



Lawyers Alliance  
*for* New York

*Connecting lawyers, nonprofits, and communities*

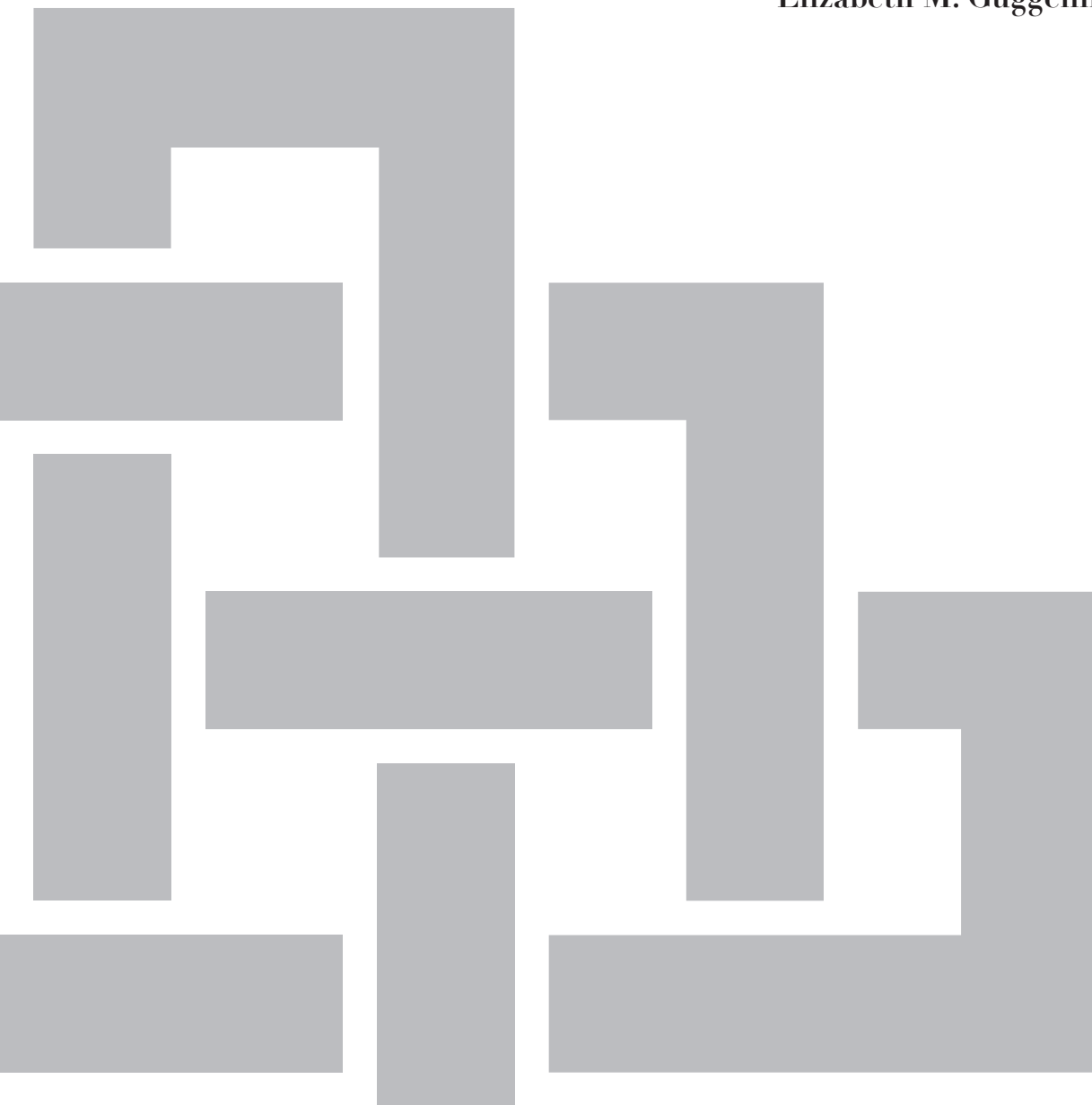
---

# Charting the Course:

Legal Help for Nonprofits  
in Troubled Times

By:

Elizabeth M. Guggenheimer, Esq.



Published by Lawyers Alliance for New York

Copyright © Lawyers Alliance for New York 2012

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means without the prior written permission of Lawyers Alliance for New York, 171 Madison Avenue, 6th Floor, New York, New York 10016.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is distributed with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the service of an attorney or other competent professional person should be sought.

Moreover, this publication includes links to websites for the convenience of the reader, based on information available on or after August 15, 2012, unless otherwise specified. Web links are subject to change, and the author and publisher do not represent that referenced website links will be active if visited by the reader.

While attempt has been made to provide accurate information, neither the author nor the publisher can be held accountable for any error or omission in this publication.

---

## *Acknowledgements*

Lawyers Alliance thanks the New York Community Trust for its leading support of Lawyers Alliance's legal work aimed at program preservation, including the Strengthening Organizational Sustainability collaborative to provide coordinated technical assistance for New York City's safety net organizations. We are very grateful to the Altman Foundation, Clark Foundation, and Frances L. and Edwin L. Cummings Memorial Fund for their significant generosity that has made it possible for Lawyers Alliance to provide legal and educational services to a larger number of nonprofit organizations coping with the economic downturn.

This publication would not have been possible without the assistance of several Lawyers Alliance staff members and volunteers. Special thanks to Executive Director Sean Delany for valuable editing assistance and constant encouragement; Legal Director Linda Manley and Senior Staff Attorney Elizabeth Perez for managing the program preservation initiative and helpful guidance; Senior Staff Attorneys Hedwig O'Hara and Judith Moldover for expert advice; Orrick Fellow Susannah Nagle and Weil Extern Georgia Quinn for quality analysis; and Marketing and Communications Manager Emily Crossan and Program Assistant Kendra Sykes for steering this publication through completion. Law students Narissa Lyngen, Theresa Omansky, Melissa Ruhry, Lauren Shohat, and Helen Wu, along with college students Kate Burkhardt and Grace Tan, provided excellent research assistance. My immediate family was unconditionally supportive from this project's start to finish.

As this publication was going to print, Hurricane Sandy created additional challenges for New York communities, emphasizing the need for nonprofit organizations to consider multiple legal issues to remain strong during uncertain economic times.

Lawyers Alliance is privileged to work with so many dynamic nonprofit managers whose dedication and talents enable nonprofit organizations to have a positive and lasting impact on individuals and communities in need.

Elizabeth Guggenheimer  
Deputy Executive Director  
Lawyers Alliance for New York  
November 2012

---

## *Table of Contents*

<b><i>Executive Summary .....</i></b>	<b><i>i</i></b>
<b><i>Introduction .....</i></b>	<b><i>1</i></b>
<b><i>Part I: Troubled Times: Financial Challenges for Nonprofit Organizations and Those They Serve .....</i></b>	<b><i>5</i></b>
A. Private Funding Overall Has Been Down .....	6
1. Foundation Giving .....	10
2. Corporate Giving .....	13
3. Individual Donations .....	14
B. Public Funding Is Precarious .....	16
1. State and Local Government Funding .....	17
a. Contract Dollars .....	17
b. Contract Process .....	21
2. Federal Government Funding .....	22
C. Other Revenue Sources Have Not Filled the Holes .....	24
1. Fee Income .....	24
2. Investment Income and Cash Reserves .....	24
D. Communities Need Nonprofit Organizations to Deliver Critical Services ....	26
<b><i>Part II: Legal Help: Strategies to Manage Risk and Preserve Programs .....</i></b>	<b><i>31</i></b>
<b><i>Part III: Mission .....</i></b>	<b><i>33</i></b>
A. Providing Mission-Oriented Programs and Services Is a Goal and a Challenge .....	33
B. Legal Strategies Related to Mission .....	35
1. Ensure Active Board Oversight of Fiscal Health .....	35
2. Reaffirm Mission and Maintain Core Programs That Further the Mission .....	38
3. Amend Corporate Purposes .....	40
4. Clarify Corporate Bylaws .....	41
<b><i>Part IV: People .....</i></b>	<b><i>43</i></b>
A. Personnel Are the Greatest Asset and Greatest Expense .....	43
B. Legal Considerations for Staff Reductions Through Layoffs .....	47
1. Careful Planning .....	47
2. Termination Decisions .....	48

---

3. Advance Notice and Payments .....	51
4. Remaining Workers .....	52
C. Strategies to Control Labor Costs by Means Other Than Staff Reductions ...	54
1. Freeze or Reduce Pay .....	54
2. Reduce Work Hours and Implement Furloughs .....	56
3. Reduce Benefit Packages .....	60
4. Pay Taxes When Due .....	64
5. Reassign Employees .....	65
6. Engage Temporary or Nontraditional Paid Workers .....	66
7. Rely More on Volunteers .....	69
<b>Part V: Facilities .....</b>	<b>73</b>
A. Strategies for Reducing Owners' Facilities Expenses .....	75
1. Refinance Loans .....	75
2. Defer Maintenance and Building Expenses .....	76
3. Maintain Real Estate Tax Exemptions .....	77
B. Strategies for Reducing Tenants' Facilities Expenses .....	78
1. Terminate a Lease .....	78
2. Modify Lease Terms .....	79
3. Sublet Space or Assign a Lease .....	82
4. Review Leases for Rent Increases and Shared Costs .....	84
5. Enter a New Lease .....	85
<b>Part VI: Funds .....</b>	<b>86</b>
A. Strategies for Preserving and Increasing Revenues .....	87
1. Lobby to Protect Government Funding .....	87
2. Expand Fundraising .....	91
3. Explore Fee-Generating Activities .....	96
B. Strategies for Accessing Cash and Other Financial Resources .....	98
1. Manage Investments Prudently .....	99
2. Tap Endowment Funds and Other Restricted Gifts .....	101
3. Borrow Funds .....	103
<b>Part VII: Relationships .....</b>	<b>106</b>
A. Types of Relationship Changes .....	106
B. Formalizing, Modifying, and Documenting Relationships:	
Contracts with Third Parties .....	110
1. Renegotiate Vendor Agreements .....	111
2. Collaborate with Other Service Providers .....	113
C. Nonprofit Mergers and Strategic Alliances .....	119

---

1. Consider and Pursue a Nonprofit Merger .....	119
2. Undertake a Strategic Alliance .....	124
D. Debt Restructuring Options for Not-for-Profit Corporations .....	126
1. Attempt a Voluntary Workout .....	127
2. File for Bankruptcy Protection .....	127
<b>Part VIII: Observations and Recommendations .....</b>	<b>131</b>
A. Lessons about Legal Services Delivery .....	131
B. Areas for Public Policy Improvement .....	135
1. Protect and Encourage Advocacy by Nonprofit Organizations .....	135
2. Eliminate Unnecessary Regulatory Barriers to Organizational Change .....	137
3. Rationalize and Prioritize Reform of Government Contracting .....	139
4. Increase Access to Working Capital .....	142
<b>Conclusion .....</b>	<b>146</b>

## *Charting the Course:* **Executive Summary**

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 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.

This report addresses the legal steps that nonprofit organizations have taken 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. They generally depend on charitable contributions from foundations, corporations, and individuals, plus government grants, for a majority of their revenues.

### **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. New York City surveys reflect similar trends.

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. Charities report that the economy, including global, national, and local issues, is their greatest fundraising challenge for 2012 and beyond.



**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. Since then the annual total has remained relatively flat. Reports from the Foundation Center and Chronicle of Philanthropy 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. 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.

**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. 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. 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”).

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.

**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. 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.

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. 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.

***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. 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, 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. 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.

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. 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. 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.

## **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. Nonprofit managers also may welcome help complying with lobbying registration and reporting rules. 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. 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. 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"), 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. 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.

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, or Chapter 7, the liquidation provision, 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. 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. 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. 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. Some states 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 how 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.





## *Charting The Course:* **Legal Help For Nonprofits In Troubled Times**

### *Introduction*

As the recession spread worldwide in the fall of 2008, many nonprofit organizations in New York and across the country faced major operating stresses that jeopardized their programs and disrupted their plans. For some nonprofit organizations, a strong commitment to serving clients' needs and hope for a quick economic turnaround meant putting off, longer than financially prudent, difficult decisions about how to control costs, raise additional funds, and preserve essential programs. For others, modest reserves and the sudden severity of the economic downturn required them to confront resource and operational challenges more immediately. As the impact of the economic downturn on the nonprofit sector deepened in the second half of 2009 and 2010, more nonprofit organizations changed their budgets, structures, and activities in an effort to cope with a new economic reality. Throughout 2011 and 2012, amidst the threat of further reductions in state and local government support, the nonprofit sector continued to make adjustments and strive for stability. From the organizations particularly susceptible at the start of the recession to those better prepared for the stress, most nonprofit organizations – especially those serving low-income populations and neighborhoods – must now operate with a revised set of assumptions, procedures, and partners in order to preserve programs and move forward. This report discusses how legal assistance can help.

At stake is a sizeable and vital segment of the United States economy. The nation's 1.6 million nonprofit organizations employed approximately 10% of the total United States workforce or 13.5 million persons in 2009. The nonprofit sector provides 5.5% of the nation's Gross Domestic Product, constituting more than \$750 billion worth of output.<sup>1</sup> Equally impressive is the wide range of program offerings that benefit the broad public interest, but are not similarly provided by the government or private sector, including those that further human services, health services, education, arts, environment, civic rights, economic development and more. Moreover, many charitable organizations form critical support and relief networks that benefit children, senior citizens, minorities, and other underserved

---

<sup>1</sup> *The Sector's Economic Impact*, Independent Sector, citing National Center for Charitable Statistics figure for 2009 released in Mar. 2011, [http://www.independentsector.org/economic\\_role](http://www.independentsector.org/economic_role).

populations in their communities. Thus, the negative impact of the recession on nonprofit organizations strains not only their own viability and the job security of their employees but also the intended beneficiaries of their programs and services.

The nonprofit sector has plenty of experience working tirelessly with limited budgets, increasingly doing more with less, but this prolonged recession has challenged even the most resourceful organizations. Decreased cash flow, exacerbated by an increased demand for services, traps nonprofits in a constant, rather than cyclical, state of financial strain. To sustain programs in the changing economic environment, adaptable nonprofit organizations have reexamined one or more of the following five qualities critical to their success: mission, people, facilities, funds, and relationships. In each of these five areas, they have had to navigate a range of legal issues related to their structure and operations. For example, an organization's corporate purposes can empower but also limit the scope of activities. To the extent organizations decrease labor costs by reducing staff, staff salaries or benefits, employment law considerations will apply. Renegotiating or exiting leases to reduce occupancy costs raises real estate law questions. Financial transactions, such as borrowing money, trigger corporate law principles. Tapping into cash reserves or expanding fundraising efforts may implicate laws concerning restricted gifts or charitable solicitation. Efforts to increase operational efficiencies, such as forming partnerships with other providers, may raise contract, intellectual property or regulatory issues.

This report seeks to analyze the impact of the economic downturn and a protracted weak economy on nonprofit organizations in the context of the legal and regulatory framework in which they operate. By law and practice, nonprofit organizations are different from for-profit businesses in several fundamental respects that can affect their options during tough financial times. Nonprofit organizations are mission-driven entities. They do not have private owners or shareholders; they can raise charitable funds, but not private equity. Finally, nonprofit organizations are governed by a board of directors that is charged with preserving organizational assets and furthering the organization's charitable mission. When nonprofit organizations make changes to their mission, people, facilities, funding or relationships, the effectiveness of the directors' decisions and manner in which the changes are implemented are important factors in the ultimate success of any organization's strategic choices. Because nonprofit organizations are so significant to American society, and demand for their services is so high, the legal sector should work closely with the nonprofit sector to help such

organizations make legal changes and pursue public policy developments that preserve vital programs.

The severity and timing of the recession and its impact on the nonprofit sector varies in different parts of the country. This paper addresses the economic and legal issues affecting nonprofit organizations nationwide, while focusing on data and examples from New York City's nonprofit sector. It gives special attention to issues faced by the human services, economic development and community based organizations that seek to alleviate hunger and homelessness, stimulate access to jobs and capital, and serve children and youth, the elderly, and other poor or disadvantaged individuals and families. We emphasize the experiences of these organizations for two reasons. First, these organizations often have roots in the neighborhoods where their low-income constituents live, making their safety net services particularly vital when an economic crisis leaves millions of Americans unemployed and underemployed. Second, many of these organizations rely heavily on state and local government funding, so state and local government budget cuts greatly endanger their programs.

Part I of this paper provides factual background by summarizing the financial challenges nonprofit organizations and low-income communities face because of changes in foundation giving, cuts in government funding, and pressure on individual donations. It also recognizes the simultaneous strong demand for services. Parts II through VII examine many of the common legal issues associated with the coping strategies that nonprofit organizations have used, and may continue to use, to sustain their five pillars: mission, people, facilities, funding, and relationships. Part VIII reflects on the implications of a long term economic downturn and posits practical and policy recommendations to help foster stability and momentum for nonprofit organizations. This includes promoting legislative advocacy by nonprofit organizations rationalizing government contracting, simplifying regulatory reviews, and expanding access to working capital to enable these organizations to endure disruptions in government funding more effectively.

While the financial outlook remains unpredictable, there are legal strategies that nonprofit organizations can pursue going forward to minimize risks, preserve programs, maximize their resources, and better position themselves to carry forth their programs. As the leading provider of business and transactional legal services to nonprofit organizations that are improving the quality of life in New York City neighborhoods, Lawyers Alliance for New York has made it a

priority since late 2008 to help the nonprofit sector cope with the legal impact of this economic downturn. Appropriate legal guidance can help organizations persevere notwithstanding tough financial times. We welcome the opportunity to share our knowledge of the legal and public policy framework with a wider audience and help more resource-constrained nonprofit organizations adjust to a challenging and uncertain economic reality.

## *Part I*

### **Troubled Times: Financial Challenges for Nonprofit Organizations and Those They Serve**

The economic downturn hit nonprofit organizations from multiple directions: fewer resources, pressing expenses, and increased needs in the communities they serve. Some countervailing factors helped to defer the blow, such as fiscal relief under the American Recovery and Reinvestment Act of 2009 (“ARRA”) and philanthropic support for safety net programs. Overall, however, 2008 and 2009 were marked by painful declines in revenues, whereas 2010 and 2011 showed some steadying of revenues but only compared to the prior two years of major decreases. During 2012, revenue challenges remained, but the nonprofit sector’s eternal optimism and commitment to mission has helped to carry many organizations through a troubled financial period. Overall, the “new normal” positions the nonprofit sector in a still unsettled fundraising climate with unfilled revenue holes. Charting a successful course during the economic downturn is a complex and inexact process for most nonprofit organizations as they seek to generate revenues, control expenses, and refocus programs to serve evolving needs.

It helps to review changes in the fundraising climate before exploring the legal issues because funding is integral to program preservation. Organizations that focus on human services for the poor,<sup>1</sup> although numerous in number, tend to have smaller revenues, budgets and asset holdings than the nonprofit average.<sup>2</sup> Community-based and other small organizations serving the poor generally depend on charitable contributions from foundations, corporations, and individuals

---

<sup>1</sup> The term “human services” is used herein to refer broadly to groups providing an array of services directly to those in need, including childcare, employment, housing/shelter, public safety, food and nutrition, youth development, and other services. The National Center on Charities Statistics and other tracking systems also use the category “human services organizations” when dividing the nonprofit sector into different types of organizations.

<sup>2</sup> Human services organizations represented 31.9% of the 501(c)(3) organizations filing Internal Revenue Service (“IRS”) Form 990s during the 24 months prior to July 2009, but only 12.55% of revenues and 10.34% of asset holdings. Molly F. Sherlock & Jane G. Gravelle, *An Overview of the Nonprofit and Charitable Sector*, Cong. Research Serv., R40919, at 9 (Nov. 17, 2009), <http://www.fas.org/sgp/crs/misc/R40919.pdf> [hereinafter “CRS 2009”].

plus government grants for a majority of their revenues.<sup>3</sup> For most organizations, this funding arrangement has developed out of a blend of design and necessity, consistent with their tax-exempt designation under Section 501(c)(3) of the Internal Revenue Code ("IRC"). When funding is largely from private philanthropy and government contracts, and not self-paying participants, it can be difficult to synchronize fulfilling increased demand for the organization's services with obtaining the funds needed to pay for them.

### A. Private Funding Overall Has Been Down

---

Nationally, total charitable contributions (from foundations, corporations, individuals, and bequests) to nonprofit organizations fell in both 2008 and 2009 by higher percentages than any other time in the past 50 years and more than during previous downturns.<sup>4</sup> Based on IRS tax returns, Giving USA<sup>5</sup> estimates

---

<sup>3</sup> A 2009 Congressional Service Report showed that human services organizations receive approximately 41% from fee for service, 36% from government funding, 16% from private funding, and the remaining 7% from investments and other income. Overall, the same report showed that the nonprofit sector gets approximately 49% of its revenue from fee for service, 29% from government contracts, 12% from private contributions, 7% from investment income and 3% from other sources. CRS 2009, *supra* note 2, at 9. While fee-for-service accounts for the largest share of all revenues, this number is skewed by health-care providers, universities, employee-trusts and other large institutions deriving most of their revenue from fee for service. For IRS Form 990 filers responding to a 2010 GuideStar survey with annual revenues under \$5 million, the median dependence on charitable contributions was 44%. Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, a June 2010 Survey*, GuideStar USA, at 4 (June 2010) [hereinafter "GuideStar June 2010"]; Letter to the Editor, *GuideStar's Data Paint Clear Picture: Many Charities Face Big Challenges*, The Chronicle of Philanthropy (Oct. 17, 2010), <http://ceo.GuideStar.org/tag/chronicle-of-philanthropy/>.

<sup>4</sup> Giving USA Foundation, *Giving USA 2011: The Annual Report on Philanthropy for the Year 2010 Executive Summary*, Chicago: Giving USA Foundation, at i, ii, 11, 16, 17 (June 2011) (retrieved July 2011 from <http://www.givingusareports.org/>) [hereinafter "Giving USA ES 2011"]; Holly Hall, *Americans Gave a Lot Less in the Recession Than Experts Predicted*, The Chronicle of Philanthropy (Apr. 22, 2011) [hereinafter "Hall Apr. 2011"].

<sup>5</sup> *Giving USA*, an initiative of Giving USA Foundation, is a report researched and written annually by the Center for Philanthropy at Indiana University. Giving USA Foundation releases estimates each June for the prior year. It later revises the estimates based on subsequent IRS tax return information from individuals and entities. For example, the report issued in 2012 seeks to present final estimates for 2007-2009, revised estimates for 2010, and initial estimates for 2011, but the specific numbers may change in future revisions. Giving USA Foundation, *Giving USA 2012: The Annual Report on Philanthropy for the Year 2011 Executive Summary*, Chicago: Giving USA Foundation, at 23 (June 2012 rev'd Aug. 2012) (retrieved Sept. 2012 from <http://www.givingusareports.org>) [hereinafter "Giving USA ES 2012"].

\$279 billion in total giving in 2009, compared to more than \$290 billion in 2008 and more than \$300 billion in 2007.<sup>6</sup>

Total charitable giving rose to almost \$287 billion in 2010 and to \$298 billion in 2011, up 2.2% over two years in inflation adjusted dollars, but remaining under 2007 and 2008 levels in actual and inflation adjusted dollars.<sup>7</sup> As discussed further below, this overall drop since 2007 is largely attributable to lowered contributions from individuals and foundations who felt the effects of the weak economy.<sup>8</sup> The average rate of annual growth in charitable giving in 2010 and 2011 is the second lowest of any two-year post-recession period since 1971, with the other weak climb being the two-year period following 2001.<sup>9</sup>

The Giving USA data is consistent with survey data from charities about their fundraising efforts. According to Nonprofit Research Collaborative surveys, the majority experienced reduced or flat annual contributions during calendar years 2008 through 2010, but a smaller percentage experienced year-to-year reductions in 2010. Specifically, for 2008, 2009, 2010, respectively, overall 46%, 43%, and 43% reported an increase, 14%, 11%, and 24% reported receiving about the same amount as in the prior year, and 40%, 46%, and 33% saw a decline. The only other year since 2000 when more than thirty percent reported a decrease

---

<sup>6</sup> Giving USA ES 2012, *supra* note 5, at 20; Giving USA ES 2011, *supra* note 4, at 16; Giving USA Foundation, *Key Findings of the Giving USA 2012 Report*, Chicago: Giving USA Foundation (June 2012), <http://martsandlundy.com/sites/default/files/files/KeyFindingsReport.pdf> [hereinafter "Giving USA Findings 2012"].

<sup>7</sup> Giving USA ES 2012, *supra* note 5, at 20; Giving USA Findings 2012, *supra* note 6, attachment; Holly Hall, *Donations Barely Grew at All Last Year, 'Giving USA' Finds*, The Chronicle of Philanthropy, June 19, 2012, <http://philanthropy.com/article/Donations-Barely-Grew-at-All/132367/> [hereinafter "Hall 2012"]; *Sources of Giving in America: How They Are Recovering From the Recession*, The Chronicle of Philanthropy (June 19, 2012), <http://philanthropy.com/article/Sources-of-Giving-in-America-/132337/> [hereinafter "Sources of Giving"] (providing inflation adjusted dollars based on Giving USA reports).

<sup>8</sup> Hall 2012, *supra* note 7.

<sup>9</sup> Giving USA ES 2012, *supra* note 5, at 3, 20. See also Press Release, *U.S. Charitable Giving Shows Modest Uptick in 2010*, Chicago: Giving USA Foundation (June 20, 2011), <http://www.jeffreybyrneandassociates.com/GUSA2011MediaKit.pdf>; Press Release, *Has America's Charitable Giving Climbed out of its Great Recession-fueled Trough?*, Chicago: Giving USA Foundation (June 19, 2012), <http://martsandlundy.com/sites/default/files/files/GivingUSAPressRelease.pdf> [hereinafter "Giving USA PR 2012"].

was post-2001, when 39% reported a decline in 2002.<sup>10</sup> The experience of individual organizations varied, particularly for smaller organizations, which were less likely to report an increase than larger organizations.<sup>11</sup>

More recent reports on charitable giving for 2011 and 2012 suggest hope, although the recovery remains slow and delayed, especially for smaller nonprofit organizations. Initially, in a fall 2011 survey by the Nonprofit Research Collaborative, large numbers of nonprofit organizations reported that their fundraising results had not improved over the past year and their budgets were “cut to the bone” as they struggled to secure funding for programs.<sup>12</sup> However, the end of 2011 was more positive. In early 2012, for the first time since 2007, the majority of survey respondents reported an increase in annual donations in 2011 compared to 2010; 53% respondents saw an increase, 16% received about the same amount, and 31% saw a decline. Organizations with up to \$1 million in revenues were less likely than larger organizations to see an increase; those with up to \$3 million were more likely to report declining or stagnant returns. Looking ahead, 71% of total survey respondents expected to raise more in 2012 than in 2011. Results for 2010 and 2011 are noticeably weaker than 2003 through 2007, when each year more than 60% of the charities responding to a similar survey reported increased annual giving.<sup>13</sup> Therefore, the 67% and 69% of charities reporting the same or better in 2010 and 2011, compared to the prior year, is likely to include a large number of organizations that are stabilizing at lower overall levels than they had enjoyed pre-recession.

Approximately nine percent of the nation’s annual contributed revenues go to human services organizations, although in more recent years this subsector has

---

<sup>10</sup> *The 2011 Nonprofit Fundraising Study: Funds Raised in 2010 Compared With 2009*, The Nonprofit Research Collaborative, at 7 (Mar. 2011) [hereinafter “NRC 2011”], available at <http://www.urban.org/uploadedpdf/1001529-2010-Nonprofit-Fundraising-Survey.pdf>.

<sup>11</sup> NRC 2011, *supra* note 10 at 3, 11.

<sup>12</sup> *Late Fall 2011 Nonprofit Fundraising Study*, The Nonprofit Research Collaborative, at 7, 23 (Dec. 2011), available at <http://www.urban.org/UploadedPDF/412466-Late-Fall-2011-Nonprofit-Fundraising-Study.pdf>.

<sup>13</sup> *The 2012 Nonprofit Fundraising Study: Governing Charitable Receipts at U.S. Nonprofit Organizations in 2011*, The Nonprofit Research Collaborative, at 2-9, 13, 32 (Apr. 2012) [hereinafter “NRC 2012”]; Noelle Barton and Maria Di Mento, *Many Big Charities Struggle to Raise Money in the Bad Economy*, *The Chronicle of Philanthropy* (Oct. 16, 2011) (“smaller charities are suffering more”).



received closer to 12 percent.<sup>14</sup> Contributions for Haiti earthquake relief masked an otherwise overall drop in private contribution for human services in 2010.<sup>15</sup> New York City human services organizations faced a more difficult overall experience. In a summer 2009 survey aimed at this New York City constituency, 73% of respondents reported that their annual private funding decreased when the recession hit, with 44% reporting reductions of more than 20%.<sup>16</sup>

Despite some modest uptick in total giving in 2010 and 2011, commentators have aptly warned that the recession is likely to linger for years, so those seeking to increase revenues more aggressively should seek to improve their organization's fundraising approaches rather than wait for an overall lifting of private funding.<sup>17</sup> If history is a guide, after past recessions, private giving growth lags economic growth by at least a year, and it can take three to five years for private giving to return to pre-recession inflation adjusted levels.<sup>18</sup> Absent faster economic recovery, it can take longer.<sup>19</sup> Charities overwhelmingly report that the economy, including

<sup>14</sup> Giving USA ES 2011, *supra* note 4, at 6; Giving USA ES 2012, *supra* note 5, at 5, 11.

<sup>15</sup> Giving USA ES 2011, *supra* note 4, at 6, 12. If giving to international human services organizations had been excluded from the total (as distinguished from giving to the international affairs subsector), giving to human services organizations would have dropped by 5.6% in 2010 according to initial estimates, the largest decline among all causes. Jacob Berkman et al., *Nonprofit Causes Fared in 2010 – and What 2011 May Bring*, The Chronicle of Philanthropy, at 8 (June 30, 2011).

<sup>16</sup> Jack Krauskopf et al., *The Helpers Need Help: New York City's Nonprofit Human Service Organizations Persevering in Uncertain Times*, Baruch College, at 10 (Summer 2009), [http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM\\_HelpersNeedHelpReport.pdf](http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM_HelpersNeedHelpReport.pdf) [hereinafter "Baruch 2009"].

<sup>17</sup> Noelle Barton and Maria Di Mento, *Big Grant Maker's Don't Expect to Increase Giving in 2012*, The Chronicle of Philanthropy (March 18, 2012) [hereinafter "Barton Mar. 2012"]; Gabrielle Canon, *Economic Recession Continues to Hit Nonprofits Hard*, Huffington Post (March 22, 2011), [http://www.huffingtonpost.com/2011/03/22/nonprofits-continue-to-fe\\_n\\_838855.html](http://www.huffingtonpost.com/2011/03/22/nonprofits-continue-to-fe_n_838855.html); Holly Hall, *'Giving USA' Forecasts Tough Years Ahead for Fund Raisers*, The Chronicle of Philanthropy (June 19, 2011).

<sup>18</sup> Giving USA Foundation, *Giving USA 2010: The Annual Report on Philanthropy for the Year 2009 Executive Summary*, Chicago: Giving USA Foundation, at 16 (2010) [hereinafter "Giving USA ES 2010"].

<sup>19</sup> "If the economy continues at the slow pace seen in 2010 and 2011, it will take over a decade to reach pre-recession levels." Statement of Patrick Rooney, executive director of the Indiana University Center on Philanthropy, in Giving USA PR 2012, *supra* note 9, at 2; Hall 2012, *supra* note 7.

global, national and local issues, is their greatest fundraising challenge for 2012 and beyond.<sup>20</sup>

### **1. Foundation Giving**

When the recession hit, many foundations reduced their own operating expenses in order to preserve more of their limited dollars for grant-making or endowment. For example, two-thirds of foundations reported reducing operating expenses between fall 2008 and June 2009.<sup>21</sup> Meanwhile, data from foundations shows several trends between 2008 and 2012, including reduced or flat giving levels, targeted funding for services related to the economic downturn, and planning for the future despite economic uncertainty.

After foundation assets dropped an estimated 28% in 2008, total nationwide foundation giving dropped from its high of \$42 billion in 2008 to \$41 billion in 2009; since then foundation giving has been relatively flat as grant makers struggle with sluggish and uncertain asset growth.<sup>22</sup> Initial indicators for 2011 suggested that annual foundation giving might increase. The majority (52%) of respondents to a 2011 Foundation Center survey reported that they expected to increase their giving in 2011 as compared to 2010; 17% expected no change, and 30% expected to decrease their giving.<sup>23</sup> However, the ultimate 2011 results were not as strong, due to the slow recovery of foundation assets from the 2008 stock market crash. More than one-third of foundations reported reducing giving in 2011 and estimated total foundation giving (not including corporate

---

<sup>20</sup> NRC 2012, *supra* note 13, at 32.

<sup>21</sup> Steven Lawrence, *Moving Beyond the Economic Crisis: Foundations Assess the Impact and Their Economic Response*, The Foundation Center, at 2 (Nov. 2010), [http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory\\_economy\\_201011.pdf](http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory_economy_201011.pdf) [hereinafter "Fdn Ctr Nov. 2010"]; Steven Lawrence, *Foundations' Year-End Outlook for Giving and the Sector*, Foundation Center, at 1-2 (Nov. 2009), [http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory\\_economy\\_200911.pdf](http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory_economy_200911.pdf) [hereinafter "Fdn Ctr Nov. 2009"].

<sup>22</sup> Fdn Ctr Nov. 2009, *supra* note 21, at 1; Giving USA 2011, *supra* note 4, at 4; Giving USA Findings 2012, *supra* note 6, attachment. Foundation Center estimates are higher than Giving USA estimates because the Foundation Center includes corporate foundation giving in foundations whereas Giving USA includes it in corporations. Giving USA ES 2012, *supra* note 5, at 4.

<sup>23</sup> Steven Lawrence & Reina Mukai, *Foundation Growth and Giving Estimates: Current Outlook 2011*, The Foundation Center, at 5-7 (Apr. 2011) (due to rounding, the figures do not equal 100%), <http://foundationcenter.org/gainknowledge/research/pdf/fgge11.pdf>. In this same 2011 Foundation Center survey, many foundations anticipated 2012 giving to be steady, with more than 50% expecting to give about the same in 2012 and 2011; 27% expecting a rise; 6.5% planning lower levels of giving; and 16% of foundations uncertain about their outlook.

foundations) was between \$41 and \$42 billion.<sup>24</sup> Similarly, 68 of the 96 biggest foundations surveyed by the Chronicle of Philanthropy reported in spring 2012 that they planned to give the same or amount or less in 2012.<sup>25</sup>

The practice of many foundations in setting grant-making budgets based on a three-year rolling average value of assets permitted by the Internal Revenue Code means it will take at least a few years of consistent market gains to offset the large asset losses in 2008. Overall foundation giving is not expected to rebound dramatically soon, given the overall poor stock market performance in 2011 and unsteady economic recovery.<sup>26</sup> Only 19% of foundation respondents to a 2012 Foundation Center survey reported that they expect to increase their giving in 2013 compared to 2012; 54% expect steady giving, 9% expect a decrease, and 14% did not yet know.<sup>27</sup> The large majority of foundations are trying to keep the number of grantees and new grantees steady, with anticipated increases roughly offsetting anticipated decreases.<sup>28</sup>

Nevertheless, many foundations stepped forward beginning in 2009 to provide support to nonprofit organizations addressing problems related to the economic downturn. Grant-making nationwide increased immediately for “safety-net” services, defined by the funding community to include food, housing assistance, financial assistance, and supportive services for low-income and disadvantaged populations.<sup>29</sup> According to the Foundation Center, between January and June 2009, foundation and corporate support for economic crisis-related grants rose sharply, from \$117 million to \$322 million. More than half of these funds went to housing and shelter, including foreclosure prevention, and almost a quarter went to emergency assistance and food assistance. The large majority of this funding was

---

<sup>24</sup> Steven Lawrence, *Foundation Growth and Giving Estimates*, Foundation Center, at 1-2 (June 2012), <http://foundationcenter.org/gainknowledge/research/pdf/fgge12.pdf> [hereinafter “Fdn Ctr June 2012”]; Giving USA ES 2012, *supra* note 5, at 4 (while up slightly from 2010 in current dollars, the 2011 figure reflects a drop in inflation-adjusted dollars).

<sup>25</sup> Barton Mar. 2012, *supra* note 17.

<sup>26</sup> *Ibid.*

<sup>27</sup> Fdn Ctr June 2012, *supra* note 24, at 2-3.

<sup>28</sup> *Ibid.*, at 3.

<sup>29</sup> Cassandra Benjamin & Sara Kimberlin, *Strengthening the Safety Net: Bay Area Philanthropy’s Response & Early Lessons*, Safety Net Funders Network, at 3 (May 2010), <http://www.sff.org/press/news-releases/june-3-2010/>.

for program support, rather than general operating support or capital projects.<sup>30</sup> Local grant-making also was a priority for certain funders.<sup>31</sup> By fall 2010, 41% of foundations responding to a national Foundation Center survey reported giving grants specifically to address economic crisis issues, counting more than \$474 million grants to ameliorate the recession's impact on the foundations' home communities. The total increased to more than \$520 million by summer 2012.<sup>32</sup> Sustaining such grants for a multi-year recession is difficult especially for grant makers that increased the size or share of assets they distributed to help nonprofit organizations during the economic downturn.

Getting beyond the downturn for foundation grantees involves making compelling requests for funding and considering alternative models that meet the funder's goals. There currently is not widespread evidence that foundations have made or are planning long-term changes in their geographic or program priorities because of the economic downturn.<sup>33</sup> Some have declared that they seek to be more strategic and focused in their funding decisions going forward, possibly by giving more dollars to fewer groups, giving fewer dollars to more groups, decreasing the

---

<sup>30</sup> Initial reports from foundations showed 84% of foundation's crises related grants were for program support, compared to 4% for capital support and general support. *The Foundation and Corporate Response to the Economic Crisis: An Update*, The Foundation Center, at 1-2 (July 2009), [http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory\\_economy\\_200901.pdf](http://foundationcenter.org/gainknowledge/research/pdf/researchadvisory_economy_200901.pdf).

<sup>31</sup> Steven Lawrence, *A First Look at the Foundation and Corporate Response to the Economic Crisis*, The Foundation Center, at 1 (Jan. 2009).

<sup>32</sup> Fdn Ctr Nov. 2010, *supra* note 21, at 2-3. *Mapshot: Foundations Respond to the Economic Crisis*, The Foundation Center, [http://maps.foundationcenter.org/economic\\_crisis](http://maps.foundationcenter.org/economic_crisis), maintains an online chart of foundation giving, nationwide and by state and county, since the start of the recession. By mid-2011, the total reported grants and program-related investments was more than \$495 million for 3809 grants to 3002 recipient organizations. By mid-2012, the total reached \$521 million for 3170 recipients. Of the more than \$80 million that went to New York City, the majority of funds went to safety net organizations that provide citywide services, \$77 million to or through groups based in Manhattan, and \$1.7 million to those based in Brooklyn. This includes \$50 million from the Open Society Institute to Robin Hood Foundation and more than \$800 million from the New York Community Trust's safety net grant-making. See "New York" section of Foundation Center's *MapShot*. Data on fall 2010 giving was accessed on December 14, 2010; mid-2011 data was accessed on June 20, 2011; and mid-2012 data was accessed on Aug. 3, 2012.

<sup>33</sup> In fall 2010 the majority of foundations surveyed by the Foundation Center did not expect long-term changes in their geographic or program priorities because of the economic downturn. Only about 8% of the respondents expected lasting changes in their grant-making priorities as a result of the downturn. Fdn Ctr. Nov. 2010, *supra* note 21, at 2-3. Nine out of ten respondents to a 2012 Foundation Center survey anticipated no changes in the number of program areas they fund or geographic areas they serve. Fdn Ctr June 2012, *supra* note 24, at 2-3.

number of multi-year grants or using requests for proposals that targeted particular programs or services. Some have questioned giving to operating expenses.<sup>34</sup> Others have suggested that foundations can make a positive difference by focusing their support on operating expenses, working capital, and nonprofit advocacy.<sup>35</sup> Funding collaborations are another option.<sup>36</sup> With a fixed or reduced total amount of philanthropic grants, it remains harder for groups less central to a foundation's core priorities, or without an existing or prior relationship with the funder, to obtain new funding.

## 2. Corporate Giving

Corporate giving, including grants from corporate foundations, dropped 16% between 2007 and 2008, from \$15.4 billion to \$13 billion in inflation adjusted dollars, and then fluctuated between \$14.5 and \$15 billion for each of the years 2009, 2010 and 2011.<sup>37</sup> However, because the financial crisis affected the profits of different industries differently, corporate giving since 2007 has not been uniform, with 50% increasing giving and 45% decreasing it between 2007 and 2010.<sup>38</sup> Because so many corporations gave less, some commentators have

<sup>34</sup> One survey showed that the median amount of foundations' budgets devoted to general operating support, rather than restricted grants, held steady between 2008 and 2011 at approximately 20 percent. Caroline Preston, *General Operating Support Remains Flat, Study Finds*, The Chronicle of Philanthropy (Mar. 18, 2012) (referencing survey of 755 foundations conducted in 2011 by Grantmakers for Effective Organizations and the TCC Group), <http://philanthropy.com/article/General-Operating-Support/131195/>.

