization and performs tasks related to the charitable mission. Clarity is also necessary if a current or previous employee seeks to serve as a volunteer.

V. Facilities

Nonprofit organizations that offer onsite client and community services or have active office operations need adequate space and equipment to succeed. Rent, mortgage payments, and other site-related expenses can account for a significant portion of the annual budget, especially in New York City where real estate is expensive relative to the national median. During the economic downturn, many organizations struggled with fixed facilities costs due to obligations created during a different economy, while the weakened real estate market enabled others to modify or negotiate new real estate transactions on more favorable financial terms.

By 2009, more than one quarter of the nonprofit organizations responding to a Johns Hopkins University survey had delayed maintenance projects, and more than one quarter delayed or abandoned expansion or relocation plans altogether.[25] In Nonprofit Finance Fund annual surveys, 14 percent of respondents reported reducing or refinancing occupancy costs in 2009 compared to 19 percent that reduced occupancy costs in 2010 and 2011.[26] Nonprofit organizations, such as affordable housing programs, that create, renovate, or invest in facilities encountered reductions in traditional financing streams and more rigorous credit processes.

Reducing facilities costs requires time, creativity, negotiation, and proper legal documentation. The realistic legal options will depend on the nonprofit organization's bargaining position, flexibility, and whether it is an owner or tenant.

A. Strategies for Reducing Owners' Facilities Expenses

Refinance Loans: The possible benefits of a loan refinancing are largely market driven and will depend on the organization's credit situation and existing financing terms, not only the terms of the new financing agreement. Legal counsel can review relevant deeds and mortgages, assist in negotiations, and advise about any necessary board or government consents.

Defer Maintenance and Building Expenses: Negotiating well-drafted leases helps to avoid disputes over who is responsible for the expense of maintaining property. Property owners who do not maintain their buildings when cash flow is impaired may have less desirable facilities to rent to future tenants or risk legal claims from occupying tenants. For nonprofit organizations engaged in construction or rehabilitation, legal counsel can help negotiate financing and building agreements that permit multiple project phases or different payments depending on funding.

Maintain Real Estate Tax Exemptions: Nonprofit organizations owning property in New York State are eligible for an exemption from real estate taxes if they use the property to further the organization's tax exempt purposes and meet certain other qualifications.[27]

B. Strategies for Reducing Tenants' Facilities Expenses

Terminate a Lease: Legal counsel can help a nonprofit organization that is leasing space to review its lease for early termination rights, determine what payments and notices are required to activate these rights, and understand the costs of walking away from a lease. Absent an early termination provision in its lease, a nonprofit organization may seek the landlord's consent to terminate the lease prematurely through a buy out or surrender of a lease.

Modify Lease Terms: As written contracts, leases can be amended upon written consent of the parties. Rent reductions, rent deferrals, reductions in the amount of rental space, sublet arrangements, and the landlord's payment of additional expenses are examples of lease modifications obtained by resource-constrained nonprofit organizations. Landlords may seek something meaningful in exchange, such as an upfront payment or longer lease term. Organizations are in a stronger position to obtain lease modifications if the landlord has business reasons for keeping the tenant, the tenant has other options, and the parties are each financially able to make concessions.

Sublet Space or Assign a Lease: To reduce leasehold expenses, some nonprofit organizations seek to sublet or assign unused space to a third-party. In a sublet, the tenant transfers a portion of all or part of its interest in the premises to another party, but remains responsible to the landlord for the payment of the rent. In an assignment, the tenant transfers its full and remaining interest in the lease and exits its tenancy. Most leases contain a provision regarding subletting and assignments, either permitting them under certain conditions, such as advance notice or landlord consent, or prohibiting them altogether. Legal counsel can help the organization to understand its options and the costs of such arrangements.

Review Leases for Rent Increases and Shared Costs: Leases typically contain intricate clauses about how rent increases are to be calculated and what portion of real estate taxes and other operating expenses get passed through to the tenant. Periodically reexamining the lease terms along with landlord bills is a way for tenants to determine whether or not the landlord is correctly billing the organization for rent or pass through payments.

