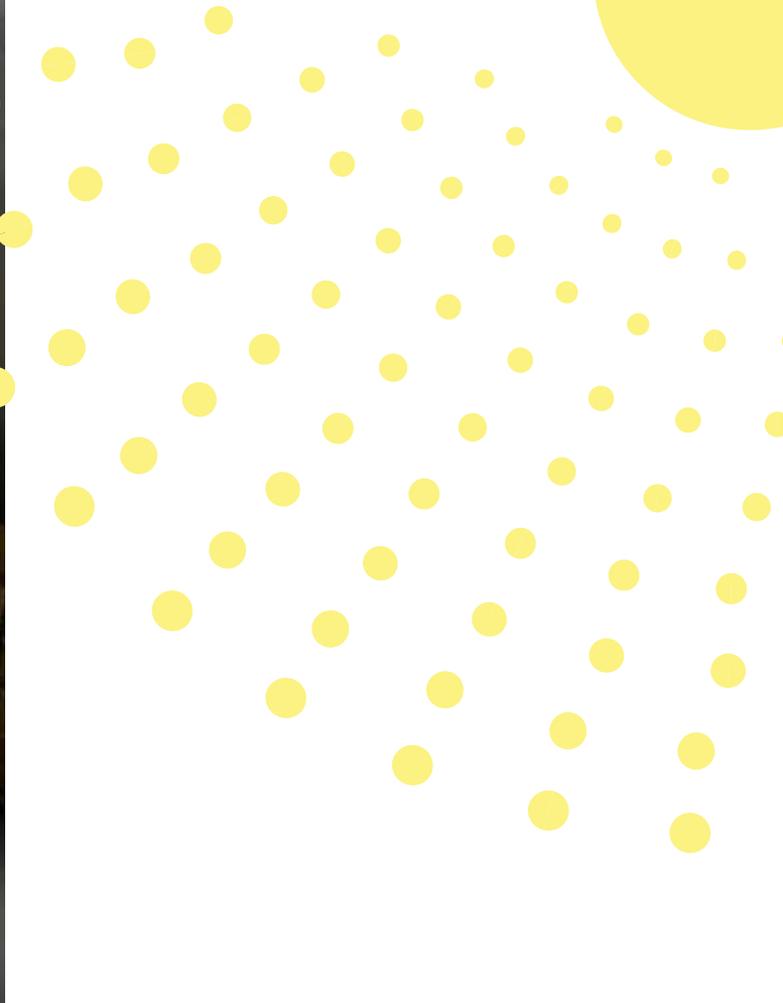


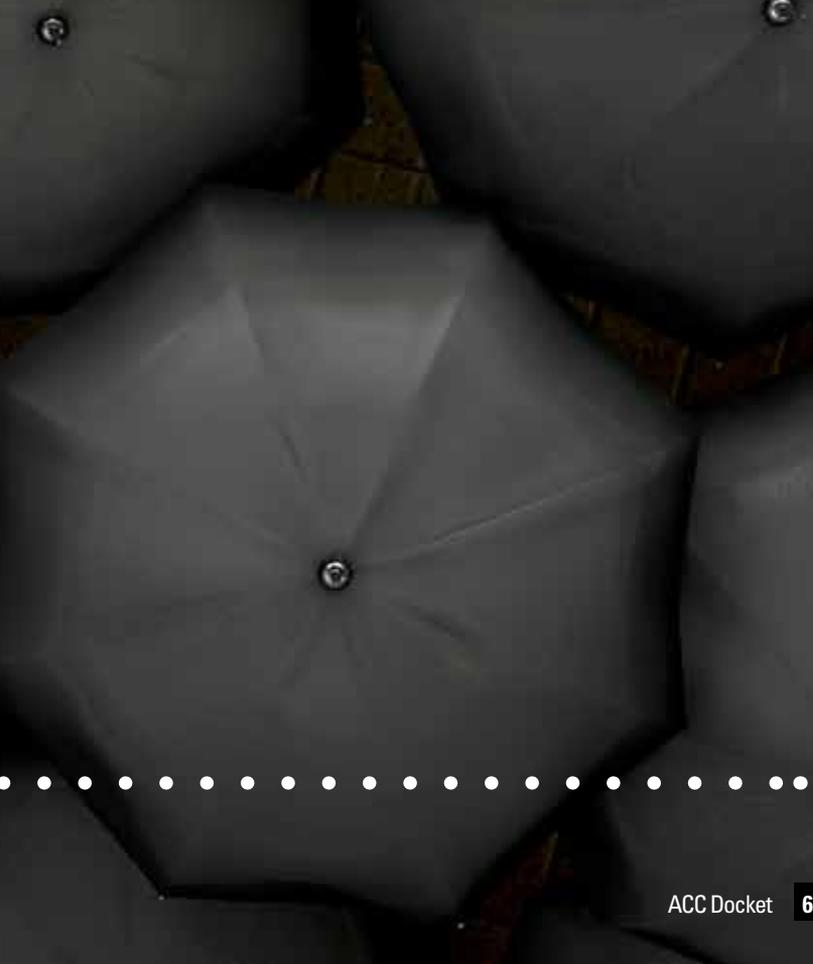


# AFTER THE STORM

tips for charity involvement



# in a post-madoff era



By Susan Bonfield and Michael J. Kline

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**S**ince the December, 2008 arrest of Bernard L. Madoff (Madoff) for his global Ponzi scheme, the media has continuously covered the nuances of the tribulations, and embarrassment of numerous charitable organizations that invested with him. Whether these charities were alleged victims or profiteers from the scandal, the scheme has profoundly affected their operations and reputations. How did charities become enmeshed in the Madoff morass and could this have been avoided? What lessons can in-house counsel draw from the Madoff experience to address their own potentially diverse involvements with charitable organizations? Against the backdrop of the Madoff scandal and recent regulatory changes, this article examines how in-house counsel can use their skills and available tools to enhance decision-making about charity involvement, both as counsel and individually.

## In-house counsel initiatives in support of charities

In-house counsel and their client corporations are increasingly aware of advantages that can flow from visible support of, and alignment with, charitable organizations. The image of your client corporation can be greatly enhanced by supporting entities that are tax exempt under Section 501(c)(3) of the Internal Revenue Code of 1986 (Section 501(c)(3)). In the best case, such support demonstrates good citizenship and awareness, promotes a positive business image within the organization and in the general public, and satisfies expectations of a variety of stakeholders. However, in the last several years there have been developments with regard to charities that you should consider when advising your client corporation in these matters.

As in-house counsel, you may be called upon to lead or participate in charitable initiatives of your client corporation. These initiatives may take a variety of forms, such as a one-time substantial contribution, a pledge commitment for contributions over a number of years, the naming of a building or portion thereof, placement of the corporate name in a journal of the charity, or even placement of someone on the board of a charity.