<sup>35</sup> Douglas B. Bauer, *Foundations Should Offer Thoughtful Support to Struggling Charities*, The Chronicle of Philanthropy (Feb. 6, 2011), <http://philanthropy.com/article/Foundations-Need-to-Adjust/126206/%20>.

<sup>36</sup> For example, Lawyers Alliance, the Nonprofit Finance Fund, and Cause Effective created a collaboration to provide fundraising, legal and finance technical assistance to a small number of established New York City organizations with funding support from the New York Community Trust. The purpose is to strengthen and sustain organizations that provide safety net services in New York low-income neighborhoods. <https://lawyersalliance.org/SOScollaboration.php>.

<sup>37</sup> See Giving USA Findings 2012, *supra* note 6, attachment, for revised 2009 and 2010 estimates, Giving USA ES 2012, *supra* note 5, at 4, for initial 2011 estimate in actual dollars, and Sources of Giving, *supra* note 7, for inflation adjusted dollars.

<sup>38</sup> Press Release, *Companies Report Increased Philanthropic Giving in 2010*, Committee Encouraging Corporate Philanthropy (June 2, 2011); Press Release, *Companies Report Increased 2010 Contributions, but Show Divergent Paths since the Economic Downturn in 2007*, Committee Encouraging Corporate Philanthropy (Oct. 27, 2011). Corporate giving declined in the majority (55%) of organizations that reported a decline in charitable receipts the first nine months of 2010. *November 2010 Fundraising Survey*, The Nonprofit Research Collaborative, at 11 (Nov. 2010) [hereinafter "NRC Nov. 2010"].

attributed the overall growth in corporate giving during recession years to gifts from some of the largest companies for selected charities and to in-kind giving, not a trend necessarily benefitting smaller nonprofit organizations.<sup>39</sup> For New York City nonprofit organizations, corporate fundraising remains difficult because the recovery from the economic downturn has not been consistent across business sectors.<sup>40</sup>

### **3. Individual Donations**

Nationwide, donations from individuals account for approximately three-fourths of private contributions, more than foundation and corporate giving combined. This includes individual gifts from appeals, events, online giving and other methods. However, a large amount of individual giving is to religious organizations, which historically receive about one-third of total charitable contributions.<sup>41</sup> In contrast, although community-based and other small and non-religious organizations generally count on fundraising aimed at individuals to help diversify their overall funding, individual gifts are often a more modest part of their annual budget. Human services organizations collectively receive closer to one-sixth of their revenue from private contributions, of which individual donations are an important part.<sup>42</sup>

After more than doubling between 1987 and 2007, individual giving fell by more than 10% in both 2008 and 2009, as individuals and families adjusted to the recession and reduced their year end giving.<sup>43</sup> Fewer donors and smaller donations were the primary reasons given by the 37% of charities reporting decreased individual giving during the first nine months of 2010.<sup>44</sup> Overall giving by individuals has since improved modestly. The Giving USA 2012 estimates are \$200.7 billion for 2009, \$209.6 billion for 2010, and \$217.8 billion for

---

<sup>39</sup> Giving USA ES 2010, *supra* note 18, at 1, 4, 9.

<sup>40</sup> *Economic Trends in New York State*, Report 2-2012, N.Y. State Office of the State Comptroller, at 1 (Apr. 2011) [hereinafter "Comptroller Apr. 2011"].

<sup>41</sup> Giving USA ES 2010, *supra* note 18, at 7; Giving USA ES 2011, *supra* note 4, at 6; Giving USA ES 2012, *supra* note 5, at 4, 11.

<sup>42</sup> CRS 2009, *supra* note 2, at 17.

<sup>43</sup> Hall Apr. 2011, *supra* note 4, citing IRS figures related to itemized individual giving for 2008. See also *The 2010 Nonprofit Fundraising Survey: Funds Raised in 2009 Compared With 2008*, The Nonprofit Research Collaborative, at 8 (Mar. 2010).

<sup>44</sup> NRC Nov. 2010, *supra* note 38, at 9. Another source to watch is donor-advised funds, as some slowly grew after two years of bruising losses due to the recession. Andrew W. Hastings, *2010 Donor-Advised Fund Report*, National Philanthropic Trust (2010).

2011.<sup>45</sup> Fluctuations are likely to be due in part to changes in donors' economic confidence. For example, in a 2012 survey of Main Street Americans, who have \$100,000 or less in investable assets, half report decreasing their charitable giving since the recession, with the primary reason being hard financial times; 27% reported increasing their charitable giving, with a major motivator being increased awareness of others' misfortunes. Charities that rely heavily on donations from individuals tend to be susceptible to economic fluctuations that affect individual giving.<sup>46</sup>

Also relevant to individual giving is the fundraising regulatory scheme. Charities that are tax exempt under Section 501(c)(3) of the IRC can offer donors a powerful inducement. Donations to such organizations, within limits, generally are deductible from the donors' income for federal income tax purposes.<sup>47</sup>

A mid-2010 legislative development in New York State related to tax deductions for charitable contributions by high earners further demonstrates the connection between government policy and charitable giving in the downturn. As part of 2010-2011 budget legislation, the New York legislature reduced the state income tax charitable deduction for individuals with an annual income of \$10 million or more. For 2010 through 2012, these taxpayers can deduct 25%, not the previous 50%, of their charitable contributions on their state income tax return.<sup>48</sup> Some wealthy donors and nonprofit organizations opposed the move out of concern that it will negatively impact charitable giving. Nonprofit organizations across the country now fear that other state governments with budget difficulties may adopt similar reductions. Debate has increased about modifying the federal income tax

---

<sup>45</sup> Giving USA Findings 2012, *supra* note 6, attachment; Giving USA ES 2012, *supra* note 5, at 8.

<sup>46</sup> Adriana Reyneri, *Charitable Giving Declines Among Main Street Investors*, Spectrom's Millionaire Corner (Jul. 20, 2012), <http://www.millionairecorner.com/article/charitable-giving-declines-among-main-street-investors> (the remaining 23% reported not giving to charity); CRS 2009, *supra* note 2, at 17.

<sup>47</sup> IRC § 501(c)(3). IRS Publication 526, *Charitable Contributions* (Rev. Jan. 27, 2012), <http://www.irs.gov/pub/irs-pdf/p526.pdf>.

<sup>48</sup> Governor Paterson signed A. 9710-D (same as S. 6610-C) on August 4, 2010, and this provision is contained in Tax Law §615(g)(2) and New York City Administrative Code §11-1715(g)(2), as amended. The State Assembly estimated that this provision would generate up to \$100 million in state revenue for fiscal year 2010-2011 and \$135 million in 2011-2012.



deduction as a way to control the federal deficit,<sup>49</sup> and the federal government's Congressional Budget Office ("CBO") has been exploring options for changing the tax treatment of charitable giving.<sup>50</sup>

## **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 pieced together a patchwork of public funding streams to help operate meaningful programs. Public funding includes grants and contracts from federal, state, and local government agencies. Community-based nonprofit organizations, including human services organizations, tend to receive a larger percentage of their revenue from government grants and payments than those organizations focused on arts and culture, education, the environment, animals, and international activities.<sup>51</sup> New York City human services groups are heavily reliant on government contracts; in 2009, 70% reported getting 40% of their operating funds from public sources and 44% getting more than 80% from public sources.<sup>52</sup>

However, since early in the recession, strains on government budgets have caused large actual or threatened cuts in public funding for community services. In a national survey of human services organizations, 56% of respondents reported a

---

<sup>49</sup> Grant Williams, *N.Y. Governor Signs Charitable-Gift Limits Into Law*, The Chronicle of Philanthropy, (Aug. 10, 2010), <http://philanthropy.com/article/NY-Governor-Signs-Into-Law/123863>; Stephanie Strom, *Nonprofits Fear Losing Tax Benefit*, N.Y. Times (Dec. 3, 2010), at B1, <http://www.nytimes.com/2010/12/03/business/03charity.html?src=busln>.

<sup>50</sup> Some of the proponents of a change refer to CBO calculations that the estimated amount of foregone federal revenue, due to tax-deductible contributions, totaled approximately \$340 billion between 2010 and 2014. U.S. Cong., Cong. Budget Office *Options for Changing the Tax Treatment of Charitable Giving*, at 1 (May 2011).

<sup>51</sup> Nationally, public funding accounted for 36% of 2005 revenues for human services organizations, compared to 12% for the other categories of nonprofit organizations, except health care where it was 37%. CRS 2009, *supra* note 2, at 19.

<sup>52</sup> Baruch 2009, *supra* note 16, at 5-9.



drop between 2008 and 2009 in revenues from state agencies.<sup>53</sup> The majority of human services organizations surveyed in New York City reported a decrease in public funding between mid-2008 and mid-2009, with 22% reporting annual cuts of more than 30%.<sup>54</sup> Because nonprofit social service agencies, rather than the government, are the primary provider of so many health and human services, government cuts directly impede the nonprofit sector's ability to continue such services.<sup>55</sup>

Subsequent years also have been difficult. In one national survey of all categories of nonprofit organizations, about 45% percent reported receiving government grants; more saw a decrease (38%) between 2009 and 2010 than saw stable government funding (32%) or an increase (31%).<sup>56</sup> In another national survey, more than half of the nonprofit organizations receiving government funding in 2011 experienced payment delays, adding to the unreliability of government funding.<sup>57</sup>

## **1. State and Local Government Funding**

### **a. Contract Dollars**

Challenges are created by both dollars and procedures. States and localities throughout the country have slashed funds for government-funding programs and imposed new fees and taxes on 501(c)(3) organizations, notwithstanding the

---

<sup>53</sup> Elizabeth T. Boris et al., *Contracts and Grants Between Human Service Nonprofits and Governments*, Center on Nonprofits and Philanthropy at the Urban Institute, brief #25 at 4 & Table 2 (Oct. 2010), <http://www.urban.org/UploadedPDF/412229-Contracts-and-Grants.pdf> [hereinafter "Boris Contracts 2010"]. For full report, see Elizabeth T. Boris et al., *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants*, Urban Institute (Oct. 2010) <http://www.urban.org/uploadedpdf/412228-Nonprofit-Government-Contracting.pdf> [hereinafter "Boris Findings 2010"].

<sup>54</sup> Plus, of those receiving grants, 22% reported a decrease of more than 15%. Baruch 2009, *supra* note 16, at 5-9.

<sup>55</sup> Boris Contracts 2010, *supra* note 53, at 5-6.

<sup>56</sup> NRC 2011, *supra* note 10, at 33.

<sup>57</sup> 2012 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 2(2012), [http://nonprofitfinancefund.org/files/docs/2012/2012survey\\_brochure.pdf](http://nonprofitfinancefund.org/files/docs/2012/2012survey_brochure.pdf) [hereinafter "NFF Summary 2012"].

essential services and support nonprofit organizations provide to their residents.<sup>58</sup> News reports estimated that states allocated 5% less in 2009 and 4% less in 2010 for education, health care, and human services.<sup>59</sup> A major turnaround in funding levels does not appear to be imminent because state and local governments faced escalating expenses in 2011 and 2012, such as pension costs. 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 issue advocacy or direct programs delivering vital services.

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. It relies significantly on nonprofit organizations to provide a wide range of needed services, including workforce development, human services and health clinics, through these contracts. Nevertheless, the number of grant contracts has declined steadily over the past three years, with 3,815 new or renewed contracts with 2011 start dates compared to 9,413 with 2009 start dates. Multiple factors contributed to this reduction, including multi-year contracting, the expiration of

---

<sup>58</sup> *State Budget Crises: Ripping the Safety Net Held by Nonprofits*, National Council of Nonprofits (Mar. 17, 2010), <http://www.councilofnonprofits.org/sites/default/files/Special-Report-State-Budget-Crises-Ripping-the-Safety-Net-Held-by-Nonprofits.pdf> [hereinafter "NCON 2010"]; Boris Findings 2010, *supra* note 53, at 5-14. See also Lester M. Salamon et al., *Taxing the Tax-Exempt Sector – A Growing Danger for Nonprofit Organizations*, Johns Hopkins University Center for Civil Society Studies, Communique No. 21 (2011) (63% of organizations surveyed reported paying some type of tax, fee, or payments in lieu of taxes ("PILOT") to their state or local governments, which could range significantly, from small organizations paying \$2,557 on average for user fees, to \$422,095 median payments by large organizations for PILOT payments).

<sup>59</sup> Dianna L. Sutton, *The State of Philanthropy Today and the Outlook for Tomorrow*, KeysNews.com, Feb. 14, 2010, <http://keysnews.com/node/20842> (cites research by Independent Sector) [hereinafter "Sutton"].

ARRA funding, fewer legislative initiatives, and budget cuts.<sup>60</sup>

Since the start of the economic downturn, New York nonprofits have battled threats to state-funded initiatives as the governor and state legislature deal with state budget deficits by cutting programs. The 2009-2010 state budget eliminated a \$17.7 billion budget gap through a combination of federal stimulus funds, new taxes and fees, cuts to state health care programs, and other spending reductions. The delayed passing of the 2010-2011 state budget amplified the effects of serious budget cuts and delayed payments. During this delay, through the spring into the summer, the State Comptroller observed, “as a result of the late state budget, not-for-profits are not getting paid for services provided under existing contracts, forcing some organizations to consider suspending services until the state passes a budget or even closing their doors.”<sup>61</sup> Once adopted, the 2010-2011 state budget reduced funding in several areas where nonprofit organizations traditionally have been active, such as runaway and homeless youth, homeless intervention (also reduced in fiscal 2009-2010 deficit reduction budget) and adult literacy.<sup>62</sup> The news only got worse in the 2011-2012 state budget when New York State cut such areas as Temporary Assistance for Needy Families

<sup>60</sup> 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> [hereinafter “Comptroller Mar. 2010”] (the State Comptroller reports on the impact that not-for-profit contracting entities have on state and local economies); N.Y. Office of the State Comptroller, *New York State’s Not-for-Profit Sector, Delayed State Contracts and Late Payments Hurt Service Providers*, at 1-2 (Nov. 2011), [www.osc.state.ny.us/reports/nfp/nfpreport11-2011.pdf](http://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*, at 5 (May 31, 2012), [http://www.osc.state.ny.us/agencies/pcl\\_reports/pcl\\_2011.pdf](http://www.osc.state.ny.us/agencies/pcl_reports/pcl_2011.pdf) [hereinafter “Comptroller May 2012”]. The number of new and renewed contracts refers to contracts subject to New York’s Prompt Contracting Law, Article XI-B of the State Finance Law.

<sup>61</sup> Press Release, *DiNapoli: State’s Financial Crisis Hurting Not-For-Profits* (June 10, 2010), <http://www.osc.state.ny.us/press/releases/june10/061010a.htm>. The State Comptroller warned that, with projected state budget deficits through at least 2012, “nonprofit organizations will continue to be negatively affected as the State struggles to deal with these deficits and subsequent cuts to program.” Comptroller Mar. 2010, *supra* note 60, at 2.

<sup>62</sup> *Summary of the FY 2010-2011 New York State Enacted Budget*, United Neighborhood Houses (Sept. 2, 2010).

("TANF") commitments.<sup>63</sup> The 2012-2013 budget legislation signed by Governor Cuomo in March 2012 was mixed for human services and other community-based organizations. While the budget contains \$150 million in restorations, this does not match nearly \$1 billion of direct service cuts during the prior two years. Meanwhile, the nonprofit sector needed to advocate to keep Cost of Living Adjustments in the 2012-2013 budget and faces possible caps on the state's reimbursement of executive compensation and administrative expenses associated with contracted services.<sup>64</sup>

At the local level, New York City budget cuts have affected many nonprofit organizations, including those offering after school programs, adult literacy, senior care, and health care to vulnerable and immigrant New Yorkers. Citing severe cutbacks from state and federal sources, Mayor Bloomberg's budget proposal for 2010-2011 raised the possibility of New York City cutting all local aid to soup kitchens and food pantries.<sup>65</sup> The Mayor's fall 2010 proposal to close an anticipated \$3.3 billion budget deficit for the fiscal year 2011-2012 through mid-year and future cuts added to the uncertainty. Only after nonprofit advocacy and weeks of negotiations between the New York City Council and Mayor's Office, did the Council restore part or all of several mid-year 2010-2011 cuts in human service programs, including for Department for the Aging case management contracts, programs for runaway and homeless youth, Beacons programs, Out of School Time programs, and in the area of child protective services.<sup>66</sup> For fiscal year 2011-2012, programs that protect children's welfare, provide funding for senior centers, create out-of-school and employment learning opportunities for children and youth, shelter the homeless, and support mental health patients all

---

<sup>63</sup> *Enacted 2011-12 New York State Budget County Impact Summary*, N.Y. State Ass'n of Counties & N.Y. State County Executives Ass'n (Apr. 1, 2011) [hereinafter "N.Y. State Ass'n of Counties"]. TANF assistance includes funding for domestic violence, summer youth employment, child care subsidies, emergency food and housing support, and transitional jobs programs: in 2009-2010's enacted budget, TANF commitments received just over \$2 billion dollars; in the 2011-12 budget, TANF received only \$975 million.

<sup>64</sup> See *FYE12 Enacted State Budget Summary*, Who Cares I Do, <http://www.whocares-ido.org/stateCuts.html> [hereinafter "Who Cares"] for online advocacy efforts by Human Services Council and others related to budget cuts.

<sup>65</sup> Courtney Gross, *Council Gives Final OK on Budget*, Gotham Gazette, June 30, 2010, <http://www.gothamgazette.com/article/searchlight/20100630/203/3303>; Neil deMause, *Feeling the Recession's Impact*, City Limits (Mar. 8, 2010).

<sup>66</sup> *Council Restores Some Mid-Year Budget Cuts*, New York Nonprofit Press, Jan. 6, 2011, <http://www.nynp.biz/breaking-news/4729-council-wins-restores-some-mid-year-budget-cuts>.

faced decreased budgets. When the Mayor proposed a balanced Executive Budget for FYE 12, he also noted that the City must address budget gaps of \$4.8 to \$5.3 billion for each of the next three fiscal years.<sup>67</sup> He subsequently announced a financial plan in November 2011 with cuts to close future gaps. The preliminary Executive Budget for 2012-2013 from May 2012 cut \$185 million of funding for human services, including in childcare, after-school programs and elder services in low-income neighborhoods.<sup>68</sup> According to the Mayor, the City still faces annual budget gaps of between \$3.0 billion to \$3.7 billion for FYE14 through FYE 16.<sup>69</sup> Operating amidst the threat of further cuts also is unsettling.

*b. Contract Process*

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 they 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 impact of delayed contract approvals, delayed reimbursements, and mid-contract funding cuts has been more significant.<sup>70</sup> One estimate put the amount that state governments owe to nonprofit organizations in backlogged payments at \$15 billion.<sup>71</sup> In fall 2010, the Urban Institute and Center on Nonprofits and Philanthropy released the results of a national study showing that human service organizations were more likely to freeze or reduce salaries, reduce the number of staff and/or draw on reserves if they faced mid-year contract changes, payments less than costs, and/or late

---

<sup>67</sup> Finance Division, The Council of the City of New York, *The Council's Response to the Mayor's FY2012 Preliminary Budget and Preliminary Management Report (in fulfillment of sections 12 and 247 of the New York City Charter)* (Apr. 8, 2011) [hereinafter "Council FY2012 Response"]; Mark Page, Director, Office of Management and Budget, *The City of New York Executive Budget Fiscal Year 2012: Budget Summary*, at 32 (May 6, 2011), [http://www.nyc.gov/html/omb/downloads/pdf/sum5\\_11.pdf](http://www.nyc.gov/html/omb/downloads/pdf/sum5_11.pdf) [hereinafter "OMB FY2012 Summary"].

<sup>68</sup> See *Who Cares*, *supra* note 64, for summary of human services cuts.

<sup>69</sup> Press Release, Office of the Mayor of the City of New York, *Mayor Bloomberg Presents Fiscal Year 2013 Executive Budget* (May 3, 2012).

<sup>70</sup> NCON 2010, *supra* note 58.

<sup>71</sup> Sutton, *supra* note 59.

contract payments, compared to organizations that did not report such problems.<sup>72</sup>

These findings are consistent with the New York experience. As of early 2010, a survey of New York nonprofit organizations showed 66 percent had borrowed money due to late government payments during the past two years.<sup>73</sup> The New York State Comptroller reports that 71% and 80% of contracts with not-for-profit entities were not approved by the start or renewal dates, as reported by state agencies for calendar years 2010 and 2011, respectively. State payment cannot occur unless the contracts are approved. New York's Prompt Contracting Law requires state agencies to execute grant contracts with not-for-profit entities within specific time, specifically 180 days from state appropriation of funds for new competitive grant contracts and prior to the start of the new contract period for renewal grant contracts. In 2011, state agencies paid interest on about 37% of the 1,996 contracts reported eligible for interest. The Comptroller has proposed legislative and regulatory reforms to improve the grant contracting process, and a bill to require payment of interest at the time of the first payment moved through Senate and Assembly during the spring 2012 Legislative Session.<sup>74</sup>

## **2. Federal Government Funding**

While some nonprofit organizations regularly receive federal funding,<sup>75</sup> the main recession-related change has been the arrival and then phasing out of the federal economic stimulus package. President Obama signed ARRA on February 17, 2009 as a strategy to promote economic recovery, keep employed Americans in their jobs, create new jobs, reduce state and city service cuts and tax hikes, fund science and other crucial growing sectors, and foster transparency on how funds

---

<sup>72</sup> This report also noted that human services organizations had more than 200,000 state contracts in 2009. Boris Contracts 2010, *supra* note 53, at 2.

<sup>73</sup> *Comptroller Questions, Nonprofits Respond*, New York Council of Nonprofits (Jan. 19, 2010), <http://www.nycon.org/news/newsDetails.asp?newsid=266>.

<sup>74</sup> Comptroller Nov. 2011, *supra* note 60, at 1-3; Comptroller May 2012, *supra* note 60, at 6-7, 9-11. Assembly bill 9342-2011 by Assemblyman Steven Englebright and the companion Senate bill 6469-2011 by Senator John DeFrancisco were introduced at the Comptroller's request in 2012 and, if enacted, would allow the Comptroller's office to pay nonprofit organizations directly for interest due because of a late state contract.

<sup>75</sup> Out of 2758 New York human service nonprofit organizations with government contracts in 2009 responding to an Urban Institute survey, 16% had federal contracts compared to 62% with state contracts and 23% with city contracts. Elizabeth T. Boris et al., *National Study of Nonprofit-Government Contracting: State Profiles*, Center on Nonprofits and Philanthropy at the Urban Institute, (Oct. 2010), at 73-74.

were being used. ARRA initially designated \$787 billion of funds for economic recovery. In 2011, the expenditure estimate was increased from \$787 billion to \$840 billion to be in line with President Obama's 2012 budget and CBO calculations. Between ARRA's enactment in February 2009 and July 2012, the government paid out \$765.5 billion nationally: \$297.8 billion in tax benefits, \$238.4 billion in contracts, loans and grants, and \$230.3 billion in entitlements. This amounts to more than 90% of the amount designated.<sup>76</sup>

By April 2012, New York State had received and approved for state spending more than \$36 billion, including more than \$14 billion for health and human services, as part of hundreds of billions of dollars appropriated to states and other recipients over the length of the federal stimulus program.<sup>77</sup> Some of these funds have gone to nonprofit organizations directly through contracts administered by state agencies, for example as part of the state's Department of Housing and Community Renewal grants for weatherization assistance for low-income individuals. Some funds have gone indirectly through county and city agencies, such as the state's Office of Children and Family Services transfer of ARRA funds to New York City Finance Commissioner for child care and development block grants.<sup>78</sup> New York City received more than \$8.8 billion in ARRA funding, of which \$67 million (1.4%) was allocated to economic and workforce development and \$2.275 billion (25.6%) was allocated to health and social support services. This money was used to create or retain almost 26,000 of New York City jobs for 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.<sup>79</sup>

However, at this point the federal government has allocated most of the ARRA funds designated for contracts, loans and grants, so this revenue stream is

---

<sup>76</sup> Recovery.Gov Home Page, <http://www.recovery.gov> (data on amounts paid through June 30, 2012 retrieved Aug. 6, 2012).

<sup>77</sup> The Comptroller's office tracks New York's spending of federal stimulus funds on its Open Book New York website at <http://www.openbooknewyork.com/stimulus/index.htm> (data on approved funds through March 30, 2012 retrieved Aug. 6, 2012).

<sup>78</sup> Child care block grants is an example of an area where New York City received ARRA funds but a reduction in state funding in fiscal year 2010-2011.

<sup>79</sup> NYC Stat Stimulus Tracker, Funding Summary, <http://www.nyc.gov/html/ops/nycstim/html/home/home.shtml>. Given that the City updates this online Stimulus Tracker regularly, the jobs figures for the first quarters of 2011 and 2012 have been superseded by more recent figures; the data for the first quarter of 2011 was accessed on July 15, 2011; and comparable data for the first quarter of 2012 was accessed June 1, 2012.



dwindling or has become inaccessible for most nonprofit organizations.<sup>80</sup> As it disappears, the impact of other funding losses become more severe. In an early 2010 national survey about their ARRA experience, 36% of respondents said that their organization received government stimulus money. Of these, only 32% said they expected to be able to replace such funds after the stimulus funding ended, whereas 46% said they did not, and 23% said their funding was for a temporary program.<sup>81</sup> Even with ARRA, the federal share of New York City's budget dropped from 15% in 2002 to 10% in 2012, and the Mayor asserted that the City cannot absorb further state and federal cuts without staff layoffs or cuts to vital services.<sup>82</sup>

## **C. Other Revenue Sources Have Not Filled the Holes**

---

### **1. Fee Income**

The recession's impact on fee-for-service income appears to vary greatly by program area and organization. For example, in one survey of 2009 fee-generating activity, 69% of youth development organizations reported that fee income decreased while just 17% of community and economic development groups said fee income declined. Because fee income includes both direct payments and third-party payments such as Medicaid, it is difficult to generalize about the recession's impact on fee income. During 2009, 39% of human service organizations that collect fees from self-paying participants reported a decline in fee income while 40% reported no change.<sup>83</sup> Fee income from paying participants is a potential alternative source of revenue that many nonprofit organizations are exploring in difficult financial times. However, in addition to legal limits discussed in Part VI of this paper, practical constraints may limit this option for many human services providers and other community-based organizations, whose clients cannot afford to pay for the bulk of the costs of the services they receive.

### **2. Investment Income and Cash Reserves**

Although investment income traditionally has been a small portion of the revenue stream for most small and community-based nonprofit organizations, the economic

---

<sup>80</sup> NFF Summary 2012, *supra* note 57, at 2.

<sup>81</sup> 2010 *State of the Sector Survey*, Summary Survey Brochure, Nonprofit Finance Fund, at 3 (2010), <http://nonprofitfinancefund.org/files/images/2010SurveyBrochure.pdf> [hereinafter "NFF Summary 2010"]

<sup>82</sup> OMB FY2012 Response, *supra* note 67, at 2, 14.

<sup>83</sup> Boris Contracts 2010, *supra* note 53, at 4.



downturn affects those with investments in two key respects. First, investments in a reserve fund, if accessible, can help an organization to weather tough financial times. Second, a reduction in investment income can create budgetary holes if the organization has been relying on interest and other investment income in pre-recession years to support program. In each of three annual surveys conducted by the Nonprofit Finance Fund for 2008, 2009, and 2010, at least 60% of the organizations reported having 90 days or less of cash on hand, and 10% had none going into 2011.<sup>84</sup> Elsewhere, a third of human services nonprofit organizations reported no investment income in 2009 because they had no investments or no return on investments; 72% of those with investments reported losses, although investment income accounts for only 4% of their annual revenues.<sup>85</sup> Later, the Nonprofit Finance Fund's survey of 2011 showed slight improvement, with 57% having 90 days or less cash on hand, and 9% having none going into 2012.<sup>86</sup>

For organizations with cash reserves, endowments, and other investments, many had to choose in recent years whether to dip into those funds or scale back staff and programs during the recession.<sup>87</sup> While it is possible to draw from and then replenish or add more to investment accounts in the same year, it is much harder to add to investments when strapped for cash. According to Nonprofit Finance Fund surveys, during 2009, 2010, and 2011, respectively, 24%, 34%, and 27% of the responding organizations used reserve funds; during 2010 and 2011, respectively, 25% and 23% added to their reserve funds. The 2011 results are weaker than what groups planned at the beginning of the year, when 18% anticipated using and 33% planned to add to reserve funds.<sup>88</sup> Over time,

<sup>84</sup> 2011 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 3 & Chart 5 (2011), [http://nonprofitfinancefund.org/files/surveybrochure\\_032311.pdf](http://nonprofitfinancefund.org/files/surveybrochure_032311.pdf) [hereinafter "NFF Summary 2011"].

<sup>85</sup> This is in the context of investment income accounting for only 4% of annual revenues for human services nonprofits. Boris Findings 2010, *supra* note 53, at 18.

<sup>86</sup> NFF Summary 2012, *supra* note 57, at 3. The response of New York organizations was similar to the national profile: 57% reported having three months or less cash on hand, including 11% reporting none. 2012 *State of the Sector Survey Results, NFF Survey Analyzer (Filtered for New York)*, Nonprofit Finance Fund (2012), available at <http://survey.nonprofitfinancefund.org/#respondents,demand,actions,gov,engagement,finhealth/0:Y> [hereinafter "NFF Survey Analyzer 2012"].

<sup>87</sup> Noelle Barton & Ben Gose, *Charity's Declining Fortunes*, *The Chronicle of Philanthropy* (June 4, 2009) (reporting that endowments lost \$46.6 billion between 2007 and 2009, reflecting a median 25.4% decline since 2008).

<sup>88</sup> NFF Summary 2010, *supra* note 81, at 4; NFF Summary 2011, *supra* note 84, at 4 & Chart 9; NFF Summary 2012, *supra* note 57, at 4.

previously stable organizations can become weaker if they constantly use reserves or do not find alternative revenue sources to pay for continued operations.

Donor-restricted endowment funds, requiring nonprofit organizations to preserve the value of the original gift in perpetuity, add another level of scrutiny. Typically organizations use or reinvest the interest. Yet, when the market sours, the value of endowment funds can be less than the historical dollar cost. Until recently, New York limited endowment fund expenditures to the excess above historic dollar cost. As a result, organization could not spend interest and other appreciation to meet program expenses once the value of the holdings plummeted due the collapse of the stock market. However, New York became the 47th state to adopt a prudence standard for expenditures of endowment funds, by enacting New York Prudent Management of Institutional Funds Act ("NYPMIFA"), effective September 17, 2010.<sup>89</sup> Under NYPMIFA, unless otherwise specified by donors, an organization can expend endowment funds if the board determines in good faith that the expenditure is prudent and consistent with the purpose for which the endowment fund was created. NYPMIFA generally is intended to give organizations greater flexibility and access to cash than the old standard.

#### **D. Communities Need Nonprofit Organizations to Deliver Critical Services**

---

Program demand is up. The government, philanthropic and business sectors, along with the millions of individuals and families aided by nonprofit organizations, continue to count on the nonprofit sector to provide a range of programs and services important to quality of life in neighborhoods throughout the United States. As a major contributor to the nation's economy, the nonprofit sector can supplement community resources and strengthen neighborhoods

---

<sup>89</sup> N.Y. Not-for-Profit Corp. Law §§ 551, 553. This statutory change is also discussed in Part VI, "Funds." For a fuller description of this statutory change, see Memorandum, *Enactment of the New York Prudent Management of Institutional Funds Act Affecting New York Not-For-Profit Institutions*, Simpson Thacher (Sept. 20, 2010), <http://www.simpsonthacher.com/content/publications/pub1062.pdf>.

during difficult financial times in ways that the government sector does not.<sup>90</sup> The economic downturn highlighted the value of a strong nonprofit sector in at least three respects: their programs are needed, wanted, and worthy of investment independent of government funding.

First, the prolonged weak economy has caused substantial financial and personal hardship to persons who generally depend on the nonprofit sector, particularly the unemployed and underemployed, senior citizens, and mentally ill. With the national unemployment rate fluctuating between 8.2% and 10.1% between January 2009 and June 2011 (compared to 5% in January 2008) and the New York 2010 annual average above 10% (compared to 4.7% in January 2008), the negative impact of the recession continued for those individuals who struggle financially to make ends meet.<sup>91</sup> From July 2011 through June 2012, unemployment lessened compared to the previous two years, but still showed strains, with national unemployment rates between 8.1% and 9.1% and New York's seasonally adjusted unemployment rate 8.9% for June 2012.<sup>92</sup> Along with unemployment rates are gloomy statistics about more people using food stamps after the recession began.<sup>93</sup> Some services offered by nonprofit organizations ameliorate the symptoms of poverty and a recession, including unemployment, hunger and depression, whereas others are focused on addressing the causes.

<sup>90</sup> Nonprofit organizations employ nearly 10% of the workforce, more people than the finance, insurance, and real estate sectors combined. *The Sector's Economic Impact*, Independent Sector website (citing National Center for Charitable Statistics 2009 figure released in Mar. 2011), [http://www.independentsector.org/economic\\_role](http://www.independentsector.org/economic_role). Nonprofit organizations pay \$670 billion each year in wages and benefits in the United States. *Ibid.* Nonprofit organizations in New York employed 1.25 million people in 2010, which is 14% of the state's workforce. Comptroller Nov. 2011, *supra* note 60, at 1.

<sup>91</sup> *Unemployment Rate at 9.2% in June 2011*, Bureau of Labor Statistics (July 11, 2011), [http://www.bls.gov/opub/ted/2011/ted\\_20110712\\_data.htm](http://www.bls.gov/opub/ted/2011/ted_20110712_data.htm); *State Unemployment Rates in 2010*, Bureau of Labor Statistics (Mar. 2011), [http://www.bls.gov/opub/ted/2011/ted\\_20110301.htm](http://www.bls.gov/opub/ted/2011/ted_20110301.htm).

<sup>92</sup> *National Unemployment Update*, Nat'l Conference of State Legislatures, <http://www.ncsl.org/issues-research/labor/national-employment-monthly-update.aspx>; *State Labor Department Releases June 2012 Area Unemployment Rates*, N.Y. State Dep't of Labor (July 24, 2012), <http://labor.ny.gov/stats/pressreleases/prlaus.shtm>.

<sup>93</sup> For example, 26 million people nationwide received monthly food stamps before the recession compared to 43.6 million by November 2010. Pamela M. Prah, *Food Stamp Rolls Reach Historic Levels*, Stateline.org (Feb. 7, 2011), <http://www.stateline.org/live/details/story?contentId=548024>.

Second, the majority of nonprofit organizations have experienced strong demand for their services since the recession began, with overwhelming increases in demand reported for 2010 and 2011, especially by human services organizations. The significant amount of demand for nonprofit services has been demonstrated in several nationwide surveys as well as local anecdotes and news stories. According to GuideStar, 62% of its survey respondents saw greater demand for their services during the first nine months of 2009 than 2008.<sup>94</sup> The following year, 68% of those responding to a similar survey reported greater demand for their services during the first nine months of 2010 than the first nine months of 2009. Calendar year 2010 was the first year since 2006 during which the percentage of organizations reporting increased demand was greater than the prior year. GuideStar's survey revealed no meaningful variation in demand based on budget size, but in 2010 the human services subsector reported a 78% increase in demand, the highest among the different subsectors analyzed, followed by a 70% demand increase in both health and public benefit organizations.<sup>95</sup> These national statistics are similar to those prepared by the Nonprofit Finance Fund, which report 73%, 71%, and 77% increases in demand (31%, 36%, and 41% reported significant increases in demand), respectively, for 2008, 2009, and 2010.<sup>96</sup> The Nonprofit Finance Fund's survey of 2011 activities revealed ever-increasing need for nonprofit services: 85% of total survey respondents reported increased demand compared to the prior year (44% reported significant increases); and of those self-identifying as providing critical "lifeline" services (43%), 90% noted increased demand (57% reported significant increases).<sup>97</sup> For New York organizations, 83% reported increased demand in 2011 (41% reported significant increases).<sup>98</sup>

Third, reductions in government programs and funding means nongovernmental entities must fill a growing void, as illustrated by some of the challenges faced by New York organizations. Nonprofit groups report demand spikes as more individuals and families seek assistance related to food, shelter, unemployment

---

<sup>94</sup> Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, an October 2009 Survey*, GuideStar USA, at 5 (Oct. 2009). The next spring, 63% of respondents to a June 2010 GuideStar survey reported increased demand during the first five months of 2010 compared to the same period a year earlier. Guidestar June 2010, *supra* note 3, at 4.

<sup>95</sup> NRC Nov. 2010, *supra* note 38, at 12-13.

<sup>96</sup> NFF Summary 2011, *supra* note 84, at 2 & Chart 1.

<sup>97</sup> NFF Summary 2012, *supra* note 57, at 1.

<sup>98</sup> NFF Survey Analyzer 2012, *supra* note 86.

support, mental health services, credit, and other issues worsened because of the weak economy.<sup>99</sup> Cuts in government programs such as TANF inflate the demand for nonprofit sector services by downsizing human services provided by the public sector.<sup>100</sup> According to the Food Bank for New York City, 93% of food pantries and soup kitchens saw an increase in first-time visitors from 2008 to 2009.<sup>101</sup> News reports note that, in New York City, the recession caused a 21% increase in the demand for food assistance, but government funding cuts made it more difficult for food banks to obtain the food and resources to satisfy demand.<sup>102</sup> Senior citizens, another vulnerable population, faced the closure of 27 additional senior citizen centers in the City's proposed 2011-2012 budget, on top of the 26 closed the year before, and the City's Department for the Aging was looking at a loss of \$90 million in funding over the past three years.<sup>103</sup> Similarly, despite continuing high unemployment rates, particularly for people of color and in low- and moderate- paying jobs, the proposed 2011-2012 state budget eliminated the entire transitional jobs program.<sup>104</sup>

Maintaining current service levels is difficult enough, but keeping up with an increase in demand is even more challenging. Most nonprofit groups have done extraordinarily well under trying circumstances. Nevertheless, 44%, 49%, and 48% of national survey respondents reported not being able to meet demand in 2009, 2010, and 2011, respectively, and 50% expect to be unable to meet demand in 2012.<sup>105</sup> New York groups are slightly more optimistic, with 53% meeting demand in 2011 and 49% anticipating that they will do so in 2012.<sup>106</sup> Fortunately for individuals and communities in need, there are legal coping

<sup>99</sup> Comptroller Mar. 2010, *supra* note 60, at 1; Baruch 2009, *supra* note 16, at 24.

<sup>100</sup> N.Y. State Ass'n of Counties, *supra* note 63.

<sup>101</sup> *Hunger in New York*, Hunger Action Network of New York State website, <http://www.hungeractionnys.org/hungerny.htm>.

<sup>102</sup> Betsy Brill, *When Local Charities Become State Budget Casualties*, *Forbes.com* (Mar. 24, 2010), <http://www.forbes.com/2010/03/24/charity-illinois-census-intelligent-investing-philanthropy.html>; Council FY2012 Response, *supra* note 67, at 8.

<sup>103</sup> Bobbie Sackman, *Senior Program Budget Cuts Would Be Devastating*, *Queens Chronicle* (May 26, 2011), at [http://www.qchron.com/news/queenswide/article\\_6cbb95ab-067d-5668-9531-085a8882051b.html](http://www.qchron.com/news/queenswide/article_6cbb95ab-067d-5668-9531-085a8882051b.html).

<sup>104</sup> Comptroller Apr. 2011, *supra* note 40, at 1; Citizen Action of New York et al., *Unequal Budget: The Impact of 2011-12 State Budget Proposals on New York Communities of Color*, at 10 (Mar. 25, 2011).

<sup>105</sup> NFF Summary 2011, *supra* note 84, at 2 and Chart 2; NFF Summary 2012, *supra* note 57, at 1.

<sup>106</sup> NFF Survey Analyzer 2012, *supra* note 86.

strategies to support the nonprofit sector's spirit of resilience, so that nonprofit organizations can provide vital services.

## *Part II*

### **Legal Help: Strategies to Manage Risk and Preserve Programs**

There is significant need for the programs and services delivered by nonprofit organizations. With appropriate legal and other technical assistance, more nonprofit organizations should be able to preserve programs, meet demand and provide valuable services in and beyond troubled financial times.

Nonprofit organizations have responded to the economic downturn in multiple, non-uniform ways. There is not a one-size-fits-all solution to financial challenges, and the varied responses reflect the creativity, passion, and diverse governance approaches that infuse the nonprofit sector. Since the start of the great recession, several national and local studies have compiled factual data on measures undertaken by nonprofit organizations to deal with economy-related operating stresses. While these analyses use different sets of nonprofit organizations, terminology, and time periods, they are sufficiently comparable to reveal general trends. The data, referenced throughout this paper, shows a deep and broad impact on the nonprofit sector. The record also demonstrates a widespread desire among nonprofit leaders to make budgetary and organizational changes that preserve services and programs. These changes create legal issues.

In both stable and unstable economic times, effective nonprofit managers make plans and seek to implement policies that have legal implications. 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. 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. 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.