Enter a New Lease: Many nonprofit organizations reached or are near the end of their lease term in an altered real estate environment. A lawyer versed in leasing can help a prospective tenant to understand the current market and negotiate new lease terms, beyond the base rent, that build in economy-related contingencies.

VI. Funds

Revenues are essential to sustain programs, no matter how creative the nonprofit sector is at cost-cutting. As the weak economy impedes fundraising and government support has become less reliable, nonprofit organizations have been compelled to take action, both to protect existing revenues and to fill the major holes in their income and cash flow. An increasing number of nonprofit groups have advocated against government funding cuts for services, pursued new types of fundraising, and turned to reserves, endowments, or loans to access cash for programming.

A. Strategies for Preserving and Increasing Revenues

Lobby to Protect Government Funding: State and city budget crises have altered the nonprofit advocacy arena. There are many misconceptions about lobbying laws. When nonprofit leaders communicate with legislators to urge them to restore budget cuts or change a proposed budget, this can be "lobbying" activity because the budgets are enacted by a legislative body. However, lobbying does not jeopardize an organization's tax-exempt status under IRC Section 501(c) (3) if it is an insubstantial part of the organization's activities. Legal guidance can help groups to use either a facts and circumstances test or make the IRC Section 501(h) election to measure lobbying expenditures.[28] Nonprofit managers also may welcome help complying with lobbying registration and reporting rules.[29] Understanding lobbying definitions, limits, and regulations allows nonprofit organizations to voice their legislative concerns with greater confidence and without penalties.

Expand Fundraising: Regardless of how charities modify their fundraising efforts during rough financial times, they are subject to fundraising laws and regulations. Charities should make clear requests and be careful not to present misleading or deceptive information in their charitable solicitation materials. In addition, most states require charities and their paid fundraisers to register and file accurate financial statements with state charities officials if they are soliciting within the particular state.[30] At the federal level, charities must make copies of the annual IRS Form 990 available for public inspection and should be attentive to rules about deductibility and documentation of charitable contributions.[31] Legal counsel can help with regulatory compliance, review agreements with paid fundraisers, and consult on event venue contracts so that nonprofit organizations can expand their fundraising activities.

Explore Fee-Generating Activities: Generally it is permissible and not uncommon for nonprofit organizations to engage in fee-generating activities, although in a recession the public's ability to pay fees will be constrained. Organizations should check funding contracts, proposals, and awards to ensure that they do not prohibit the collection of fees. Two Internal Revenue Code issues are whether fee-based revenues are unrelated business income subject to tax and whether, if fees are not below cost, the organization is engaged in undue commerciality.

B. Strategies for Accessing Cash and Other Financial Resources

Manage Investments Prudently: The fiduciary duties of care, loyalty, and obedience apply to the management and expenditure of assets. For nonprofit organizations incorporated under New York law, the New York Prudent Management of Institutional Funds Act ("NYPMIFA"),[32] adopted in September 2010, provides specific direction regarding the prudent management and investment of institutional funds. Boards of directors, after due diligence, are expected to make careful decisions about the proper size, parameters, and use of their organizations' investments and, for liquid assets, about whether and when a withdrawal is prudent, in the best interests of the organization, and legally permissible.

Tap Endowment Funds and Other Restricted Gifts: In difficult financial times, nonprofit organizations may seek greater access to funds that are restricted in purpose, use, or investment. Under the New York Not-for-Profit Corporation Law, organizations must use donated assets consistent with a gift restriction, or they can obtain donor or court approval to modify the restriction.[33] Endowments are a specific type of restricted gift, where the principal continues in perpetuity but the charity can use the income, appreciated value and, within limits, the interest. When poor investment performance puts endowment funds "underwater" (such that current value is less than the value at the time of the gift), NYPMIFA controls the parameters under which organizations may appropriate and spend from those funds. Changes in laws and investment values are reasons to reexamine endowment funds and other gift restrictions, prepare any required notices to donors, update investment policies, and review spending practices.