In addition, you may be personally motivated to contribute to a charity and perhaps even volunteer your time as a board member. Charities are hungry for experienced professionals who can provide leadership in an environment where board members are largely limited to “psychic income” for their personal dedication. Your judgment and experience as in-house counsel are valuable assets for a charity. You should perform sufficient due diligence regarding the charity, however, prior to your association. The due diligence considerations listed in the sidebar on page 41 can be useful in evaluating the merits of a charity for your client’s affiliation as well.

Your role as corporate counsel for your client corporation in its charitable initiatives may be related to, or independent of, your personal charitable objectives. However, many of the issues you should consider when deciding your own charitable affiliations overlap with matters relevant to your client’s affiliation choices.

## Recent significant developments affecting charities

Over the course of the last several years, events have occurred that affect charities and their governance, and should increase your level of analysis, caution and inquiry, both personally and on behalf of your client. One of these events has been the deep and prolonged economic recession



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in the United States that has adversely affected the finances of charities. The difficult economic climate greatly reduced contributions and the value of endowments, while appreciably heightening the demand on many charities for the social services required for individuals who became unemployed, lost their health insurance, had their homes foreclosed, etc.

Two other recent watershed events that affected charities will provide a backdrop for this article: Madoff’s global Ponzi scheme and new disclosure requirements in the Form 990 (Form 990). All charities (excluding religious organizations) that exceed minimum thresholds of revenues and assets are required to file these new disclosures with the Internal Revenue Service (IRS) annually. By happenstance, the Madoff scandal coincided with the new and far more comprehensive annual reporting obligations in Form 990, which the IRS has imposed on charities commencing for 2008 (the New Form 990).

## The Madoff scandal and its impact on charities

*Charities affected by Madoff are both large and small*

One of the most perplexing and disquieting group of investors (victims) of Madoff’s infamous Ponzi scheme is the long list of charities — many of them large and well-respected — that reportedly lost many millions of dollars through investing directly or indirectly with him. A number of the charities have been forced to cease their operations as a result of the losses incurred with Madoff.