The economic downturn makes certain types of legal assistance more pressing

because the stakes can be higher and the circumstances can be more urgent. Early in the recession, many nonprofit organizations focused on immediate cost-cutting, confronting legal questions that arose when reducing ongoing expenses such as personnel costs and vendor agreements. As the economic impact deepened and revenue problems continued, the repertoire of common coping strategies expanded, generating a wider variety of legal work related to the downturn. As more and more time passes, the survival imperative has caused organizations to consider long-term institutional changes, including shedding programs and consolidation of operations, which compel difficult choices about core values and relationships and involve a different set of legal needs. The relevant legal principles are largely the same irrespective of the economy. Lawyers can draw upon the full array of corporate, contract, real estate, tax, financing, intellectual property, tax-exempt organization, employment, regulatory oversight, and other laws that affect nonprofit operations to guide organizations through this extraordinary economic period. Many of these business law needs are similar to those faced by for-profit corporations, particularly small to mid-sized businesses. However, certain governance, reporting and operating rules are unique to the nonprofit sector by virtue of the entity's tax-exempt status and laws related to the solicitation and management of charitable assets.

The actions commonly taken by nonprofit organizations during the economic downturn fall into five categories that correspond to five qualities that are critical to the organizations' success: mission, people, facilities, funds, and relationships. By starting with charitable mission, Part III of this paper identifies legal issues related to corporate purposes and governance that many nonprofit managers face as they consider and pursue a wide range of coping strategies. Parts IV-VII focus on more specific strategies related to people, facilities, funds, and relationships, respectively. As illustrated by case examples interspersed in Parts III-VII, nonprofit organizations that receive legal guidance and other technical assistance are better able to implement coping strategies in a manner that preserves valuable programs while minimizing legal risk. Nonprofit managers should examine their organization's resources in all five fundamental areas so that, even when such resources are limited, they are used for maximum effect.



## **Part III**

### **Mission**

#### **A. Providing Mission-Oriented Programs and Services**

##### **Is a Goal and a Challenge**

The charitable mission of a nonprofit organization creates an aspirational, 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.<sup>1</sup> The legal source of the charitable mission is the corporate purposes clause set forth in the organization's Certificate of Incorporation. Legally, the corporate purposes may be broader, but not narrower, than the mission, purposes, and activities actually pursued.<sup>2</sup> Practically, the corporate purposes can be a source of inspiration and help an organization stay focused on its charitable mission when the organization is struggling during difficult financial times to identify priorities and preserve programs.

As mission-driven entities, most nonprofit organizations sought to weather the initial months of the economic downturn without cutting programs, but several reports suggest that by mid-2009 at least a third to one-half of the sector had found it necessary to reduce at least some services. For example, nationally, 43% of the respondents to a survey by The Bridgespan Group<sup>3</sup>, 39% of those responding to a Johns Hopkins University survey<sup>4</sup>, and 59% of those reporting to a survey by

---

<sup>1</sup> As one commentator noted, "The presence of deeply embedded values . . . is a distinct feature of many nonprofits and foundations. How far they influence organizational behavior varies, but the significant presence of values implies at the very least a more complex . . . between operational and ultimate objectives. Howard K. Anheier, *The Global Economic Downturn: Philanthropy and Nonprofit Organizations*, Center for Social Investment, University of Heidelberg & Center for Civil Society, UCLA, at 4 (Jan. 2009).

<sup>2</sup> As discussed further in Part III.B.3, amendment of the corporate purposes in New York requires a vote of the Board of Directors, with state court approval, upon notice to the state Attorney General. N.Y. Not-for-Profit Corp. Law §§ 201, 202, 801(b)(2), 803, 804(a)(ii).

<sup>3</sup> William Foster, Gail Perreault, & Sarah Sable, *Managing in Tough Times: Nonprofit Leaders Survey Update*, The Bridgespan Group (June 29, 2009), <http://www.bridgespan.org/Publications-and-Tools/Strategy-Development/Managing-in-Tough-Times/Managing-in-Tough-Times-May-2009-Nonprofit-Leaders.aspx> [hereinafter "Bridgespan 2009"].

<sup>4</sup> Lester M. Salamon et al., *Impact of the 2007-09 Economic Recession on Nonprofit Organizations*, John Hopkins University Center for Civil Society Studies, Communique No. 14, at 18 (June 2009) [hereinafter "Salamon 2009"].

GuideStar<sup>5</sup> reported scaling back program to address a financial shortfall.<sup>6</sup> In New York, approximately 35% of human services organizations reported program reductions during this initial period, with 23% reporting significant changes.<sup>7</sup>

Retrenchment continued into 2010 and 2011 for some organizations. In a GuideStar survey on the first five months of 2010, 59% of the 29% of respondents that reported budget cutbacks for 2010 compared to 2009 also reported reducing activities and services to reduce budget.<sup>8</sup> Meanwhile, 26% of organizations responding to the Nonprofit Finance Fund's annual surveys anticipated budget-related program cutbacks in 2010 compared to 2009, 26% engaged in such cutbacks in 2010, and 20% engaged in budget-related service cutbacks during 2011.<sup>9</sup> One-fourth of New York organizations reported cutting programs or services during 2011.<sup>10</sup>

Yet, some of this program reduction has helped to free up resources for other services, especially those deemed mission-critical.<sup>11</sup> Plus, the nonprofit sector stepped up its services to meet growing demand. Despite revenue challenges, a large majority of nonprofit organizations, particularly those serving low-income

---

<sup>5</sup> Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, an October 2009 Survey*, GuideStar, at 2 (Oct. 2009).

<sup>6</sup> For smaller organizations, namely those with annual budgets under one \$1 million in revenues, the percentage is higher. Bridgespan 2009, *supra* note 3.

<sup>7</sup> Jack Krauskopf et al., *The Helpers Need Help: New York City's Nonprofit Human Service Organizations Persevering in Uncertain Times*, Baruch College, at 22 (Summer 2009), [http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM\\_HelpersNeedHelpReport.pdf](http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM_HelpersNeedHelpReport.pdf).

<sup>8</sup> Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, a June 2010 Survey*, GuideStar USA, at 6 (June 2010). A few months later, two-thirds of the 20% anticipating further budget cuts in 2011 also anticipated further program cuts in 2011. *November 2010 Fundraising Survey*, The Nonprofit Research Collaborative, at 11 (Nov. 2010).

<sup>9</sup> 2010 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 2 (2010) [hereinafter "NFF Summary 2010"], 2011 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 (2010) [hereinafter "NFF Summary 2011"], 2012 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 (2012) [hereinafter "NFF Summary 2012"], all available at <http://nonprofitfinancefund.org/state-of-the-sector-surveys>.

<sup>10</sup> 2012 *State of the Sector Survey Results, NFF Survey Analyzer*, Nonprofit Finance Fund, at 9 (2012), available at <http://survey.nonprofitfinancefund.org/#respondents,demand,actions,gov,engagement,finhealth/0:Y> [hereinafter "NFF Survey Analyzer 2012"].

<sup>11</sup> In the Bridgespan study, 67% of organizations with revenues under \$1 million and 39 percent of those in the \$1-10 million range reported scaling back certain programs to enhance other programs. Bridgespan 2009, *supra* note 3.

populations, were able to maintain or expand core or critical services as the recession's impact spread in 2009, thereby reaching more people in need.<sup>12</sup> More recently, 55% of Nonprofit Finance Fund survey respondents added or expanded programs or services during 2010 to respond to perceived client needs in the new normal, as did 55% during 2011.<sup>13</sup> This included 56% of New York organizations.<sup>14</sup>

In choosing which programs to eliminate, scale back, continue or expand, nonprofit leaders often confronted hard choices that implicate the organization's mission and corporate purposes.

## **B. Legal Strategies Related to Mission**

---

### ***1. 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 in furtherance of the organization's mission.<sup>15</sup> Under the duty of care, directors and officers are obligated to oversee the way assets are managed, ensuring that funds are prudently invested and spent, not wasted.<sup>16</sup> Under the duty of obedience, directors, and officers are obligated to ensure that the organization complies with applicable laws and governance policies and that it uses its charitable assets consistent with the organization's mission.<sup>17</sup> The duty of loyalty requires directors and officers to act in good faith, in the interest of the corporation, and to manage conflicts if the organization's fiscal or programmatic interests intersect with their own or their family's interest.<sup>18</sup>

Traditionally, the oversight role of the board of directors in all but the smallest nonprofit organizations is carried out through board and board committee

---

<sup>12</sup> For the period September 2008-March 2009, 73% percent of respondents reported maintaining or increasing the number of clients served, compared to the same period one year earlier; 92 percent of those serving economically disadvantaged populations reported this result. The exception is arts groups, which had more difficulty. Salamon 2009, *supra* note 4, at 12.

<sup>13</sup> NFF Summary 2011, *supra* note 9, at 4; NFF Summary 2012, *supra* note 9, at 4.

<sup>14</sup> NFF Survey Analyzer 2012, *supra* note 10, at 9.

<sup>15</sup> *Right from the Start: Responsibilities of Directors of Not-for-Profit Corporations*, N.Y. State Office of the Attorney General, [www.charitiesnys.com/pdfs/Right%20From%20the%20Start%20Final.pdf](http://www.charitiesnys.com/pdfs/Right%20From%20the%20Start%20Final.pdf) [hereinafter "Right from the Start"].

<sup>16</sup> N.Y. Not-for-Profit Corp. Law §§ 715, 717.

<sup>17</sup> *Right From the Start*, *supra* note 15, at 7-8.

<sup>18</sup> N.Y. Not-for-Profit Corp. Law § 717.

processes that allow for periodic supervision, and day to day management of the organization is left to staff. The economic downturn has encouraged a different paradigm, with more active involvement by attentive directors and a reassessment by boards of fundamental questions that are less frequently revisited in times of economic stability. When resources are scarce, watching the dollars and responding appropriately can be the difference between financial stability and financial distress. Operationally, it is imperative for directors to work with management staff to monitor the organization's fiscal health on a sufficiently regular basis to manage fiscal risk. Because effective governance by nonprofit boards is a foundation upon which effective organizations are built, heightened oversight by directors, with attention to mission, is indispensable for organizations to remain sustainable through such a recession.

To carry out their legal duties, it is appropriate for boards of directors to behave differently when financial circumstances are more severe, unpredictable or rapidly changing compared to more certain economic times. While the specific steps that directors and officers take should comport with their particular organization's financial situation, certain activities are likely to improve oversight. This includes, for example, reviewing financial statements more often, requesting additional financial documents, budgeting conservatively, making budget modifications as needed, and asking more questions than might be posed when finances are more stable. This also entails reviewing income, expenses and budget variances, by program or department as well as overall, in order to understand how each program is faring, individually and as part of the organization as a whole. Careful attention to volatile financial circumstances can inform decisions about what bills to pay, what funds to seek, and whether to seek loans or make other changes to manage cash flow. Many organizations have weathered economic uncertainty better because their board leadership was actively involved in financial planning, for example, by doing scenario planning, encouraging cash-strapped organizations to explore access to capital or credit, and supporting efforts to prepare multi-year budgets in addition to careful budgeting for the current fiscal year.

In addition, it may be prudent for board members to meet more often in difficult economic times. Under the NPCL, the bylaws may provide for a minimum or a set number of regular board meetings each year, in addition to an annual meeting. However, the statute does not preclude a board from holding additional meetings, creating special oversight committees, or increasing the frequency with

which key committees meet. The board may choose to delegate more detailed fiscal monitoring to a finance or other committee that reports back to the full board.<sup>19</sup> Because the board acts by collective action, more frequent meetings are a valuable opportunity for the organization's leadership to exchange views and information and reach consensus more readily on decisions that further the organization's financial health and charitable mission.

Regardless of how stable an organization was when the recession began, the economic downturn affected most organizations' balance sheets, cash flow projections, and income and expense statements in unexpected ways. With lawyers to assist them in fine-tuning their 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.<sup>20</sup>

*Example:<sup>21</sup> A nonprofit organization that provides temporary housing and job readiness services to homeless adults is contemplating the purchase of an office condominium one block from its most active housing project, offered for sale at 25% less than a year ago because of market forces. The prior year the board of directors declined to bid on the property, but the board president calls a special meeting of the board to reevaluate the organization's options because the additional space would allow the organization to expand its job training program. Legal counsel explains the process for purchasing property and reminds directors of their fiduciary duties. When directors review updated quarterly financials and see that cash reserves have eroded from seven to four months of operating expenses during a half year period, they collectively decide that the organization should not pursue a real estate deal at this time. They further request that the finance committee receive monthly rather than quarterly financial reports for the remainder of the year. With the benefit of more frequent board review and input,*

---

<sup>19</sup> N.Y. Not-for-Profit Corp. Law § 712.

<sup>20</sup> Sound financial management not only protects the organization from incurring unbearable debt, but also minimizes the directors' and officers' risk of individual liability. As a general matter in New York, uncompensated board members are not personally liable for a not-for-profit corporation's debts. There are exceptions, including violation of the director's fiduciary duties (N.Y. Not-for-Profit Corp. Law § 717) and failure to meet payroll or deposit employment tax withholdings (N.Y. Lab. Law § 198-a). If the organization cannot meet payroll or pay other expenses such as rent, utilities and vendors in a timely manner, it is a sign of possible financial distress, requiring more extreme action to solve the financial woes and prevent legal liability.

<sup>21</sup> Case examples in this paper are fictional. They are based on Lawyers Alliance for New York's experience advising nonprofit clients on legal matters.

*the board and management modify the operating budget, so income and expenses are better aligned and the organization can afford to lease nearby smaller space in order to serve more clients.*

## **2. Reaffirm Mission and Maintain Core Programs That Further the Mission**

The charitable mission emanates from the Certificate of Incorporation. The Certificate of Incorporation must state “the purpose or purposes for which [the corporation] is formed.”<sup>22</sup> The corporate purposes typically will relate to serving certain types of clients (e.g., assisting senior citizens), providing certain types of services (e.g., operating a soup kitchen), and/or benefitting a designated cause (e.g., reducing the causes of poverty or preserving the environment). The corporate purposes clause also may prescribe a geographic territory where the organization’s work will be conducted (e.g., the metropolitan New York area). In New York, the organization must file its Certificate of Incorporation with the Secretary of State.<sup>23</sup> Although the charitable mission may be stated in the corporate bylaws, a separate “mission statement,” or other corporate documents, the Certificate of Incorporation will control if there is any ambiguity about the organization’s authorized purposes or powers.

Many organizations choose to adopt a “mission statement” that explains why the organization exists and what it seeks to accomplish. This action is legally permissible so long as the mission statement is consistent with the corporate purposes in the certificate of incorporation as well as the purposes and activities stated to IRS in the organization’s federal tax exemption application and other IRS filings. A mission statement is not a legal document, and it typically evolves over time to reflect the priorities and plans of the organization. Commonly, an organization will highlight the mission statement in its marketing materials. As the New York Attorney General’s Office has noted, one of the benefits of a mission statement is that it helps “to ensure that everyone involved with the organization, directors and officers, employees, volunteers, fundraising professionals, and other professionals, is fully familiar with and understands the mission.”<sup>24</sup> An organization might use different versions of its mission statement, such as a short and long statement, depending on the occasion and audience.

---

<sup>22</sup> N.Y. Not-for-Profit Corp. Law, Art 2, § 402.

<sup>23</sup> N.Y. Not-for-Profit Corp. Law § 104.

<sup>24</sup> Right From the Start, *supra* note 15, at 7-8.

As the recession became an ongoing challenge for nonprofits that had successfully weathered its early months through cost-cutting and cost controls, many boards of directors turned to the purposes contained in their organizing documents and the mission statements that their organizations had embraced prior to the downturn to seek guidance in planning for a prolonged period of retrenchment. Difficult decisions about which programs to maintain as government and contributed support diminished, especially in the face of soaring demand for human services, were better informed through an assessment of how core those programs were to the organization's mission. For organizations "sticking to their knitting" in this fashion, their decisions to eliminate programs and services less essential to their mission were accepted more easily staff and external stakeholders.

Yet, one common and continuing dilemma is how to proceed when some programs are better funded than others, particularly if the under-funded programs are central to the organization's mission. Nonprofit managers are better equipped to make fiscal and fundraising choices once they have completed a program assessment. This analysis is an opportunity to review the organization's different programs to ensure that they fit well with the charitable mission, serve community needs, and can be delivered in a cost-effective way.<sup>25</sup> 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 along with sufficiently funded core activities.

At the same time, scaling back on non-core programs can free up dollars and staff for more mission-critical services. In an economic downturn, it is hard to justify continuing an under-funded program ancillary to the organization's mission, and hence the organization should consider phasing out or transferring such programs. Moreover, even well-funded non-core programs can be a diversion. An organization facing financial constraints will likely need to contract such programs and services following the program assessment to get through protracted periods of insufficient funding. Making these determinations requires a look at the corporate purposes as well as the finances.

---

<sup>25</sup> As observed by one technical assistance expert, "An ironic twist in these times is that some of the programs most attractive to your funders may be those that are least aligned with your mission or with what the community thinks is important." Denise Williams, *Responsible Retrenchment: Advice to Nonprofits*, in *It May be Hard Times: How to Navigate a Financial Downturn*, The Nonprofit Quarterly, 13 (2008), available at [www.bridgespan.org/LearningCenter/?id=2786](http://www.bridgespan.org/LearningCenter/?id=2786).



*Example: A nonprofit organization whose purpose is to promote nutrition and exercise among teenagers in the city's public high schools added staff prior to the recession to prepare educational materials for families about global warming. When funding did not increase at the same rate as staff salaries, it used an increasing percentage of general operating funds for 2009-2010 to support the global warming project and left two vacancies for the healthy children's project unfilled. When planning its budget for 2010-2011, the Board reexamined this staffing and cost structure and refocused current staff and a new hire on its nutrition and exercise activities. Legal counsel helped it to review and negotiate its final deliverables under a modest grant for environmental trainings, so that it could complete these trainings within a shorter timeframe and free up staff for its core projects.*

### **3. Amend Corporate Purposes**

For some organizations, the recession has created opportunities to serve a different client constituency, pursue programs shed by other nonprofits, acquire facilities in a more favorable real estate market, or otherwise switch direction. Beyond the important issues of fiscal prudence, those choices can also raise legal issues. When a not-for-profit corporation changes its programmatic focus, it must go through the legal process of amending its Certificate of Incorporation if the document does not appropriately encompass the new purposes, powers, and activities. For example, an expanded organization may be absorbing the programs of a dissolving group and in turn increase its geographic reach beyond that specified in the certificate of incorporation (e.g., from a few neighborhoods in Queens to the entire borough or citywide). Alternatively, in response to a shrinking budget, an organization may consider dropping or transferring certain programs while adding others that are more fundable.

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.<sup>26</sup> As a matter of convention, the amendment application should include an affidavit from a corporate officer declaring that the organization will use pre-amendment assets only for pre-amendment purposes and powers and future assets for the purposes and powers set forth in the amended certificate of incorporation. This affidavit usually is necessary to satisfy the New York Attorney General's office

---

<sup>26</sup> N.Y. Not-for-Profit Corp. Law, Art. 8.



that the organization will not unduly divert assets obtained for its prior purposes (e.g., childcare) to different purposes (e.g., elder care).<sup>27</sup>

#### **4. Clarify Corporate Bylaws**

Another foundational document, the corporation's bylaws, sets forth the procedures by which the directors, officers (and members, if any) are to follow when making significant changes, such as an amendment of corporate purposes.<sup>28</sup> Having clear and functional corporate bylaws makes it easier for the organization's leadership to make significant decisions or changes because there is a process in place (including notice, quorum, and voting requirements) for corporate action. Many decisions prompted by economic challenges, such as cutting or adding programs, budgeting, budget modifications, and borrowing money, are appropriate for and sometimes require board review and approval. For example, a lender may require verification that the board of directors is duly constituted, under the Certificate of Incorporation and bylaws, and has authorized a loan, before the lender makes the loan. Following sound bylaws helps the organization to have an active board of directors and complete transactions successfully. It is easier to amend the bylaws of a New York not-for-profit corporation than the Certificate of Incorporation because usually vote of the board of directors (and, if members, a membership vote) is sufficient for a bylaws amendment, not the additional steps of court review or Secretary of State's office filing.<sup>29</sup> With quality legal help, nonprofit organizations are able to ensure that their organizational documents are in order and sufficient to support their charitable mission.

*Example: A nonprofit organization that had focused its efforts on providing meals and temporary housing to homeless families in Queens has seen a rise in requests for help from families experiencing prolonged unemployment for the first time due to the recession. It seeks to add a series of citywide educational programs, in conjunction with job training organizations, to try to reduce the barriers to employment. Legal counsel examines the organization's certificate of incorporation and alerts the organization that, although such educational programs fall within the corporate purposes of serving the multiple human needs*

---

<sup>27</sup> *Procedures for Forming and Changing Not-for-Profit Corporations*, N.Y. State Dept. of Law, Charities Bureau, 6-7 (revised 2011), [www.charitiesnys.com/pdfs/how\\_to\\_incorporate.pdf](http://www.charitiesnys.com/pdfs/how_to_incorporate.pdf).

<sup>28</sup> By-laws are "the code or codes of rules adopted for the regulation or management of the affairs of the corporation irrespective of the name or names by which such rules are designated." N.Y. Not-for-Profit Corp. Law § 102(a)(2).

<sup>29</sup> N.Y. Not-for-Profit Corp. Law §§ 602, 708.

*of homeless families, the certificate needs to be amended because it limits the organization's geographic reach to Queens and Long Island.*

## *Part IV*

### **People**

#### **A. Personnel Are the Greatest Asset and Greatest Expense**

---

Only people can transform mission into results. There are multiple stakeholders in the lifecycle of a nonprofit organization, both internal parties such as directors, staff and volunteers, and external parties such as regulators, funders and beneficiaries. Managing all of them effectively is a challenge for nonprofit leaders, even in strong economic times. The economic downturn has elevated the significance of proper personnel management because staff salaries and benefits are a major, and often the largest, expense for the overwhelming majority of nonprofit organizations. When finances are tight and an organization exhausts non-personnel cuts, there is little else to cut besides staff positions, yet personnel are usually necessary for programming.

The economic downturn has caused almost all 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 as nonprofit organizations sought to retain current staff, but by 2010 layoffs became inevitable for more organizations. Other common steps include keeping vacancies unfilled, furloughs, job sharing, reduced staff hours, reduced benefits, and reduced professional development.<sup>1</sup> In an April 2010 Johns Hopkins University survey, 31% of respondents reported reducing their workforce during the prior six months, 23% reported net gains, and 46% reported no net change. Of those with no net change, nearly 40% indicated that they lacked sufficient staff to deliver their programs and services, and another 4% indicated they sustained programs only

---

<sup>1</sup> William Foster, Gail Perreault, & Sarah Sable, *Managing in Tough Times: Nonprofit Leaders Survey Update*, The Bridgespan Group (June 29, 2009), <http://www.bridgespan.org/Publications-and-Tools/Strategy-Development/Managing-in-Tough-Times/Managing-in-Tough-Times-May-2009-Nonprofit-Leaders.aspx> [hereinafter "Bridgespan 2009"]; Lester M. Salamon et al., *Impact of the 2007-09 Economic Recession on Nonprofit Organizations*, John Hopkins University Center for Civil Society Studies, Communique No. 14, at 7 (June 2009); *2010 State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 (2010), <http://nonprofitfinancefund.org/files/images/2010SurveyBrochure.pdf> [hereinafter "NFF Summary 2010"]; *2011 State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 and Chart 9 (2011), [http://nonprofitfinancefund.org/files/surveybrochure\\_032311.pdf](http://nonprofitfinancefund.org/files/surveybrochure_032311.pdf) [hereinafter "NFF Summary 2011"].

because of the assistance of new volunteers.<sup>2</sup> In comparable GuideStar surveys, the percentage of nonprofit organizations reporting layoffs increased from 28% in 2009 to 38% in 2010, putting layoffs ahead of hiring freezes but not as popular as salary freezes.<sup>3</sup> The New York City's human services industry experienced a larger percentage of layoffs than these national numbers.<sup>4</sup>

Surveys looking ahead to 2011 suggested some cautious optimism, but also continued strains and uncertainty. In one composite national report, among the 20% of nonprofit organizations anticipating budget cuts for 2011, 59% expected to cut or freeze staff salaries or benefits, and 49% planned layoffs or hiring freezes.<sup>5</sup> The Nonprofit Finance Fund's spring 2011 survey showed that 35% of respondents retained all current personnel in 2010, while 39% expected to do so in 2011. At the same time, 46% made replacement hires and 44% hired staff for new positions in 2010, and 34% had plans to do each type of hiring in 2011. While 34% reported freezing or reducing salaries in 2010, 18% planned to do so in 2011; 44% gave raises in 2010 and 34% planned to do so in 2011; and others were less certain of their personnel plans for the future.<sup>6</sup>

By 2012, economic stagnation had set in for much of the nonprofit sector, including in New York City, with most nonprofit managers and their staff having personally experienced the challenges of trying to meet demand despite uncertain or reduced staffing. Increasingly common are anecdotes from organizations that required existing staff to accept additional duties, had difficulty retaining or finding quality staff to serve clients when the compensation has been reduced or

---

<sup>2</sup> Lester M. Salamon, Stephanie L. Geller & Kasey L. Mengel, *Recession Pressures on Nonprofit Jobs*, The John Hopkins Listening Post Project, at 3 (2010) [hereinafter "Salamon 2010"].

<sup>3</sup> Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, an October 2009 Survey*, GuideStar, at 7 (Oct. 2009); Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector, a June 2010 Survey*, GuideStar USA, at 6 (June 2010).

<sup>4</sup> For example, 53% of respondents to a New York City survey reported layoffs between 2008 and 2009. Smaller organizations were less likely than mid-size organizations to pursue a layoff; 39% of organizations with operating budgets under \$1 million reported layoffs compared to 55% of those with \$1-10 million budgets. Jack Krauskopf et al., *The Helpers Need Help: New York City's Nonprofit Human Service Organizations Persevering in Uncertain Times*, Baruch College, at 18-22 (Summer 2009), [http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM\\_HelpersNeedHelpReport.pdf](http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM_HelpersNeedHelpReport.pdf).

<sup>5</sup> *November 2010 Fundraising Survey*, The Nonprofit Research Collaborative, at 18 (Nov. 2010), available at <http://www.urban.org/publications/1001467.html>.

<sup>6</sup> NFF Summary 2011, *supra* note 1, at 4 & Chart 9.

frozen, and experienced low staff morale from work burdens.<sup>7</sup> In one composite national report, 7% of nonprofit organizations planned budget-related layoffs and another 15% anticipated a hiring freeze in 2012, for a total of 22% taking steps to reduce staff levels; another 22% anticipated hiring, including 4% following a prior hiring freeze.<sup>8</sup> The Nonprofit Finance Fund's 2012 survey showed that 39% of respondents overall (34% for New York) retained all current personnel in 2011, while 45% (35% for New York) expected to do so in 2012. At the same time, 46% (56% in New York) made replacement hires and 50% (53% in New York) hired for new positions, while 40% (45% in New York) planned to hire replacements in 2012 and 35% (nationally and in New York) planned to fill new positions. To save money in 2011, 21% (24% in New York) reported freezing or reducing salaries and 10% (12% in New York) cut staff hours through short weeks or furloughs, but fewer planned to make such changes in 2012.<sup>9</sup> During 2011, staff changes and cuts in positions and salaries were more common among human services organizations than non-human services organizations.<sup>10</sup>

At the same time, the nonprofit sector's economic role as an employer remains substantial.<sup>11</sup> Recognizing that the nonprofit sector nationwide employs millions of individuals as employees and millions more as volunteers, some commentators have suggested that "[r]eversing the nonprofit plunge is a matter of jobs" and

<sup>7</sup> 2012 *State of the Sector Survey*, Nonprofit Finance Fund 4, at 3-4 (2012), [http://nonprofitfinancefund.org/files/docs/2012/2012survey\\_brochure.pdf](http://nonprofitfinancefund.org/files/docs/2012/2012survey_brochure.pdf) [hereinafter "NFF Summary 2012"].

<sup>8</sup> *Late Fall 2011 Nonprofit Fundraising Study*, The Nonprofit Research Collaborative, at 14 (Dec. 2011), available at <http://www.guidestar.org/rxg/news/publications/nonprofits-and-economy-late-fall-2011.aspx>.

<sup>9</sup> NFF Summary 2012, *supra* note 7, at 3-4; 2012 *State of the Sector Survey Results*, NFF Survey Analyzer, New York Filter, Nonprofit Finance Fund, at 9 (2012), available at <http://survey.nonprofitfinancefund.org/#respondents,demand,actions,gov,engagement,finhealth> [hereinafter NFF Survey Analyzer 2012].

<sup>10</sup> NFF Summary 2012, *supra* note 7, at 4.

<sup>11</sup> Lester M. Salamon, S. Wojciech Sokolowski, & Sephanie L. Geller, *Holding the Fort: Nonprofit Employment During a Decade of Turmoil*, John Hopkins University Center for Civil Society Studies (January 2012), available at [http://ccss.jhu.edu/wp-content/uploads/downloads/2012/01/NED\\_National\\_2012.pdf](http://ccss.jhu.edu/wp-content/uploads/downloads/2012/01/NED_National_2012.pdf). (report shows that the U.S. nonprofit sector posted an average annual growth rate of 2.1 percent from 2000 to 2010 including two recessions).

“putting more Americans to work in the nonprofit sector.”<sup>12</sup> In New York City, health, human services and cultural nonprofit organizations employ close to 500,000 workers, 15% of the total, making nonprofit organizations the largest private sector employer, surpassed only by the government sector.<sup>13</sup> The average number of employees per organization can range from 20 for smaller social services organizations to more than 2,000 workers at hospitals.<sup>14</sup>

Labor and employment law issues can arise as employers try to trim and moderate workforce costs. The board of directors’ fiduciary responsibility includes ensuring that the organization has proper personnel management procedures in place to effectuate the necessary changes.<sup>15</sup> Organizations should seek to minimize the organization’s potential liability to disgruntled current or former employees. Lawyers Alliance has seen its own employment law practice increase dramatically in recent years, as clients have sought legal guidance on a range of personnel cost-cutting measures. This includes steps that seem but are not always simple, such as staff layoffs and reducing compensation or work hours, as well as more complicated strategies such as furloughs and the use of non-traditional workers. The trend of increased attention to employment law questions is hardly unique to the nonprofit sector; it parallels a spike in labor and employment law needs by for-profit businesses during the recession.<sup>16</sup>

Staff changes can be unsettling to those who remain as well as those who depart. With effective and legally compliant personnel practices, resource-constrained

---

<sup>12</sup> John Bridgeland & Bruce Reed, *The Quiet Crises: The Impact of the Economic Downturn on the Nonprofit Sector* Civic, Enterprises & Democratic Leadership Council (Mar. 2009). Urging policy support for nonprofit jobs, this paper recognizes that the nonprofit sector employed more than 11 million workers and engaged more than 4.7 million full-time volunteers as the recession began. *Id.* at 3-5.

<sup>13</sup> Lesley Rosenthal, *Cuomo Can Strengthen New York Through its Nonprofits*, *Crains New York Business* (Nov. 14, 2010); N.Y. State Office of the Attorney General Press Release, *Schneiderman Announces Members of A.G.’s Leadership Committee for Nonprofit Revitalization* (June 27, 2011).

<sup>14</sup> *The Economic Situation of New York City’s Health and Human Services and Cultural Nonprofit Organizations*, Fiscal Policy Institute, at 4 (Apr. 7, 2009).

<sup>15</sup> *Internal Controls and Financial Accountability for Not-for-Profit Boards*, N.Y. State Office of the Attorney General, Charities Bureau, at 2, 3, <http://www.charitiesnys.com/pdfs/Internal%20Controls%20-%20Final%20-%20Small%20Type.pdf>.

<sup>16</sup> Joyce Gannon, *For Employment and Labor Lawyers, the Economic Downturn Means More Work*, *Pittsburg Post-Gazette* (Dec. 27, 2010 & July 3, 2012), <http://www.post-gazette.com/pg/10361/1113040-499.stm#ixzz19MEQ8noL>.

organizations are better positioned to preserve programs, preserve staff positions, and engage workers who are committed to providing quality services to the extent resources allow.

## **B. Legal Considerations for Staff Reductions Through Layoffs**

---

Working for mission-driven organizations, it is naturally difficult for nonprofit managers to reduce staff when demand for the organization's services is so high. During difficult economic times, job preservation and program preservation are intertwined because staff often are essential for the organization to serve individuals, families and communities in need. Also tugging at some nonprofit managers is their principled world view that those who work for the nonprofit sector are already making personal financial sacrifices, an orientation that is at odds with the deliberate displacement of employees. As a result, many organizations see layoffs as a last resort. Nevertheless, staff reductions are often an unavoidable consequence of a weakened economy, prompting legal concerns.

### ***1. Careful Planning***

Organizations that carefully plan a layoff, also known as a reduction in force or RIF, can minimize potential emotional, operational, and legal problems associated with terminating employees. By taking time to show compassion toward affected workers, sticking to objective business criteria, and considering the impact of a RIF on remaining workers, organizations are better able to ameliorate some of the ill will created by an unpleasant situation. Nevertheless, the potential legal risks of a RIF can be significant.

Part of the value of legal advice is to help organizations decide whether or not a layoff is the right choice. The financial benefits of a layoff include reduced salary, benefits, and other personnel expenses, along with a possible opportunity to hire another employee at lower cost. There are potential direct financial costs of a layoff, such as severance, paid time off accruals, pension costs, increased unemployment insurance taxes, and potential litigation if layoff is challenged. There are indirect costs of lowered morale and decreased productivity associated with a staff layoff. Because many nonprofit organizations are already lean in staffing and have invested in the training of current staff, many nonprofit managers

have deferred layoffs or chosen alternatives to layoffs after balancing the benefits and costs.<sup>17</sup>

*Example: An organization that serves older youth, including those aging out of foster care, loses major funding for its upcoming summer internship program, creating a budget deficit. Management contemplates whether to suspend the program and reassign or layoff any current staff. After consulting with legal counsel and examining its staff composition and expense projections, management recommends to the board of directors that several staff positions be eliminated early in the fiscal year and that the programs associated with those positions end. With these changes, other staff positions are preserved and the organization continues to operate without a deficit through its fiscal year.*

## **2. Termination Decisions**

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 modify an at-will employee’s work hours, change his or her job status, or terminate the at-will employee without cause. Over the past decade, employees who believe they have been wrongfully terminated have sought to get around the at-will doctrine by pointing to written and oral communications that arguably create a contractual right to their continued employment. Therefore, it is important for employers to review the language of their employment applications, hire letters, employee handbooks, and performance reviews to check that they do not unintentionally create a limitation on the employer’s right to terminate or change the job status of an at will employee.<sup>18</sup>

Anti-discrimination laws are also implicated in RIFs. Employers are prohibited from discriminating against employees on the basis of race, color, creed, religion, national origin, gender, family care or medical leave status, military status, or any other protected basis. Federal, state and local discrimination laws extend to

---

<sup>17</sup> *Surviving the Downturn: Considerations Before Trimming Your Workforce*, Employment Practices Solutions (Feb. 2009), [www.epspros.com/KNOWLEDGECENTER/SurvivingtheDownturn209/tabid/471/Default.aspx](http://www.epspros.com/KNOWLEDGECENTER/SurvivingtheDownturn209/tabid/471/Default.aspx).

<sup>18</sup> Leonard D. Andrew & Richard S. Hobish, eds., *Employment Law Guide for Non-Profit Organization*, Pro Bono Partnership, Chapter II (2007), <http://www.probonopartner.org/PBPGuide/frame.htm> [hereinafter “PBP 2007”]. See also *Rooney v. Tyson*, 91 N.Y.2d 685 (N.Y. 1998).



virtually every aspect of the employment relationship, including reassignments, job classification, leave time and termination. In addition, the employer is required to make reasonable accommodations due to religious beliefs or disabilities. When making staff changes aimed to reduce costs, nonprofit organizations should take steps to maintain neutrality with respect to these protected classes.<sup>19</sup>

To reduce the risk of employment discrimination charges, organizations should have a sound business reason for selecting the number and identity of employees who will be terminated. The reason can be programmatic, for example, when the work can be done by a part-time rather than full-time worker, a funding contract ends, or a program is being eliminated as part of shifting priorities. Alternatively, the reason can be performance-based, for example, when the employee has a record of poor quality work. Performance history should be documented. The employer should determine appropriate layoff selection criteria, trying to be as objective as possible. Skills, experience, attendance record, performance, seniority, terms of employment agreements, and necessity of job duties are examples of criteria that might be included. Once layoff selections are made, a contemporaneous document should support the decisions.<sup>20</sup>

It is important for an organization to have an attorney review RIF documents and procedures because the legal issues are complex. Legal counsel can review applicable personnel policies, review the organization's plans for paying salary and benefits to terminated workers, suggest steps that the organization might take to ensure that the RIF does not have a "disparate impact" on members of a protected class, and prepare any legally required termination notices. Moreover, legal counsel can provide guidance on the pros and cons of offering additional severance in exchange for a "release" in which the employee agrees not to challenge the termination. If any discrimination charges or employment litigation

---

<sup>19</sup> Potentially applicable anti-discrimination statutes include, without limitation, Title VII of the Civil Rights Act, Equal Pay Act, Older Workers Benefit Protection Act, and Americans with Disabilities Act.

<sup>20</sup> Wayne F. Cascio, *Employment Downsizing and its Alternatives: Strategies for Long-Term Success*, SHRM Foundation, at 7-8 (2009), <http://www.shrm.org/about/foundation/products/documents/downsizing%20epg-%20final.pdf> [hereinafter "Cascio"].

are filed or threatened, the organization should be represented by legal counsel.<sup>21</sup>

In the event of a discrimination charge or other legal challenge, the employer will be better positioned to show that a termination decision was not related to an individual's protected class if the employer can show that the decision was based on economic realities and applied in the same way to other similarly situated employees. Special worker protection statutes may limit the employer's ability to terminate those on leave pursuant to the Family Medical Leave Act<sup>22</sup>, military deployment<sup>23</sup> or state leave laws. Certain categories of employees may have a legal right to job reinstatement at the end of their leave unless the job would have been eliminated had the employee not been on leave. Depending on the facts, legal counsel may recommend waiting until the employee returns from leave to reevaluate his or her performance.

*Example: An organization that provides child care for children under five years of age at two locations determines that it must close one of its sites because of insufficient funding and seeks legal advice for the reduction in force. The personnel policies and hire letters are explicit that all staff members are at-will employees. Eight of the ten employees are over 40 and one is disabled. With legal guidance, the organization terminates all but one of the employees. The tenth employee, with exceptional music skills and a strong performance record, is asked to work at a different child care location that recently lost the staff member running its arts and music program and accepts this reassignment. The organization documents the business reason for the layoffs, including why it selected one site instead of the other, and offers six days of severance to staff members who sign a release. No claims are brought against the organization by terminated workers.*

---

<sup>21</sup> If any discrimination charges or employment litigation are filed or threatened, the organization should be represented by legal counsel. The Equal Employment Opportunity Commission ("EEOC") is responsible for enforcing the federal anti-discrimination employment statutes, including the Civil Rights Act of 1964 and the Americans with Disabilities Act of 1990. The failure to file any charge with the EEOC arguably is an absolute jurisdictional bar to the filing of a federal court action. New York State and New York City have laws that empower the New York State Division on Human Rights ("SDHR") and New York City Commission on Human Rights ("CCHR"), respectively, to prevent employment discrimination within the state and city by employers with four or more employees. See PBP 2007, *supra* note 18, Chapter XIII.

<sup>22</sup> 29 U.S.C. § 2601 (1993) *et seq.*

<sup>23</sup> The Uniform Services and Employment Rights Act of 1994, 38 U.S.C. § 4301 (1996) *et seq.*; N.Y. Mil. Law. § 317.

### **3. Advance Notice and Payments**

In layoffs involving a significant number of employees, advance notice may be required under federal and/or state WARN Acts, parlance for versions of the Worker Adjustment and Retraining Notification Act.<sup>24</sup> The statutes contain elaborate rules about which employers are covered, what layoffs require notice, who must receive the notice, the content of the notice, and exceptions to the notice requirements. Unless the employer falls within a carefully defined exception, such as unforeseeable business circumstances or a faltering company, possible penalties for noncompliance include back pay and benefits for the full notice period and legal fees.<sup>25</sup>

Employers of 20 or more employees must provide terminated employees with notice of the availability of continued medical coverage at group rates under the Consolidated Omnibus Budget Reconciliation Act ("COBRA").<sup>26</sup> This statute allows qualified workers and their families who lose their health benefits to choose to pay the full premium amount, at group rates, and remain in the group plan for limited periods of time following certain circumstances, including job loss, reduction in work hours, job transition, death, divorce or other life events. The American Recovery and Reinvestment Act of 2009 ("ARRA") reduced the amount of COBRA premiums to be paid by those who were involuntarily terminated between September 1, 2008 and May 31, 2010, making it easier for qualifying individuals to pay for continued health insurance but imposing additional paperwork and procedures on their previous employers.<sup>27</sup>

New York law requires that employers pay departing employees earning \$900 or less a week not only accrued salary but also for accrued, unused vacation time,

---

<sup>24</sup> The federal WARN Act, which became effective on February 4, 1989, is codified at 29 U.S.C. §§ 2101- 2109, with WARN Act Regulations at 20 C.F.R. §§ 639.1- 639.10. See also U.S. Department of Labor, <http://www.dol.gov/compliance/laws/comp-warn.htm>. The New York WARN Act, effective on February 1, 2009, is codified at N.Y. Lab. Law § 860. The New York WARN Act is more expansive than the federal WARN Act so New York employers who were already covered under the federal WARN Act, as well as smaller employers, now need to comply with these New York requirements.