Borrow Funds: Pressed for cash, nonprofit organizations may be able to borrow funds to sustain their operations. When nonprofit organizations access lines of credit, negotiate new working capital, modify their loan obligations to avoid defaults, or refinance existing loans, they face legal issues. Legal guidance can help nonprofit organizations to present their information to underwriters in a favorable manner, review loan documents, better understand their fiscal duties, comply with conflicts of interest policies, and negotiate changes or clarifications of provisions before they enter new loans or a refinancing. Nonprofit organizations facing economic distress should proceed carefully with a refinancing because it often means additional debt or risk. Loan defaults are best avoided because that is a material breach of contract with serious consequences.

VII. Relationships

A fifth vital resource is a nonprofit organization's network of relationships with external parties, including vendors, subcontractors, other program partners, licensees, clients, lenders, creditors, donors, and other contacts.

A. Types of Relationship Changes

Survey data, news articles, and case examples suggest that nonprofit organizations have explored and changed a variety of relationships for programmatic, funding, and administrative reasons. Many have renegotiated or cancelled vendor agreements, such as equipment leases, to reduce overhead expenses. Also common are formal and informal partnerships, grouped together under the term "collaborations." Since 2009, according to Nonprofit Finance Fund and other surveys, between 44 and 49 percent of respondents reported partnering with another organization during the prior year to improve programs or increase services, and 12 to 17 percent reported collaborating to decrease administrative expenses; the percentages were highest in 2012.[34]

Other changes aimed at survival are more comprehensive. Despite increased interest in mergers during the recession, the number of actual mergers remains small. Rather than formally merging, financially strapped organizations may opt to create a parent-subsidiary relationship through a strategic alliance. Another coping mechanism that affects relationships is a debt restructuring, either voluntary or through formal bankruptcy proceedings.

B. Contracts with Third Parties

Renegotiate Vendor Agreements: In stronger economic times, nonprofit managers may not have considered approaching vendors during the middle of a contract to renegotiate terms, recognizing that overhead expenses are largely fixed costs. In challenging economic times, both nonprofit organizations and their vendors may seek to ease contract terms. Vendor agreements can be modified by mutual consent or, on occasion, because of a breach or other triggering event. Legal counsel can help identify and document potential modifications, such as lower fees, different products or services, relaxed payment deadlines or late penalties, and changes in the frequency of deliveries or services. Depending on the parties' priorities, they may lengthen the contract period to ensure the vendor a long-term customer or shorten it to give both the customer and vendor more flexibility.

Collaborate with Other Service Providers: In collaborations, each participant maintains its independent identity while working with the other participants to achieve shared objectives. The details and legal complexity of the relationship are driven significantly by the collaboration's purpose and what each participant is expected to contribute to it. The main purpose of programmatic collaborations is sustaining or improving programming, not cost control. In contrast, collaborations focused on "back office" functions – such as finance, human resources, marketing, purchasing, information technology, and cleaning services – can be an appealing way to lower costs and increase organizational efficiencies.

Confirming and documenting costs and each party's respective roles and responsibilities, usually through a written agreement, is an integral part of establishing a successful collaborative relationship. In addition, employment law questions may arise when employees hired by different employers work together, and intellectual property questions may exist related to the joint creation of products and programs.

C. Nonprofit Mergers and Strategic Alliances

The primary goal of mergers and strategic alliances for nonprofit organizations struggling during a weak economy is program preservation. Identifying the right partner, completing due diligence, and finalizing the transaction can take significant time. Therefore, it is advantageous for an organization to begin exploring these options when it can pay its ongoing expenses and has assets of value to share with a prospective partner, rather than when it is in financial distress.

Consider a Nonprofit Merger: A merger occurs when one not-for-profit corporation absorbs another. In theory, the resulting organization is stronger than the individual parts. Mergers involve costs, and they also require an active board of directors to review and facilitate the transaction and ensure that is in the corporation's best interests. An organization considering a merger should retain an attorney to help it conduct due diligence regarding the finances and particulars of partners, review confidentiality issues, consider structuring options, and prepare a merger plan and agreements. In New York, an attorney is required to file in court if any party is a charitable corporation. Among the many issues to be addressed in merger documents are preservation of programs and staff, the surviving organization's name, outstanding real estate and other obligations, and board representation.