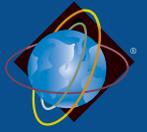
Interestingly, the affected charities include not only large and small public charities, but also private foundations that are tax-exempt under Section 501(c)(3) (foundations). Charitable giving through the foundation format qualifies wealthy individuals and families to certain tax benefits. While many of the considerations for public charities are similar to those for foundations, the focus of this article is on public charities.

There were some unique attributes of charities that made them attractive targets for Madoff, and some charities made judgment errors in investing with him. As an educated and knowledgeable professional, you may be in a position to assist charities in which you are involved to better protect themselves in the future.

## The New Form 990

Economic hardships and the Madoff scandal coincide with the new and far more comprehensive and transparent annual reporting obligations of public charities on the New Form 990. The New Form 990 can be a useful vehicle for you to analyze and compare charities in their commitment

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to “best practices” in the areas of finance, governance and compliance practices. Forms 990 filed with the IRS are universally available for review and copying from the internet.

#### *Factors that made charities such attractive targets for Madoff*

To identify errors that charities made in investing with Madoff, it is important to understand the specific attributes of charities that made them primary targets, and the conduits that assisted Madoff in continuing his decades-long Ponzi scheme. They include the following:

1. For 50 years, Madoff enjoyed the status and reputation of being a leader, innovator and even a quasi-regulator in the investment industry, having served as chair of the NASDAQ Stock Market.
2. Madoff created trust by appearing to be a paragon of the “Three Ws” — prized attributes charities seek in their board members that include generosity from wealth, sharing of wisdom and performance of work.
3. Madoff reported consistently high, stable “returns” over many years, even when other investment advisers suffered losses. This encouraged charities to maximize investments with him and to limit distributions.
4. Charities with large endowments have consistently

limited their spending to a small percentage of their endowment funds — usually five percent or less — in a given year, to grow endowment funds for the future.

5. Public charities did not need to take distributions from the Madoff investments to pay income taxes. Even foundations pay only a small excise tax on their annual investment returns.
6. Highly respected charities appeared to successfully obtain large and stable returns with Madoff over a long period, and other charities wanted to emulate their performance.
7. Madoff convinced charities that his acceptance of their money made them members of a select group.
8. During recent years, charities have felt themselves under enormous pressure to generate investment returns that exceed those of recognized comparable investment benchmarks and are not less favorable than their peers.

#### *Some “errors” that charities made in investing with Madoff*

The leadership of charities that invested with Madoff undertook policies that were questionable in a number of aspects; and some may relate to your own client-corporation and board. It is necessary to always be aware that a char-

## **Factors to Consider While Representing Your Client Corporation in Transactions with Charities**

Following are some general points and questions for consideration by a business corporation (the donor) that is making substantial contributions, pledges or affiliations with a new charity:

- Perform all of the applicable due diligence contained under “Conducting Due Diligence Prior to and After Becoming a Director of a Charity.”
- Confirm the exact entity name of the selected charity or division.
- Determine the form of recognition or dedication desired by the donor.
- Is the gift for the general purpose and mission of the charity or for a specific purpose?
- Is a contribution for a specific purpose sustainable by the charity?
- If the gift is over a period of time, what schedule and/or milestones are required for donor payments?
- If the gift is in connection with a business promotion by the donor, be certain that the charity and the donor are compliant with applicable state charitable “co-venture” laws.
- If the gift is for a major dedication by the donor, such as a building or campus (the area), designate the following in a written agreement:
  - o the permitted use of the dedicated area by the charity;
  - o later permitted uses of the area if the original purpose becomes obsolete or frustrated;
  - o the method, location, and style of lettering and media publicity for recognition of the gift;
  - o who can consent on behalf of the donor to make changes in the agreement;
  - o appropriate protection for the donor’s trademarks and logos;
  - o whether portions of the area are permitted for naming opportunities by others;
  - o alternative recognition for the donor if the gift or the area is not completed;
  - o naming a designee of the donor to the board or an advisory board of the charity if the donor so chooses;
  - o what alternative continuing recognition is to be given to the donor if the area is sold, destroyed or otherwise transferred;
  - o provide for a public recordation of appropriate parts of the agreement limiting use of the area; and
  - o the circumstances under which the donor can require the charity to cease using its name in connection with the area.

ity differs fundamentally from a business entity: A business seeks to maximize revenues and profits, and the IRS must recognize a charity's primary mission as a benefit to society.