<sup>25</sup> Cascio, *supra* note 20, at 8.

<sup>26</sup> Consolidated Omnibus Budget Reconciliation Act ("COBRA"), 29 U.S.C. § 1151 (1985).

<sup>27</sup> American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5 (2009); see also U.S. Department of Labor, *Fact Sheet: COBRA Premium Reduction*, Apr. 26, 2010, [www.dol.gov/ebsa/pdf/fsCOBRAPremiumReduction.pdf](http://www.dol.gov/ebsa/pdf/fsCOBRAPremiumReduction.pdf). Some states, including New York, have similar laws about the extension of benefits by employers with fewer than 20 employees.

unless there is a written vacation forfeit policy. This payment requirement does not apply to certain employees earning more than \$900 a week.<sup>28</sup> However, the organization may have resignation, termination or other personnel policies or employment agreements that set forth additional obligations, such as the payment of additional salary or insurance premium coverage depending on length of service.

Legal counsel can help employers evaluate the pros and cons of paying salary or benefits beyond the required amounts. Severance is only feasible if the organization has funds to pay for it. While optional, severance payments can benefit the organization by creating goodwill among departing staff with whom the organization may later interact, and current and future staff who seek a supportive work environment. In order to prevent lawsuits, in recent years an increasing number of employers have required employees to sign a release in exchange for severance. This helps to prevent later employment law claims related to terminations.<sup>29</sup> If the employee being terminated is over 40, the release must contain special language to be valid under the Age Discrimination in Employment Act ("ADEA") and the Older Workers Benefit Protection Act ("OWBPA").<sup>30</sup>

#### **4. 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

---

<sup>28</sup> N.Y. Lab. Law §§ 191, and 198-c provide that salary payments are due not later than the regular pay day for the pay period during which the termination occurred, and that it is a misdemeanor for employer not to pay within 30 days of when payment is due. Whether the employer is obligated to pay for unused leave time may depend upon the terms of the personnel policies. A New York court held that an agreement to furnish benefits or wage supplements, such as vacation, can specify that employees will forfeit accrued benefits under certain conditions; to be valid, the employer must have notified employees, in writing, of the conditions that nullify the benefit. *Glenville Gage Co., Inc. v. Indus. Bd. of Appeals of the State of New York, Dep't of Labor*, 70 AD2d 283 (N.Y. App. Div. 1979), *aff'd*, 417 N.E.2d 525 (N.Y. 1980). See also U.S. Department of Labor, *Wages and Hours Frequently Asked Questions*, <http://www.labor.ny.gov/workerprotection/laborstandards/faq.shtml#11>.

<sup>29</sup> In 2008, 93% of United States companies required employees to sign a release in exchange for severance, up from 76% in 2001. Cascio, *supra* note 20, at 8. While the overall percentage may not be as high in the nonprofit sector, releases are advisable for all employers that pay additional severance.

<sup>30</sup> Age Discrimination in Employment Act of 1967, Pub. L. No. 90-202 (1967); Older Workers Benefit Protection Act, Pub. L. No. 101-433. OWBPA is codified as an amendment to ADEA at 29 U.S.C.A. § 621 *et seq* (1990).

who have been laid off. The Federal Fair Labor Standards Act ("FLSA")<sup>31</sup> and New York State's wage and hour law<sup>32</sup> set forth standards for employers to pay minimum wages and overtime pay. Certain categories of employees are exempt from these requirements, including those in "executive," "professional," and "administrative" positions. There is a detailed body of law controlling whether a particular employee is "exempt" or "non-exempt," often necessitating an attorney to review the detailed job duties of a particular employee before rendering advice on an individual's status. Employees paid on an hourly basis generally are non-exempt, although salaried employees may also be non-exempt.<sup>33</sup> The statutes also provide that certain employees earning below a certain amount of weekly salary are non-exempt rather than exempt, regardless of their title or responsibilities.<sup>34</sup>

The most relevant consequence of being "exempt" is that employers are not required to pay overtime to exempt employees. Exempt employees receive a salary that is not dependent on the number of hours worked. However, the "non-exempt" employees must receive at least the minimum wage, and they are entitled to overtime pay if they work more than 40 hours during a workweek. While the federal and state laws do not allow private employers to use time off to compensate for overtime work, an employer may cap a non-exempt employee's workweek at 40 or fewer hours by requiring compensatory time off during the same workweek because employers are allowed to control the amount of time an employee works.

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 that should have been paid on such wages. For example, the New York State Department of Labor will charge the employer and help collect underpayments for a worker who has not received the minimum wage or overtime

---

<sup>31</sup> FLSA, as amended, 29 U.S.C.A. § 207 (2010).

<sup>32</sup> New York's wage and hour laws are contained in Articles 5 and 6 of the New York Labor Law as well as certain "minimum wage orders" available on the New York State Department of Labor website at [www.labor.state.ny.us](http://www.labor.state.ny.us).

<sup>33</sup> See PBP 2007, *supra* note 18, Part V.

<sup>34</sup> For example, FLSA requires executives to be paid at least \$455/week; New York law requires them to be paid at least \$543.75/week (on and after July 24, 2009, inclusive of room and board). See 29 C.F.R. § 541.101 (2004); 12 N.Y.C.R.R. 142-2.14(c)(e)(5) (2011).

pay once the worker files a claim with the department.<sup>35</sup> The department in turn may conduct an audit to investigate the exempt versus non-exempt classification of additional workers, requiring the organization to incur substantial time and expense responding to the audit and, if found liable, to make additional payments.

*Example: A community organization that provides mental health support to children and families coping with death, serious illness, or recent unemployment of a family member was struggling financially at the start of the recession, and reluctantly had begun to plan a layoff of a few of its workers. When it did not receive renewed funding from a principal funder of its crisis intervention program, it terminated one-third of its staff and instituted a hiring freeze. A few months later, it chose to offer a series of additional community meetings and support groups to help residents cope both with two tragic deaths in the community as well as recent job losses. When doing so, and with the assistance of legal counsel, the organization confirmed which existing staff members were and were not eligible for overtime for working longer hours, revised work schedules and caseloads accordingly, and paid required overtime but kept overtime hours minimal. Terminated and remaining staff members felt that they were treated professionally under difficult circumstances and, when the organization was in a financial position to lift the hiring freeze eighteen months later, it was able to recruit and hire qualified staff and properly classified new employees as exempt and non-exempt from the start of their employment.*

By carefully planning RIFs, organizations ideally are left with core programs that are consistent with their mission and meeting vital community needs. With the help of legal advice, there is less likelihood of claims of wrongful discharge, discrimination or unpaid salary and benefits. The organizations can move forward concentrating on their remaining programs with fewer expenses, albeit with a smaller workforce.

## **C. Strategies to Control Labor Costs by Means Other Than Staff Reductions**

### **1. Freeze or Reduce Pay**

One direct way to cut labor costs is to reduce pay or freeze pay and not fill

---

<sup>35</sup> The N.Y.S. D.O.L. website provides further details and model forms for compliance with the state wage and labor laws at [www.labor.ny.gov/workerprotection/laborstandards/workprot/lshmpg.shtm](http://www.labor.ny.gov/workerprotection/laborstandards/workprot/lshmpg.shtm).

jobs that become vacant through attrition. However, compensation remains an important psychological inducement for positive performance and affects workers' ability to meet personal and family financial obligations. For most nonprofit sector employees, who are already paid relatively low salaries, there is little or no room for salary reductions without a negative impact on their quality of life. Before implementing pay freezes or reductions, employers can try to create a work culture that encourages staff to recognize that reduced compensation may be a necessary part of a collective effort to preserve more jobs overall, share sacrifices, and weather the economic storm together. This can be a formidable challenge given that, historically, many employers and employees have viewed base pay as sacrosanct,<sup>36</sup> but in the new reality expectations are changing.

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. The employer should confirm that there are no contrary employment agreements and take care to ensure that the changes do not discriminate against a protected class. Any reductions in compensation must be prospective. Employers are required to pay employees the full amount of already earned salaries.<sup>37</sup> Minimum wage laws impose additional constraints. Wage reductions cannot result in amounts below minimum wage.<sup>38</sup> Moreover, reducing an exempt employee's salary below the statutory level for exemption (e.g., \$455/week for a professional employee under FLSA<sup>39</sup>) can convert that exempt employee into a non-exempt employee. In New York, employers also must comply with notice provisions of the state's Wage Theft Prevention Act if reducing compensation.<sup>40</sup>

If there is a prevailing union contract, legal counsel can help the parties to renegotiate cost-saving terms. Often the greatest challenge for employers of union and other contracted employees is to persuade workers to accept any reduced compensation, which workers may deem a concession, as part of a serious job preservation plan. The shorter the period of a pay reduction, the more acceptable it may be to affected workers.

---

<sup>36</sup> Cascio, *supra* note 20, at 14.

<sup>37</sup> N.Y. Lab. Law § 190.

<sup>38</sup> 29 C.F.R. § 541.100 (2004) *et seq.*

<sup>39</sup> 29 C.F.R. § 541.11 (2004).

<sup>40</sup> N.Y. Lab. Law § 195.



Beyond legal exposure, the negative impact of pay cuts or extended pay freezes is not to be underestimated. If previously productive workers are disillusioned or less motivated, they may be less productive, diminish the morale of co-workers or leave the organization, requiring additional expenditures to fill gaps in their or others' performance. The long-term effect of poor morale can be increased labor costs and/or reduced services.

*Example: An organization that provides free outdoor programs in public space implemented a two year salary freeze for all employees and eliminated employer paid transit checks as a cost savings measure. In doing so, staff members who had been with the organization for at least one year were consulted as to the general nature of the organization's budgeting dilemma and management's desire to spread the financial pain broadly but not deeply. They had an opportunity to provide input on which employee benefits were most important to them. By building a culture of respect, long-term valued employees stayed with the organization through the organization's most difficult financial period and, when funding subsequently permitted, received salary adjustments to reflect improved financial conditions.*

## **2. Reduce Work Hours and Implement Furloughs**

Another possibility is for employers to tie a reduction in compensation to a corresponding reduction in work. Among the most popular forms of reduced work hours are 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. Such steps may be more desirable for an organization with insufficient work to justify an employee's continued full-time employment; otherwise reduced hours can hurt the program, services, or administrative operations. If the organization must reduce payroll amounts in order to survive financially, then reduced work hours may be a viable approach.

The legal issues implicated in work reduction strategies vary, depending on a particular employee's status and the nature of the job change. For non-exempt employees, issues arise that are similar to those that occur when there are compensation cuts without reduced work. Provided the nonprofit organization continues to pay at least the hourly minimum wage, it generally may reduce a non-exempt, at-will employee's hours at its discretion. However, complications will arise if there is a contract or collective bargaining agreement precluding the



contemplated change. The employer will need to negotiate any changes to the agreement with the employee or union. To lessen the financial blow to employees, qualifying employers may apply to a state's "shared work" program, which provides for partial unemployment insurance for full-time employees whose weekly hours are reduced as part of cost-cutting.<sup>41</sup>

In contrast, an exempt employee's salary generally cannot be reduced based upon a variation in the quantity or quality of work performed during the pay period. This is known as the "salary-basis" test. Under FLSA and comparable state laws, if an exempt employee performs any work – no matter how little – during the workweek, the full weekly salary must be paid. Any reductions in exempt employees' compensation should be made without reference to the hours that the employee will be working when paid at the reduced level. Additionally, employers should take care to insure that exempt employees with reduced salaries continue to earn enough to retain their exempt status under FLSA.<sup>42</sup>

Legal guidance can help the organization structure a shortened workweek or other work reduction so that exempt employees remain exempt from FLSA and so that their modified work schedule does not run afoul of the salary basis test. For example, prospectively modifying a senior manager's or professional staff member's work arrangement on an ongoing basis to four-fifths or three-fifths time, consistent with the personnel policies and FLSA exemption, could save the organization money if done correctly. The exempt employee's salary does not fluctuate based on hours but is reset at a new amount. Otherwise, shortening the workweek of exempt salaried employees will not cut salary costs.

During the economic downturn, many nonprofit organizations have implemented furloughs as a way to reduce staff-related costs. A furlough is a temporary unpaid leave of absence that occurs during a defined period of time. It can be voluntary or involuntary, and all or some of an organization's employees may be included in the furlough. Both a furlough and salary reduction will result in a reduced paycheck for an employee; the practical difference is that, when the furlough ends, the employee reverts to the previous compensation level. To be legally sound

---

<sup>41</sup> For more information about the New York Shared Work program, see [www.labor.state.ny.us/ui/dande/sharedwork1.shtm](http://www.labor.state.ny.us/ui/dande/sharedwork1.shtm). The program is not available if hours are reduced by more than 60%.

<sup>42</sup> 29 C.F.R. § 541.118(a). Similarly, several states have comparable statutes that prevent employers from reducing the pay of an exempt employee due to the employer's decision to operate on a shorter workweek due to economic conditions.

and not trigger payment obligations, the employees of nonprofit organizations cannot work at all during the furlough period.<sup>43</sup> Under federal wage and hour laws, the minimum furlough period is one week. In New York, exempt employees can be furloughed for week-long increments, such as one week every three months, without running afoul of the federal or state salary-basis test.<sup>44</sup> Even checking emails or participating in conference calls with external contacts could be deemed work that requires compensation. Legal counsel can advise employers on steps to take to ensure that employees do not work, for example, posting away messages on email and voice mail, otherwise shutting down email accounts, taking possession of office cell phones, and getting employees to sign a statement confirming that they will not work during the furlough period. As human resources consultants advise, "The risk is so great that employees should acknowledge in writing that they have been so instructed."<sup>45</sup> Practically, getting staff to be comfortable with a furlough, like other changes, is important for ensuring compliance and maintaining morale and productivity.<sup>46</sup>

A furlough is different than requiring employees to use accrued paid vacation on certain days, as a way to reduce the employer's liability to pay accrued vacation time at a later date. Requiring employees to use vacation time is generally permissible and does not affect one's exempt status. Such a change technically is not a furlough, so long as the worker receives his or her weekly salary.<sup>47</sup>

There are a range of additional legal issues that an organization should examine before implementing any form of work reduction for current employees. Nonprofit managers should check the personnel policies and employment letters to determine if the change alters an employee's eligibility for benefits such as health insurance,

---

<sup>43</sup> While there is an exemption for public (e.g., government) employees, private employers must pay an exempt employee's full weekly salary if the employee works at all during the furlough week. See U.S. Department of Labor Wage and Hour Division, *Fact Sheet # 70: Frequently Asked Questions Regarding Furloughs and Other Reductions in Pay and Hours Worked Issues* (2009), <http://www.dol.gov/whd/regs/compliance/whdfs70.htm>.

<sup>44</sup> Stephen P. Sonnenberg & Glenn S. Grindlinger, *Workplace Restructurings: Managing the Pain*, New York Law Journal, May 26, 2009, <http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1202430909774&slreturn=1&hbxlogin=1>.

<sup>45</sup> Cascio, *supra* note 20, at 10.

<sup>46</sup> See Denise Williams, *Responsible Retrenchment: Advice to Nonprofits*, in *It May be Hard Times: How to Navigate a Financial Downturn*, The Nonprofit Quarterly, 12-16 (2008), available at [www.bridgespan.org/LearningCenter/?id=2786](http://www.bridgespan.org/LearningCenter/?id=2786).

<sup>47</sup> Cascio, *supra* note 20, at 10.

pensions, or accrued vacation.<sup>48</sup> To guard against legal charges of discrimination or wrongful discharge, the organization should have a sound business reason for the number and identity of affected employees. Possible reasons might include decreased work, phasing out a program, closing an office, or loss of funding used to support certain positions. To this end, before proceeding, the organization may wish to consult with counsel about potential applicable discrimination laws.

For larger organizations, shutting down a site, even temporarily, can trigger advance notification rules under the federal or state WARN Acts. A shutdown for purposes of the New York and federal WARN Acts is a reduction of hours of more than 50% during each month of a six month period.<sup>49</sup> Legal advice can help an employer sort out whether the WARN acts apply to their situation, review a possible exception for “unforeseeable business circumstances,” create the correct form of notice, and resolve payment or other obligations to affected employees. Failing to comply with WARN acts can expose the organization to liability for back wages and lost benefits as well as civil penalties.

With each of these measures, employers must adjust their productivity expectations. Overall labor input is adjusted downward when a furlough is implemented, although the decrease in hours worked is spread among a larger pool of employees than under layoffs.<sup>50</sup> The theory is that, by sharing limited amount of pain among multiple workers, the organization will retain talented staff, build worker loyalty, and avoid severance or unemployment compensation payments.

*Example: An organization that provides after-school art and music programming for young teenagers experiences a twenty percent reduction in a government contract and in turn a similar reduction in a matching foundation grant. After evaluating the different staffing options, it decides to offer five full-time youth workers a four-fifths schedule for the coming academic year, for slightly more*

---

<sup>48</sup> Furloughs may not be an option for employees working pursuant to certain types of non-immigrant visas, such as an HB-1 visa that requires a certain number of work hours. See U.S. Department of Labor, *Wage and Hour Division Administered Immigration Programs*, <http://www.dol.gov/whd/immigration/index.htm>.

<sup>49</sup> 29 U.S.C.A. § 2101 (West 2009); N.Y. Lab. Law §§ 598, 860.

<sup>50</sup> Sometimes called “short-time” employment, there is a downward adjustment in labor input and, in turn, labor output. See Wayne Vroman & Vera Brusentsev, *Short-Time Compensation as a Policy to Stabilize Employment*, The Urban Institute (2009), [www.urban.org/uploadedpdf/411983\\_stabilize\\_employment.pdf](http://www.urban.org/uploadedpdf/411983_stabilize_employment.pdf).

*than four-fifths their current salary plus benefits. Four accept this change in schedule and the fifth storms out of the office threatening to sue for breach of an employment contract. In the absence of any such employment contract, and upon advice of counsel, the organization documents the situation and is able to defend its position. The fifth employee resigns, no lawsuit is initiated, and three of the remaining employees return to full-time status with a salary adjustment six months later while the fourth chooses to continue part-time with benefits. The organization is able to continue all of its after-school programs, by enrolling more students in each section and reducing the frequency of field trips, notwithstanding reduced staffing.*

### **3. Reduce Benefit Packages**

Limiting benefits can be financially appealing because benefits, especially health care costs and pension plans, are the largest expense after salaries for most nonprofit employers. However, nonprofit organizations traditionally have offered favorable benefits to remain competitive with other nonprofit and for-profit employers, so changes should be made carefully if the organization seeks to retain and attract workers. The large majority of nonprofit organizations have not significantly reduced employee benefits in recent years except for the increased sharing of health care expenses. According to the respondents of a survey of nearly 500 New York City nonprofits by Professionals for NonProfits, in 2009 no organization eliminated health benefits, 12% reduced the health benefits they offered, and 24% increased the employee share of their health plan costs. As for pensions, 5% of survey respondents eliminated the employer's contributions to employee retirement plans, 16% reduced it, and 79% made no change to their plans.<sup>51</sup> In 2009, 25% of the respondents to a national survey reduced their benefits in some way compared to 19% in 2010 and 11% in 2011.<sup>52</sup> Yet, there are ways to reduce the expense of employee benefits while maintaining benefits that are most appreciated by the organization's employees.

Workforce demographics can affect which benefits are most welcome by staff and which ones are most economical and practical for the organization. Health insurance preferences may vary depending on age, marital and parenting status, spousal employment, family health conditions, and whether an employee or family

---

<sup>51</sup> *Nonprofits Tightened Belt on Employee Benefits*, New York Nonprofit Press, (Nov. 9, 2010), [www.nynp.biz/breaking-news/4098-nonprofits-tightened-belt-on-employee-benefits-](http://www.nynp.biz/breaking-news/4098-nonprofits-tightened-belt-on-employee-benefits-).

<sup>52</sup> NFF Summary 2010, *supra* note 1, at 4; NFF Summary 2011, *supra* note 1 at 4 & Chart 9; NFF Summary 2012, *supra* note 7, at 4; NFF Survey Analyzer, *supra* note 9, at 4.

member regularly uses prescription drugs or has special needs. Demographics also may affect the value to staff of dental coverage, life insurance, vision care, dependent care benefits, transportation benefits, or tuition reimbursement or other benefits. As the workforce composition shifts, a plan structure with an attractive price or features a few years ago may no longer be as cost-effective or as appreciated by staff as current alternatives.<sup>53</sup> It also helps to review benefits offered by comparable employers in order to get ideas of alternatives and keep the organization competitive. For those contemplating increases, comparable data also is relevant to ensure that overall compensation is reasonable, not excessive.

A useful starting point for controlling benefit expenses is for an organization to review its benefits philosophy, benefits history, and workforce composition because the viability of different cost saving options depends, in part, on the organizational culture. For example, if the organization believes that employees should be responsible for their own health, it may offer health care benefits that are more advantageous to those who exercise or pursue preventive care. If the organization historically has paid the full or same amount of an employee's health insurance premiums regardless of the employee's family status, pay level, or health care usage, it may be less palatable to transfer part of those costs to employees than if a different structure is in place. Highly valued employees are likely to have selected or remained at their job, in part, because of this benefit. On the other hand, organizations that introduce an employee contribution may find that, at least initially, they achieve amplified cost savings because some covered employees may choose to exit the plan due to preferable healthcare coverage elsewhere such as through a spouse or parent.

Increasingly, nonprofit organizations are examining alternative IRS-sanctioned health insurance options. One route continues to be standard point of service plans that allows participants to go to doctors within (and, depending on the plan, outside) the insurer's network and, after satisfying a deductible, receive coverage; each year most employers find themselves making difficult tradeoffs between higher premiums versus reduced health care coverage. Second is an employer-owned Health Reimbursement Account or Health Reimbursement Arrangements ("HRA"), where the employer uses non-taxable dollars to reimburse

---

<sup>53</sup> Bill Jones, *Containing Benefit Costs During an Economic Crisis*, New York Nonprofit Press, May 26, 2009, <http://www.nynp.biz/strengthening-nonprofits/927-containing-benefit-costs-during-an-economic-crisis>.

employees for specified health care costs, including deductibles and co-pays, up to a pre-determined amount. It may be used in conjunction with a “High Deductible Health Plan” (“HDHP”), thereby lowering monthly premium amounts. Third, is an employee-owned Health Savings Account (“HSA”), typically funded by the employer and/or employee with non-taxable dollars, that is used to pay the employees’ current and future health care costs whether or not the employee remains with the employer; it is used in conjunction with a HDHP.<sup>54</sup> A fourth option is the Professional Employer Organization (a “PEO”), where a third-party, for a fee, becomes a co-employer and provides multiple personnel-related services to the nonprofit organization’s employees, from payroll, to workers compensation, to health insurance; it is able to offer lower health insurance premium rates because it pools many employers together to obtain superior pricing from insurance carriers.

Given the rising costs of health care, most nonprofit organizations are finding that they must transfer more health care costs onto the employee, so the struggle becomes one of evaluating which alternatives are less unpopular. Based on the workforce demographics, the employer may decide to reduce non-cost effective plan features, increase employee co-payments for services, move to a high deductible health plan, try an HSA or HRA, and/or increase the amount of payroll deductions for participating employees. When making adjustments, employers who look at the full compensation package – salaries and benefits – are better able to manage the impact of changes on employee morale, especially if the organization historically has kept salaries relatively low and benefits expansive. Moreover, although the full impact of the federal Affordable Care Act has yet to take effect, employers and insurers must take into account any new legal obligations under this Act when changing health insurance plans.

An attorney can help an organization examine how to modify its benefit structure legally without unduly reducing benefits in areas most important to the staff the organization seeks to retain. One way an organization can save costs is to manage who is and who is not eligible for its benefit programs, for example, by restricting benefits to those who work at least a prescribed number of hours per week or who have been with the organization for a certain number of years.

---

<sup>54</sup> See IRS Publication 269, *Health Savings Accounts and Other Tax-Favored Health Plans, for Use in Preparing 2010 Returns* (2011), <http://www.irs.gov/pub/irs-pdf/p969.pdf>, for a review of different programs that give individuals tax advantages to offset health care costs, including: health savings accounts, health flexible spending arrangements and health reimbursement arrangements.

A second approach is to check that all dependents included in the employer's health care plan are indeed eligible dependents. Unintentionally or intentionally, employees may be listing married or over-age children, extended family members, or divorced spouses on their health care plans, causing additional charges to the employer. A third cost-saving step is to implement a working spouse rule, which provides a financial incentive (such as a buyout for waiving coverage) or disadvantage (such as requiring a contribution to include the working spouse) for employees who can access health insurance for themselves and/or their families from a working spouse's employer. Attorney review is valuable because there may be legal restrictions regarding inclusions and exclusions from pension and welfare plans.

Organizations that contribute to employees' retirement plans can explore reducing or suspending the amount of the organization's contributions to those plans. The timing and ability to make a change will depend on the pension provider, the terms of the plan, the organization's personnel policies, and the application of benefits laws such as the federal Employee Retirement and Income Security Act ("ERISA").<sup>55</sup> There are two types of possible discrimination claims to avoid. One is a charge that the pension change improperly impacts a member of a protected class, which as discussed elsewhere is best precluded by business-based decisions for any change. The second, specific to ERISA, concerns any distinctions made in a pension plan between higher and lower paid employees.

Meanwhile, nonessential benefits, such as travel (including transit checks in New York), parking, meals and discretionary bonuses, are popular targets for cost-cutting. The legality of reducing such benefits will depend on whether or not the benefit was truly discretionary. If an employer previously promised the bonus or other form of compensation, retroactively eliminating this compensation could result in liability on the grounds of breach of contract or a violation of the labor laws. In New York, an employer must pay wages and fringe benefits in

---

<sup>55</sup> Employee Retirement Income Security Act of 1974, 29 U S C § 1001, *et seq.*, provides minimum standards for pension plans by private (e.g., non-governmental) employers and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans.



accordance with its personnel policies.<sup>56</sup> The New York State Department of Labor (“NYS DOL”) sees its role as investigating and collecting claims for unpaid benefits or wage supplements that the employer has agreed to pay, including vacation or holiday pay, paid sick leave, reimbursement of expenses, and other similar items.<sup>57</sup>

#### **4. 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. The funds withheld from employees’ paychecks are known as “trust fund taxes.” An employer is responsible for depositing federal withholding taxes into an authorized financial institution or the Federal Reserve Bank, either quarterly, monthly or semi-weekly, depending on the amount of the tax liability and payroll period.<sup>58</sup> New York employers are required to deposit state withholding taxes directly with the New York State Department of Taxation and Finance within three or five days (depending on filer type) following each payroll or distribution with a tax liability of at least \$700 and file quarterly tax forms.<sup>59</sup>

Organizations that are struggling with cash flow may be tempted to delay remitting these payments to taxing authorities. Failing to pay the trust fund taxes to the taxing authorities subjects both the organization and any “responsible person” to liability for the amount due. A “responsible person” is the person

---

<sup>56</sup> Under New York law, an employer must notify employees of its policy on leave time and hours and, for employees hired after October 26, 2009, notify new hires of their rate of pay and regular pay day including an overtime rate if applicable. While not required to provide severance, vacation pay, or bonuses, if the employer adopts such benefits as part of its personnel policies then it must comply or face civil or criminal penalties. See N.Y. Lab. Law §§ 195-198.

<sup>57</sup> N.Y. State Department of Labor, *Wage and Hour Law, Unpaid or Withheld Wages*, [www.labor.ny.gov/workerprotection/laborstandards/workprot/lshmpg.shtm](http://www.labor.ny.gov/workerprotection/laborstandards/workprot/lshmpg.shtm).

<sup>58</sup> IRS Publication 15 (Circular E), *Employer’s Tax Guide* (2012), <http://www.irs.gov/publications/p15/index.html>.

<sup>59</sup> For services performed in New York, employers must withhold tax on compensation that is considered wages for federal income tax withholding purposes, including tips, bonuses, supplemental unemployment compensation benefits, and deferred compensation. See, e.g., Publication NYS-50, *Employer’s Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax* (revised Oct. 2011), [www.tax.ny.gov/pdf/publications/withholding/nys50.pdf](http://www.tax.ny.gov/pdf/publications/withholding/nys50.pdf). New York State and New York City schedules of withholding taxes and methods are contained, respectively, in NYS-50-TNYS (effective May 1, 2011) and NYS-50-T-NYC (effective May 1, 2011), both of which are available via the New York State Department of Taxation and Finance website at [www.tax.ny.gov/bus/wt/wtidx.htm](http://www.tax.ny.gov/bus/wt/wtidx.htm).



who decides not to pay the withholding taxes on time and potentially can include volunteer board members. Taxing authorities also have the power to levy and impose liens on bank accounts.<sup>60</sup> The negative impact on an organization can be severe, for example, if the IRS assesses the organization for a year of unpaid withholding taxes, plus interest. Such payment liabilities can put the organization into financial distress if the organization cannot afford to pay off the debt even via an installment plan. Funders and lenders are less likely to be sympathetic to an organization whose cash flow problems are crippling because of outstanding, unexcused IRS debt and liens than those who remit payroll taxes promptly but need bridge loans or additional grants for general operations to get them through a tough budget cycle. Ensuring payment of withholding taxes and compliance with other laws is part of the duty of obedience.<sup>61</sup> Because proper payment of payroll and withholding taxes is an essential part of strong board governance, there is even more reason for funders to invest in organizations that do it right.

*Example: A youth services organization is strapped for cash. Its busy bookkeeper withholds payroll taxes from employee paychecks in 2009 but does not remit such monies to the taxing authorities for several months. Instead, the bookkeeper pays an outstanding rent bill, planning to remit such payroll taxes when the organization receives payment on a delayed contract. While the organization ultimately gets back on track to meet its rent and payroll obligations, there is a four month gap in withholding taxes, which the IRS identifies in 2011. With the assistance of legal counsel, the organization negotiates a repayment plan and settlement with the IRS, but it must pay interest and part of the penalties. The board of directors, previously unaware of the gap, investigates the matter, disciplines the bookkeeper and executive director, and adopts improved financial controls. The organization reduces its staffing in order to pay the IRS debt. By 2012, when the auditors are preparing the organization's annual audit, it has rectified the situation.*

## **5. Reassign Employees**

As nonprofit organizations reprioritize program areas and fundraising, one option to retain staff and control costs is to reassign existing staff to other jobs within the same organization. The job change can save the employer costs if the employee's former job remains vacant, the reassigned employee is paid less or has fewer

<sup>60</sup> N.Y. Tax Law § 685; 26 U.S.C.A. §§ 6671, 6672 (1998); 26 U.S.C.A. § 6695 (2007).

<sup>61</sup> *Right from the Start: Responsibilities of Directors of Not-for-Profit Corporations*, N.Y. State Office of the Attorney General, Charities Bureau, at 7-8, [www.charitiesnys.com/pdfs/Right%20From%20the%20Start%20Final.pdf](http://www.charitiesnys.com/pdfs/Right%20From%20the%20Start%20Final.pdf).

benefits than someone he or she is replacing, or the reassigned employee is facing a salary or benefits reduction in a reassigned role. Over 60% of the nonprofit organizations responding to a 2009 survey of nonprofits conducted by the Bridgespan Group reported that they had realigned staff members in order to support their most important programs during the start of the recession.<sup>62</sup>

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 implications beyond staff morale or productivity. The employment at-will doctrine means there is no guarantee of continued employment in the same position for at-will employees. An employment contract, collective bargaining agreement or an employee handbook may prevent reassignment or permit it only under certain conditions. Employers must provide reasonable accommodations under the Americans with Disabilities Act to disabled employees if they assign them to a new position.<sup>63</sup> If the employee refuses the reassignment and is terminated as a result, the employer may, but is not necessarily, be required to pay unemployment benefits. The obligation to pay such benefits will be heavily dependent on the specific facts and whether the reassignment is effectively a termination of the employee's existing job.

### **6. Engage Temporary or Nontraditional Paid Workers**

Nonprofit organizations are well-known for utilizing a range of workers, including employees, volunteers, and independent contractors.<sup>64</sup> Most people working at a nonprofit organization are employees, who perform services under the direction and control of an employer in exchange for compensation. Unlike employees, independent contractors enter a written contract with the organization to provide services under very limited supervision from the employer. Employers have certain legal obligations to "employees," including wage and hour laws, workers compensation, unemployment insurance, withholding tax requirements, and anti-discrimination laws, that do not necessarily apply to other workers.

Rather than staff layoffs, some nonprofit organizations have reduced workforce costs by eliminating contract workers, consultants or other types of independent

---

<sup>62</sup> Bridgespan 2009, *supra* note 1.

<sup>63</sup> Americans with Disabilities Act, 42 U.S.C.A. § 12101 (1990).

<sup>64</sup> Maria Cilenti, Elizabeth M. Guggenheimer, & Rebecca Kramnick, *The Volunteer Workforce: Legal Issues and Best Practices for Nonprofits*, Lawyers Alliance for New York, at 4-20 (2007) [hereinafter "Cilenti"].

contractors. Ending the relationship and the services makes practical sense if the worker's services are not critical to core programs. Alternatively, a full-time employee can pick up some or part of the consultant's work, although this is not ideal if the employee lacks the capacity or relevant skills. Legal guidance is helpful if any of these changes involves changing or prematurely terminating a consultant's contract.

Alternatively, during tough financial times, employers may be tempted to replace employees with independent contractors on the theory that independent contractors are less costly because the employer does not pay benefits. The organization is not required to withhold or remit taxes for an independent contractor and can issue a Form 1099 document rather than a W-2 for compensation paid. This can be a cost effective alternative if the math works out and the independent contractor is sufficiently skilled and available. Practically, some organizations feel that contractual workers "lack the same level of dedication to the mission" as salaried staff.<sup>65</sup> Moreover, an independent contractor is not always less expensive than an employee when all costs are considered. The independent contractor may demand a higher hourly rate to offset his or her own expenses, or the organization may need to hire additional workers to fill gaps in the independent contractor's services.

Lawyers regularly guide nonprofit organizations through common misconceptions about independent contractors. Whether a worker should be classified as an employee or an independent contractor can be a complex, highly fact-specific exercise. A written agreement stating that a worker is an independent contractor is not dispositive; nor is the fact that a worker comes to the office for a relatively small number of hours each week. The IRS, like most states, relies on common law, which looks for evidence of financial control, behavior autonomy, and the nature of the worker's relationship with the hiring entity. Unless a worker's job changed significantly, employers generally will have difficulty making a compelling case that

---

<sup>65</sup> During the current downturn, the use of use of contract workers and part-time employees reportedly has been most common in the arts fields (42-51% compared to 15-28% in the human services and community development fields) and among organizations with under 50 employees compared to the largest groups. See Salamon 2010, *supra* note 2, app. B-2 at 9.

a former employee should be treated as an independent contractor.<sup>66</sup>

If an employee is misclassified as an independent contractor, and an employer did not have a good faith basis for the misclassification, taxing and labor authorities will require payment of back taxes and related penalties and interest.<sup>67</sup> This issue typically arises when a terminated worker, whom the employer deemed to be an independent contractor, files for unemployment insurance with the state labor department, which in turn investigates because the state has no record of employee tax withholdings. In recent years the IRS and states have shared information for employment tax examinations.<sup>68</sup> As with wage and hour complaints, the IRS, United States Department of Labor ("US DOL"), or NYS DOL may audit the classification of all workers, not just the complaining individual, creating additional exposure. Additionally, if a worker was an hourly employee that did not receive minimum wage or overtime payments, there could be a violation of the wage and hours laws. Misclassification of employees as independent contractors also results in a failure to remit required payroll taxes, creating liability not only for the organization but also for its board members.<sup>69</sup>

*Example: An organization that offers free and low-cost art classes to children from low-income neighborhoods revamps the format and content of its course offerings. It replaces three full-time instructors, who historically have been treated as employees, with six less expensive part-time "consultants," whom it pays as independent contractors. It simultaneously engages a fundraising consultant to develop an individual donor outreach plan and a trainer to conduct two morning professional development programs for the new part-time workers. After obtaining legal guidance, it reclassifies five of the six part-time workers as employees; the sixth is a professional artist who sets his own schedule and fees and uses the organization's website to promote his course. It continues to classify the*

---

<sup>66</sup> See Internal Revenue Service, *Independent Contractor (Self-Employed) or Employee?*, [www.irs.gov/businesses/small/article/0,,id=99921,00.html](http://www.irs.gov/businesses/small/article/0,,id=99921,00.html). While an employer or worker can file a Form SS-8 with the IRS to request an IRS determination for purposes of federal employment taxes and income tax withholding, a preferable approach for employers generally is to obtain legal advice and make any corrections and decisions based on legal review.

<sup>67</sup> See 26 U.S.C.A. § 3509.

<sup>68</sup> Since 2007, the IRS has had partnership agreements with New York and the majority of other states to share the results of employment tax audits. IR-2007-184, *I.R.S. and States Share Employment Tax Examination Results*. Internal Revenue Service (November 6, 2007), [www.irs.gov/newsroom/article/0,,id=175457,00.html](http://www.irs.gov/newsroom/article/0,,id=175457,00.html).

<sup>69</sup> Cilenti, *supra* note 64, at 16, 65.

*fundraising consultant and trainer as independent contractors. When the NYS DOL inquires about the employment status of the trainer, the organization has appropriate records to satisfy the regulators concerns and is not subject to any liability.*

### **7. Rely More on Volunteers**

Financially strapped and with more unemployed workers available to donate their time, the nonprofit sector has embraced the role of the “volunteer” with a timely blend of sincere appreciation and cautious deployment.<sup>70</sup> Thanks to the availability of volunteers, many organizations have been able to maintain or increase their services to individuals, families, and communities during the economic downturn. By definition, volunteers, as distinguished from “employees,” work without compensation by choice for motives other than compensation.<sup>71</sup> They usually, but not always, work part-time. Volunteers can increase the quantity of work performed in areas of need, handle necessary work disliked by paid staff, free up a paid worker to perform higher-level tasks, add expertise not present among paid staff, or take on more senior staff responsibilities ranging from fundraising to program management. As with employees, there are soft costs for proper recruitment, screening, training, and supervision of volunteers. If volunteers add capacity with little or modest expense, existing funds can be used to retain existing staff and better leverage staff resources.

As nonprofits rely more heavily on volunteers, two categories of legal questions have surfaced. One relates to minimizing the organization’s risk of liability if a volunteer injures a third party while providing services on behalf of the organization. The second relates to ensuring that volunteers are truly volunteers, so that the organization does not violate wage and hour or other laws.

For countless years, the majority of nonprofit organizations have used volunteers,

---

<sup>70</sup> Lester M. Salamon & Kasey L. Spence, *Volunteers and the Economic Downturn*, Corporation for National & Community Service, at 1, 4 (2009) [hereinafter “Salamon & Spence 2009”].

<sup>71</sup> Cilenti, *supra* note 64, at 46-51.

but resources for volunteer management have been more limited.<sup>72</sup> Some nonprofit managers have shied away from volunteers because they believe volunteers “do not have the capacity (e.g., skills, time) to replace professional staff.”<sup>73</sup> Data from a 2009 Johns Hopkins Listening Project Survey revealed that, while more than one-third of the organizations increased their number of volunteers and volunteer hours during the recession, only 15% reported an increased ability to manage the volunteers.<sup>74</sup> Programmatically, inadequate attention to volunteer management can impede productivity and volunteer and client satisfaction. Legally, if a volunteer negligently causes injury to a third party while volunteering on behalf of the nonprofit organization then more severe liabilities are created. Careful screening and supervision of volunteers can reduce risk but are not guarantees against liability. Legal counsel can help nonprofit organizations create volunteer policies that clarify worker expectations and, if followed, reduce the likelihood of injury. Attorneys can provide guidance on permissible, required and impermissible background checks; the appropriate scope of activities for volunteers; insurance coverage; ways to terminate a problematic volunteer arrangement; and procedures to preserve confidentiality related to the organization and its clients.<sup>75</sup>

Legal counsel also can help nonprofit organizations avoid missteps that might convert a volunteer into an employee. In contrast to employees and independent contractors, a volunteer freely performs services at the direction of the nonprofit organization but without compensation or expectation of compensation. Nevertheless, a volunteer may receive certain limited cash awards, stipends, non-cash benefits, reimbursements, and other payments without making the worker an employee. Paying for the volunteer’s travel, lunch, or other minimal expenses related to volunteering is permitted. Paying more than actual expenses associated

---

<sup>72</sup> An Urban Institute report, based on a 2003 survey on volunteerism revealed positive information from respondents: 80% of the organizations used volunteers; a large majority found the volunteers to be beneficial to their organizations; three-fifths had a paid volunteer coordinator, although this person typically had other responsibilities; and paid coordinators are more likely in larger charities and when volunteers engage in direct services. The more frequently reported challenges were: insufficient staff resources devoted to volunteer management; a limited ability to adopt best practices; and, to a lesser extent, difficulty recruiting volunteers during the workday and from within the community. See Mark A. Hager, *Volunteer Management Capacity in America’s Charities and Congregations: Executive Summary*, The Urban Institute (2004), available at <http://www.urban.org/url.cfm?ID=410963>.