Undertake a Strategic Alliance: In a strategic alliance, the parties create a "parent-subsidiary" relationship whereby each not-for-profit corporation retains its own corporate structure, programs, assets and liabilities, but one effectively exerts control over the other. This can be accomplished by giving the parent authority to appoint or elect a majority of the subsidiary's directors, through a sole membership or other structure. From a legal perspective in New York, a strategic alliance usually is simpler and faster to achieve than a merger because it involves amending the Bylaws, not the Certificate of Incorporation. Bylaws amendments require board of directors (and possibly member) approval, but usually not that of the Attorney General or state supreme court. Nonetheless, a strategic alliance may create transitional and long-term operational hurdles, and legal guidance is helpful for due diligence, structuring, board discussions of risk assessment, and drafting of new Bylaws.

D. Debt Restructuring Options for Not-for-Profit Corporations

Lenders, vendors, and other types of creditors provide funding, services, equipment, and other resources that nonprofit organizations need to function. The extent of an organization's liabilities to creditors affects its financial position. Moreover, if a not-for-profit corporation becomes insolvent, such that liabilities exceed assets, the board of directors has a duty to the creditors, not only to the charitable mission. A debt restructuring may be essential to improve liquidity and continue operations.

Attempt a Voluntary Workout: An organization can try to reduce and restructure its debt by negotiating directly with creditors. A voluntary workout does not involve court supervision or court action, and the organization has the ability to negotiate settlement terms with each creditor separately. The parties should document changes to debt obligations in order to avoid future misunderstandings. Voluntary workouts tend to be more successful when they are begun early enough for the parties to complete their negotiations before a creditor decides to commence litigation.

File for Bankruptcy Protection: Filing for protection under the federal Bankruptcy Code allows a financially distressed organization time to reorganize and refocus its debts under court supervision. However, the bankruptcy process is long, difficult, and expensive, and this route usually makes sense for a not-for-profit corporation only when a voluntary workout fails or is practically impossible. A significant advantage is the "automatic stay" of actions by creditors. Not-for-profit corporations may file for bankruptcy protection under Chapter 11, the reorganization provision,[35] or Chapter 7, the liquidation provision,[36] but only the Chapter 11 proceeding enables corporations to discharge their debts. Assets will be distributed to creditors accordingly to a court-approved plan. Bankruptcy counsel is needed to prepare legal papers, litigate claims by and against the debtor, and prepare and negotiate the plan.

VIII. Observations and Recommendations

A. Lessons about Legal Services Delivery

Repeated and unpredictable funding cuts have resulted in several waves of nonprofit organizations needing legal assistance to cope with diminished resources while there is a high demand for their services. When the recession first hit, urgent legal questions flowed from nonprofit organizations scrambling to make staff changes, downsize or sublet space, terminate contracts, or take other immediate steps to react to specific revenue reductions. Next, as the nonprofit sector absorbed further cuts, nonprofit organizations that were fiscally vulnerable prior to the economic downturn needed customized legal assistance to undertake significant changes to maintain vital programs. The economic downturn did not create their weak financial position, but it revealed those problems once revenues became less stable. At the same time, forward-looking organizations began to work with attorneys to help them reevaluate their mission, finances, board structure, personnel policies, fundraising strategies, and management practices in order to survive. Finally, without economic recovery, comprehensive legal services have become more critical for organizations that already downsized or depleted cash reserves to continue programs, as well as for those who fiscal and legal problems percolated until they exploded because they did not take prior action.