In one or more respects, the boards of charities that invested with Madoff may have fallen short:

- Madoff's purported (but fraudulent) investment strategy was complex, involving options. Such a strategy, if followed, is not inherently suspect and is actually used legitimately by numerous investors and investment managers. Query, however, whether the volunteer board members of various charities had sufficient experience and judgment to understand such an investment policy, even if Madoff had actually made the investments. Were they aware of what the investment strategy was for the endowment assets of the charity as a whole? Volunteer board members of charities often lack sufficient background, experience or inclination to be able to evaluate such investments, or even to evaluate the qualifications of investment advisers who are recommending them. Your experience, knowledge and ability to select consultants as in-house counsel can be an important addition to a charity board; you can provide assistance in evaluating investment advisers and their policies.
- A number of charities had conflicts of interest with Madoff and his associates, who served as board members while the charities invested with him — directly or indirectly — often for a generous fee. In other cases there may have been “perceptual” conflicts of interest, e.g., where Madoff was not a board member, but was a major contributor to the charity or had ties with board members who were otherwise investing with him. Your experience in evaluating and advising your client corporation on actual and potential conflicts of interest would be valuable for a charity that you serve as a board member.
- As stated earlier, a charity has a mission that transcends merely raising funds and growing endowments. Board members must not get caught up in the generation of investment returns to build endowments as a primary goal. Donors are generally giving for a mission and not to increase endowments. Your experience as in-house counsel could help the leadership of a charity to stay focused on its primary mission.
- The fact that Madoff's “outside” auditor was a two-person accounting firm located at the same address as Madoff should have raised some alarms in light of the enormous global scale of the Madoff operations. Your experience in interacting with outside auditors as in-house counsel would be invaluable assistance to a charity.

## Due Diligence Points to Know

1. Select a charity with a mission that is meaningful to you.
2. Review, analyze and compare Forms 990, audited financial statements and published annual reports of the charity from the last several years. Each is directed to a different audience and emphasizes different types of information.
3. Determine what is expected of a director regarding the three charitable Ws: wealth, work and wisdom.
4. If you become a director, determine whether there are potential conflicts of interest between you, or your client corporation, and the charity, or its directors or officers.
5. Review your employment arrangements in order to ascertain that service to the charity is permitted.
6. Similar to the board of your client corporation, volunteer members of a board of a charity are fiduciaries that should generally discharge their duties in good faith; in compliance with law and prevailing business ethics; with the degree of diligence, care and skill that an ordinary, prudent person would exercise under similar circumstances; and without undue conflict of interest.
7. Seek information from management of the charity about the organization, the success of its mission, existing litigation and regulatory activity, and compliance with applicable state charitable registration acts.
8. Determine whether the charity has director and officer liability insurance coverage and indemnification provisions in its formation documents to protect directors.
9. Determine the extent to which the laws of the applicable state may exempt volunteer directors of charities from personal liability.
10. Determine the extent, if any, to which your own malpractice insurance may provide coverage for your service as a director of a charity.
11. Ascertain that your services as a director will not make you the de facto legal counsel to the board, and always indicate that you are speaking as a board member, not legal counsel, when you provide input that may be deemed legal advice.
12. Determine the level of skill set and experience of the charity's consultants and professionals, especially the auditors who will prepare the Form 990.
13. Always be aware of the universal public transparency of the transactions and operations of a charity through the Form 990 and the potential for public embarrassment and criticism.

- The improvident investment policies of a charity that invested with Madoff may now cause not only balance sheet “losses” but also the potential for “clawback” from the charity, if the charity actually received cash distributions that exceeded their investment with him. The overused adage, “If it sounds too good to be true, it probably is,” has been repeatedly stated as applicable to Madoff.
- Losses and potential clawback for a charity that invested with Madoff provide an example of the complexities facing charities and their volunteer boards in current times — charities need knowledgeable and committed board members. While you would not be counsel to a charity of which you are board member, you can provide important insights, pose meaningful questions to counsel and consultants for the charity, and assist other volunteers in understanding complex issues based on your own diverse experience as in-house counsel.
- The unfortunate experiences with Madoff of many charitable organizations should be poignant lessons for all charities, whether victims of Madoff or not. It has become critical that all charities review, analyze and reform their operating policies, and procedures and transparency in finances, and governance investment policies. Whether your relationship to a charity stems from representing your client corporation or your personal interest in its mission, the proactive efforts of the charity in improving these processes should be an important prerequisite for your support and affiliation.