<sup>73</sup> Salamon 2010, *supra* note 2, at 9.

<sup>74</sup> Salamon & Spence 2009, *supra* note 70, at 2.

<sup>75</sup> Cilenti, *supra* note 64, at 46-51.

with volunteer service runs a risk of establishing an employment relationship.

Similarly, if the employer frustrates the voluntary nature of the relationship, perhaps by requiring tasks otherwise done solely by paid workers or advertising that certain tasks are paid, the volunteer may expect payment. The nonprofit organization can direct the volunteer's activities but not mandate performance. To avoid confusion, the organization can prepare a letter or code of conduct for the volunteer that describes the volunteer's role, including expected hours and activities, and confirms the unpaid, voluntary nature of the arrangement. To help preserve the volunteer relationship, such a writing should clarify that any payment the organization makes to the volunteer is a reimbursement of expenses not a wage.

*Example: A legal services organization hosts a recent law school graduate for a year, assigning the individual to a research and writing project about the increasing unmet civil legal needs among poor people. From the organization's perspective, this worker is a volunteer and given the title of "fellow." The worker is not paid by the organization, but receives a payment from an unrelated party, conditioned on the worker's successful completion of six months of work at the organization. To clarify the relationship, the organization creates a volunteer agreement that specifies that the fellow is working voluntarily, without the expectation of any compensation from the organization, and the organization encourages but does not require the work to be performed during the organization's regular office hours. The organization is not liable for any wages or other compensation for this worker.*

Employment law is implicated if an employee "volunteers" outside their regular working hours. Examples are a youth outreach worker who chaperones students from a weekday arts program during a weekend visit to a museum, a part-time development assistant who regularly works Monday through Wednesday but comes in on Friday because she knows the organization is short-staffed for a fundraising mailing, or a laid off employee who offers to do the same work for free for a few weeks while the organization seeks additional funds to rehire her. The US DOL has declared that employees of a nonprofit organization may volunteer for the organization only if the services (i) are not the same type of services the employee is employed to perform and (ii) take place outside of the employee's



normal working hours.<sup>76</sup> Otherwise the FLSA wage rules apply. For a previous employee, an attorney can advise the organization whether, and if so how, it can restructure the subsequent “volunteer” position in a way that is voluntary with no expectation of compensation.

During the economic downturn, commentators have paid increased attention to the use of “interns” by for-profit and not-for-profit corporations, raising a question of when such workers are employees, trainees, or volunteers.<sup>77</sup> The word “intern,” rather than carrying a legal definition, typically is used in a non-legal sense to describe a temporary worker, often a young person, who seeks an internship at least in part to obtain useful experience, but who may or may not expect compensation in exchange. An intern may be motivated to work at a nonprofit organization at least in part to benefit the charitable mission. In contrast, the term “trainee” has a limited legal meaning. The federal and state wage and hour laws contain a narrow “trainee” exception for individuals engaged in a bona fide job training program or vocational educational program; they may be paid “training wage” below minimum wage that covers their expenses.<sup>78</sup> The correct employment classification will turn on the facts, but an “intern” is more likely to be a “volunteer” than an “employee” (and not a “trainee”) if the individual performs tasks that benefit the organization’s charitable mission, intends to be donating his time to benefit the organization, and does not receive or expect to receive wages or other compensation in exchange. Payment expectations or a bona fide training program can change the equation.<sup>79</sup> As with other workers, if the nonprofit organization misclassifies an “employee” as a “volunteer,” the IRS, federal or state DOL, or a court may find that this employee is entitled to back pay and also require the employer to pay back taxes and penalties. Nevertheless, properly classified volunteers can be a major asset to nonprofit organizations seeking to leverage their limited resources to preserve program.

---

<sup>76</sup> Cilenti, *supra* note 64, at 89.

<sup>77</sup> Steven Greenhouse, *The Unpaid Intern: Legal or Not?*, N.Y. Times, (Apr. 3, 2010), at B1.

<sup>78</sup> Such “trainees” may receive a reasonable stipend to cover expenses, less than minimum wage, provided six US DOL criteria are met, including that the training is for the benefit of the trainee and the trainees are not displacing regular employees but working under their supervision. See U.S. Dep’t of Labor Training and Employment Guidance Letter No. 12-09 (Jan. 29, 2010).

<sup>79</sup> Unless operating a training program as part of the organization’s mission, nonprofit organizations that seek to recruit students to volunteer usually will be better situated legally if they clarify that these workers, while gaining valuable work experience, are not bona fide trainees but are doing their assignments voluntarily.



## Part V

### Facilities

For established nonprofit organizations with staff and programs that require space to succeed, the economic downturn presents real estate challenges and opportunities. Adequate facilities are important both for organizations that offer onsite services, such as childcare, worker education and housing, as well as organizations with active office operations, such as those engaged in economic development or advocacy. 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.<sup>1</sup> The expense burden is compounded, and expense reductions may be limited, because facilities costs are typically fixed costs and many organizations entered facilities obligations prior to the downturn in a market that reflected a different economy. While some organizations have suffered from these financial strains, the weakened real estate market has enabled others to renegotiate or exit current leases, negotiate a new lease or enter other transactions on more favorable financial terms than prior to the recession.<sup>2</sup> Reducing facilities costs requires time, creativity, negotiation, and proper legal documentation to protect the organization's rights and clarify its responsibilities.

Data on the impact of the recession on nonprofit organization's facilities is mixed and partly anecdotal. By 2009, more than one quarter of the nonprofit organizations responding to a Johns Hopkins University national survey had

<sup>1</sup> Floyd Norris, *A Reversal for Real Estate After Some Mild Gains*, New York Times New York edition B3 (Apr. 30, 2011) (noting early 2011 declines and describing two market indices); Moody's Investors Service, *Special Report: Moody's/REAL Real Commercial Property Price Indices* (June 2011) (showing that, although down since its 2008 peak, New York City's office market increased in each of the four quarters ending April 2011 and had gains better than national office index); National Association of Realtors, *Metropolitan Median Prices*, <http://www.realtor.org/research/research/metropri> (containing quarterly data on the median sales price of existing single-family homes for metropolitan areas around the country, which is informative to the extent median home price is a common measurement used to compare real estate prices in different geographic areas).

<sup>2</sup> *Real Estate Crisis Offers Real Opportunities*, New York Nonprofit Press (Nov. 24, 2009), <http://www.nynp.biz/strengthening-nonprofits/1687-real-estate-crisis-offers-real-opportunities>; Amanda Fung, *Real Estate Deal Watch: Lawyers Alliance Sets Penny-Pinching Example*, Crains New York Business.Com (June 9, 2009), [http://www.crainsnewyork.com/dcce/20090609/12/real-estate/122/deals\\_active/2383001](http://www.crainsnewyork.com/dcce/20090609/12/real-estate/122/deals_active/2383001).

delaying maintenance projects, and more than one quarter delayed or abandoned expansion or relocation plans altogether.<sup>3</sup> In Nonprofit Finance Fund annual surveys, 14% of responding organizations reported reducing or refinancing occupancy costs in 2009 compared to 19% that reduced occupancy costs in 2010 and 2011.<sup>4</sup> For example, as the recession forced New York City arts organizations to reduce their budgets by a projected 61% as of 2010, arts groups have sought to find more reasonably priced facilities for their artists to work, live, rehearse and perform. The Center for the Urban Future published a report with 17 recommendations to help the arts sector take advantage of increased vacancy and foreclosure rates to secure more affordable and alternative types of space.<sup>5</sup>

The recession created additional difficulties for programs that create, renovate or invest in facilities as many traditional facilities financing streams decreased and lenders implemented more rigorous credit processes. Given uncertain or reduced financing, nonprofit organizations revisited construction plans, added construction contingencies, and focused on the essentials. Community Development Financial Institutions and other loan funds provided capital for projects in low-income communities, but those resources are also limited.<sup>6</sup> Some nonprofit organizations scaled back on building and equipment maintenance. For nonprofit organizations engaged in development and facilities activities to further their mission, there remains a continued need to maintain buildings and negotiate land, materials, and professional services.

The realistic legal options for cost control vary depending on whether a nonprofit organization owns or rents property, has a below or above market mortgage or lease arrangement, and otherwise has a strong or weak bargaining position. Nonprofit organizations that need less space due to downsizing may be eager

---

<sup>3</sup> Lester M. Salamon et al., *Impact of the 2007-09 Economic Recession on Nonprofit Organizations*, John Hopkins University Center for Civil Society Studies, Communique No. 14, at 31 (June 2009).

<sup>4</sup> *2010 State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 (2010), <http://nonprofitfinancefund.org/files/images/2010SurveyBrochure.pdf>; *2011 State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 4 and Chart 9 (2011), [http://nonprofitfinancefund.org/files/surveybrochure\\_032311.pdf](http://nonprofitfinancefund.org/files/surveybrochure_032311.pdf).

<sup>5</sup> Center for the Urban Future, *Time to Be Creative* (Oct. 2010), available at [http://www.nycfuture.org/content/articles/article\\_view.cfm?article\\_id=1270](http://www.nycfuture.org/content/articles/article_view.cfm?article_id=1270); Nicole G. Anderson, *Recession Could Provide Hidden Boost for the Arts*, *Gotham Gazette* (Nov. 23, 2010).

<sup>6</sup> Nonprofit Finance Fund, *A Guide to Navigating Changing Times: A FAQ for the Nonprofit Sector*, <http://nonprofitfinancefund.org/nonprofit-consulting/navigating-financial-crisis> [hereinafter "NFF Guide"].

to shed property quickly. Those already bound by a mortgage or lease most likely must renegotiate loans or their lease to lower ongoing facilities costs in a meaningful way. Those with more flexible timing and assets may choose to expand their property holdings. Legal guidance is essential for nonprofit organizations to review their deeds, mortgages and leases, assess viable alternatives, and negotiate more favorable real estate deals.

## **A. Strategies for Reducing Owners' Facilities Expenses**

---

### ***1. Refinance Loans***

When a nonprofit owner seeks to retain its property at a lower cost, it may be able to lower monthly and/or long term expenses through a refinancing.<sup>7</sup> One possibility is to renegotiate with the current lender a lower interest rate or extension of the maturity date for payment. Another is to use an entirely new credit facility to provide new financing to replace an existing loan. The benefits of refinancing are largely market driven and will depend on the organization's current credit situation. An organization that borrowed funds under a long term, low-interest arrangement is less likely to achieve substantial gains from refinancing than one that borrowed at the market's peak when interest rates were higher.

Lawyers can assist the board of directors and senior staff to evaluate the fiscal consequences of refinancing by examining relevant contract terms in existing financing instruments, including prepayment penalties and the different maturity dates for repayment. Sometimes existing agreements contain a lockout period during which the borrower cannot accelerate repayment of the loan. The agreement also may contain restrictions on how the property may be used during the loan period or require lender's consent for certain uses in order to protect the lender's interest in the property.

Legal counsel also can guide the organization through the negotiation of its new financing agreement and assist in obtaining proper consents. Financing agreements typically identify specific entities and individuals whose consent is needed when taking on substitute financing, such as other lenders, along with required methods of consent and notice periods. Board approval is required if a New York not-for-profit corporation sells, mortgages, or leases its real property. For real estate transactions, the statute explicitly requires two-thirds of the entire

---

<sup>7</sup> *Loan Modifications for California Nonprofits Affected by the Economic Downturn*, Public Counsel (Aug. 2009), <http://www.publiccounsel.org/tools/publications/files/loanmodNP.pdf>.

Board to approve the transaction if there are twenty or fewer directors and a majority vote if there are more than twenty directors.<sup>8</sup> Legislation drafted by the New York State Attorney General's Office and introduced in the New York State Senate in spring 2012 would reduce the number of affirmative votes required for routine real estate transactions, including most leases, in order to make it easier for organizations to move forward promptly with transactions, but the larger threshold currently stands.<sup>9</sup> If a government contract or government receivable is pledged as collateral for a loan, the government agency's consent also may be required.

*Example: An economic development organization received a multi-million mortgage for its community center at a 7% interest rate for a 15-year term prior to the downturn. Now the organization is receiving quotes from other lenders that would reduce the interest rate to 5% while keeping maturity date and principal amount the same. Legal counsel helps the organization review the refinancing arrangement, noting that "set up fees" would cost the organization thousands of dollars, but those fees would be offset after six months of paying a lower interest rate.*

## **2. Defer Maintenance and Building Expenses**

For property owners, some expenses associated with maintaining buildings may be deferred beyond scheduled levels when cash flow is impaired. However, the tradeoff is aging and less desirable facilities, which in the long run can threaten the value of property investments, impede an organization's ability to operate programs at the site and may lead to higher expenses later.<sup>10</sup> If the organization seeks to rent out unused space to supplement its revenues, but does not adequately maintain the property, it risks making the property less attractive to tenants. If the property is already occupied by tenants, the nonprofit owner runs the risk of legal claims by those tenants if the property has not been maintained, along with the

---

<sup>8</sup> N.Y. Not-for-Profit Corp. Law § 509 ("No purchase of real property shall be made by a corporation and no corporation shall sell, mortgage or lease real property, unless authorized by the vote of two-thirds of the entire board, provided that if there are twenty-one or more directors, the vote of a majority of the entire board shall be sufficient").

<sup>9</sup> S. 7431 (N.Y. 2012) sponsored by Senator Marcellino in 2012 would amend section 509 of the Not-for-Profit Corporation Law to allow a majority vote of the Board or authorized Board committee, rather than a two-thirds vote of the entire board, to approve non-substantial real estate transactions. The two-thirds voting requirement is maintained for transactions involving real property that constitutes all or substantially all of the non-profit's assets.

<sup>10</sup> George Head, *Sustaining Nonprofits During Economic Downturns*, Nonprofit Risk Management Center, [www.nonprofitrisk.org/library/articles/strategy09002003.shtml](http://www.nonprofitrisk.org/library/articles/strategy09002003.shtml).

cost of defending against those claims. As tenants, nonprofit organizations have felt the pinch from landlords whose own financial situation caused them to cut back on building maintenance or to try to pass building improvements on to the tenant. As landlords, they are faced with those same choices. Negotiating well-drafted leases helps to avoid disputes over who is responsible for the expense of maintaining the property.

For organizations planning or in the midst of a facility project, careful planning and prioritization is important.<sup>11</sup> Attorneys can help prepare financing and construction documents to break the project into phases or allow for different scenarios based on the amount of funds raised, or they can review agreements with project managers, architects, and vendors to help organizations renegotiate the cost of materials and professional services.

### ***3. Maintain Real Estate Tax Exemptions***

Nonprofit organizations owning property in New York State are eligible for an exemption from real estate taxes if they are using the property for tax exempt purposes. There are specific requirements to qualify for this exemption: the space is to be used exclusively to further the organization's exempt purposes; the property must be in actual use (although a special case can be made for contemplated uses); no officer, member, or employee can profit from the occupancy (except for reasonable compensation for services rendered); any portion of the premises that is used by the owner or a tenant for commercial or other non-exempt purposes remains subject to taxation; and any rental income cannot exceed the amount of the carrying charges, maintenance, and depreciation of the property. There are additional exemptions and statutory details that apply to particular categories of nonprofit organizations.<sup>12</sup>

The real property tax exemption takes on increased significance for nonprofit organizations that are trying to trim costs. Eligible groups that have not yet taken advantage of this exemption can still apply. As taxes for real property owners rise, the effect of the exemption becomes more meaningful. Even when actual real estate values decrease during a downturn, a property owner's taxes can rise because the tax rate is set annually by the Mayor and City Council and then

---

<sup>11</sup> NFF Guide, *supra* note 6.

<sup>12</sup> N.Y. Real Prop. Tax Law § 420-a(1)(a). This section provides the criteria for receiving tax exemption. The real estate tax exemption does not apply to for-profit entities that rent to nonprofit groups. The owner must meet the tax exempt purposes standard.

applied to assessed property values. To apply in New York City, groups submit an application to the City's Department of Finance along with a copy of the application for 501(c)(3) status and IRS determination letter. Applications are not granted automatically, but the Commissioner of Finance can grant the exemption retroactively to the property purchase date. Exempt organizations are required to submit annual renewal forms, which update the locality on the property's use, in order to maintain the exemption.<sup>13</sup> To cover real estate taxes not subject to the exemption, nonprofit landlords often may include a clause in the lease allowing them to pass along real estate property taxes to the tenant in a separate bill or in a rent increase.

## **B. Strategies for Reducing Tenants' Facilities Expenses**

---

### ***1. Terminate a Lease***

If a nonprofit organization seeks to exit its lease prematurely, either because it no longer needs the space due to program cuts or because it plans to relocate to less expensive space, legal counsel is essential to determine the organization's options and, if necessary, negotiate with the landlord. Some leases have provisions that allow the tenant to terminate its lease before the end of the lease term under certain conditions. Possible grounds for early termination may include the tenant's loss of funding or the landlord's failure to maintain the premises. Early termination also might be available with advance notice and payment of a penalty or fee. Legal counsel can help a nonprofit organization review the lease terms for early termination rights and determine what payments and notices, if any, are required to activate these rights. Legal counsel also should review any accompanying documents, including any corporate or personal guarantees, to ensure that the organization understands the costs of walking away from a lease.<sup>14</sup>

*Example: A nonprofit youth services organization does not receive a renewal of a significant foundation grant. In recent years, funds from this grant covered the rent for one of the organization's two locations where students went for after school programs. Legal counsel identifies an early termination clause in the lease that*

---

<sup>13</sup> The New York City Department of Finance provides online information about the real estate tax exemption, including links to the application and renewal forms, at *Property Tax Exemption for Not-For-Profit*, [http://www.nyc.gov/html/dof/html/property/property\\_tax\\_reduc\\_non\\_profit.shtml](http://www.nyc.gov/html/dof/html/property/property_tax_reduc_non_profit.shtml).

<sup>14</sup> See Michael Bettinger, *How to Renegotiate Your Lease and Save Money*, The New York Enterprise Report (Apr. 1, 2009), [http://nyreport.com/articles/66077/how\\_to\\_renegotiate\\_your\\_lease?page=0,1](http://nyreport.com/articles/66077/how_to_renegotiate_your_lease?page=0,1).

*allows the organization to terminate the lease, upon 30 days' notice and payment of one month of rent if there is a loss of certain sources of funding to support the after school program. The organization gives the required notice, exits the lease six months early, and consolidates its operations in another location.*

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, the tenant agrees to pay a landlord a certain amount of money, in exchange for which the landlord releases the tenant from further liability. If the landlord does not consent and the tenant moves out, abandoning the lease, the tenant organization will remain liable for its obligations. Under New York law, unless the parties agree otherwise, the landlord is not required to release vacated space or try to lessen its damages if a tenant vacates the space prematurely.<sup>15</sup> Real estate counsel can review and help negotiate a lease agreement to evaluate whether it contains language favorable to their client, as landlord or tenant, about the duty to mitigate damages and what steps constitute a legal surrender by tenant of the lease.

## **2. Modify Lease Terms**

As the recession weakened the commercial real estate market, nonprofit organizations began to have more latitude to negotiate lease modifications, such as rent abatements, rent deferrals, sublet arrangements and other concessions.<sup>16</sup> The long term impact on the real estate prices is still to be determined. As written contracts, leases can be amended with the written consent of the parties. The organization will be in a stronger position in seeking lease modifications if the landlord has business reasons for keeping the tenant. For example, the landlord may be willing to make lease concessions if the organization is a long-time tenant that has always paid its rent promptly, the organization is paying at or above market rate, the landlord purchased the building at inflated prices and is eager for continued income, there are an unusually high number of vacancies in the building or geographic area, and/or the space is less attractive and hence more difficult to rent than space in the building. Similarly, if the lease contains termination rights favorable to the tenant, and the tenant is open to moving if the landlord is unwilling to renegotiate, then landlord may be more receptive to a tenant's

---

<sup>15</sup> See *Holy Props. v. Cole Prods.*, 87 N.Y.2d 130, 637 N.Y.S.2d 964 N.Y. (1995) (commercial lease); *Rios v. Carrillo*, 53 A.D.3d 111, 861 N.Y.S.2d 129 (2d Dept. 2008) (residential lease).

<sup>16</sup> Bettinger, *supra* note 14.



proposed changes than if the tenant is locked in and set on staying.

Lawyers help resource-constrained nonprofit clients negotiate a variety of lease modifications during the economic downturn. Part of the negotiation may involve showing the landlord, with financial statements, that the nonprofit organization is facing economic distress and some rent relief is necessary, at least in the short term, in order for the tenant to be able to continue its rent obligations. Among the more commonly negotiated concessions in new leases and lease modifications that benefit the tenant are: lower rental payments; reductions in the amount of rented space; the landlord's assumption of a greater share of costs related to insurance, property taxes, utilities, and other building expenses; reductions in automatic rent increases; and more flexibility for subletting or assignment of a lease.

*Example: A nonprofit organization providing language classes and financial literacy training to new immigrants lays off half of its employees due to declining revenues and decreases its course offerings, but projects sufficient funding to operate for two years on a reduced budget. With six months left on its lease, it renegotiates with the landlord to take half of the amount of space at the same rate but to extend the lease for a total of two years.*

On the other hand, the landlord may have its own financial constraints that limit its ability or desire to modify a lease. For example, if the property is being financed by a loan, the landlord may be required by its lender to impose certain conditions or use a specific form of lease to protect the lender's interest in the collateral. Moreover, because the economic downturn has persisted and real property owners experienced a loss in the value of their assets, some reached a point where they had to impose additional costs on tenants when renewing lease agreements, from facilities improvements to increased real estate taxes, in order to have sufficient funds to pay building expenses. More recently, as the economy has begun to stabilize, some landlords are seeking to pass on more of their existing debt obligations to tenants because these landlords operated for so long on the margin that they need more funds to repay such debt. For real estate lawyers, understanding the financial condition of the landlord is important for negotiating the best arrangement for a client.

*Example: A nonprofit elder services organization rents a kitchen and work space from a church for its program to prepare and deliver meals for homebound seniors, a program that has been particularly active in the economic downturn*



*due to increased demand for food assistance. The relationship with the church is set forth in a “space and usage agreement” signed by both the organization and the church. In recent years the church spent thousands of dollars to refurbish the kitchen and it now seeks to raise the organization’s rent to help pay off its debt. The organization obtains legal assistance negotiating a revised agreement, with less onerous payment terms, given that the organization’s own finances are heavily dependent on government contracts with an unpredictable future. With legal help, the organization structures a rental schedule that satisfies the landlord’s need for upfront dollars and the organization’s desire for rent relief or early termination at a later date if certain contracts are not renewed.*

Usually a landlord will require something meaningful in exchange for a lease modification, such as a longer lease term or larger amount of rented space. For nonprofit organizations that are delinquent in rent payments due to financial distress, the landlord may require payment of unpaid rent and prepayment of a month or more of future rent before agreeing to further rent relief. However, before agreeing to such terms, the nonprofit organization will be well-served to consult with legal counsel, who can help it evaluate whether it is capable of fulfilling these additional lease obligations. Unfortunately, not all organizations that are able to negotiate rent reductions remain able to stay in their existing space under the new terms, and some are compelled to scale back further than anticipated because of inadequate resources and insufficient planning.

*Example: A community organizing group successfully negotiated rent relief and managed to persuade the landlord to pay for improvements to the office space where the staff worked. The rent relief was structured as a combination of a rent reduction and rent deferral. Ultimately, it did not have sufficient funding to afford even the reduced rental payments. It therefore moved out and sought less expensive space in a less convenient location.*

As some sectors of the economy recover and landlords are able to command better terms, their receptivity to rent relief for nonprofit organizations may be abating. In lease renewals, some landlords have sought to drive more aggressive bargains, such as seeking payments for capital improvements even where the original lease or license agreement did not provide for such payments. Similarly, some landlords have begun to impose higher rental increases upon expiration of the lease, even in situations where there has been a longstanding relationship with the nonprofit tenant. Legal counsel can help clients to negotiate a lease agreement

that is consistent with market conditions, and help to limit lease provisions such as payments by the tenant for improvements made by the landlord.

*Example: A nonprofit housing organization has a long-standing month-to-month tenancy with a commercial landlord for space used to provide homeless individuals with mental health counseling and employment-related services. The landlord is demanding that the organization vacate if it will not sign a five lease agreement at much higher rent. Legal counsel helps the nonprofit organization with the negotiations, so that any resulting lease includes terms important to the tenant, such as limits on the payment of insurance and other specific costs and no use restrictions, and the multi-year lease is affordable given current economic constraints.*

### **3. Sublet Space or Assign a Lease**

To reduce leasehold expenses, some nonprofit organizations sought or are now looking 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. Subletting may be practical when the tenant plans to continue to use part of the space, or vacate the full space only temporarily, for example, while seeking to raise more funds to add staff in future years. In an assignment, the tenant transfers its full and remaining interest in the lease to that third party, and exits its tenancy. Assignments are more appropriate for tenants that are shutting down entire programs and otherwise planning to vacate the premises permanently.

While intrinsically appealing, both of these strategies generally require a convergence of circumstances to be successful. For either a sublet or an assignment, the tenant must have authority under the lease agreement and must identify a suitable subtenant or assignee. For sublet arrangements, the tenant must be willing to manage the new relationship with the subtenant and rely on that subtenant's ability to pay its share of the rent and other costs provided in the sublease. The costs associated with the sublet should allow the tenant receives a sufficient revenue stream to offset its rent expenses as anticipated.<sup>17</sup> In recent years, some nonprofit organizations were able to offer their extra space to small

---

<sup>17</sup> Jeffrey Weil, *The Art of Subletting Space*, Office Times (1992), available at <http://www.officetimes.com/taosos.html> (reviews many of the more nuanced aspects of subleasing office space, including a range of contract provisions that exist in leases and subleases).

nonprofit organizations that had exited their own leases and were looking for interim arrangements. In a weak real estate market, however, subletting and assignment are usually more viable options if there are several years remaining on the underlying lease. Not only does this make the space more appealing to prospective tenants, who may not wish to move in to new space for a brief period and then have to relocate, it also allows more time to amortize the costs of any construction and repairs to attract the new tenant.

From the moment a nonprofit organization is considering a sublet or assignment, through the execution of the necessary documents, there are legal issues to consider. Most important are the terms of the underlying lease. Most leases will contain a provision regarding subletting and assignments, either permitting them under certain conditions or prohibiting them altogether. The lease may require the tenant to give the landlord ample notice to review a proposed sublet or assignment, allow the landlord to withhold consent absolutely, or require the landlord to have reasonable reasons for withholding consent. Even where sublease is permitted, the landlord will typically have the right to review financial and other information about a proposed subtenant. If the landlord's written consent is required, the tenant needs to allow time for the landlord's review.

Some leases contain a "recapture" clause, giving the landlord the option of terminating the lease, rather than accepting the subtenant or assignee. This allows the landlord the opportunity to reclaim the space for its own use or to release it, compelling the tenant to relinquish the space. Second, the tenant may encounter additional expenses in pursuing a sublet or assignment option, such as broker fees, subletting commissions to the landlord, or build-out charges. Understanding these obligations helps the nonprofit organization to evaluate the costs and benefits of the deal, and prevent unexpected liability later. Finally, the sublease or assignment document must be drafted and negotiated. Legal counsel can help the organization prepare an appropriate assignment or sublet agreement, consistent with the underlying lease. For example, if there are any use restrictions in the underlying lease, the sublease should specify that the subtenant

will abide by those restrictions.<sup>18</sup>

*Example: A nonprofit social services organization that rents three floors from a commercial landlord in the South Bronx recently reduced the size of its staff through attrition, consolidated its office operations, and now has two empty half floors of space. It is one month behind in rent. With slightly more than five years remaining on the lease, it enters into sublease negotiations with a youth development program that has had a balanced budget throughout the recession but is not yet settled in long-term space. It starts to negotiate a four year sublease with the prospective subtenant for half a floor, with the possibility of a one year renewal, but only after legal counsel is aboard does it understand that it must give the landlord 60 days' advance notice of its subletting plans and the landlord can require a credit check on the prospective subtenant. Legal counsel helps the client to negotiate the terms of the landlord's consent, pending a credit report and payment of back rent, as well as the details of the sublease agreement with the subtenant.*

#### **4. Review Leases for Rent Increases and Shared Costs**

Standard commercial leases include provisions for rent increases that may take several forms, and for sharing costs such as utility expenses and real estate taxes. Keeping a check on lease-related expenses requires diligence on the tenant's part, and limited staff resources can make it even more difficult to monitor the landlord's bills and charges. Yet, 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 the underlying bills from the landlords, is a way for tenants to determine whether or not the landlord is correctly billing the organization for rent or pass through payments. Legal counsel can help clients understand their payment obligations and right to obtain backup for the bills, and if necessary obtain bill adjustments, as part of a lease review.

---

<sup>18</sup> Some leases may prohibit subletting or assignments altogether, in which case a sublet or assignment must be negotiated as part of a lease modification. If the lease is silent, public policy favors allowing tenants the freedom to transfer its lease obligations through subleasing, although generally a lease will be more restrictive on a tenant's right to assign than to sublet. See S. H. Spencer Compton and Joshua Stein, *Tenant's Checklist of Silent Lease Issues*, First American Title website, reprinted from *The Practical Real Estate Lawyer*, Vol. 16, No. 3 (May 2000), available at <http://www.firstamny.com/detail.aspx?id=144&mid=17495>; see also N.Y. Real Prop. Law § 226-b (for residential tenants).

### **5. Enter a New Lease**

As the downturn continues, more nonprofit organizations have reached or are nearing the end of their lease terms during a period of economic uncertainty. While rental rates are primarily a function of the market and the parties' bargaining power, there continues to be ample room for negotiation of lease terms as landlords and tenants both seek flexibility as a result of lessons learned during the economic downturn. Location and other incentives continue to affect pricing and terms, as does the landlord's financial position and volume of available rentals.<sup>19</sup> Having a lawyer versed in leasing can help the tenant understand the current real estate market and understand the tradeoffs of various provisions that cover key terms beyond the base rent, such as: early termination rights, rent increase formulas linked to financial conditions, pass through of utilities and taxes and other costs, subletting and assignment options, the impact of a merger or change in corporate control, use restrictions, alternations, and responsibility for payment of tenant improvements. The parties may pay greater attention to the landlord and tenant's rights and options if the nonprofit tenant loses or has decreased funding, or if the landlord cannot maintain the premises, due to the weak economy. As for rent, a lawyer can help identify creative ways for the parties to structure a mutually acceptable rent schedule, with appropriate contingencies, provided the tenant is realistic about its financial situation.<sup>20</sup>

---

<sup>19</sup> Tina Traster, *Landlords Sweeten the Deal Downturn*, Crains New York Business.Com (Feb. 13, 2011), [http://www.crainsnewyork.com/article/20110213/REAL\\_ESTATE02/302139987](http://www.crainsnewyork.com/article/20110213/REAL_ESTATE02/302139987).

<sup>20</sup> See Stephen Millas and Christina Coronado, Orrick Herrington & Sutcliffe LLP, *Issues and Concerns for A Nonprofit When Negotiating a Commercial Lease*, Pro Bono Partnership (Sept. 2009), available at <http://www.probonopartner.org/pages/Publications/real-estate>.

## Part VI

### Funds

If organizations are to be sustainable, revenues are at least half of the equation, no matter how creative the nonprofit sector is at cost-cutting. Although, with limited exceptions, the initial phase of the economic downturn did not cause general operating expenses to increase significantly, it did trigger a collapse in almost every revenue category upon which nonprofit organizations rely to fulfill their charitable missions.<sup>1</sup> In addition to revenue generation challenges, few community-based and small nonprofit organizations have large enough investment holdings or other operating funds to enable deficit budgeting for a protracted period. The majority report having at most a few months of available cash and limited credit. For example, for each of the three years 2009, 2010, 2011, at least 60% of national survey respondents had sufficient cash to cover three or fewer months of expenses and at least 28% had none or one month;<sup>2</sup> New York organizations fared only slightly better.<sup>3</sup> Many groups tapped into their savings

---

<sup>1</sup> See Part I.

<sup>2</sup> 2012 *State of the Sector Survey*, Nonprofit Finance Fund, at 3 (2012), [http://nonprofitfinancefund.org/files/docs/2012/2012survey\\_brochure.pdf](http://nonprofitfinancefund.org/files/docs/2012/2012survey_brochure.pdf). Small organizations generally have fewer months of reserves than large organizations. William Foster, Gail Perreault, & Sarah Sable, *Managing in Tough Times: Nonprofit Leaders Survey Update*, The Bridgespan Group (June 29, 2009), <http://www.bridgespan.org/Publications-and-Tools/Strategy-Development/Managing-in-Tough-Times/Managing-in-Tough-Times-May-2009-Nonprofit-Leaders.aspx> [hereinafter "Bridgespan 2009"].

<sup>3</sup> Data from a 2009 survey of New York City human services organizations showed 67% lacking an endowment, 30% having no lines of credit, and smaller organizations even less likely to have an endowment or credit line. Jack Krauskopf et al., *The Helpers Need Help: New York City's Nonprofit Human Service Organizations Persevering in Uncertain Times*, Baruch College, at 1, 14-17 (Summer 2009), [http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM\\_HelpersNeedHelpReport.pdf](http://www.baruch.cuny.edu/spa/researchcenters/nonprofitstrategy/documents/CNSM_HelpersNeedHelpReport.pdf). For New York respondents of the Nonprofit Finance Fund survey, 57% reported having less than four months of cash available in 2011 and 26% having none or one month. 2012 *State of the Sector Survey Results, NFF Survey Analyzer (Filtered for New York)*, Nonprofit Finance Fund (2012), available at <http://survey.nonprofitfinancefund.org/#respondents,demand,actions,gov,engagement,finhealth/0:Y>.

during the past few years to maintain operations.<sup>4</sup>

As the weak economy persisted and government support remains unreliable, nonprofit organizations have been compelled to reexamine their revenue streams and take action, both to defend what they have – especially severely threatened government funding – and fill major holes through additional revenue sources as well as cash flow changes. Most of the available options have legal implications, including advocating for government budget support, expanding private fundraising activities, charging fees for services, building investments that will generate income, and accessing additional cash in reserves and through loans. Although not a panacea, each of these efforts can help organizations keep their programs going despite major and prolonged gaps in more traditional funding.

## **A. Strategies for Preserving and Increasing Revenues**

---

### ***1. Lobby to Protect Government Funding***

State and city budget crises have altered the nonprofit advocacy arena. An increasing number of organizations, individually and through coalitions and umbrella groups, have turned to advocacy for the first time, or renewed their advocacy with heightened energy, because of the threat of diminished government support. Nonprofit leaders are lobbying for program dollars. They also are lobbying to reduce contract delays and other procurement problems that have long plagued the government contracting system. From busing senior citizens to the state capital in Albany to protesting on the steps of City Hall, nonprofit organizations are informing legislators about the harsh consequences that cuts or delays will have on programs as part of an effort to prevent the interruption of fundamental services. State, regional, and mission-based coalitions are encouraging individual nonprofits to have a collective voice as they demand

---

<sup>4</sup> In Bridgespan and Johns Hopkins University mid-2009 surveys, 33% and 25% of respondents, respectively, reported tapping reserves between late 2008 and June 2009; for Bridgespan, the 33% was up from 19% six months earlier. Bridgespan 2009, *supra* note 2; Lester M. Salamon et al., *Impact of the 2007-09 Economic Recession on Nonprofit Organizations*, John Hopkins University Center for Civil Society Studies, Communique No. 14 (June 2009). See also Special Report Number 8, *A Respectful Warning Call to our Partners in Government: The Economic Crisis is Unraveling the Social Safety Net Faster than Most Realize*, National Council of Nonprofits, at 2 (Aug. 10, 2009).

budgetary alternatives.<sup>5</sup> Legal counsel can advise nonprofit managers about the federal, state, and local regulations related to lobbying activity so that they can advocate to the maximum extent possible while being protected from liability.

Legislative advocacy is highly regulated by some statutes particular to the nonprofit sector and others that apply to lobbying in general. A threshold question is whether the organization or its representative is “lobbying,” that is, attempting to influence legislation.<sup>6</sup> Lobbying limits in the Internal Revenue Code (IRC) on 501(c) (3) tax-exempt organizations are not as restrictive as many groups believe. For starters, not all advocacy work will be deemed “lobbying.” For example, releasing a nonpartisan research report or testifying when invited to speak at a public hearing is not lobbying activity under the lobbying laws. Other forms of legislative engagement – from sending correspondence to a government official supporting or opposing legislation to visiting with public officials to urge them to adopt a particular position on such legislation – are regulated lobbying activity. Lobbying can be done directly, for example by staff members contacting legislators, or indirectly via grassroots lobbying, which involves a “call to action” asking others to contact legislators.<sup>7</sup> When nonprofit leaders communicate with legislators to urge them to restore budget cuts or change a proposed budget, this activity falls within definitions of “lobbying” because State and City budgets are enacted by a legislative body.<sup>8</sup>

Moreover, lobbying in itself does not jeopardize 501(c) (3) tax-exempt status, so long as lobbying is not a “substantial part” of the organization’s activities. Legal counsel can help groups to use either a “facts and circumstances test” or

---

<sup>5</sup> For example, in 2011 the Human Services Council ran a “Who Cares? I Do” online petition campaign to “call on government to allocate adequate State and local resources to all New Yorkers in need of essential services” and also participated in a May 2011 rally in front of New York City Hall to call on the Mayor and City Council to restore proposed budget cuts to education, health and human services.

Similarly, the National Council of Nonprofits has urged nonprofit leaders to “embrace our special role in democracy” by engaging in advocacy through state associations and sharing concerns and ideas to policymakers. *State Budget Crises: Ripping the Safety Net Held by Nonprofits*, National Council of Nonprofits at 10-11 (Mar. 16, 2010), [www.councilofnonprofits.org/sites/default/files/Special-Report-State-Budget-Crises-Ripping-the-Safety-Net-Held-by-Nonprofits.pdf](http://www.councilofnonprofits.org/sites/default/files/Special-Report-State-Budget-Crises-Ripping-the-Safety-Net-Held-by-Nonprofits.pdf). [hereinafter “NCON 2010”].

<sup>6</sup> I.R.C. § 4911(e) (2); Treas. Reg. § 56.4911-2 (b)(1).

<sup>7</sup> See I.R.C. § 4911 (e)(2); Treas. Reg. § 56.4911-2 (b)(1).

<sup>8</sup> See New York State Lobbying Act, N.Y. CLS Legis. Law § 1-c; New York City Lobbying Act, NYC Admin. Code Title 3, § 3-211.



make the IRC Section 501(h) election to measure the amount of their lobbying activities. Under the facts and circumstances test, organizations are required to give the IRS detailed descriptions of their lobbying-related activities to show their lobbying is not a “substantial part.” Alternatively, organizations that make a 501(h) election may devote up to a defined percentage of their expenditures to lobbying without threatening their tax-exempt status and without any additional annual filing obligation. Section 501(h) defines what lobbying communications will count toward the limits, making it clearer and more predictable than the facts and circumstances test. The size of the organization determines exactly how much money it is permitted to spend on lobbying, but in all cases lobbying cannot account for more than 20% of the annual operating expenses for the organization and not more than \$1,000,000. There is a smaller cap, within the total, for grassroots lobbying.<sup>9</sup> Absent appropriate legal guidance, nonprofit groups may be unaware of the 501(h) election or unclear on how it applies to them. Yet, the 501(h) election means they can pursue certain lobbying strategies with little or no IRS scrutiny and, if they stay within the specified lobbying limits, without risking their tax-exempt status.<sup>10</sup> Understanding lobbying definitions and limits empowers groups to voice legislative concerns with greater confidence that these efforts are “insubstantial part” of their activities.

In addition, legal guidance can help nonprofit leaders to navigate federal, state, and local lobbying registration and reporting obligations, saving their organizations time and money. These laws do not limit activity, but require reporting of activity. The Federal Lobbying Disclosure Act requires nonprofit and for-profit organizations that are active on Capitol Hill in the District of Columbia to register and file reports once certain expenditure levels are reached; with an exemption if the organization’s federal lobbying expenses do not exceed \$11,500 during a quarterly period, this statute generally applies only to nonprofit

---

<sup>9</sup> The financial cost of lobbying for most organizations consists primarily of staff time although other expenses, such as the cost of mailings, can be counted. I.R.C. § 501(h); Treas. Reg. §§ 56.4911-0 et seq. Expenditures are reported on Schedule C of the I.R.S. Form 990.

<sup>10</sup> If the organization exceeds its lobbying expenditure dollar limit in a particular year, it must pay an excise tax equal to 25 percent of the excess. Revocation of tax exempt status is authorized only if the electing organization exceeds the lobbying limits by at least 150% averaged over four years. See *Measuring Lobbying Activity: Expenditure Test*, Internal Revenue Service, [www.irs.gov/charities/article/0,,id=163394,00.html](http://www.irs.gov/charities/article/0,,id=163394,00.html).

organizations that are regularly lobbying in the federal arena.<sup>11</sup> The thresholds are lower at the state and city level. The New York City Lobbying Law has a \$2,000 annual expenditure threshold for reporting lobbying expenditures, requires semi-annual filing by lobbying organizations and bi-monthly filing by lobbyists (including nonprofit staff members who lobby), and only covers lobbying at the municipal level. The New York State Public Integrity Act has a \$5,000 threshold, but includes both state and municipal lobbying and also requires semi-annual and bi-monthly reporting.<sup>12</sup> A pending New York City Lobbying Commission proposal would raise the City threshold from \$2,000 to \$5,000.<sup>13</sup> Failure to file on time can expose a nonprofit organization to penalties; for example, the possible State lateness fee is \$10/day for first-time filers and \$25/day thereafter.<sup>14</sup> Significantly, the New York State Commission on Public Integrity is amenable to negotiating a waiver or reduction of penalties depending on the circumstances, but the New York City Clerk's office currently will not negotiate a reduction or waiver for registration delinquencies or late filing.<sup>15</sup> Although the state and local statutes are complex and in places ambiguous, appropriate legal guidance can help nonprofit organizations to lobby legally or important government funding and to file proper reports without incurring penalties and interest.