While the sustainability of the nonprofit sector is due to many factors, effective legal services can bolster mission, people, facilities, funding, and relationships. The most useful form of legal intervention for an organization in financial crises will depend on the nature and timing of the organization's problems. Some may need a diagnostic assessment, some may benefit most from an emergency or short consultation, and some may require comprehensive or intensive legal services. Resource-constrained organizations are more ready for and responsive to legal assistance if they have strong board and staff leadership, appreciate the importance of legal assistance, and have sufficient capacity to work with attorneys. A blend of different types of legal advice is valuable: preventative and proactive, strategic and opportunistic, and discrete and ongoing. In addition to paid counsel, pro bono attorneys are willing to donate their time and services to help organizations to identify and address legal issues before they become mission-threatening and to make limited resources stronger in compliance with the law.

B. Areas for Public Policy Improvement

The economic downturn has exposed weaknesses in the legal and regulatory environment in which nonprofit organizations operate. Public policy reforms would make it easier for nonprofit managers to focus on program delivery.

Protect and Encourage Advocacy by Nonprofit Organizations: The viability and scope of programs operated by nonprofit organizations is affected by government budget decisions, contract payment delays, regulatory compliance rules, and legislation on substantive issues that concern the beneficiaries of their services. Particularly when federal, state, and local government budgets are tight, advocacy is necessary to increase total government funding of community services, improve the delivery of services across the nonprofit sector, and gain support for cost-neutral legislative issues.

Despite increased interest in and need for advocacy by nonprofit leaders, the amount of advocacy in which nonprofit organizations actually engage remains limited. Tax-exempt organizations have the right, subject to applicable laws, to advocate for and against public policies, including government budgets. Yet, myths about lobbying and other types of advocacy unduly deter some 501(c) (3) organizations from increasing their engagement in such activities, and funding for nonprofit advocacy remains scarce.

Attorneys, charities, funders, policy makers, and others with an interest in strengthening the nonprofit sector should support nonprofit advocacy with focus and vigor. Nonprofit leaders should familiarize themselves with the legal and regulatory framework so that they can be more vocal and effective advocates for their causes. Private foundations have an opportunity to provide critical funding, research, analysis, and input. Finally, greater legislative attention to clarifying the lobbying laws and rules would make it easier for nonprofit organizations to engage in permissible and valuable advocacy, while remaining legally accountable.

Eliminate Unnecessary Regulatory Barriers to Organizational Changes: State officials have authority to review certain major changes in the lifecycle of a not-for-profit corporation. Under New York law, for example, most not-for-profit corporations must obtain state supreme court approval on notice to the state Attorney General before they can amend their corporate purposes, transfer substantial assets, merge or consolidate, or dissolve.[37] The review process includes obtaining and showing approvals from the board of directors, membership if required, and state agencies that might have an interest in the organization's activities. Plus, the Attorney General may scrutinize transaction details and the organization's plans for the future use of current charitable assets. This process can take considerable time and effort. For an organization in a fiscal crunch, the burdens of legal and regulatory compliance may make these organizational changes impractical, even if these changes on the merits would strengthen the organization's governance, operating structure, facilities, finances, or affiliations.

The regulatory review process should be simplified and clarified. Both statutory amendments and faster reviews by state agency staff can help. First, New York policy makers should consider eliminating the need for court approval of significant organizational changes if the state Attorney General has approved it. Second, the legislature should consider replacing certain state agency pre-approvals with agency notifications, and eliminating the need for either approval or notification if the agency does not presently regulate the organization.[38] Third, clearer public guidance is welcome from all relevant state agencies on how nonprofit organizations can obtain an expedited review of their applications for organizational changes.

Rationalize and Prioritize Reform of Government Contracting: A significant threat to the stability of many nonprofit organizations is the unreliability of their state or local government funding. In addition to repeated funding cuts or threats of funding cuts, the nonprofit sector continues to operate amidst a dismal record of lengthy contract application and approval processes, confusing decision-making by government agencies, payments that do not cover the full cost of services, duplicative reporting to agencies, changes to contracts mid-stream, and late payments beyond contract or statutory requirements. Change is needed to enable nonprofit organizations to have adequate, reliable income to plan and continue the services that the government and public expect them to provide.