## Additional Sources for Further Information About Madoff and Charities

- [www.charitynavigator.org](http://www.charitynavigator.org). Charity Navigator works to advance a more efficient and responsive philanthropic marketplace by evaluating the financial health of more than 5,500 of America’s largest public charities.
- [www.guidestar.org](http://www.guidestar.org). Among other attributes, GuideStar is a one-stop, comprehensive website that allows for simplification of the increasingly complex due diligence process by permitting verification of a charity’s charitable status, providing online access to current and past Forms 990 and Forms 990-PF, and identifying supporting organizations.
- [www.irs.gov/charities/index.html](http://www.irs.gov/charities/index.html). The Internal Revenue Service website on tax information for charities and other nonprofits provides diverse information about developments in regulation of charities, Forms 990 and related topics.
- <http://whitecollarcrime.foxrothschild.com/articles/bernard-madoff>. An on-going blog analysis of Madoff stakeholders’ concerns, written by Michael J. Kline, Esq., a partner of Fox Rothschild LLP.
- [http://s.wsj.net/public/resources/documents/st\\_madoff\\_victims\\_20081215.html](http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html). *The Wall Street Journal* has provided an online list of what it characterized as the “most exposed investors” with Madoff, and sorts the list by the amount of potential losses.

## The New Form 990 and its role in analysis and evaluation of charities

### *The New Form 990 as a resource for in-house counsel*

A number of issues flow from the Madoff scandal that relate to the expanded and more comprehensive New Form 990. It can be anticipated that the changes in the New Form 990 may only be the beginning of an evolution in Form 990 that will require even more comprehensive disclosures by charities in the future. Familiarity with the New Form 990 can be the cornerstone for understanding and comparing charities.

### *Form 990 as a financial reporting document in previous years*

For many years, Form 990 was viewed as an annual financial report by a public charity to the IRS on the charity’s operations for the prior fiscal year. However, even in earlier years, the Form 990 had informative disclosures of interest to potential donors, such as the compensation of the five highest-paid employees and the amounts paid to the five highest paid outside vendors. The Form 990 financial statements generally follow the format of the charity’s annual audited financial statements, but with limited financial footnotes. The new requirements in New Form 990, however, has made the form more of a governance disclosure document for charities, akin to portions of the Form 10-K annual report, which public companies file with the Securities and Exchange Commission.

### *Universal transparency and filing dates for Form 990*

The Form 990 is required to be filed with the IRS by the 15<sup>th</sup> day of the fifth month following the end of a charity’s fiscal year, with a potential for up to two extension periods totaling six months. This could extend the final filing date for charities with a calendar fiscal year ending Dec. 31, for example, to as late as Nov. 15 of the following year. Unlike federal income tax returns filed by business corporations, the Form 990 can be accessed anonymously on the internet. A filed Form 990 becomes a matter of public record after it is filed with the IRS. Various websites,

such as [www.guidestar.org](http://www.guidestar.org) and [www.charitynavigator.org](http://www.charitynavigator.org), publish Forms 990 that are available online, ordinarily within several months after they are filed. Note, however, that many calendar-year New Forms 990 for 2008 were not posted online until months after filing with the IRS, presumably because of the crush of last minute November 2009 filings.

Nonetheless, if you want or need to get Form 990 information for a charity immediately, there are other alternatives. Generally the IRS requires that Forms 990 be made available by the charity for public inspection and copying **on the same day** if the request is made **in person** at the principal offices of the charity. However, a charity has up to 30 days to respond to written requests by regular mail, email, facsimile or private delivery. While the charity is allowed to charge for actual postage and modest copying fees, many are highly sensitive to their obligations to make Forms 990 promptly available, and may even respond within a day to a telephone, facsimile or email request, without charge.

You should have a healthy skepticism about charities that are unaware of their Forms 990 public inspection responsibilities, or are evasive or unwilling to provide the Forms 990 upon request.

#### *Governance principles raised in the New Form 990*

The New Form 990 has greatly broadened the scope of transparency about the way charities operate. In the New Form 990, this is done through a series of new yes/no questions to the charity, and a request for explanations depending upon the answer.