*Example: An organization devoted to immigrant rights in New York City has been advocating for increased funding for immigrant services in both the state legislature and the New York City Council, and it has made the 501(h) election to insure that its lobbying expenditures do not exceed the limits set by the Internal Revenue Code. However, it has never registered or filed reports with the New York State Commission on Public Integrity or the New York City Clerk. Legal counsel analyzes the nature and the level of the organization's activities in both Albany and New York City, and determines that, for some years, the lobbying*

---

<sup>11</sup> Lobbying Disclosure Act, 2 U.S.C. § 1601 *et seq.* For further clarification, see Office of the Clerk U.S. House of Representatives, *Lobbying Disclosure Act Guidance* (rev. Dec. 1, 2011), [http://lobbyingdisclosure.house.gov/amended\\_lda\\_guide.html](http://lobbyingdisclosure.house.gov/amended_lda_guide.html).

<sup>12</sup> Unlike the Internal Revenue Service, neither New York State nor New York City limit the amount an organization can spend on lobbying, but they both require reporting if lobbying activity exceeds these thresholds. New York State Lobbying Act, N.Y. Legis. Law § 1-j; New York City Lobbying Act, NYC Admin. Code § 3-216.

<sup>13</sup> *Preliminary Report of the New York City Lobbying Commission*, New York City Lobbying Commission, at 3-4 (Aug. 9, 2011), [http://www.nyc.gov/html/lobby/downloads/pdf/preliminary\\_report\\_of\\_the\\_new\\_york\\_city\\_lobbying\\_commission.pdf](http://www.nyc.gov/html/lobby/downloads/pdf/preliminary_report_of_the_new_york_city_lobbying_commission.pdf).

<sup>14</sup> New York State Lobbying Act, N.Y. Legis. Law §§ 1-e (e)(iv), 1-h (c)(3), 1-i (c)(3), 1-j (c)(3).

<sup>15</sup> In Lawyers Alliance's experience, these City fees have not been negotiable.

*thresholds were not reached by the organization's lobbying expenditures. For those years in which the thresholds were exceeded, counsel is able to negotiate a waiver of the state penalties and minimize the New York City penalties by helping the organization carefully distinguish between actual lobbying expenditures and those activities that did not involve reportable expenditures.*

## **2. Expand Fundraising**

Throughout the economic downturn, many nonprofit organizations have intensified their fundraising activities directed at private individuals and businesses. When the recession hit, some organizations were hesitant to engage in major cost-cutting measures and instead expanded fundraising in the hope that doing so would improve cash flow.<sup>16</sup> As the economic downturn persisted and cost-cutting became imperative, fundraising has remained a priority. Common approaches have included staying close to loyal donors, emphasizing the importance of their safety net services in targeted appeals, cultivating new donors who may be particularly supportive during difficult financial times, and cancelling special events where costs threatened to exceed income. Some organizations have tried to raise more dollars from an increased number of smaller donations, while others have been more successful securing a smaller number of large gifts. Additional initiatives include expanding marketing efforts, adding new online donation methods, expanding advocacy for public funding, increasing board development efforts, and increasing development capacity for individual donor programs.<sup>17</sup>

However charities expand their fundraising efforts, they are well-served by adhering to fundraising laws and regulations. At the state level, the regulatory scheme helps to ensure that donations are used for charitable purposes and consistent with donor intent. To avoid a solicitation fraud action, charities should make clear requests and be careful not to present misleading or deceptive information in their charitable solicitation materials. While most fundraising campaigns raise money for worthwhile projects, the state Attorney General's Office serves as the enforcer of laws intended to protect donors in the state from

---

<sup>16</sup> *Managing in Tough Times: Survey Themes 2008*, The Bridgespan Group, at 3 (Dec. 3, 2008), <http://www.bridgespan.org/tough-times-survey-themes.aspx>.

<sup>17</sup> NCON 2010, *supra* note 5, at 5.

fraudulent solicitations.<sup>18</sup> In addition, most states require charities and their paid fundraisers to register and to file accurate financial statements with state charities officials if they are soliciting within the particular state.<sup>19</sup> In New York State, the Charities Bureau of the state Attorney General's Office administers this process and maintains an online Charities Registry listing the registration status of groups that have filed with the office.<sup>20</sup> State and city agencies may verify that filings are current before approving a government contract, increasing the stakes of timely compliance. Because these filings are available for public inspection, charities seeking to impress donors, the press, charities watchdog groups and others are well-served to file timely reports not only to comply with the law but also to improve public relations.

At the federal level, charities must make copies of the annual IRS Form 990 readily available for inspection by donors and other members of the public,<sup>21</sup> and they should be attentive to the rules about documentation of tax-deductible gifts. Donors have come to expect that most 501(c)(3) organizations will automatically provide them with the documents necessary for a deduction, even though, for purely monetary contributions, the documentation obligation technically is on the donor. For cash gifts under \$250, taxpayers must maintain a written record, such as a bank record or written communication from the donor; if \$250 or more, the

---

<sup>18</sup> The New York governing statute is Article 7-A, Solicitation and Collection of Funds for Charitable Purposes, of the New York Executive Law. Section 172-d of the New York Executive Law prohibits fraudulent solicitation, including acts which may be characterized as deceptive. N.Y. Exec. Law § 172-d.

<sup>19</sup> State charities offices throughout the United States regulate charitable organizations and solicitations. Charitable organizations that solicit in multiple states may use the Unified Registration Statement, available at <http://www.multistatefiling.org> and accepted by 37 states and the District of Columbia. Those soliciting on the Internet can use as a guide *The Charlestown Principles: Guidelines on Charitable Solicitations Using the Internet*, posted at <http://www.nasconet.org/wp-content/uploads/2011/05/Charleston-Principles-Final.pdf>, which reflects the consensus of the National Association of State Charities Officials about when and where charities and their fundraisers must register.

<sup>20</sup> Article 7-A of the New York Executive Law sets forth registration and reporting requirements for charities soliciting in New York. N.Y. Exec. Law §§ 171-a et seq.. Instructions, copies of registration forms, and the registry are currently available online at [http://www.charitiesnys.com/registration\\_reporting\\_new.jsp.r](http://www.charitiesnys.com/registration_reporting_new.jsp.r).

<sup>21</sup> Under I.R.C. § 6104(d), organizations exempt under 501(c)(3) or 501(c)(4) of the I.R.C. must make their three most recent Form 990s available for inspection and provide copies upon request. IRS Form 990s are due to the IRS by fifteenth day of the fifth month following the end of the fiscal year. The IRS can revoke tax-exempt status for failure to file required Form 990s for three consecutive years. See Treas. Reg. § 1.6033-2.

taxpayer must maintain a contemporaneous written acknowledgement from the donee. In contrast, for *quid quo pro* contributions, where the donee receives goods or services in exchange, the obligation is on the donee, who must give the donor a written disclosure statement if the total payment is over \$75. The disclosure statement shall briefly describe and make a good faith estimate of the fair market value of the goods or services provided by the charity in exchange and state that the donor can deduct only the amount of the contribution that exceeds this fair market value. For non-cash items, such as donated items for a silent auction, the contribution amount is the fair market value of the property at the time of the contribution.<sup>22</sup>

*Example: An established charity that offers counseling services to cancer patients seeks legal guidance about whether to accept and how to acknowledge \$5,100 from a group of individuals who had raised the money in memory of the death of a friend who had died from cancer. This group of individuals had approached the established charity after one of them received a solicitation letter requesting funds to help the charity during the downturn. The charity and the group of donors are cautious about this proposed gift because last year the state Attorney General obtained a temporary restraining order against an unrelated Long Island group that allegedly raised more than \$500,000 by falsely claiming that donations would support the fight against breast cancer when the funds instead were used for luxury shopping, restaurants and sorority dues. Legal counsel advises the established charity about appropriate procedures. As a result, the charity contacts each of the donors to confirm their intended donation, acknowledges the donations properly, and is able to accept and use these additional funds to help cancer patients.*

While the dearth of funds had led some organizations to reduce fundraising expenses, others have sought to hire outside fundraising professionals, instead of or in addition to current staff, hoping this added capacity will lead to additional dollars. Experienced fundraising professionals can assist with direct appeals to specific donors, grant-writing, special events, feasibility analyses and other activities. Particularly for organizations with minimal experience with paid

<sup>22</sup> See I.R.S. Publication 526, *Charitable Contributions* (Rev. Jan. 27, 2012), <http://www.irs.gov/pub/irs-pdf/p526.pdf>, for a summary of what types of donations are tax-deductible [hereinafter "I.R.S. Pub. 526"], and I.R.S. Publication 1771, *Charitable Contributions: Substantiation and Disclosure Requirements* (Rev. 9-2011), <http://www.irs.gov/pub/irs-pdf/p1771.pdf>, for a summary of documentation requirements.

fundraising professionals, having legal guidance can help them to evaluate the applicable laws and the pros and cons of different fundraising expansion strategies.

States regulate paid fundraisers, although different states use different terminology and legal rules to describe such individuals and entities. New York charities law requires Professional Fundraisers and Fundraising Counsel to register annually and file their fundraising contracts with the Charities Bureau, with the former having more extensive reporting requirements. The primary difference between the two is that Professional Fundraisers, for compensation, handle solicited funds, make the solicitation, and/or have authority to pay fundraising expenses; Fundraising Counsel, for compensation, provide advice and manage fundraising campaigns, but do not have any of the additional responsibilities.<sup>23</sup> Commercial Coventurers are entities that are regularly engaged in a trade or business and advertise that the purchase of their goods or services will benefit a charity. Commercial Coventurers are not required to register, but must have written contracts with charities and provide the charity with an accounting.<sup>24</sup>

Lawyers are helpful in reviewing contracts between charities and fundraising professionals of all types. Among topics to be negotiated are the roles of each party, length of contract, payment terms, assignment rights, and termination, accounting, and amendment procedures. Before a charity engages a fundraising professional, the charity should confirm that both it and its fundraiser are in compliance with charities registration rules. Moreover, legal counsel can help an organization protect its rights to any intellectual property that may be generated or used in the course of a fundraising project, such as logos or copy, or receive appropriate compensation for the licensing of any such rights.

As part of the panoply of expanded fundraising activities, some nonprofit organizations have attempted or are now contemplating more special events, such as dinners, concerts, auctions, and game-nights. Although overall donor interest in events diminished during the earliest part of the downturn, some organizations have raised additional dollars or increased the number of donors through such activities. Lawyers help such organizations to maximize their dollars and minimize risk by reviewing venue agreements and encouraging charities to

---

<sup>23</sup> N.Y. Exec. Law §§ 171-a (4), 173, 173-a.

<sup>24</sup> N.Y. Exec. Law §§ 173-a (3).

check their insurance coverage or obtain a rider for event-related losses. When entering contracts for events at off-site venues, groups will want to verify and possibly negotiate terms related to services, payment, cancellation, contingency plans, insurance, and other areas of concern. The organization's general liability coverage may not be sufficient, from the organization's or venue's perspective, in which case the organization will want to investigate a supplement to its own insurance or the venue contract.

Legal and accounting advisers also can review with nonprofit managers the IRS rules regarding deductibility and documentation of charitable contributions, especially *quid quo pro* contributions (i.e., those when donor gets goods or services back in exchange for a portion of the donation) and non-cash gifts. Events typically involve a *quid quo pro* analysis because the donor receives food, entertainment, auction prizes or other items in exchange. For *quid pro quo* contributions, the charity must give the donor a written disclosure statement if the payment is over \$75 and is a *quid quo pro* contribution.<sup>25</sup> Counsel also can provide guidance on Form 990 requirements for reporting event income.<sup>26</sup>

The regulation of charitable gaming activities is more complicated, and the compliance burden sometimes will chill creative gaming efforts. Charities may seek to hold a raffle, bingo tournament, casino night, video lottery, or other game of chance as a recreational or fundraising activity, as a stand-alone activity, or as a complement to another event. The IRS generally considers gaming that generates revenue to be a trade or business activity, not a charitable activity. A charity conducting gaming as an insubstantial part of its activities ordinarily will not jeopardize its tax-exempt status, but its gaming income may be subject to the Unrelated Business Income Tax ("UBIT"). Depending on the facts, the gaming income from an annual fundraising event (in contrast to weekly/monthly casino

---

<sup>25</sup> I.R.S. Pub. 526, *supra* note 22; I.R.S. Pub. 561; *Determining Value of Donated Property* (Rev. Apr. 2007), <http://www.irs.gov/pub/irs-pdf/p561.pdf>.

<sup>26</sup> Schedule G of I.R.S. Form 990 or 990-EZ, *Supplemental Information Regarding Fundraising or Gaming Activities*, is for organizations to report revenues and direct expenses from special events if they have more than \$15,000 in annual fundraising event gross income and contributions (and list specific events with more than \$5,000). Schedule G separately requires reporting by those with a total of more than \$15,000 of expenses for professional fundraising services or more than \$15,000 of gross income from gaming activities.



nights) may be exempt from UBIT because the gaming is not “regularly carried on” activity.<sup>27</sup>

Meanwhile, each state has an agency or agencies that regulate gaming, and different states and localities have their own charitable gaming rules.<sup>28</sup> Many like New York permit only certain types of charitable gambling, such as bingo and charitable raffles, and have a series of detailed steps and rules that are required for compliance.<sup>29</sup> Proceeds typically are to be used exclusively for charitable purposes. For nonprofit organizations willing and able to follow the charitable gaming rules, these activities can be an entertaining and sometimes financially viable supplement to other fundraising efforts.

### **3. Explore Fee-Generating Activities**

Charging for goods and services, if successful, is another way to provide some financial cushion during hard times and to gear up new sources of potential revenue for when prosperity returns. Software, works of art, substantive trainings, after-school programs, and counseling services are among the multitude of goods and services of value provided by nonprofit organizations that can command remuneration. Sometimes nonprofit managers and boards of directors are reluctant to charge fees because of the culture or mission of the organization, such as when the organization serves indigent people unable to pay for services. However, not all fees are inconsistent with an organization’s mission or prohibited by the law. Generally it is permissible and not uncommon for tax-exempt, nonprofit organizations to generate revenues through fees. Legal counsel can dispel myths and help nonprofits pursue appropriate fee-generating activities as a way to diversify funding.

---

<sup>27</sup> Another possibly applicable UBIT exception is for gaming income from work that is all done by volunteers. I.R.S. Pub. 3079, *Tax-Exempt Organizations and Gaming*, at 9, 11 (Rev. 6-2010), [www.irs.gov/pub/irs-pdf/p3079.pdf](http://www.irs.gov/pub/irs-pdf/p3079.pdf).

<sup>28</sup> See [www.gambling-law-us.com/Useful-Sites/State-Gambling-Agencies.htm](http://www.gambling-law-us.com/Useful-Sites/State-Gambling-Agencies.htm) for list of state agencies that regulate gaming, and [www.gambling-law-us.com](http://www.gambling-law-us.com) for the different states’ gambling laws.

<sup>29</sup> The NYS Racing & Wagering Board regulates charitable gaming in New York and provides information about the regulatory scheme on its website at [www.racing.state.ny.us](http://www.racing.state.ny.us). To raise funds through games of chance in New York, organizations must: apply for a games of chance number from the state and a license from the locality; exist and serve charitable or religious purposes for at least 3 years prior to applying for authorization; devote at least 75 percent of the organization’s activities to programs other than conducting games of chance; and submit an accounting afterwards.



As nonprofit organizations contemplate charging fees, lawyers can provide information about the legal parameters. One issue is whether the resulting revenue is unrelated business income subjecting the organization to UBIT, and, if so, how much UBIT must be paid. Fee-generating activity generally will not be taxable under UBIT if it is related to the organization's charitable purposes, for example, when a job training and placement program charges participants a fee for its resume and interviewing workshops. Similarly, UBIT exemptions may apply, such as when a nonprofit organization is selling donated goods or using volunteers to do the work.<sup>30</sup> Legal counsel can help organizations to analyze the facts and assess UBIT implications.<sup>31</sup> The possibility of incurring unrelated business income tax is not necessarily a reason to refrain from unrelated business activity, but the tax liability should be taken into account to considering the promise of additional revenues.

Unrelated business income tax liabilities generally do not impact an organization's tax-exempt status unless the extent of those activities, and the revenue derived from them, represent a substantial part of the organization's focus. At an extreme, the IRS has denied recognition of 501(c)(3) tax-exempt status on the grounds that the financial support of the organization is entirely fee-based when the services are also provided by commercial providers. In the absence of a broad fundraising program that will enable the organization to provide fee-based services "below cost," the IRS may be concerned about "undue commerciality" and inquire whether charging fees for program services "significantly detracts from the organization's charitable purpose."<sup>32</sup>

Practically, nonprofit organizations face difficult questions about the mechanics of charging fees. Plus, the organization should review funding contracts, funding proposals and award letters to ensure that charging a fee is not prohibited under current or requested grants. While a broad bar against fees is uncommon, the contract or grant award may limit the nonprofit organization's ability to charge

---

<sup>30</sup> See I.R.C. §§ 511, 512, 513.

<sup>31</sup> The need to raise funds or use profits from an unrelated activity to fund programs is not in itself sufficiently related to exempt purposes. For more information on whether an activity is taxable as UBIT and how much UBIT is permissible without jeopardizing an organization's tax-exempt status, see I.R.C. § 513(a) and IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations* (Rev. Mar. 2012), [www.irs.gov/pub/irs-pdf/p598.pdf](http://www.irs.gov/pub/irs-pdf/p598.pdf).

<sup>32</sup> IRS, *H. IRC 501(c)(3) Substantially Below Cost* (1986 EO CPE Text), <http://www.irs.gov/pub/irs-tege/eotopich86.pdf>.

certain individuals or to charge for certain types of goods, services, intellectual property, or other assets derived from contract funds. Absent any such limits, the organization generally may choose a flat fee, waivers and discounts for certain situations (e.g., volume discounts, waivers for volunteers), a sliding scale, or other reasonable fee structure. When creating a sliding scale based on ability to pay, organizations are well-served by having a clear and written fee policy that sets forth eligibility standards, required documentation to show eligibility, and procedures for protecting any personally identifiable information. This helps to ensure accountability and fairness and prevent claims of unequal treatment.

*Example: A nonprofit community center that operates evening programs for teenagers charges a \$20/person attendance fee for quarterly "Battle of the Bands" concerts, which the prior year was free and well-attended, and offers a new six-week SAT preparation course with free or reduced tuition based on financial need. The SAT preparation course is funded in part by a grant specifying that at least half of the students in the program must receive a full scholarship. The Battle of the Bands concerts are funded out of general operating funds. With legal guidance, the organization develops a written sliding scale and first-come, first-serve policy for the SAT preparation course and with attorney and accountant input determines that the new income from these programs is not subject to UBIT.*

In the final analysis, nonprofit managers and board members should be realistic in their assessment of the revenue prospects that can be realized from fee-generating activity. Program participants who are accustomed to receiving services without charge may be reluctant to bear a portion of the expense by paying even a nominal fee, especially if the services are available elsewhere without charge. In the recession, the public's ability to pay fees even for essential services is severely constrained. The start-up expenses associated with creating a new line of fee-generating activity can easily be understated, and access to credit to address unanticipated problems in an environment of inhibited bank lending will be limited. Careful business planning, with the assistance of legal counsel to understand the legal parameters, is essential to strengthen rather than undermine the organization's stability.

## **B. Strategies for Accessing Cash and Other Financial Resources**

---

For nonprofit organizations in a range of financial situations – even those with sufficient reserves at the start of the recession or with solid revenues throughout

the economic downturn – another area of concern during uncertain economic times is cash position. Cash flow can be strained by government contract delays, deferred foundation grants, the timing of fundraising appeals, or unusual one-time expenses associated with reducing costs such as severance payments or fees for early termination of leases. Sometimes donors or lenders may have imposed restrictions on the management or use of certain funds held by the organization. Legal assistance can help nonprofit organizations to access more cash and credit, or at least better evaluate their options for doing so.

### ***1. Manage Investments Prudently***

For organizations with sufficient reserves, drawing from these accounts can be a short-term strategy to fund programmatic services. On the other hand, a competing goal may be to grow the reserves over time, through positive investment performance, so that investment holdings will generate more interest or otherwise be available for future program needs. The term “reserves” typically is used in the non-legal sense to refer to funds held by organizations, beyond general operating income, that are available for use. Reserves may be kept in savings and money market accounts, certificates of deposit, stocks, or a range of other investment funds that can be easily liquidated to provide cash beyond general operating funds. Reserves may be legally restricted (e.g., through donor or lender restrictions) or unrestricted. Nonprofit boards may create different types of reserves, specifying particular restrictions or plans for how each type is to be invested and managed (e.g., types of accounts) or used (e.g., designation that funds be saved for an office move, particular staff position, or program initiative).

A board-imposed spending restriction may be lifted by the board without donor or court approval. Similarly, if the board of directors places a restriction on the management, investment, or use of certain funds, the board can lift or modify that restriction by an appropriate board vote. Part of the legal analysis involves determining whether any restrictions are imposed by the board, a donor, a lender, or other source; if so, whether and how they may be removed; and, if not, what steps are appropriate (e.g., withdrawal or reinvestment) given the available reserves and the organization’s needs.

Nevertheless, directors and officers are governed by the duties of care, loyalty and obedience regarding the management and expenditure of all assets held

by the organization, including unrestricted assets and restricted assets.<sup>33</sup> These overarching themes apply to nonprofit organizations nationwide, whether they invest their funds in conservative, mid-risk or high-risk investment vehicles.

For nonprofit organizations incorporated under New York law, the New York Prudent Management of Institutional Funds Act ("NYPMIFA") now provides more specific direction regarding the prudent management and investment of their "institutional funds."<sup>34</sup> Legal counsel can help groups understand whether their holdings are "institutional funds," which is defined broadly as a "fund held by an institution," or fall within one of the narrow NYPMIFA exclusions such as assets held for programmatic purposes."<sup>35</sup> Moreover, since the statute became effective on September 17, 2010, nonprofit organizations and their attorneys have sought to decipher the meaning and impact of NYPMIFA's standards of prudent conduct. The statute requires nonprofit managers and directors to consider eight factors when making investment and management decisions related to institutional funds: general economic conditions, possible effect of inflation/deflation, any expected tax consequences, effect on overall investment portfolio, expected total return from income and appreciation of investments, other resources of the institution, needs of institution and fund to make distributions and preserve capital, and any special relationship between an asset and the institution's charitable purposes.<sup>36</sup> The statute also requires all charities to have an investment policy if they have any Institutional Funds, defined broadly as funds held "exclusively for charitable purposes."<sup>37</sup> The Attorney General's Office has issued some guidance on these and other provisions.<sup>38</sup> Based on a review of multiple factors, different boards of directors may, after due diligence, come to different prudent decisions about the

---

<sup>33</sup> N.Y. Not-for-Profit Corp. Law §§ 517, 519, 552(b).

<sup>34</sup> NYPMIFA provides that each person responsible for managing and investing an institutional fund "shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." N.Y. Not-for-Profit Corp. Law § 552 (d).

<sup>35</sup> The NYPMIFA definition of "institution" includes New York not-for-profit, education and religious corporations. "Institutional funds" excludes (i) "program –related assets, which as a practical matter excludes buildings, facilities, or collections used by the organization for program activities and (ii) wholly charitable trusts, although such trusts remain subject to similar prudent investor rules. N.Y. Not-for-Profit Corp. Law §§ 551 (d), (e).

<sup>36</sup> N.Y. Not-for-Profit Corp. Law § 552 (e)(1).

<sup>37</sup> N.Y. Not-for-Profit Corp. Law § 552 (f).

<sup>38</sup> *A Practical Guide to the New York Prudent Management of Institutional Funds Act*, N.Y. State Office of the Attorney General (Mar. 2011), available at [http://www.charitiesnys.com/guides\\_advice\\_new.jsp](http://www.charitiesnys.com/guides_advice_new.jsp).

proper size, parameters and use of reserves for their respective organizations.

The protracted economic downturn increased the volume and significance of practical and legal questions related to managing and tapping reserves. Organizations that had sizable, unrestricted cash reserves entering into the recession had greater flexibility because they could choose to continue or increase their level of services for at least the short term, knowing these reserves were available to cover expenses should their revenues fall short. Those with smaller reserves and less predictable cash receipts more likely needed to cut back on services to keep income, cash, and expenses more in balance. Legal counsel can help nonprofit managers to weigh the pros and cons of different investment and liquidation strategies and, for liquid assets, help them determine whether and when a withdrawal is prudent, in the best interests of the organization, and legally permissible.

## ***2. Tap Endowment Funds and Other Restricted Gifts***

Donors may restrict their gifts in multiple ways, such as for a specific purpose (e.g., to support a specific program or capital project), for use during a specific time (e.g., for a specified 12 month period), or for investment in a particular manner (e.g., for a certain type of account). These restrictions on use may be created by gift solicitation language, written in a funding agreement, or included in the donor's writing accompanying the gift.<sup>39</sup> Under the New York Not-for-Profit Corporation Law, the board of directors must ensure that the organization uses donated assets for the purposes specified in the gift instrument.<sup>40</sup> To comply with gift restrictions, the organization's books of account should distinguish between funds received under a particular grant or contract and those more generally available for expenditure. Some funding sources, such as certain government contracts, require that the contract funds be maintained in separate bank accounts. In order to modify or remove a donor restriction, a charity must obtain either

---

<sup>39</sup> It is a violation of Article 7-A of the New York Executive Law "to fail to apply [charitable] contributions in a manner substantially consistent with the solicitation for charitable purposes." N.Y. Exec. Law § 172-d (4).

<sup>40</sup> N.Y. Not-for-Profit Corp. Law § 513 (b). Gifts received without specific restrictions generally must be used for the organization's stated charitable purposes. If an organization subsequently changes its corporate purposes or activities, it generally must use pre-amendment funds for pre-amendment purposes not the new or different purposes.

written consent from the donor<sup>41</sup> or court approval.<sup>42</sup> A release of a gift restriction may not allow funds to be used for purposes other than the existing purposes of the corporation.<sup>43</sup>

Endowments are a specific type of restricted gift and raise additional legal issues. Endowment funds are not wholly expendable on a current basis under the terms of the gift instrument. The principal is intended by the donor to continue in perpetuity, but the charity can use the income and appreciated value from the gift and, with certain limitations, the appreciation.<sup>44</sup> Sometimes a board has the power to spend all of the funds but affirmatively chooses not to; these are “board designated” funds, not endowment funds. When poor investment performance during the economic downturn put some organization’s endowment funds “underwater” (i.e., current value is less than the value at the time of the gift), organizations that needed the interest from those funds for programming faced a legal and accounting conundrum. Until New York State adopted NYPMIFA in September 2010, a charity could use the income, but not the appreciated value of endowment funds, unless the “historic dollar value” of the fund was preserved, or the charity had explicit donor or court permission.<sup>45</sup> Depending on the circumstances, possible legal options were to: expend only fund income; expend appreciation appropriated when the endowment was “above water;” seek the donor’s permission to release or modify the endowment restrictions; or seek judicial release of endowment restrictions.

NYPMIFA now permits appropriation and expenditure of endowment funds below the historic dollar value of endowment gifts, subject to donor intent, if the board determines in good faith that the expenditure is prudent and consistent

---

<sup>41</sup> N.Y. Not-for-Profit Corp. Law § 555 (a).

<sup>42</sup> In New York, a charity may apply to the state supreme court (upon notice to the donor, if available), for a modification of a gift restriction on the grounds that the particular purpose or a restriction contained in the gift instrument has “become[s] unlawful, impracticable, impossible to achieve, or wasteful.” N.Y. Not-for-Profit Corp. Law, § 555 (c).

<sup>43</sup> N.Y. Not-for-Profit Corp. Law § 555 (a).

<sup>44</sup> N.Y. Not-for-Profit Corp. Law § 551 (b).

<sup>45</sup> The old rule was set forth in N-PCL § 513(c), now deleted. NYPMIFA is contained in Article 5-A (Sections 550 *et seq.*) of the N-PCL, a new section. See N.Y. Not-for-Profit Corp. Law §§ 550-558.

with purpose for which fund was created.<sup>46</sup> NYPMIFA specifies eight prudence factors for nonprofit managers to consider before authorizing any appropriation of endowment funds for expenditure, which are separate from the eight prudence factors for investment decisions.<sup>47</sup> The statute requires an organization to give notice to available donors before it applies the new NYPMIFA appropriation standard for the first time to funds received prior to September 17, 2010.<sup>48</sup> Because of NYPMIFA, charities holding institutional funds in New York are reexamining their endowment funds, preparing notices to previous donors, updating their investment policies, and trying to understand the implications of NYPMIFA for their particular funds.

*Example: In late 2010, a charity seeks to appropriate about 5% of the fair market value of three endowment funds, which all were created three years earlier and are modestly underwater. The board of directors has weighed the alternatives, including shutting down a youth program that would otherwise be financed by this appropriation, and concluded this is a prudent course of action. With help from legal counsel, the board considers each fund separately, records in board minutes its consideration of all the NYPMIFA prudence factors, prepares a notice to the fifteen donors of the different funds, and appropriates but does not invade the funds during the 90-day NYPMIFA notice period. After 90 days, when the donors either do not respond or respond indicating that the charity may spend as much of the endowment gift as is prudent under NYPMIFA, the charity transfers such funds into an account that will pay for staffing for its youth program.*

### **3. Borrow Funds**

As cash constraints grew, some nonprofit organizations borrowed 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

<sup>46</sup> NYPMIFA replaces historic dollar cost with a prudence standard, like similar statutes in 30 other states and the District of Columbia, but NYPMIFA has some unique provisions, including a Notice to donors of pre-September 7, 2010 endowment gifts and the requirement that, as one of eight factors, boards of directors consider the effect of alternatives to spending endowment funds before making any expenditure decisions. NYPMIFA is contained in Article 5-A (Sections 550 *et seq.*) of the N-PCL, a new section. See N.Y. Not-for-Profit Corp. Law §§ 550-558.

<sup>47</sup> For funds received after NYPMIFA became effective, there is a rebuttable presumption of imprudence for expenditures of more than 7 percent of the fair market value of the endowment fund within one year. N.Y. Not-for-Profit Corp. Law § 553 (d)(2).

<sup>48</sup> N.Y. Not-for-Profit Corp. Law § 553.

existing loans, they face contract law issues. In addition, borrowers typically go through an underwriting process in which the lender seeks information about their creditworthiness. Lawyers can help these organizations to present their information to underwriters in a favorable manner, which has been important in recent months and years because some lenders tightened their lending criteria due to uncertain credit markets. Organizations also benefit from lawyers who can review their loan documents, including terms related to the loan amount, interest rate, collateral, representations and covenants about the borrower's finances, events of default, and the consequences of a loan default. With appropriate legal help, organizations are better able to negotiate improvements or at least understand the terms before signing loan agreements.

Refinancing raises further legal issues. Refinancing benefits nonprofit organizations that are able to take advantage of lower interest rates or negotiate a shorter or longer payment period to suit their needs. For nonprofit organizations already facing economic distress, refinancing may defer but not resolve their serious financial problems, and legal counsel can explain the legal pros and cons of taking on additional debt. For example, in order to receive better loan terms, borrowers might be required to pledge additional collateral, placing additional assets at risk in an already precarious financial situation, or they might have to pay more interest overall when the new loan is for an extended period.

Defaulting on a loan is best avoided because it is a material breach of contract with serious consequences. If the loan is a revolving line of credit, the lender may refuse to extend additional credit after a default. For a term loan or a revolving line of credit, a default may enable the lender to increase the interest rate or demand immediate payment of the full balance. With a secured loan, the lender may sue the borrower for default and take possession of the collateral. For a guaranteed loan, the lender may have the right to collect the debt from the guarantor. Rather than defaulting, the nonprofit organization may approach the lender to try to work out a modified payment schedule or other loan amendments. In such circumstances, legal counsel can review any amendments or refinancing documents, help the nonprofit organization to understand its revised fiscal responsibilities, and, if possible, help to negotiate changes or clarifications before the new documents are signed.

Sometimes the lender may be an employee, director, officer or significant funder. Individual board members and employees may lend the organization money,



provided there is not a conflict of interest or violation of personnel policies,<sup>49</sup> but in such cases the board of directors should review and comply with conflicts of interest policies before the organization approves any such loan.<sup>50</sup> Excessive interest rates, default penalties, and less favorable terms than those that would be available from an unrelated third-party are not likely to be in the organization's best interest.<sup>51</sup> On occasion, the donor may seek to forgive the loans and claim a tax-deductible contribution, in which case there should be a promissory note or loan agreement evidencing the loan obligation. In contrast, commercial lenders, community development financial institutions and credit unions generally do not convert debt to charitable contributions, and failure to repay such debt, even if the loan is forgiven, will likely tarnish the organization's credit history with the lender and other banking institutions.

*Example: Faced with late payment on two state government contracts, a nonprofit housing developer has sufficient funds available for only two more bi-weekly payrolls. It is paying above market interest rates for a one year construction loan from a commercial bank. It would like to reduce its monthly payments by refinancing the loan, lowering the interest rate, and having a longer payout period. After its lawyers review the documentation for its existing and potential new loan, the charity decides not to refinance because of a large balloon payment that will become an obligation due upon the refinancing of its initial loan, and because the total interest payments for the new loan are greater. Instead, it redirects its efforts toward lobbying the state legislature to fund housing development and avoids a default on the construction loan by being more vigilant about collecting fees for services performed.*

---

<sup>49</sup> The opposite is generally not permissible. N-PCL Section 719 bars loans from nonprofit Type B organizations to their directors or officers. N.Y. Not-for-Profit Corp. Law § 719.

<sup>50</sup> The I.R.S. provides a sample conflict of interest policy as part of its instructions for a federal tax-exemption application. I.R.S., *Instructions for Form 1023 – Additional Material - Appendix A: Sample Conflict of Interest Policy*, <http://www.irs.gov/instructions/i1023/ar03.html>.

<sup>51</sup> Under the N-PCL, an interested party transaction may be voidable by the corporation if: there is no evidence that the transaction is fair and reasonable to the corporation; the conflict is not disclosed in good faith or known to the board; and the transaction is not properly approved by board vote without counting the interested person's vote. N.Y. Not-for-Profit Corp. Law § 715.

## *Part VII*

### **Relationships**

A fifth vital resource is a nonprofit organization's network of relationships with external parties. Nonprofit organizations rely upon their positive reputations and commercial relationships to carry out their operations and move forward. Vendors of goods and services, subcontractors, other program partners, licensees, clients, lenders, creditors, media contacts, and elected officials are examples of external parties with whom a nonprofit organization may have frequent or significant interactions as it weathers a tough economy. Yet, these parties also may be struggling. Therefore, maximizing external relationships often requires nonprofit managers to think and act creatively and not merely accept the status quo.

#### **A. Types of Relationship Changes**

---

As nonprofit organizations explore opportunities and alliances, they may choose to change their relationships in a way that has legal implications. Under increased pressure to reduce overhead expenses, many nonprofit organizations have sought to renegotiate or cancel vendor agreements, such as equipment leases, to be leaner administratively.<sup>1</sup> Such a move may pressure a previously healthy vendor relationship, albeit on less expensive terms, or it may leave the organization without goods and services needed for program delivery. Either way the relationship is likely to be tested and involve revised legal documents.

Also common are formal and informal partnerships, grouped together under an expansive use of the term "collaborations." For example, multiple nonprofits may collaborate to serve a larger group of clients or respond jointly to a request for proposals. In the Johns Hopkins University 2009 survey, almost half of the respondents reported creating or expanding a collaborative relationship with other nonprofit organizations as a strategy for dealing with the downturn.<sup>2</sup> In the 2011 Nonprofit Finance Fund survey, 47 percent reported partnering with another

---

<sup>1</sup> See Don Howard & Ann Goggins Gregory, *Don't Compromise "Good Overhead" (Even in Tough Times)*, Bridgespan Group (Oct. 28, 2008), <http://www.bridgespan.org/nonprofit-good-overhead-in-tough-times.aspx>; Stuart Kahan, *It Is Time To Renegotiate Everything*, *The NonProfit Times* (Feb. 15, 2011), <http://www.thenonproffitimes.com/article/detail/it-is-time-to-renegotiate-everything-1492>.

<sup>2</sup> Lester M. Salamon et al., *Impact of the 2007-09 Economic Recession on Nonprofit Organizations*, John Hopkins University Center for Civil Society Studies, Communique No. 14 at 18 (June 2009).

organization during the past year to improve or increase services, including 50 percent of those that self-identified as lifeline organizations and 44 percent of the non-lifeline organizations.<sup>3</sup> By 2012, as human needs increased, 49 percent of Nonprofit Finance Fund survey respondents reported collaborating to provide services.<sup>4</sup> Nonprofit collaborations that focus on programs and service delivery range widely in form, from a simple client referral agreement to a complex services agreement involving detailed division of responsibility and benefits.<sup>5</sup> Programmatic collaborations do not necessarily save money. However, that usually is not the goal; the main purpose of these arrangements is sustained or better programming.

In addition to programmatic collaborations, the economic downturn has prompted funders, nonprofit executives, and back-office service providers to consider “back office” collaborations as a tool for organizational efficiency. These collaborations focus on functions such as finance, human resources, information technology, and marketing, and, as such, are more likely intended to save money

---

<sup>3</sup> 2011 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund 2, 4 (2011), [http://nonprofitfinancefund.org/files/surveybrochure\\_032311.pdf](http://nonprofitfinancefund.org/files/surveybrochure_032311.pdf) [hereinafter “NFF Summary 2011”]. Lifeline organizations are those providing services critical to the health and safety of those in need.

<sup>4</sup> 2012 *State of the Sector Survey*, Nonprofit Finance Fund 4 (2012), [http://nonprofitfinancefund.org/files/docs/2012/2012survey\\_brochure.pdf](http://nonprofitfinancefund.org/files/docs/2012/2012survey_brochure.pdf) [hereinafter “NFF Summary 2012”]. For New York respondents, the 2012 figure is 47 percent. 2012 *State of the Sector Survey Results, NFF Survey Analyzer (Filtered for New York)*, Nonprofit Finance Fund (2012), available at <http://survey.nonprofitfinancefund.org/#respondents,demand,actions,gov,engagement,finhealth/O:Y> [hereinafter “NFF Survey Analyzer 2012”].

<sup>5</sup> See Hager & Curry, *Models of Collaboration, Nonprofit Organizations Working Together*, ASU Lodestar Center for Philanthropy and Nonprofit Innovation, Arizona State University (2009), [http://www.cof.org/files/Documents/Family\\_Foundations/Grantmaking-Issues/Nonprofits-working-Together.pdf](http://www.cof.org/files/Documents/Family_Foundations/Grantmaking-Issues/Nonprofits-working-Together.pdf) (describing eight collaborative structures).

than collaborations designed to enhance programs.<sup>6</sup> Two principal models have emerged: outsourcing and shared services.<sup>7</sup> During the past three years of Nonprofit Finance Fund surveys, the number and percent of respondents who reported collaborating to decrease administrative expenses has grown, representing 12 percent in 2010, 14 percent in 2011, and 17 percent in 2012.<sup>8</sup> The full extent of collaborations is not ascertainable because many of these arrangements are not formalized. Nevertheless, in New York City and elsewhere in the nation, outsourcing and shared services are an option for small and mid-sized nonprofits to explore to reduce overhead costs as nonprofit executives brace themselves for the long-term.

Other changes aimed at survival are comprehensive in nature, including mergers and consolidations of separate organizations into a single organization. Even before the economic downturn, some nonprofit advisors, funders and commentators suggested that more mergers would strengthen the nonprofit sector, based on their belief that a large number of nonprofit organizations creates undue

---

<sup>6</sup> Jennifer C. Berkshire, *Mergers Are Just One Way Charities Find to Team Up and Battle a Tough Economy*, The Chronicle of Philanthropy (Oct., 2, 2011), <http://philanthropy.com/article/CollaborationsMergers-Get/129197/> (article about the increasing popularity of collaborative ventures for back-office services). For example, the Nonprofit Coordinating Committee of New York ("NPCC"), an umbrella organization for nonprofit organizations in the New York City metropolitan area, began a Nonprofit Outsourcing Clearinghouse in 2011 to work with approximately 50 nonprofit organizations to evaluate their capacity for outsourcing and follow their process over time, focusing on nine areas: information technology, bookkeeping and financial management, fundraising, marketing and communications, real estate management, risk management, human resources, purchasing, and legal services. <http://www.npcny.org/member.htm#noc>.