To heighten awareness of the need for contract reform, government officials and independent researchers should monitor and report on problems and improvements in the contracting process. Reports by the New York State Comptroller's Office and the New York City Mayor's Office of Contract Services reflect several pressure points ripe for contract reform.[39] These types of measurements provide a valuable baseline.

Recognizing that a problem exists, nonprofit and government leaders have suggested several worthwhile regulatory and administrative changes, such as a centralized document repository, a clear master contract, different review and reporting procedures, and training for government staff.[40] Some states, including recently New York, have designated an executive level official to facilitate communications between nonprofit organizations and government agencies. These and other proposals deserve immediate consideration and support by those in a position to effectuate change, particularly if these steps will reduce redundancy and unnecessary paperwork and better correlate costs and payments. In addition, legislative and administrative changes are needed for prompt payment of interest on late contracts to hold government agencies to their obligation to pay nonprofit organizations on time.

Increase Access to Working Capital: Working capital is essential for nonprofit organizations, which may suffer periods of low cash flow because of minimal reserves, overdue receivables from government entities, or other cyclical funding. Greater access to loans or other forms of cash or credit would allow more organizations to continue services for the longer term.

Multiple existing and proposed models of new loan funds exist and are worthy of consideration. Some successful examples are geared toward small businesses, not necessarily nonprofit organizations, but they offer valuable lessons for now to increase working capital in a tough economy. Purely private lenders, purely nonprofit lenders, and government loan funds are three sources of capital, even if such financing is currently limited. Hybrid remedies can draw upon both private funds and the government's support to provide working capital loans at low interest rates. For example, one mechanism is to increase the size of funding pools through the addition of private financing, while government agencies guarantee part or all of a borrower's loan repayments if the borrower is receiving funding through a government contract or grant. Nonprofit and private lenders also can partner to establish a working capital fund.

Lenders, nonprofit leaders, and policy makers should work together to develop an appropriate fund structure for private-public endeavors. Government budget shortfalls are likely to persist after private markets rebound. Therefore, creative solutions that feature private-public partnerships are likely to be more promising than those that rely on the public sector alone.

Conclusion

During difficult economic times, the nonprofit sector can benefit significantly from legal support that focuses on the five pillars of a vibrant and successful nonprofit operation: mission, people, facilities, funds, and relationships. Lessons learned from the delivery of legal services during a protracted and painful economic downturn are also useful as the nonprofit sector stabilizes and builds momentum for the longer term. The past few years revealed useful strategies and legal principles for nonprofit organizations to consider as they pursue sound corporate governance, proper personnel management, risk management, and growth transactions in better economic times.

Endnotes

The Executive Summary outlines themes and data discussed in the full Report. Please refer to the full Report for a more detailed analysis and footnotes containing additional factual and legal references. Unless otherwise noted, website links below were last accessed on November 30, 2012.

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[4] Giving USA Foundation, *Giving USA 2011: The Annual Report on Philanthropy for the Year 2010 Executive Summary*, Chicago: Giving USA Foundation (June 2011); Giving USA Foundation, *Giving USA 2012: The Annual Report on Philanthropy for the Year 2011 Executive Summary*, Chicago: Giving USA Foundation (June 2012, revised Aug. 2012) (retrieved Sept. 15, 2012 from http://www.givingusareports.org) [hereinafter "Giving USA ES 2012"]; Giving USA Foundation, *Key Findings of the Giving USA 2012 Report*, Chicago: Giving USA Foundation (June 2012), http://martsandlundy.com/philanthropy-news/key-findings-of-the-giving-usa-2012-report [hereinafter "Giving USA Findings 2012"].

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[7] *The 2011 Nonprofit Fundraising Study: Funds Raised in 2010 Compared With 2009*, The Nonprofit Research Collaborative (Mar. 2011), http://www.urban.org/uploadedpdf/1001529-2010-Nonprofit-Fundraising-Survey.pdf; *The 2012 Nonprofit Fundraising Study: Governing Charitable Receipts at U.S. Nonprofit Organizations in 2011*, The Nonprofit Research Collaborative (Apr. 2012), http://www.urban.org/UploadedPDF/1001601-Nonprofit-Fundraising-Study.pdf.