A number of charities had close ties with Madoff and his associates, including in some cases, membership by Madoff and/or his associates on their boards. If some of the new inquiries in the New Form 990 had been in place in earlier years and had been fully and accurately answered, the potentially inappropriate relationships of Madoff and his associates to such charities may have been brought to light. The following questions in the New Form 990 fall in this category and require the charity to give an explanation if the answer is other than the *italicized* response below:

1. Are there any family or business relationships among officers, directors, trustees and key employees of the charity? *No.*
2. Is there any "material diversion" of the charity's assets? *No.*
3. Does the charity prepare contemporaneous documentation of all board and committee meetings? *Yes.*
4. Does the charity have a written conflict of interest

  
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policy with annual disclosure of related transactions with the charity by officers, directors, trustees and key employees? *Yes.* (Schedule O to the New Form 990 also asks for information about regular monitoring and enforcement of compliance by such individuals with this policy.)

5. Does the charity have a written whistle-blower policy? *Yes.*
6. Was the New Form 990 provided to the board before it was filed with the IRS? *Yes.* This new question has created substantial controversy and questions for board members at some charities who had never seen the Forms 990 in previous years, even though the board members were individually named. (Schedule O to the New Form 990 asks for the process used by the charity to review the New Form 990 by the board and its audit committee, if any.)
7. How will governing documents, conflicts policy, the New Form 990 and financial statements be made

available to the public as asked by Schedule O to the New Form 990?

*While the New Form 990 does not mandate that the charity have all of these and other governance policies in place or the type of policy that is required, the universal availability of the Form 990 will allow you to make significant analysis and evaluation as to whether the charity has taken reasonably sufficient steps, based on its size and mission, to approach "best practices" in governance.*

### Counselor beware

In-house counsel have a great deal to offer charities with their judgment, training and experience. They should use the Madoff scandal and its effect on charities, and new tools from the New Form 990 to assist their client corporations and themselves in making decisions regarding contributions to and affiliations with charities. 

*Have a comment on this article? Email [editorinchief@acc.com](mailto:editorinchief@acc.com).*

## ACC Extras on...Charities

### ACC Docket

- *Doing Good: Practical Advice for Corporate Counsel's Pro Bono Efforts (Dec. 2009).* It feels great to give back to the community, and even better when you're able to contribute through your field of expertise. If you haven't tried pro bono work, ACC and the Pro Bono Institute challenge you to get involved. Get started with this article and use your department as a catalyst for change.  
[www.acc.com/docket/advice\\_probono\\_dec09](http://www.acc.com/docket/advice_probono_dec09)
- *In-house Counsel Responsibilities In The Post-Enron Environment (March 2003).* Regulations and future proposed changes may encourage in-house counsel to involve themselves in their client's financial affairs and to report improper conduct. In-house counsel need to consider corporate conduct and investigate misconduct. This article discusses the broad responsibilities of in-house counsel and provides an overview of the post-Enron environment from the in-house perspective.  
[www.acc.com/docket/inhs\\_respon/enron\\_mar03](http://www.acc.com/docket/inhs_respon/enron_mar03)

### Webcast Transcript

- *The New IRS Form 990: What Does It Mean for Your Non-profit Organization? (Sept. 2008).* This transcript addresses the most important features of the new Form 990 and what it means for your nonprofit organization.  
[www.acc.com/webcast/IRSform990\\_sep08](http://www.acc.com/webcast/IRSform990_sep08)

### Article

- *Strategies to Enhance Charitable Fundraising in Challenging Economic Times (July 2009).* Read this article advising counsel on charitable fundraising: advises counsel to encourage donors to take advantage of low interest rates; draw on demand for fixed income by offering charitable gift annuities; to stay ahead of the charitable rollover rules; team up with other organizations; and consider tax-exempt bond financing.  
[www.acc.com/fundraising\\_ecom\\_jul09](http://www.acc.com/fundraising_ecom_jul09)

### Sample Form & Policy

- *Model Agreement for Corporate Donations (Cause-Related Marketing) (Feb. 2009).* View this form letter that includes the terms and conditions under which a company may use the name of the charity in connection with the marketing and sale of certain products.  
[www.acc.com/forms/corp\\_donates\\_feb09](http://www.acc.com/forms/corp_donates_feb09)

### Program Material

- *Legal Issues in Fundraising Management (Oct. 2001).* This program material includes: security regulations; charitable gift charts and regulations; sample form/distribution sites for unified registered states.  
[www.acc.com/fundraise\\_mgt\\_oct01](http://www.acc.com/fundraise_mgt_oct01)

ACC has more material on this subject on our website. Visit [www.acc.com](http://www.acc.com), where you can browse our resources by practice area or use our search to find documents by keyword.