<sup>7</sup> Management Assistance Group ("MAG") and the Eugene and Agnes E. Meyer Foundation (the "Meyer Foundation") partnered on a report to identify alternative back-office services that could strengthen operations and lead to greater efficiencies, particular during a difficult economy. The report reviews differences between a shared services model and the outsourcing model for back-office consolidations. MAG and the Meyer Foundation, *Outsourcing Back-Office Services in Small Nonprofits: Pitfalls and Possibilities* at 7, (Aug. 2009) <http://www.meyerfoundation.org/downloads/Outsourcing-FullReport.pdf> [hereinafter "MAG 2009"].

<sup>8</sup> 2010 *State of the Sector Survey, Summary Survey Brochure*, Nonprofit Finance Fund, at 3, 4 (2010) <http://nonprofitfinancefund.org/files/images/2010SurveyBrochure.pdf> [hereinafter "NFF Summary 2010"] (in addition, 15 percent report that they need technical assistance with collaborations or merger analysis); NFF Summary 2011, *supra* note 3, at 4; NFF Summary 2012, *supra* note 4, at 4. For New York respondents, the 2012 figure is 16 percent. See NFF Survey Analyzer 2012, *supra* note 4.

competition for funding and duplication of effort.<sup>9</sup> Difficult economic conditions, including the greater number of financially weak organizations, continue to fuel this view.<sup>10</sup> A contrasting perspective, however, is that competition due to a multiplicity of organizations produces a stronger and more innovative sector, with more services and programs.<sup>11</sup>

Despite increased interest in mergers and anecdotes about mergers, the number of actual mergers remains small. For example, only 1 to 2 percent of those responding to the 2010, 2011, and 2012 Nonprofit Finance Fund surveys reported having merged with another nonprofit during the prior year.<sup>12</sup> More have considered such steps but not pursued or completed them.<sup>13</sup> There are factors present in the nonprofit sector that discourage nonprofit mergers. These include third-party funding that skews the market, mission-driven leaders at the Board

<sup>9</sup> James Ferris & Elizabeth Graddy, *Why Do Nonprofits Merge?*, School of Policy, Planning, and Development of University of Southern California 4-5 (May 2007), [http://cphp.usc.edu/doc/RP28\\_GraddyFerris\\_Why\\_NPs\\_Merge\\_10\\_29.pdf](http://cphp.usc.edu/doc/RP28_GraddyFerris_Why_NPs_Merge_10_29.pdf) [hereinafter "Ferris"]; Alex Cortez et al., *Nonprofit Mergers and Acquisitions: More Than a Tool for Tough Times*, Bridgespan Group (Feb. 25, 2009), <http://www.bridgespan.org/Nonprofit-M-and-A.aspx>.

<sup>10</sup> See David La Piana, *Merging Wisely*, Stamford Social Innovation Review (Spring 2010), [hereinafter "La Piana"]; Nicole Wallace, *Economic Woes Bring More Charities Together*, Chronicle of Philanthropy (Mar. 26, 2009), <http://philanthropy.com/article/Economic-Woes-Bring-More/57224/> (article noting that more nonprofit leaders are open to the possibility of merging during the recession); Maria Di Mento, *Mergers Announced by Charities*, Chronicle of Philanthropy (Apr. 4, 2010), <http://philanthropy.com/article/Mergers-Announced-by-Charities/64939/> (one of several lists of mergers published by The Chronicle of Philanthropy in 2009 and 2010).

<sup>11</sup> According to the National Center for Charitable Statistics, as of August 2011 there were close to one million public charities with 501(c)(3) status in the United States. See "Quick Facts about Nonprofits," <http://nccs.urban.org/statistics/quickfacts.cfm>.

<sup>12</sup> NFF Summary 2010, *supra* note 8, at 4; NFF Summary 2011, *supra* note 3, at 4; NFF Summary 2012, *supra* note 4, at 4. For New York respondents, the 2012 figure is 2 percent compared to 1 percent nationally. NFF Survey Analyzer 2012, *supra* note 4.

<sup>13</sup> Compare Alex Cortez et al., *Bringing Mergers and Acquisitions to the Nonprofit Mainstream*, Bridgespan Group (May 1, 2009), available at [www.bridgespan.org/LearningCenter/ResourceDetail.aspx?id=3992&itemid=3992&linkidentifier=id](http://www.bridgespan.org/LearningCenter/ResourceDetail.aspx?id=3992&itemid=3992&linkidentifier=id) (20 percent of 117 nonprofit organizations in a late 2008 Bridgespan Group poll reported considering a merger as a response to the economy), with Daniel Stid & Vishal Shah, *The View from the Cliff Government-Funded Nonprofits Are Looking Out on Steep Cuts and an Uncertain Future*, Bridgespan Group 10 (Jan. 2012) available at [www.bridgespan.org/WorkArea/linkit.aspx?itemid=30466&linkidentifier=id](http://www.bridgespan.org/WorkArea/linkit.aspx?itemid=30466&linkidentifier=id) (10 percent of leaders of heavily government-funded nonprofit organizations interviewed in late 2011 considered mergers or acquisitions to be an effective coping strategy, but this data does not show whether the organizations had entered a formal merger).

and staff level who prefer to continue the organization's independence, and no mechanism for involuntary combinations outside of bankruptcy or enforcement actions for dissolution.

Rather than formally merging, financially strapped organizations may opt to create a parent-subsidiary relationship through a strategic alliance. Through a strategic alliance, nonprofit organizations can offer complimentary programs and cut costs through shared services and back office functions, yet still retain a degree of separation and independence.<sup>14</sup> The volume of strategic alliances is not readily ascertainable because they often are described or grouped together with collaborations, mergers, corporate restructurings, partnerships, or other types of joint endeavor that involve a different legal structure.<sup>15</sup>

The last coping mechanism that affects relationships is debt restructuring. For those facing financial distress, it is never too early to try to reduce and renegotiate debts with creditors in order to improve or restore liquidity and in turn continue operations. Otherwise, such organizations are at increased risk of a complicated bankruptcy or dissolution. The economic realities of the past few years have made it more common for a nonprofit organization to face significant financial challenges, such as temporary cash flow problems, unplanned layoffs, or insolvency, that force it to consider a complete debt restructuring or a liquidation of assets to satisfy its debts to creditors.<sup>16</sup>

## **B. Formalizing, Modifying, and Documenting Relationships:**

### **Contracts with Third Parties**

---

The legal framework for establishing and nurturing relationships with third parties – including individuals, for-profit businesses and other nonprofit organizations – is largely set and monitored by contract principles. At times, nonprofit law, intellectual property issues, employment law, or debt restructuring

---

<sup>14</sup> La Piana 2010, *supra* note 10.

<sup>15</sup> For example, in the June 2010 GuideStar survey, 12 percent of respondents said they used a restructuring or a merger with another organization to reduce their budget. Chuck McLean & Carol Brouwer, *The Effect of the Economy on the Nonprofit Sector: A June 2010 Survey*, GuideStar USA at 6 (June 2010), available at <http://www.guidestar.org/ViewCmsFile.aspx?ContentID=2963>.

<sup>16</sup> David Greco, *Bankruptcy Isn't a Solution to Nonprofit World's Woes*, Chronicle of Philanthropy (June 7, 2011), available at <http://philanthropy.com/blogs/money-and-mission/bankruptcy-isnt-a-solution-to-nonprofit-worlds-woes/27777> [hereinafter "Greco"].

principles may apply. Legal assistance can help nonprofit organizations to leverage their relationships. Like mission, people, facilities, and funds, relationships with third-parties must be established, nurtured, and modified if nonprofit organizations are going to adjust and thrive in the new economic reality.

### **1. Renegotiate Vendor Agreements**

One strategy for lowering overhead expenses is to revisit 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 set by long-term contracts.<sup>17</sup> However, contractual relationships are subject to change with the consent of all parties or, occasionally, because of a breach or other triggering events identified in the contract.<sup>18</sup> During challenging economic times, both nonprofit organizations and their vendors have an economic incentive to nurture their professional relationships and permit productive arrangements to continue. As a result, it may not be necessary to wait until the end of the contract period to ease contract terms.

Legal counsel can help nonprofit managers to identify and review vendor agreements with potential for renegotiation. There are a wide range of possible agreements with vendors, including: leases for copier, telephones, computers or other office equipment; mortgages; office leases and other space arrangements; contracts with internet, telephone, and other information technology services; liability and other insurance contracts; banking and credit card contracts;

<sup>17</sup> Unlike salary and related costs, which are typically directly under the control of management, the amount to be paid to third-party suppliers “is generally governed by stringent contracts, which often dictate terms such as the price paid to the supplier over the entire life of the contract. Such protections prevent suppliers from using any leverage after the contract has been signed. Yet quite often this protection against a rise in prices is the same stipulation that greatly limits the buyer’s ability to reduce its spend[ing] with third-party suppliers.” Stephen Dunn, Hobart Harris & Peter Blatman, *Beyond the Contract: Driving Value from the Renegotiation Process*, Deloitte Review, Issue 8 at 124 (2011), reprint available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Deloitte%20Review/Deloitte%20Review%20-%20Winter%202011/US\\_deloitte\\_review\\_Beyond\\_the\\_Contract\\_Jan11.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Deloitte%20Review/Deloitte%20Review%20-%20Winter%202011/US_deloitte_review_Beyond_the_Contract_Jan11.pdf) [hereinafter “Dunn”]

<sup>18</sup> Contract modifications generally require mutual assent, which in many but not all instances will need to be evidenced in writing. *Corbin on Contracts Desk Edition*, (Matthew Bender & Co., Inc., 2011), §§ 7.06, 13.01, 71.01, 71.02 [hereinafter “Corbin”]. Legal counsel can assist organizations with the proper format or grounds for a contract modification. If there is a total breach (as distinguished from an immaterial or partial breach), the aggrieved party may declare the contract ended. *Corbin*, § 53.04,



agreements with employee benefit companies; subcontracts with service providers; security and cleaning service arrangements; and back-office agreements. The first step in the analysis is to determine what types and level of goods and services must be continued for the organization to achieve its program goals, contractual obligations and overall mission.

Most nonprofit managers regularly sign vendor agreements without seeking legal guidance due to a desire to move quickly. They may focus on price and timing of payments, but not on the “boilerplate” language that specifies the circumstances, if any, under which the agreement can be modified or terminated. Other common reasons for bypassing legal review are minimal concern when small dollars are involved and a belief that the standard language either is not negotiable or is unlikely to affect them. Nevertheless, those contract provisions can prove to be important. The more technical terms of vendor agreements, such as reporting or termination provisions, may be onerous for the nonprofit organization because the vendor, or vendor’s counsel, will have drafted the language with the vendor’s best interests in mind.

If the nonprofit organization seeks to break or modify the agreement, the responsible staff or board member should review the contract’s technical terms, beginning with provisions about when and how the agreement may be amended, terminated, or renewed. For example, some agreements may have a firm ending date, while others may contain automatic renewals that lock a party in for another term absent a cancellation notice. The contract may or may not allow for a party to terminate the contract unilaterally upon specific advance notice. If the nonprofit organization does not satisfy limited termination grounds, the organization could face large payment obligations if it seeks to terminate the contract prematurely.<sup>19</sup> On the other hand, certain events, such as the loss of government funding to support a program, will not be grounds for early exiting unless that flexibility was negotiated and included in the agreement.<sup>20</sup> Charting out and understanding the monthly costs for the remaining life of existing contracts can help nonprofit managers to understand the costs and benefits of different available alternatives.

---

<sup>19</sup> For contracts for the sale of goods and services, buyer and seller remedies for breach are governed by the Uniform Commercial Code, but the parties may reserve additional or different remedies in the written agreement. *Corbin*, §§ 66.05, 66.06.

<sup>20</sup> Contracting parties may expressly include in their agreement a “power to terminate,” which will enable a party to end the contract, upon notice and without a breach, under noted conditions. *Id.* §§ 6.06, 68.08.



Just as the parties initially agree to certain terms, they subsequently can renegotiate and agree to different terms.<sup>21</sup> A successful renegotiation hinges on making the collective modifications sufficiently appealing to all parties. Reducing the nonprofit organization's monthly expense is an obvious objective from the perspective of the payee, but it is not necessarily the sole one.<sup>22</sup> Legal counsel can help the nonprofit organization to consider and document other types of changes, such as adding or substituting new products or services, relaxing payment deadlines and late penalties, changing the vendor's delivery schedule, or modifying which individuals will provide the vendor's services. While nonprofit organizations are under pressure to lower costs, vendors also are under pressure to retain clients. Depending on the parties' priorities, the term of the contract can be lengthened to ensure the vendor a long-term customer or shortened to give both the customer and vendor more flexibility. At the same time, legal assistance can ensure that any revisions to the scope of services are adequately renegotiated and documented in an amended or new agreement and that the revised contractual relationship is clear and, ideally, more cost-effective.

*Example: An organization dedicated to preventing the spread of the HIV virus among women and helping women with the HIV virus to live healthier lives is giving up its office lease and will sublet space from a second nonprofit organization in order to lower overhead expenses and facilitate potential collaborations. Because the two nonprofit organizations will share office equipment, the first organization, which is the one moving, sought to terminate its copier lease six months early. With the assistance of legal counsel, this organization negotiated a settlement of its copier lease, agreeing to make three of the remaining payments due.*

## **2. Collaborate with Other Service Providers**

Collaborations are a partnering strategy where each participant maintains its independent identity while working with the other participants in a jointly-

---

<sup>21</sup> The parties voluntarily enter into such agreements and, hence, generally can agree further to a change of terms. *Id.* §§ 7.06, 13.01, 71.01, 71.02.

<sup>22</sup> Dunn 2011, *supra* note 17, at 126-27.

developed relationship to achieve shared objectives.<sup>23</sup> 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. When the economy is flourishing, collaborations are more often designed to help organizations expand capacity and grow programs; they supplement existing efforts. Since the recession began, however, a priority for many organizations is to try to reduce costs while preserving programs. In such situations, collaborations are more likely to be used to reduce duplicative activities or fill staffing needs created by budget constraints.<sup>24</sup> Under any scenario, collaborations have hard and soft costs because the participants often will need equipment, space, and technology to operate the collaboration, and they may need to invest considerable board and staff time in communication and coordination to support the collaboration.<sup>25</sup> Confirming and documenting these costs and each party's respective roles and responsibilities, usually through a written agreement, is an integral part of establishing a successful collaborative relationship.<sup>26</sup>

The impetus for the collaboration may affect the way that the participants approach a collaborative arrangement. Some collaborations stem from nonprofit organizations initiating a specific joint project after they have known each other from working in the same or a similar geographic or program area over time. Others may be funder-driven. A government agency or foundation may make a grant to or enter a contract with one nonprofit organization while allowing or requiring that organization to subcontract with other service providers to directly

---

<sup>23</sup> A useful working definition is: "Collaboration is a mutually beneficial and well defined relationship entered into by two or more organizations to achieve common goals. The relationship includes a commitment to mutual relationships and goals; a jointly developed structure and shared responsibility; mutual authority and accountability for success; and sharing of resources and rewards." Paul W. Mattesich, Marta Murray-Close, & Barbara R. Monsey, *Collaboration: What Makes It Work*, 2nd ed. (Fieldstone Alliance 2001) (4th prtg. 2008) at 4 [hereinafter "Mattesich 2008"].

<sup>24</sup> Garvester Kelley, *Finding Incentives for Nonprofit Collaboration*, Chronicle of Philanthropy (Sept. 29, 2010), <http://philanthropy.com/blogs/money-and-mission/finding-incentives-for-nonprofit-collaboration/27236>.

<sup>25</sup> Ramya Ramanath & John A. Van Eyk, *Board Members Guide to Partnership Planning*, Johnson Center for Philanthropy, <http://www.npgoodpractice.org/topics/Board-Members-Guide-to-Partnership-Planning> [hereinafter "Ramanath"].

<sup>26</sup> Mattesich 2008, *supra* note 23, at 9, 20-21; *Mergers, Collaborations, and Partnerships*, National Council of Nonprofits <http://www.councilofnonprofits.org/knowledge-center/resources-topic/administration-and-management/partnerships-and-collaboration> [hereinafter "NCON website"]

provide specific services. Legal counsel can assist with the prime agreement as well as any subcontracts.

Most of the legal steps associated with collaborations are not related specifically to the economic downturn,<sup>27</sup> but a collaborator's financial situation may affect the legal advice. First, lawyers can assist with due diligence to help the parties satisfy themselves that they have sufficient confidence in each other to work together. Prior to entering a collaboration, each nonprofit organization should consider factors such as the organizational and fiscal capacity of the prospective collaborators, the assets that each will provide, the ability of the participants' personnel to work with each other, the participants' reputation in the funding and client community, and the benefits and risks of collaborating. For example, if one organization is relying on a second organization to provide space for client meetings or trainings, it should verify in advance that the term of the second organization's lease will permit the activity, that the lease will cover the life of the collaboration, and that the second organization is current in its rental obligations.

The second step is to establish the collaborative relationship. Lawyers can help with the negotiation process, including the creation of a "term sheet" if the collaboration is complex enough to warrant this preliminary document. Relevant topics may include who will participate, purposes of collaboration, role and responsibilities, length, how funds will be distributed, administrative and reporting procedures, ownership of any intellectual property created during the collaboration, ownership of any physical assets purchased during the collaboration, and the hiring, supervision and termination of workers.

The third step is to document the relationship with a contract.<sup>28</sup> Lawyers can draft or review the language of this agreement so that it is clear, accurate and in compliance with relevant laws or related agreements. Some nonprofit organizations have a visceral, negative reaction to signing a "contract" because they perceive collaborations to be relatively friendly ventures. They may prefer to call this document a "memorandum of understanding" or a "letter agreement." It is prudent to memorialize the understanding among the parties in a written agreement to avoid later misunderstandings and disputes. The document should

---

<sup>27</sup> Linda Schechter Manley & Neil Stevenson, *Building Successful Collaborations: A Legal Guide for Nonprofits* 14-42 (Lawyers Alliance for New York 2007).

<sup>28</sup> Mattesich 2008, *supra* note 23 at 20; NCON website, *supra* note 26; Ramanath, *supra* note 25 .

be tailored to the specific circumstances, yet allow for sufficient flexibility and refinement over time, through amendments if necessary, to reflect changes in the ideas, resources, or needs of the participants. Another advantage of having a written agreement, particularly for more extensive arrangements, is that, while it cannot prevent damages from wrongful acts by another participant, it can provide for indemnification or insurance coverage in the event such acts occur.

Another benefit of legal assistance is that legal issues may arise as the parties work to implement and manage the collaborative arrangement. The participants may obtain confidential client information, such as medical information or social security numbers, and seek guidance on what type of client consent is necessary before the information is shared with other participants.<sup>29</sup> Employment law questions may arise when employees hired by different employers, or jointly hired by two employers, are working together. Clear lines of supervision and control can minimize the risk that one party will be liable for the negligence of another party's employee and that employer's obligations to its employees are satisfied. In the event of payment disputes or delays, for example if the lead agency holds off paying subcontractors because it has not received payment from a government funder, legal counsel can advise the nonprofit organization of its options. A subcontracting organization will likely only have recourse against the lead agency under the contract, not against the funder, because the lead agency has the legal relationship with the funder. Finally, one or more of the participants may want to modify the collaboration agreement once they discover better ways to work together.

With legal guidance, nonprofit organizations are better positioned to undertake a range of programmatic collaborations. The specific scope and amount of legal work will vary depending on the details of the collaboration. For example, planning and documentation will be different for a modest joint client intake initiative (e.g., two youth organizations share staff, forms and space to market their different services to the same target population), for an integrated services delivery arrangement (e.g., multiple workforce development organizations enter extensive contracts and subcontracts to provide skills training to a larger number of unemployed workers in a larger area), or when a new network or entity is

---

<sup>29</sup> The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), Pub. L. No. 104-191 (clarified in 45 C.F.R. 164.501-34) is concerned with the privacy of medical information, and the New York State Social Security Number Protection Law (Gen. Bus. Law § 399-dd) contains restrictions on the disclosure of social security information.

contemplated to share information or take action (e.g., arts groups form an alliance to focus on joint advocacy and fundraising).<sup>30</sup> Legal counsel can help nonprofit organizations structure collaborative relationships so they are best aimed at fulfilling their programmatic objectives amidst financial constraints.

*Example: For many years a supportive housing organization, a financial literacy organization, and a local job training program informally referred clients to each other. Their target populations overlapped but were far from identical. When the housing organization faced decreased funding for its onsite money management program, its executive director approached the executive director of the financial literacy organization about how more housing residents could access financial literacy services. The two then approached the director of the job training program, and all agreed to develop a formal plan to market each other's services, offer joint classes at their respective locations, and advocate for funding for financial literacy. Counsel for the housing organization reviewed a memorandum of understanding drafted by the job training program's counsel, editing it to clarify when, where, and how each organization's staff would provide different direct services and administrative support for intake and referrals. The collaboration increased the collective number of referrals, training sessions, and program participants without requiring additional staff.*

At the same time, 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. Organizations with a small or decentralized staff and limited non-program expertise may find that they each can receive less expensive support by consolidating or sharing certain functions instead of performing them alone.<sup>31</sup> As with other collaborations, due diligence to evaluate a prospective partner's strengths and weaknesses is an important step before entering a back office arrangement.

The two primary structures for back office collaborations – shared services and outsourcing– raise additional legal issues. In a shared services arrangement, two or more nonprofit organizations will decide to “share” an employee, contractor,

---

<sup>30</sup> The wide range of possible collaborations is illustrated by case examples of approximately 120 collaborations recorded in the Nonprofit Collaboration Database maintained by The Foundation Center, available at <http://collaboration.foundationcenter.org/search/searchGenerator.php?>.

<sup>31</sup> MAG 2009, *supra* note 7, at 7.

equipment, facilities or other assets.<sup>32</sup> The shared worker can either be employed by one of the organizations, which in turn will contract the worker out, or the worker may work part-time for each of the employers. Each entity supervises the worker when he or she is working on the entity's project and, depending on their financial relationship, may be subject to payroll tax and wage and hour limits.<sup>33</sup> Employment law guidance is helpful in assessing whether, and if so how, "joint employer" laws apply.<sup>34</sup>

Outsourcing typically involves a relatively long-term transfer of specified office functions from the nonprofit organization to a third party through a contract. The third party is a specialist or specialty company that agrees to perform specified services for compensation. Workers are employed and managed by the outsourcing company. For small nonprofit organizations, finding specialized services at a reasonable rate and investing the time to contract with providers can be barriers to outsourcing.<sup>35</sup> Lawyers can make the process easier by reviewing or drafting the outsourcing agreement and helping the nonprofit organization to understand its payment, reporting, and other obligations so that it makes an informed decision. Like with a shared services model, the intention of outsourcing usually is to access expertise or services that would be more costly or unavailable if the organization proceeded on its own. Outsourcing, particularly in accounting services, information technology, and other technical fields, may become a more popular option as nonprofit organizations accept the long-term impact of the economic downturn and need for long-term adjustments.

*Example: In order to increase efficiencies in tracking children and billing for*

---

<sup>32</sup> Jackie Cefola, China Brotsky & Roxanne Hanson, *Shared Services: A Guide to Creating Collaborative Solutions for Nonprofits* 7, 9-12 (The NonprofitCenters Network and Tides 2010) (making the case for shared services as a way for small organizations to adjust to increases in operating costs such as health insurance, and recognizing that "[a]n attorney and an accountant should be consulted when planning any large-scale shared services program").

<sup>33</sup> For example, the New York State Department of Labor notes that shared employees are covered under unemployment insurance laws: financially related employers pay taxes on the first \$8,500 (annual limit as of 2011) of the shared employee's total annual earnings, and employers that are not financially related pay taxes on their share of the shared employee's earnings but are separately subject to the limit. <http://www.labor.ny.gov/ui/dande/covered1.shtm>.

<sup>34</sup> *E.g., Zheng v. Liberty Apparel Co.*, 556 F. Supp. 2d 284, 293 (2d Cir. 2003) (Court expanded the definition of "joint employer" under the Fair Labor and Standards Act when an employer utilizes a subcontractor's employees).

<sup>35</sup> MAG 2009, *supra* note 7, at 3-9.

*services, several New York City organizations that provide foster care services banded together to develop a software program. One organization convened the collaborative partners, served as lead agency contracting with the software developer and acted as the point person on software development. Through the course of this ongoing collaboration, the partners' roles grew and evolved. When the software was ready to launch, attorneys assisted the lead agency in developing a framework to protect the different parties' respective interests in owning and using the software and to allow for further evolution of the software in the future. The resulting collaboration agreement will address intellectual property and licensing issues in addition to terms related to performance obligations, timing, payments, and other contractual concerns. As a result of this better tracking and billing system, the nonprofit organizations are better able to report to their government funders and collect payment of funds necessary to continue to provide children with appropriate care and services.*

### **C. Nonprofit Mergers and Strategic Alliances**

---

The primary goal of mergers and strategic alliances for nonprofit organizations struggling during the economic downturn is program preservation.<sup>36</sup> Identifying the right partner, completing due diligence and finalizing the relationship can take a significant period of time. Therefore, it is advantageous for an organization to begin exploring merger and strategic alliance options when it still can pay its ongoing expenses and has assets of value to share with a prospective partner, rather than when it is in financial distress. Successful partnerships are built on a foundation of confidence, so it helps the process if the partnering organizations are familiar with each other through prior collaborations or professional ties among staff and board members. A nonprofit organization with sustainable programs may be able to draw upon its funder relationships to help identify a partner or to pay some of the costs of a merger or strategic alliance. However, in the end, the ability of a nonprofit organization to create a successful merger or strategic alliance will depend significantly on the strength of its relationships, including with any new partners as well as those with funders, board members, staff and others who have supported the organization through a difficult economy.

#### **1. Consider and Pursue a Nonprofit Merger**

In theory, the organization that results from a merger is stronger, and therefore

---

<sup>36</sup> Ferris, *supra* note 9, at 4.



more capable of weathering challenging economic conditions, than one or both of the individual parts. For example, two boards of directors and two sets of volunteers may mean more donor contacts, combined board or staff leadership may offer a greater diversity of valuable views and management experience, and combined services can lead to increased levels of programming. However, mergers are not without their costs. At the outset mergers may actually require spending money on transactional, marketing and administrative costs associated with integrating the two organizations. A more realistic expectation is that cost efficiencies will be achieved over time that will enable more funds to be available for program expenditures.<sup>37</sup>

A merger occurs when one not-for-profit corporation absorbs another: two separate legal entities become one.<sup>38</sup> The assets, staffs and programs of the two corporations are joined together, as are the liabilities and obligations of both corporations. The resulting corporation has all the rights, privileges, powers, and obligations of each of the joined companies, as well as their collective liabilities and obligations.<sup>39</sup> The dominant company in the merger is the “surviving” corporation, while the organization being absorbed is the “constituent” corporation.<sup>40</sup> Once merged, the surviving corporation is managed by the board of directors of the surviving corporation, although it is not unusual for directors of the constituent corporation’s board to be offered some representation on the board of directors of the surviving corporation.

The role of the board of directors in the process of negotiating a merger cannot be overemphasized. The board has a duty to ensure that this major life cycle

---

<sup>37</sup> La Piana, *supra* note 10, at 30-31. For example, effective July 2012, InnVision and Shelter Network combined in one of the biggest mergers of homeless-aid organizations in California. The newly merged organization expects to streamline operations and add case managers at combined 18 major facilities serving 20,000 people to add 1,000 more clients over the next couple of years. Kevin Fagan, *Nonprofit Merger Means More Services for Homeless*, San Francisco Chronicle (July 10, 2012), <http://www.sfgate.com/bayarea/article/Nonprofits-merger-means-more-services-for-homeless-3694839.php>.

<sup>38</sup> N.Y. Not-for-Profit Corp. Law § 901(a)(1) .

<sup>39</sup> *Id.* § 905(b).

<sup>40</sup> *Id.* § 901(b)(3)-(4). In a consolidation, the resulting entity is a new corporation called the consolidated corporation. For simplicity, this paper uses the term “merger” for both mergers and consolidations under New York law and the term “surviving corporation” for both surviving and consolidated corporations.



transaction is in the best interests of the corporation.<sup>41</sup> To help facilitate the transaction, the board of directors should build a team including board members, senior staff, and when appropriate professional advisors. The organization will want to retain legal counsel, both to benefit from legal expertise throughout the process<sup>42</sup> and because in New York an attorney will need to file statutorily-required merger court papers.<sup>43</sup> It also may be prudent to engage an independent financial advisor, accountant or management consultant to establish that the corporation's best interests are being served.<sup>44</sup> The team will work to identify and investigate potential partners, conduct due diligence regarding the assets, liabilities and other particulars of the chosen partner, and negotiate the relevant agreements.

After a partner is selected, the parties may seek to execute a "letter of intent" or "term sheet" while due diligence and negotiations proceed. Although this document is not legally required, the process of drafting it can help the parties to solidify their understanding of the transaction. The letter of intent will frequently include confidentiality provisions that safeguard the information exchanged during due diligence and negotiations. Alternatively, the parties may choose to sign a confidentiality agreement before due diligence begins. Legal counsel can play an active role in drafting or reviewing a confidentiality agreement, conducting the due diligence, and advising the parties regarding corporate structure options as the negotiations unfold.

The next step will be negotiating and drafting a legally binding agreement, referred to as the merger agreement. Negotiation will require significant input from members of the organization's team, especially legal counsel, because the

---

<sup>41</sup> *Id.* §§ 701, 713, 717; *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 592 (N.Y. Sup. Ct. 1999) [hereinafter "*MEETH*"].

<sup>42</sup> In nonprofit mergers, "[a]n attorney is essential to spotting conflicts of interest and other potential troubles, protecting the corporation's interests during the process, preserving the corporation's title to property, and paving the way for a smooth transition." Brad Castel, *Mergers, Consolidations, Dissolutions, and Affiliations: Legal Issues for Community-Based Organizations*, The National Economic Development & Law Center (Undated) at 11, available at <http://www.insightcced.org/uploads///publications/legal/701.pdf>.

<sup>43</sup> N.Y.C.P.L.R. 321(a) (a corporation must appear through an attorney). This paper focuses on mergers of charitable organizations that require New York Supreme Court approval on notice to the New York State Attorney General under Article 9 (§§ 901-10) of the N.Y. Not-for-Profit Corp. Law.

<sup>44</sup> *MEETH*, 715 N.Y.S.2d at 596 (absence of sufficient independent expert advice was a factor in court decision that not-for-profit corporation did not show that asset transfer was in its best interests).

documents are complicated legal documents that detail the steps for finalizing the merger and how the surviving corporation will operate after the transaction has been consummated. Among the issues to be addressed are preservation of programs and staff, the surviving organization's name, outstanding real estate and other obligations, and board representation.<sup>45</sup> This documentation should include a proposed "plan of merger."

Once the transaction agreements are finalized, the boards of directors of each not-for-profit corporation must approve the plan of merger and, if the corporation is a membership corporation, submit the plan of merger to the membership for approval.<sup>46</sup> In deciding whether to approve the merger, the respective boards of directors must exercise their fiduciary duty to determine that the merger is in the best interests of the corporation.<sup>47</sup> All restricted assets or proceeds that were donated to the constituent corporation for a specific purpose, including grants or contracts, must continue to be used by the surviving corporation for that specific purpose absent written donor consent or a court order modifying the restrictions.<sup>48</sup>

If any of the constituents is a Type B or C not-for-profit corporation, the merger is subject to approval of the New York State Supreme Court upon review of the New York State Attorney General's Office.<sup>49</sup> The New York Attorney General's office has established a procedure that allows the parties to a proposed nonprofit merger to submit documents for Attorney General's review in advance of a court submission. To approve a merger, the Supreme Court must find that it does not adversely affect the interests of the constituent corporations or the public interest. If the Attorney General provides a "No Objection" endorsement, the court approval process usually can proceed without a hearing.<sup>50</sup> After the court issues an order approving the plan of merger, the surviving corporation can file a certificate of merger with the New York Department of State, which is necessary for the merger

---

<sup>45</sup> Sean Delany & Linda Schechter Manley, *Mergers and Strategic Alliances for New York Not-for-Profit Corporations* (Lawyers Alliance for New York 2003).

<sup>46</sup> N.Y. Not-for-Profit Corp. Law § 903(a); *A Guide to Mergers And Consolidations of Not-for-profit Corporations Under Article 9 of The New York Not-for-Profit Corporation Law*, N.Y. State Office of the Attorney General, Charities Bureau at 8, <http://www.charitiesnys.com/pdfs/mergers.pdf> [hereinafter "*A Guide to Mergers*"].

<sup>47</sup> N.Y. Not-for-Profit Corp. Law § 717(a).

<sup>48</sup> *Id.* §§ 513, 907(c).

<sup>49</sup> *A Guide to Mergers*, *supra* note 46, at 5, 9.

<sup>50</sup> N.Y. Not-for-Profit Corp. Law § 907(e); *A Guide to Mergers*, *supra* note 46, at 4-5.

to be effective.<sup>51</sup> The parties should promptly notify the Internal Revenue Service of the merger, for example, when the constituent corporation files its final IRS Form 990 or the surviving corporation files its next Form 990 after the merger.<sup>52</sup>

Under the Nonprofit Revitalization Act, proposed by the New York Attorney General and first introduced in the State Senate in 2012, the Not-for-Profit Corporation Law would be amended to allow not-for-profit corporations seeking to merge to go through a one-step approval process (Attorney General approval) instead of the more cumbersome two-step process (court approval following Attorney General review).<sup>53</sup> This provision is intended to expedite the approval process and reduce legal costs associated with the preparation of court papers and potential court hearing. However, the current law requires court review and approval as described.

Given the importance of external relationships for a successful merger, nonprofit organizations will want to build support for the merger among significant stakeholders sufficiently before the effective date of the merger. Government funders, foundation and individual donors, corporate sponsors, staff, clients, volunteers, long-time vendors, and other key constituents have an interest in knowing why the transaction is a necessary step in the life of the organization and how it will affect daily operations.<sup>54</sup> Organizations that rely on government funding will need to work with the relevant government agencies to obtain their permission to transfer pending funding contracts to the merged entity, determine whether renewal contracts are possible, and assess whether the merged entity needs to go through different government agencies for contracts in the future. Organizations with strong ties to foundation, corporate, or large individual

---

<sup>51</sup> N.Y. Not-for-Profit Corp. Law §§ 605, 903(a)(1).

<sup>52</sup> I.R.S. Form 990 Part III question 3 (2011), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> ("Did the organization cease conducting, or make significant changes in how it conducts, any program?"); See also *2011 Instructions for Form 990, Return of Organization Exempt From Income Tax* at 8, available at <http://www.irs.gov/pub/irs-pdf/i990.pdf> (noting that articles of merger or dissolution are to be attached and that entities terminating through a merger should complete Schedule N).

<sup>53</sup> S. 7431 (N.Y. 2012) sponsored by Senator Marcellino would "enact the non-profit revitalization act" and, among other legislative changes, amend section 907 and add new sections 907-a and 907-b to the N.Y. Not-for-Profit Corp. Law. Available at <http://open.nysenate.gov/legislation/bill/S7431-2011>.

<sup>54</sup> This type of contact is usually permitted by confidentiality agreements and letters of intent, subject to the parties' advance approval of the content of the communications.

donors will want to devise an outreach strategy for advising funders of their plans sufficiently early to maintain trust but not too early to raise premature concern about their financial stability. Certain funders may be interested in funding merger costs.<sup>55</sup> Trust is likely to be enhanced when funders, staff, and clients learn of significant changes directly from the organization and have an opportunity to ask the organization's leaders directly any questions about the potential impact of a merger on programs. Lawyers should be sensitive to these relationships and practical considerations as they outline a merger timetable.

*Example: A small organization was well-known and respected for the art programming that it brought to senior centers. Through art classes and workshops, the organization's staff encouraged older adults to tell their stories and communicate positively. The organization was heavily dependent on funding from the City of New York, so when the City's Department for the Aging eliminated the organization's contract during the budget process to save money, the organization considered a merger in order to continue its art programming. The board of directors of a larger elder serving organization with significant private funding saw the value in preserving the arts program, not only in its neighborhood but for senior centers in other parts of the City, and the two organizations were able to negotiate a merger. Legal counsel for the respective organizations assisted with due diligence and the drafting of the merger documents. As a result of the merger, the art organization's programs are preserved and will continue to serve New York's older adults.*

## **2. 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 and programs but one (the parent) effectively exerts control over the other (the subsidiary). If the subsidiary is a membership corporation, this relationship can be achieved by the subsidiary granting the parent corporation control as the sole member or majority voting member. Alternatively, a non-membership corporation can vest control in another corporation if the latter corporation has the power to appoint or elect a majority of the first corporation's directors. In these types of alliances, the two corporations remain legally separate entities. The parent usually

---

<sup>55</sup> E.g., the SeaChange-Lodestar Fund provides grants to cover a portion of the one-time costs associated with nonprofit mergers and collaborations. It makes two main types of grants: exploratory grants and implementation grants. Its "mission is to facilitate and fund sensible collaborations among nonprofit organizations." <http://www.seachangeap.org/mergers.html>.

is not the owner of the subsidiary corporation's assets or liable for its obligations.

The primary reasons for choosing a strategic alliance structure over a legal merger are: the opportunity to shield each corporation from the other's liabilities, the potential for continued or additional funding through joint efforts, and the possibility of economies of scale in programming or administrative activities.<sup>56</sup> Moreover, from a legal perspective in New York, strategic alliances usually are simpler and faster to accomplish than a merger because the organizational change usually can be implemented by amending corporate documents without going to the Attorney General and Supreme Court. For example, the subsidiary corporation's revised bylaws can specify that the parent corporation is the sole member of the subsidiary corporation. The parent corporation has control because, under the New York Not-for-Profit Corporation Law, the members vote for the directors.<sup>57</sup> Bylaws amendments – in contrast to changes to the corporate purposes, a certificate of merger, or substantial assets transfer – usually do not require regulatory review. While in some instances regulatory approval may be required for a change in membership, in most instances legal counsel can prepare the corporate documents in such a manner that there is not a substantial transfer of assets and the entities are sufficiently independent.<sup>58</sup>

Although a parent-subsidary structure may be simpler and faster to implement than a merger, it can create certain long term operational hurdles that hinder the transition. There are additional expenses associated with maintaining two boards, two sets of books and records, two payrolls, and two regulatory filings and other corporate formalities. If the subsidiary corporation has very valuable assets, such as a building or endowment fund, it remains the subsidiary's asset and can only be used to benefit the parent under limited circumstances. Additionally, once the subsidiary surrenders control, it cannot regain independence without the parent corporation approving the change of its sole member and foregoing control.

---

<sup>56</sup> La Piana, *supra* note 10.

<sup>57</sup> N.Y. Not-for-Profit Corp. Law §§ 603, 706.

<sup>58</sup> Although the Attorney General's Office has asserted in litigation that an affiliation through a change of membership required Attorney General review because there is a transfer of substantially all the assets, a transaction that is subject to Attorney General review, the trial court Appellate Division rejected this view finding that the situation did not involve a transfer of substantially all the assets. *Nathan Littauer Hosp. Ass'n v. Spitzer*, 287 A.D.2d 202, 207 (3d Dep't 2001).

*Example: Two settlement houses have been working in the same community for a number of years and shared a number of directors. The long term executive director of one of the settlements retired and his successor was unable to garner the same level of funder support and so its programs were jeopardized. This organization's programs focused primarily on youth, and it offered afterschool care, summer camp, and enrichment activities in the building it owned. The loss of these youth programs would have negatively impacted the community. Some of the joint board members approached the leadership of the stronger settlement house to discuss whether there was a way they could work together to ensure continuation of youth programing. Because both organizations had significant individual donor support that leadership feared would be lost in a merger, the parties agreed to a strategic alliance achieved through sole membership. Legal counsel assisted with due diligence, structuring and risk assessment discussions with the board of directors, and drafting of new bylaws.*

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

---

Relationships with creditors are important because lenders, vendors, and other types of creditors provide funding, services, equipment and other resources necessary for nonprofit organizations to function. Program preservation and program expansion require continued access to capital and credit. On the other hand, the extent of an organization's liabilities to creditors affects its financial position. Board members, potential donors, lenders, collaborators, merger partners and other entities review financial statements and make decisions affecting the organization in light of this financial information. The board of directors has a fiduciary obligation to ensure that charitable assets are used for the charitable purposes for which they were raised and to achieve the organization's mission.<sup>59</sup> The continued ability of tax-exempt organizations to raise charitable donations is premised on donors believing that the organization's funds are being prudently managed. Organizations may put off a debt restructuring to avoid being stigmatized in their relationships with funders. However, when a not-for-profit corporation becomes insolvent, such that its liabilities exceed its assets, the board of directors has a duty to the creditors, not only to the charitable mission.<sup>60</sup>

---

<sup>59</sup> See Part III.

<sup>60</sup> Nancy A. Peterman & Sherri Morissette, *Directors' Duties in the Zone of Insolvency: The Quandary of the Nonprofit Corp.*, 23-MAR Am. Bankr. Inst. J. 12 (Mar. 2004).