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[9] *E.g.,*Steven Lawrence, *Foundations' Year-End Outlook for Giving and the Sector*, Foundation Center (Nov. 2009), http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory_economy_200911.pdf; Steven Lawrence, *Foundation Growth and Giving Estimates*, Foundation Center (June 2012), http://foundationcenter.org/gainknowledge/research/pdf/fgge12.pdf.

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[12] Giving USA Findings 2012, *supra* note 4, attachment, and Giving USA ES 2012, *supra* note 4, at 4.

[13] Giving USA Findings 2012, *supra* note 4, attachment, and Giving USA ES 2012, *supra* note 4, at 8.

[14] Baruch 2009, *supra* note 5, at 5-9.

[15] N.Y. State Office of the State Comptroller, *New York State's Not-for-Profit Sector* (Mar. 2010) http://www.osc.state.ny.us/reports/economic/nfp2010.pdf; N.Y. Office of the State Comptroller, *New York State's Not-for-Profit Sector, Delayed State Contracts and Late Payments Hurt Service Providers* (Nov. 2011), www.osc.state.ny.us/reports/nfp/nfpreport11-2011.pdf [hereinafter "Comptroller Nov. 2011"]; N.Y. Office of the State Comptroller, *Prompt Contracting Annual Report Calendar Year 2011* (May 31, 2012), http://www.osc.state.ny.us/agencies/pcl_reports/pcl_2011.pdf [hereinafter "Comptroller May 2012"].

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[21] Leonard D. Andrew & Richard S. Hobish, *Employment Law Guide for Non-Profit Organizations,* Pro Bono Partnership, Chapter II (2007), http://www.probonopartner.org/PBPGuide/frame.htm.

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[23] FLSA, as amended, 29 U.S.C.A. § 207; N.Y. Labor Law, Art. 5 and Art. 6; N.Y. Dept. of Labor "minimum wage orders" available at www.labor.state.ny.us.

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[27] N.Y. Real Prop. Tax Law § 420-a(1)(a); New York City Department of Finance, *Property Tax Exemption for Not-For-Profit,* http://www.nyc.gov/html/dof/html/property/property_tax_reduc_non_profit.shtml.

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[29] State and local lobbying registration and reporting requirements in New York State Lobbying Act, N.Y. Legis. Law, § 1-a to § 1-v, and New York City Lobbying Law, NYC Admin. Code § 3-216 to § 3-223.

[30] *E.g.,* N.Y. Not-for-Profit Corp. Law Art. 7-A.

[31] I.R.S. Publication 526, *Charitable Contributions* (Rev. Jan. 27, 2012), http://www.irs.gov/pub/irs-pdf/p526.pdf; I.R.S. Publication 1771, *Charitable Contributions: Substantiation and Disclosure Requirements* (Rev. 9-2011), http://www.irs.gov/pub/irs-pdf/p1771.pdf.

[32] N.Y. Not-for-Profit Corp. Law Art. 5-A.

[33] N.Y. Not-for-Profit Corp. Law § 555.

[34] NFF Summary 2010, *supra* note 18, at 4; NFF Summary 2011, *supra* note 18, at 2, 4 NFF Summary 2012, *supra* note 18, at 4; Salamon, *supra* note 25, at 18.

[35] 11 U.S.C. §§ 1101-1174.

[36] 11 U.S.C. §§ 701-784.

[37] N.Y. Not-for-Profit Corp. Law Art. §§510-511, 804, 907, 1102.

[38] Some of these proposals are supported by points set forth in a report by the New York Attorney General's Leadership Committee for Nonprofit Revitalization, *Revitalizing Nonprofits, Renewing New York, Report to Attorney General Eric T. Schneiderman*, N.Y. State Office of the Attorney General, 18-22 (Feb. 16, 2012), http://www.ag.ny.gov/sites/default/files/press-releases/2012/NP%20Leadership%20Committee%20Report%20%282-16-12%29.pdf [hereinafter "NYAG Comm."].

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