### ***1. Attempt a Voluntary Workout***

An organization can restructure its debt without court supervision by negotiating directly with the organization's creditors. Before beginning to formulate an informal workout plan and negotiating with creditors, the organization should prepare a list of its liabilities as well as a list of its assets that are available to pay creditors. A voluntary workout does not involve formal court action and may be as informal as speaking directly to particular creditors to seek a mutually acceptable solution. If the organization has obligations to several creditors that must be modified, a more systematic, coordinated out-of-court negotiation may be warranted. The organization has the ability to negotiate settlement terms with each creditor separately. Legal counsel to document changes to debt obligations usually is essential to avoid misunderstandings between the parties.

Just because an exempt organization has funds in the bank does not mean that those funds are available to satisfy creditor claims. Depending on state law and the nature of the claim to be paid, restricted assets may or may not be available to pay creditors.<sup>61</sup> Government contracts may limit the use of contract proceeds for creditors' claims. When an exempt organization owns real property or other significant fixed assets that will be liquidated to raise capital to pay creditors, the organization may need to obtain regulatory approval to sell the assets.<sup>62</sup>

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. It also helps if the organization is starting with credible and strong relationships with its creditors. If the voluntary workout is not successful, the organization still has the option of seeking protection under the federal Bankruptcy Code.

### ***2. File for Bankruptcy Protection***

Filing for protection under the Bankruptcy Code enables a financially distressed organization time to refocus and reorganize its debts under the protection and

---

<sup>61</sup> Bjorklund et. al, *New York Nonprofit Law and Practice* 5-18 (LexisNexis 2007).

<sup>62</sup> In New York, Supreme Court approval upon notice to the Attorney General is required for a transfer of "all or substantially all" of the assets. N.Y. Not-for-Profit Corp. Law §§ 510-11. The statute does not specify how much of an organization's assets constitutes "all or substantially all." Instead, the level requiring court approval is not quantitative but to be based on an organization's ability to fulfill its mission without those assets. *Rose Ocko Found. v. Lebovits*, 259 A.D.2d 685, 688 (2d Dep't 1999).



supervision of the bankruptcy court. Not-for-profit corporations may file for bankruptcy protection under either Chapter 11, the reorganization provision, or Chapter 7, the liquidation provision.<sup>63</sup> One of the most significant advantages of filing for bankruptcy is the “automatic stay.” This bars creditors from taking action against the debtor’s “estate” to collect debts that became due before a bankruptcy filing. The property of the debtor’s estate includes essentially all the assets owned by the debtor at the time the bankruptcy petition is filed.<sup>64</sup> These assets are distributed to creditors accordingly to a court-approved plan. Depending upon state law, a donor-restricted asset may not be available for distribution to creditors.<sup>65</sup>

However, the costs of a bankruptcy proceeding are substantial, and this route usually makes sense for a not-for-profit corporation only if other attempts to negotiate with creditors fail or appear practically impossible.<sup>66</sup> The debtor must retain bankruptcy counsel to prepare a bankruptcy petition with supporting papers, retainers for professionals and consultants, and other legal papers; litigate claims by and against the debtor in the bankruptcy court; and prepare and negotiate a reorganization or liquidation plan.<sup>67</sup> As the debtor, the not-for-profit corporation also will likely need to pay fees for accountants and other experts, as well as counsel and other professionals retained by a creditors’ committee or additional committees as the court directs. All these expenses are costs of administering the debtor’s estate and must be paid by the debtor before other creditors are paid.<sup>68</sup>

When an organization files a Chapter 11 reorganization proceeding, it retains its assets and continues to manage its business as a “debtor in possession.”<sup>69</sup> The debtor will usually propose a reorganization plan that details how and in what amount it will pay its creditors. The plan can include third-party acquisition of the

---

<sup>63</sup> A “person” can file for bankruptcy protection, and a corporation is a “person” under the U.S. Bankruptcy Code (See 11 U.S.C. §§ 101(41), 109 (2010)).

<sup>64</sup> *Id.* § 541.

<sup>65</sup> *In re Roman Catholic Archbishop of Portland in Oregon*, 345 B.R. 686 (Bankr. D. Or. 2006) (applying Oregon law to determine charitable trust was not property of the debtors estate); *In re Bishop Coll.*, 151 B.R. 394 (Bankr. N.D. Tex. 1993) (applying Texas law to determine charitable trust not property of bankruptcy estate).

<sup>66</sup> “Few organizations have the capacity and ability to survive the long, difficult, and expensive process that a bankruptcy represents.” See Greco 2011, *supra* note 16.

<sup>67</sup> 11 U.S.C. § 327.

<sup>68</sup> *Id.* §§ 330(a)(1), 503(b), 507(a), 1102.

<sup>69</sup> *Id.* § 1107.



organization, sale of assets, rejection or assumption of leases, reduction of the organization's debt, repayment of debt over time, or any combination of these options.

Essential to the Chapter 7 reorganization process are negotiations among the organization and its creditors. Under certain circumstances, creditors will accept payouts less than the amount they are owed. Under the plan of reorganization, creditors are classified into groups based on the type of debt they hold.<sup>70</sup> The most common claims, in the order of treatment, are: (i) administrative claims, which are those incurred as a result of running the debtor's business post-petition, including professional fees; administrative claims are paid in full;<sup>71</sup> (ii) secured claims, which are claims held by creditors that are secured by a lien against property of the bankrupt entity's estate, such as a mortgage;<sup>72</sup> (iii) priority unsecured claims, such as wages and benefits<sup>73</sup> and certain taxes;<sup>74</sup> and (iv) general unsecured claims, such as vendors' claims and unsecured loans.<sup>75</sup> The reorganization plan generally cannot be confirmed unless all classes of creditors vote to accept the plan.<sup>76</sup> Once the debtor "substantially consummates" the plan of reorganization, the bankruptcy case is closed and the debtor will receive a court discharge of all debts arising prior to the commencement of the bankruptcy case.<sup>77</sup>

In contrast, Chapter 7 is the part of the federal bankruptcy law that permits a debtor to satisfy its debts by filing a petition in bankruptcy court and turning all of the debtor's nonexempt assets over to a trustee to be liquidated.<sup>78</sup> The court will appoint a Chapter 7 trustee to collect the debtor's nonexempt property, convert it to cash and distribute the resulting cash to creditors.<sup>79</sup> If a Chapter 7 debtor is an individual, he or she can receive a discharge order that releases the debtor

---

<sup>70</sup> *Id.* § 1122(a).

<sup>71</sup> *Id.* §§ 507(a)(1)(C), (2), 1129(a)(9)(A).

<sup>72</sup> *Id.* §§ 506, 1129(a)(7).

<sup>73</sup> *Id.* § 507(a)(4).

<sup>74</sup> *Id.* § 507(a)(8).

<sup>75</sup> *Id.* § 1129(a)(7).

<sup>76</sup> *Id.* § 1126(c). A class of creditors is deemed to have accepted the plan if approved by creditors that represent two-thirds in dollar amount and more than one-half the number of creditors in the class excluding insiders.

<sup>77</sup> *Id.* § 1141(d).

<sup>78</sup> *Id.* § 521(a).

<sup>79</sup> *Id.* §§ 701-02. The trustee's role is primarily to preserve assets of the estate for distribution to creditors. *Id.* § 704.

from all dischargeable debts and prevents creditors from attempting to collect such debts except as provided for in the liquidation plan.<sup>80</sup> Corporations, however, do not receive a discharge of debts under Chapter 7.<sup>81</sup> Therefore, this type of bankruptcy filing is of limited use to a not-for-profit organization.

A not-for-profit corporation that intends to wind-down operations should consider state court dissolution proceedings instead.<sup>82</sup> Dissolution is beyond the scope of this publication, which is focused on survival strategies.

*Example: A nonprofit organization serving children and families is two months behind in its rent payments, has unpaid supply bills, and has reached the maximum on a letter of credit. It started to experience severe cash flow difficulties when its annual fundraising event ran a deficit and it did not receive a renewal of a major grant for its domestic violence program. When its quarterly financials showed it was nearing insolvency, the board of directors calls a special board meeting, examines outstanding liabilities and liquid assets, votes to liquidate the organization's modest stock holdings, and develops a systematic plan for contacting the five largest creditors to request a fee discount fee and payment plan. Legal counsel helps the executive director and board of directors to examine the terms of the office lease, government contracts, and letter of credit to understand the organization's obligations. The attorneys also negotiate the terms of an installment plan for payment of certain debts and the organization's transfer of a government contract that it was having difficulty fulfilling without incurring additional debt. By the end of the fiscal year, the financial statements are more positive and one of its foundation funders was considering a grant increase to support additional staffing of the domestic violence hotline.*

---

<sup>80</sup> *Id.* § 524.

<sup>81</sup> *Id.* § 727(a)(1).

<sup>82</sup> New York's dissolution process is governed by New York Not-for-Profit Corporation Law Articles 10, and 11.

## *Part VIII*

### **Observations and Recommendations**

One of the main objectives of the legal interventions discussed in this paper is to preserve programs. The challenges during the past several years of economic uncertainty reinforce the need for nonprofit organizations to pay attention to their mission, people, facilities, funding, and relationships. The sustainability of the nonprofit sector is due to many factors other than legal services, but the significant value added by the legal community is revealed repeatedly in the coping strategies that nonprofit organizations have successfully pursued. Several lessons have emerged from the experience of providing legal assistance during the recent economic downturn that are helpful to nonprofit organizations, lawyers, funders, policy makers, and others who are working in the nonprofit sector.

#### **A. Lessons about Legal Services Delivery**

---

Useful legal interventions to respond to economic problems take three principal forms: diagnostic assessments, emergency or short consultations, and comprehensive or intensive legal services. First, attorneys are needed to help nonprofit organizations identify and prioritize their legal needs so that nonprofit managers can mobilize appropriate staff and Board support and tap appropriate legal resources to take action. For example, unless they consult with an attorney about their investment and personnel policies, nonprofit managers may be unaware that there is a process they can follow to access donor-restricted funds or that the organization's treatment of employees as independent contractors exposes the organization to legal and financial risk. Organizational leaders, pressed for time and overwhelmed by the large number or complexity of issues facing them, may prefer diagnostic assessments and educational sessions to help them clarify their options before they seek direct legal assistance. Second, urgent challenges or narrowly focused issues may require only a brief or modest amount of attorney time, but they nevertheless may have significant impact. For example, guiding a struggling organization through an employee layoff or reviewing a lease for exit strategies can help the organization to reduce expenses without the risk of litigation that would divert resources from programs. Third, more in-depth customized services, where attorneys develop a comprehensive understanding of the client's programs and fiscal, corporate and governance structure, enable nonprofit managers to focus on long-term challenges created by continued funding cuts. For example, helping a client to shift certain administrative or program

functions to a separate entity, or negotiate a new loan or license agreement, can enable the organization to provide uninterrupted services to needy individuals and families with the support of or in conjunction with other parties. Nonprofit managers and their attorneys should work together to plan and staff the type of intervention that is wanted and needed at the time.

While all types of nonprofit organizations can benefit from legal assistance in times of economic stress, certain circumstances are likely to make resource-constrained organizations more ready and responsive to receive such help. Chief among them are strong leadership, preferably at both the staff and Board level, along with sufficient understanding of the importance of legal assistance and sufficient capacity to work with attorneys. Regardless of the coping strategy under consideration, attorneys may need staff and Board members to collect financial data, agreements, policies, organizational documents, and other factual information, review proposals and drafts, follow up with third parties, and make significant decisions. For example, in order to update bylaws to allow for active fundraising or the timely election of corporate officers who can execute loan documents, Board members must review and vote on those new bylaws provisions and implement the authorized changes. Similarly, negotiating participation in a new health insurance plan, with the goal of extending coverage to otherwise uncovered workers while controlling the organization's costs, will require management to assemble relevant information about eligible employees, work with an insurance broker, provide input to the attorney on feasible contract terms, and implement changes. When selecting nonprofit organizations to represent, attorneys typically will screen a prospective client to ensure readiness and try to sequence legal services to meet the client's needs. Attorneys seeking to direct legal intervention for safety net organizations which provide core community services also may consider whether the organizations serve high need, low-income clients or neighborhoods, focus on poverty issues and have a history of programmatic success in the community. Given that their own time and resources are limited, some providers of legal services choose to concentrate on particular types of organizations or legal matters, but groups with a broad range of missions should be receptive and in need of help.

The combination of repeated and unpredictable funding cuts has resulted in several waves of nonprofit organizations needing legal assistance to help them cope with diminished resources during a period of 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. As the nonprofit sector tried to absorb further cuts, nonprofit organizations that were fiscally vulnerable prior to the economic downturn were in need of 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. More recently, without economic recovery, comprehensive legal services have become necessary for organizations that have already downsized or depleted cash reserves. The sustained loss of revenue has impacted even stronger organizations that have been compelled to reexamine multiple aspects of their operations, make further adjustments to fit new internal and external circumstances, and position themselves better for long-term survival. However, not all organizations were aware of or able to receive legal assistance early enough to prevent more serious financial and legal problems, such as unaffordable contract obligations, avoidable litigation, regulatory penalties, and other liabilities. These groups comprise an additional wave of nonprofit organizations needing legal assistance to preserve programs.

To use legal help effectively, nonprofit organizations must be aware of their legal needs and have access to qualified counsel. With time and resources scarce, nonprofit managers often do not seek legal guidance absent a specifically identified legal problem. However, all of the coping strategies discussed in this publication implicate business law and transactional issues that inevitably arise as those strategies are implemented. Awareness of those legal implications can be heightened by the distribution of general legal information about timely topics and by one-on-one communications. Successful client outreach begins by identifying organizations that fit a targeted profile, such as organizations that are heavily dependent on a vulnerable funding stream, operate within a certain budget or geographic area, and focus on specific programs or subsector issues. Effective outreach messages educate the targeted organizations about the full range of those legal issues and the value of legal services available to meet those needs. Organizations may believe they have one legal need when they also have additional legal needs. For example, an organization may seek guidance in terminating an unsustainable program only to learn that there are

potentially significant employment law liabilities that may arise depending on how that termination is implemented. Access to attorneys with relevant expertise and skills is essential, but finding appropriate counsel can be a challenge, especially for organizations with few funds for legal fees. In addition to paid counsel, pro bono attorneys often donate their time and services to help organizations whose missions they find compelling. Pro bono providers operating around the country can pair nonprofit organizations with interested pro bono attorneys from law firms and corporate legal departments.<sup>1</sup> Regardless of the source, lawyers can help nonprofit organizations to identify and address legal issues so that they do not become mission-threatening problems and the organizations can pursue program preservation actions in compliance with applicable law.

Valuable legal services may include a blend of different types of interventions: preventative and proactive, strategic and opportunistic, and discrete and ongoing. For nonprofit organizations with Board and staff members who are willing and able to navigate multiple legal issues contemporaneously, a comprehensive and tailored approach allows them to consider a fuller range of options to strengthen mission, people, facilities, funding, and relationships. In the employment area, for example, attorneys may advise a community group on the classification of particular employees as exempt or non-exempt from the Fair Labor Standards Act to respond to a specific state Department of Labor inquiry, while also rewriting personnel policies to minimize further fiscal risk to the organization in the future. For a financially vulnerable organization contemplating a debt restructuring, corporate or bankruptcy attorneys may be guiding it through a systematic review of its refinancing options, but then attorneys may undertake immediate due diligence when another nonprofit organization with complementary programs proposes a strategic alliance. Operating amid economic uncertainty, nonprofit leaders who balance vision and practicality, are flexible, and examine multiple coping strategies are well-positioned to utilize legal assistance for maximum effect.

---

<sup>1</sup> Although Lawyers Alliance for New York focuses on nonprofit organizations with a program presence in New York City, its website lists pro bono providers serving nonprofit organizations working outside of New York City, at <http://www.lawyersalliance.org/ProvidersNat.php>. Most of these providers offer business and transactional law services to nonprofit organizations serving poor individuals or communities. In addition, the New York State Bar Association piloted a statewide Charity Corps program in 2012 that matched volunteer attorneys with fifty 501(c)(3) tax-exempt organizations that seek guidance on governance and compliance issues but cannot afford counsel, and it plans to serve more organizations in the future. [http://www.nysba.org/Content/NavigationMenu/ForAttorneys/CharityCorpsResources/Charity\\_Corps.htm](http://www.nysba.org/Content/NavigationMenu/ForAttorneys/CharityCorpsResources/Charity_Corps.htm).

## **B. Areas for Public Policy Improvement**

---

The economic downturn has exposed weaknesses in the legal and regulatory environment in which nonprofit organizations operate, in New York as well as elsewhere, which make it more difficult for these organizations to focus their limited resources on program delivery. Public policy reforms are needed to support nonprofit advocacy of sector wide concerns, simplify the regulatory processes for nonprofit lifecycle changes, rationalize government contracting, and increase access to working capital.

### ***1. Protect and Encourage Advocacy by Nonprofit Organizations***

The difficult economy increases the stakes for nonprofit organizations in government budget decisions, contract payment delays, regulatory compliance rules, and legislation that affects the beneficiaries of their programs. Unless nonprofit leaders are able to mobilize public opinion and influence legislative and regulatory policy, these and other issues important to the nonprofit sector are unlikely to be at the forefront of public policy discussions. Direct services and advocacy are interrelated because, through direct services, nonprofit organizations learn what does and does not work well and what the public and private sectors can do to make a difference by changing public policies. Effective advocacy may include multiple permissible activities aimed at systemic change, including legislative lobbying, executive branch activities, issue organizing, nonpartisan voter engagement, and other efforts. Through effective advocacy, nonprofit organizations can raise public awareness of their missions, provide relevant input to policy makers on proposed laws and regulations affecting their programs, and rally for government investment in their cause and other human services.

Nevertheless, the amount of advocacy in which nonprofit organizations actually engage is limited. According to a 2007 Johns Hopkins Listening Post Project survey of nonprofit organizations in four fields – children and family services, elderly housing and services, community and economic development, and the arts – 73 percent of respondents engaged in some type of lobbying or other advocacy during the prior year, but 85 percent of respondents spent less than two percent of their budget on those activities. Board support and knowledge of the relevant laws correlated with greater involvement. Survey participants reported that increased funding, both for dedicated advocacy staff and for general operating support,

would enable them to be more actively involved in advocacy and public policy.<sup>2</sup>

Funding for nonprofit advocacy is scarce. Myths about lobbying and other types of advocacy can deter 501(c)(3) organizations from increasing their engagement in such activities. This includes misstatements that such efforts are illegal, cannot be supported by private foundation grants, or always require a lot of money.

The time is overdue for attorneys, charities, funders, policy makers, and others with an interest in strengthening the nonprofit sector to support nonprofit advocacy with focus and vigor. Tax-exempt organizations have the right, subject to applicable laws, to advocate for and against public policies, including advocacy related to government budgets that are embodied in legislation. Attorneys can better explain to nonprofit leaders 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. Although private foundations generally may not earmark a grant for lobbying, they may provide general operating grants to nonprofit organizations that lobby and provide specific grants for projects with a lobbying component, so long as their grant amount does not exceed budgeted non-lobbying expenses.<sup>3</sup> Finally, clarification and simplification of federal, state, and local rules related to lobbying and political activity would make it easier for nonprofit organizations to engage in permissible advocacy, while remaining legally accountable. For example, New York City could increase its threshold for lobbying registration and reporting to at least \$5,000 in annual expenditures, making it consistent with the New York State Lobbying Act threshold. Duplicative registration and reporting obligations at the State and City level should be eliminated. Similarly, the introduction of new campaign finance disclosure requirements in the wake of the *Citizens United* decision should be done in a manner that encourages, rather than discourages, nonprofit organizations from participating in issue advocacy.<sup>4</sup>

Cognizant of the global, national, and local economies, the nonprofit sector brings strength in numbers and experiences that can advance practical, affordable public policy changes. In a tight economy, advocacy to improve the delivery of services

---

<sup>2</sup> Lester M. Salamon & Stephanie Lessans Geller, *Nonprofit America: A Force for Democracy*, Johns Hopkins University, at i-ii (2008), [http://www.adm-cf.com/jhu/pdfs/LP\\_Communiques/LP\\_Communique9\\_Advocacy\\_2008.pdf](http://www.adm-cf.com/jhu/pdfs/LP_Communiques/LP_Communique9_Advocacy_2008.pdf).

<sup>3</sup> IRC §4945(d)-(e); Treas. Reg. §53.4945-2.

<sup>4</sup> See Part VI.A.1.



across the nonprofit sector, not just to preserve one program over another, is needed to increase the totality of government-related funding as well as to focus attention on cost-neutral legislative issues.

## **2. Eliminate Unnecessary Regulatory Barriers to Organizational Change**

State officials have an interest in ensuring that charitable funds raised, received or administered by nonprofit organizations operating in their state are used for charitable purposes. Therefore, in several states, specific laws require established not-for-profit corporations to follow legal and regulatory procedures before they undertake key governance or structural changes. Under the 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. Board and membership votes and approval also are required for these and other corporate actions. In ordinary economic times, compliance with this legal framework can be costly and lengthy for organizations seeking to change their purposes or structure, particularly in New York where several aspects of the process are complicated or outdated. For organizations in a fiscal crunch, such organizational changes may be sensible coping strategies, but the burdens of legal and regulatory compliance make them unduly daunting.

These processes 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.

Organizations must engage an attorney to make the court filing because corporations cannot appear in court unless represented by counsel.<sup>5</sup> As a matter of practice, courts look for the Attorney General's stance, either a consent (sometimes framed as a waiver) or objection, before acting because the Attorney General oversees the use of charitable assets.<sup>6</sup> Allowing organizations to seek Attorney General approval instead of court approval, and apply to the court if

---

<sup>5</sup> N.Y. CPLR § 321(a).

<sup>6</sup> For example, the Charities Bureau of the Attorney General's office reviews mergers and consolidations of not-for-profit corporations on a case-by-case basis subject to Article 9 of the Not-for-Profit Corporation Law. *Right from the Start: Responsibilities of Directors of Not-for-Profit Corporations*, N.Y. State Office of the Attorney General, available at [http://www.charitiesnys.com/guides\\_advice\\_new.jsp](http://www.charitiesnys.com/guides_advice_new.jsp).

Attorney General approval is not granted, would streamline the review process while maintaining regulatory oversight.

Greater consideration should also be given to replacing more agency pre-approvals with agency notifications, and eliminating the need for either approval or notification if the agency does not presently regulate the organization through licenses or other clear mechanisms. Currently, the review process is lengthened as nonprofit organizations wait for state agencies that reviewed their certificate of incorporation to consent to the changes before the Attorney General will sign off, even when the other agencies have no or a minimal regulatory role and even though such approvals are rarely withheld. Instead, organizations should be able to notify relevant agencies when changes are made, allowing state officials a specified period within which to object. 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.<sup>7</sup>

The New York State Attorney General has proposed a plan<sup>8</sup> and a Nonprofit Revitalization Act<sup>9</sup> that contains a version of these suggested statutory changes and other steps to reduce bureaucratic burdens, including: allowing the Department of State to correct minor mistakes on certificates of incorporation or applications for authority to do business, eliminating the distinction between different “Types” of not-for-profit corporations, and allowing board and membership meeting notices and waivers of notice to be transmitted electronically. These and other legislative reforms will not obviate the need for nonprofit organizations and their boards to follow legal processes when making organizational changes, but they will streamline those obligations. They can make the process for regulatory reviews

---

<sup>7</sup> The economic downturn has also highlighted the need to reconsider the requirement that New York boards with twenty or fewer directors must approve the sale, mortgage or lease of real property by the vote of two-thirds of the entire board. This supermajority requirement applies even if the transaction is small, such as a short-term lease or sublet of a small amount of space to reduce occupancy expenses. Instead, allowing a majority vote to approve routine real estate transactions, but a larger vote if the transaction involves substantially all of the assets, would allow nonprofit boards to review and approve real estate transactions more efficiently. See Part V.A.1; N.Y. Not-for-Profit Corp. Law § 509.

<sup>8</sup> 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/media\\_center/2012/feb/NP%20Leadership%20Committee%20Report%20\(2-16-12\).pdf](http://www.ag.ny.gov/media_center/2012/feb/NP%20Leadership%20Committee%20Report%20(2-16-12).pdf) [hereinafter “NYAG Comm.”].

<sup>9</sup> S. 7431 (N.Y. 2012), available at <http://open.nysenate.gov/legislation/bill/S7431-2011>.

friendlier to the nonprofit sector by shifting from one stressed by regulatory burdens to one offering resource-constrained organizations new and different opportunities in an uncertain economy.

### **3. Rationalize and Prioritize Reform of Government Contracting**

More than any other factor, the greatest threat to the stability of many nonprofit organizations in the ongoing downturn is that their state or local funding is a core, yet not sufficiently reliable, revenue stream. Beyond repeated reductions in government funding, concerns include the failure of payments to cover the full cost of contracted services; the time required for applications and reporting; government changes to contracts mid-stream; redundant audits and other reporting; and late payments beyond contract or statutory requirements.<sup>10</sup> Systemic problems related to the delay, uncertainty, and inefficiency of government contracts take a large toll on the nonprofit sector and are not going to be fixed unless concerted effort is made to address them. This requires those with a vested interest in contract reform, especially government leaders, with nonprofit sector input, to make that reform a top priority.

To heighten awareness of the need for change, it helps when government officials and independent researchers monitor and report on the contracting process, both problems and areas where progress is being made. New York State has the advantage of a Prompt Contracting Law that requires the Office of the State Comptroller ("OSC") to issue a report on annual contracting results reported by state agencies and make recommendations to improve prompt contracting. The OSC has compiled numerous details and produced informative reports on this subject, including annual reports released each May 31st.<sup>11</sup> Further analysis

---

<sup>10</sup> See Part I.B; Elizabeth T. Boris et al, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants*, Urban Institute (Oct. 2010) <http://www.urban.org/uploadedpdf/412228-Nonprofit-Government-Contracting.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*, at 1-2 (Nov. 2011), [www.osc.state.ny.us/reports/nfp/nfpreport11-2011.pdf](http://www.osc.state.ny.us/reports/nfp/nfpreport11-2011.pdf) [hereinafter "Comptroller Nov. 2011"]; NYAG Comm., *supra* note 8, at 10-17.

<sup>11</sup> N.Y. Office of the State Comptroller, *Prompt Contracting Annual Report Calendar Year 2011*, at 1-2 (May 31, 2012), at 1-2; [http://www.osc.state.ny.us/agencies/pcl\\_reports/pcl\\_2011.pdf](http://www.osc.state.ny.us/agencies/pcl_reports/pcl_2011.pdf) [hereinafter "Comptroller May 2012"]; N.Y. Office of the State Comptroller, *Prompt Contracting Annual Report Calendar Year 2010*, at 1-2 (May 31, 2011), [http://www.osc.state.ny.us/agencies/pcl\\_reports/pcl\\_2010.pdf](http://www.osc.state.ny.us/agencies/pcl_reports/pcl_2010.pdf); N.Y. Office of the State Comptroller, *Prompt Contracting Annual Report Calendar Year 2009*, at 1-2 (May 31, 2010), [http://www.osc.state.ny.us/agencies/pcl\\_reports/pcl\\_2009.pdf](http://www.osc.state.ny.us/agencies/pcl_reports/pcl_2009.pdf).

would be welcome on the lifecycle of a government contract, showing the median length of time for state contracts to proceed through different steps of the contracting process – including application, approval, invoicing, and payment – in order to evaluate where improvements can be made and which parties can control or influence such improvements. Similar public information at the county and city level can shine more light on the importance of a prompt and rational contracting process for nonprofit organizations funded by municipalities. Currently the New York City Mayor’s Office of Contract Services (“MOCS”) publishes an annual report of procurement activities of certain mayoral agencies, including those concerned with human services.<sup>12</sup> Continued studies with facts about contracting issues, along with concrete examples of the valuable services provided by appropriately funded organizations, strengthen the compelling argument for contract reform.

Numerous worthwhile suggestions have already been proposed to improve the government contracting process. They deserve immediate, serious consideration by policy makers and government officials who are in a position to effectuate change. If implemented effectively, they can save tax payers money, are cost neutral, or are not cost prohibitive. Several recommendations relate to the timing or length of contracts, such as moving contract start dates to after the beginning of the fiscal year to separate them from the budget process and expanding the use of multiyear grant contracting if appropriate. Others focus on getting payment to nonprofit organizations faster, such as advance payments, fifth quarter financing, and electronic fund transfers. Additional recommendations seek to simplify contract templates and procedures, such as creating a new standardized contract, using a data vault, or clarifying recoverable costs.<sup>13</sup>

There are identifiable pressure points in the contracting process where a change in both procedures and expectations would make a positive difference to all affected parties. One area for improvement is presented by the fact that a large number of contracts are approved or registered after the start date set by the contracting agency in the contract. For example, OSC data shows that

---

<sup>12</sup> N.Y.C. Mayor’s Office of Contract Services, *Annual Procurement Indicator Report for Fiscal Year 2011, Executive Summary*, [http://www.nyc.gov/html/mocs/downloads/pdf/procurement\\_indicators\\_execsum\\_2011.pdf](http://www.nyc.gov/html/mocs/downloads/pdf/procurement_indicators_execsum_2011.pdf) [hereinafter “MOCS 2011”].

<sup>13</sup> Comptroller Nov. 2011, *supra* note 10, at 4; National Council of Nonprofits, *Costs, Complexification, and Crises: Government Human Services Contracting “System” Hurts Everyone*, 23-29 (Oct. 7, 2010); NYAG Comm, *supra* note 8, at 11.

approval and execution dates followed start dates in 87 percent of new 2011 contracts and 71 percent of new 2010 contracts,<sup>14</sup> even though state agencies and nonprofit organizations are advised that no work is to be done on a contract until there is OSC approval.<sup>15</sup> MOCS reported that contract registration followed start date for 29 percent of the renewed dollar value contracts with New York City's major human services agencies in fiscal year 2011.<sup>16</sup> Steps should be taken by government contracting agencies to streamline grant processing and change the philosophy to one that seeks to address the root causes of delays and begin work when scheduled in the contract. A second pressure point relates to the need for government grant applicants to submit material separately to more than one government agency. This can occur when the organization has multiple contracts or grants with different agencies or because different agencies are conducting different compliance checks and levels of review for the same contract.<sup>17</sup> To reduce duplication and time lags, New York City is piloting the use of an online data vault for background documents for health and human services contracts, as one strategy to decrease the average of more than fifteen months between issuance of a request for proposals and contract registration.<sup>18</sup> The New York Attorney General's Leadership Committee for Nonprofit Revitalization has suggested that the state government create a similar electronic data vault accessible to all state funding agencies.<sup>19</sup> These are just examples of the many target areas that can be explored further for contract reform.

One recent positive step is New York Governor Cuomo's appointment in 2012 of a new Interagency Coordinator for Not-for-Profit Service to help improve the way government and nonprofit service providers work together, following the creation of a similar cabinet level position created in Connecticut in 2011. Such centralized posts can help to advance contract reform, both by facilitating communications between the nonprofit sector and government agencies and by improving interagency coordination.

---

<sup>14</sup> Comptroller May 2012, *supra* note 11, at 11.

<sup>15</sup> N.Y. Office of the State Comptroller, *Frequently Asking Questions for New York State Contract Search Open Book New York*, Question 37, <http://www1.osc.state.ny.us/transparency/contracts/contractfaq.cfm>.

<sup>16</sup> MOCS 2011, *supra* note 12, at ix, 44-45.

<sup>17</sup> NYAG Comm, *supra* note 8, at 11.

<sup>18</sup> N.Y.C. Office of the Deputy Mayor for Health & Human Services, *HHS Accelerator Project Overview* (Aug. 3, 2012), <http://www.nyc.gov/html/nonprofit/downloads/pdf/HHS%20Accelerator%20Overview.pdf>.

<sup>19</sup> NYAG Comm, *supra* note 8, at 15.

Lastly, 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. To encourage best practices, government and nonprofit leaders should support steps that educate government agencies on interest requirements if they are responsible for delays, educate nonprofit providers on how to obtain interest, and require government agencies to pay accumulated interest at the same time as the first payment due after the start of the contract. When budgets are limited, there can be a tension between paying contract interest and using the funds for program services, but careful legislation can ensure that budgets cover mandated interest without impairing funds allocated to program.<sup>20</sup>

Particularly in difficult economic times, contract reform steps are likely to be more effective if they incorporate several principles. Dedicated executive leadership is essential, so that there are sufficient resources and commitment to implement the specific change. One goal is to make it faster, simpler, and overall easier for nonprofit organizations to enter contracts with government agencies. Another goal is better correlation between services and payments, both timing and amount, so that nonprofit organizations have adequate, reliable income to plan and continue services. Action steps that clearly reduce redundancy also are welcome. In addition, there should be reasonable measurements to assess the effectiveness of each change and allow for further refinements. Finally, the multiple stakeholders inside and outside of government, including executive and agency staff, legislators, nonprofit organizations and private funders, should have an opportunity for input into the development and measurement of new contract procedures.

#### ***4. Increase Access to Working Capital***

Another strategy for stabilizing and strengthening the nonprofit sector is to establish more public, private, or hybrid financing vehicles to help nonprofit organizations bridge gaps in their operating funds. Working capital is essential for nonprofit organizations to sustain mission-oriented activities, but they may

---

<sup>20</sup> While the State Legislature has supported OSC legislation requiring payment of prompt contracting interest with the first contract payment, MOCS is taking a different approach and prefers to address lateness through no interest loans rather than mandated interest. Comptroller May 2012, *supra* note 11, at 13; MOCS 2011, *supra* note 12, at 47. However, prompt payment of interest usually is preferable to no-interest loans because there are costs and burdens for organizations associated with borrowing and loans as discussed in Part VI.B.3 of this publication.

not maintain adequate operating reserves and may suffer periods of low cash flow due to overdue receivables from government entities or other cyclical funding. While not necessarily addressing the root of an organization's financial challenges, greater access to cash and credit would remove certain financial roadblocks and allow more organizations to continue services and reposition themselves for the longer term. In the current economic context, the public sector's fiscal woes 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. Nevertheless, multiple models are worthy of consideration.

Purely private lenders or purely nonprofit lenders are two sources of capital, although the availability of such financing is limited. Interest rates, annual and initial fees, and collateral requirements will vary and generally will be set by the lender. A small number of private banks have assisted nonprofit organizations during the economic downturn, but they are more inclined to do so for organizations engaged in property development, not human services, where real estate can serve as tangible security for a loan. Non-bank private financing options are conceivable, such as asset-based lending and factors tied to accounts receivable, but they can be complicated. Increasingly, nonprofit organizations have pooled capital received from private donations and other fundraising sources to make loans to other nonprofit organizations for a variety of uses, including working capital gaps. In most cases, loan funds managed by nonprofit lenders are narrow in geographic scope, loan amount, and loan term due to their limited resources. Examples of regional grantmakers engaged in this activity are Community Foundation for Greater Atlanta, Nonprofits Assistance Fund in Minneapolis, and the Emergency Loan Fund program of Northern California Grantmakers.<sup>21</sup> Finally, some community development financial institutions ("CDFIs") provide credit and financial services to underserved markets and populations and make loans to nonprofit organizations, including for bridge financing. Some CDFIs such as Nonprofit Finance Fund specialize in lending to nonprofit organizations.<sup>22</sup> For nonprofit organizations able to access any of these forms of financing, an attorney can review and advise them on loan documentation.

<sup>21</sup> Fund information is at: <http://www.cfgreateratlanta.org/Grants-Support/Nonprofit-Loan-Fund.aspx>; [http://www.nonprofitsassistancefund.org/index.php?src=gendocs&ref=rates\\_and\\_terms&category=Loans](http://www.nonprofitsassistancefund.org/index.php?src=gendocs&ref=rates_and_terms&category=Loans); <http://www.emergencyloanfund.org/>.

<sup>22</sup> See <http://nonprofitfinancefund.org/loans-financing/loans>.



Government loan funds are another approach. The New York legislature can help by capitalizing a short-term revolving loan fund that is hospitable to nonprofit organizations in need of immediate operating funds. One way to proceed would be to use the loan fund created by statute in 1991 for nonprofit organizations that contract with the state.<sup>23</sup> So far the account authorized in 1991 has never been funded and never made any loans,<sup>24</sup> except the state's 2011 operations budget appropriated \$150,000,<sup>25</sup> an insufficient amount to address late contracting issues or carry out this fund's intended purposes. A second way to proceed is to use a government loan fund with a new, expanded, or modified structure. While the 1991 state legislation is a helpful starting point, it limits loans to one-half of the first quarter payment of the subject government contract, which may not be sufficient to sustain programs if contract payments are delayed, and it has strict lending criteria.<sup>26</sup> An active model is the Fund for the City of New York's revolving cash flow loans programs. This government supported initiative, managed by a separate nonprofit entity, has several products, each geared toward a different purpose or borrower, and all intended to bridge the cash flow gap between government contract or grant award and payment. The loans accrue no interest although some require a processing fee, which may be partially refunded upon early repayment. Initiated in 1976 and revamped in 2009, the Fund for the City of New York lends about \$20 million a year to approximately 400 organizations.<sup>27</sup> Although these programs are limited in scale, the experience is informative for policy makers considering options at the state or federal level.

Hybrid remedies can draw upon both private funds and the government's support to provide working capital loans at low interest rates. Some existing or proposed examples are geared toward small businesses not necessarily nonprofit organizations. In one model, private and government funders jointly capitalize a loan fund, such as the Cascadia Loan Fund in Oregon and Washington and the Erie County Business Development Fund in New York. In another, the fund is capitalized solely by public funds but the private lender matches or exceeds the government loan amount. A third solution is for the government to provide private lenders a guarantee of at least a portion of the loan amount, such as

---

<sup>23</sup> N.Y.S. Fin. Law §§ 97-ji & 179-z.

<sup>24</sup> NYAG Comm, *supra* note 8, at 16 & fn. 28.

<sup>25</sup> State Operations Budget, 2011 N.Y. Laws ch. 50, at 57, *available at* [http://assembly.state.ny.us/leg/?default\\_fld=&bn=S02800&term=2011&Text=Y](http://assembly.state.ny.us/leg/?default_fld=&bn=S02800&term=2011&Text=Y).

<sup>26</sup> N.Y.S. Fin. Law §179-z.

<sup>27</sup> Cash Flow Loans described at: <http://www.fcny.org/fcny/core/cfl/#cashflow>.



the Minneapolis Working Capital Guarantee Program and the NYC Capital Access Loan Guarantee Program of the New York City Economic Development Corporation.<sup>28</sup> A variation would be for the government entity to provide the nonprofit organization a credit enhancement that reflects a portion of the loan in the form of cash or a letter of credit and to assign contract payments to the lender or loan fund.

Nonprofit and private lenders also can work together. For example, the Nonprofit Finance Fund is launching a new Resilience Fund to provide bridge financing to New York City human services organizations, such as community-based organizations, senior centers and homeless shelters. This fund, under development with multiple partners, seeks to provide grant capital and loans, along with strategic financial advisory services, to preserve essential community programs and services.<sup>29</sup>

Lenders, nonprofit leaders, and policy makers who have relevant financing experience and appreciate the cash flow needs of nonprofit organizations should work together to develop an appropriate fund structure for private-public endeavors. There are practical mechanisms even if government budgets are strapped. Critical questions include: who provides initial capitalization and in what amounts, who will offer a guarantee or credit and in what amounts, and what would constitute realistic lending and underwriting criteria? Other structuring issues relate to the specifics of fund management, loan terms, and whether there should be changes to the contracting process if the loans are related to specific government contracts. Consideration should also be given to supplemental requirements for participation, if appropriate, such as updating the organization's budget or fiscal management practices to manage cash flow concerns. Funding pools can be increased by the addition of private financing, but government agencies, whose delayed contract payments caused cash flow shortages, would be responsible for part or all of loan repayments pursuant to guarantees that the government would offer. In a perfect world, governments would honor contracts and make timely payments for services, but the more realistic scenarios must also include multiple sources of interim financing to bridge gaps.

---

<sup>28</sup> Funds described at: [http://www.ci.minneapolis.mn.us/cped/ba/cped\\_working\\_cap\\_fact](http://www.ci.minneapolis.mn.us/cped/ba/cped_working_cap_fact); <http://www.nycedc.com/program/nyc-capital-access-loan-guaranty-program>.

<sup>29</sup> Fund information at: <http://nonprofitfinancefund.org/Resilience>.

## *Conclusion*

During a weak economy, nonprofit organizations face multiple legal and financial issues as they strive to generate revenues, control costs, and refocus programs to address evolving community needs. Lawyers can help nonprofit organizations to evaluate and implement strategies for strengthening the five pillars of a vibrant and successful nonprofit operation: mission, people, facilities, funds, and relationships. Let us use lessons learned from the delivery of legal services during a protracted and painful economic downturn to assist the nonprofit sector as it stabilizes and builds momentum for the longer term. Many coping steps taken out of fiscal necessity in recent years also have the benefits that come from sound corporate governance, proper personnel management, risk management, and growth transactions in better economic times.

With scarce public and private resources, the nonprofit sector must summon extra energy and attention to protect and increase its voice and reputation in the public policy arena. Nonprofit organizations that provide vital services need to advocate louder and harder so that government decision makers and the public are sufficiently aware of their valuable societal role, the laws and regulations that affect their work, and their need for continued funding and public policy support to continue services.



---

## **Lawyers Alliance for New York**

171 Madison Avenue

6th Floor

New York, NY 10016

phone: (212) 219-1800

fax: (212) 941-7458

email: [info@lawyersalliance.org](mailto:info@lawyersalliance.org)

[www.lawyersalliance.org](http://www.lawyersalliance.org)

