Madoff's Unintended Legacy to Charities

by Michele A. W. McKinnon[1]

Introduction. In the days following Bernard L. Madoff's confession to the operation of a massive Ponzi scheme in December 2008, news began to surface regarding a number of charities, including family foundations, public charities, and colleges and universities, that had significant losses due to Madoff's fraud. In fact, some charities indicated that all of their investment assets had been invested with or through Madoff and, with the expected loss of all of their assets, they were being forced to cease operations. Estimates have put the number of charities invested with Madoff at close to 150, and the amount invested has been suggested to be in excess of $2 billion.[2]

While the public's initial reaction was anger for the damage Madoff had caused within the nonprofit community, the focus is now shifting towards the persons responsible for making these investments within the affected charities. On December 16, 2008, just days after Madoff's confession, Senator Charles Grassley, senior Republican member of the Senate Finance Committee, noted the lack of diversification with some charities and suggested that the boards of these organizations should explain why they had "all their eggs in one basket." Senator Grassley went on to note that greater transparency of investments may be needed along with a federal prudent investor rule, as originally called for in the Senate Finance Committee staff proposals for reform of nonprofits in 2004.[3] Both the Internal Revenue Service and members of the Senate Finance Committee are encouraging state attorneys general to conduct further investigation of the investment decision-making processes of these charities.

Some question why Madoff's wrong-doing should call into question the actions of those deciding to invest charitable assets with him, while others wonder what failures must have occurred to allow such an investment in the face of what, at least in hindsight, appear to be obvious warning signs and indications that some charities, after performing their due diligence, chose not to invest with Madoff. While there may well be disagreement over who should be held accountable and under what circumstances, it is becoming apparent that Madoff's charitable legacy may be increased regulation and oversight of the governance and investment activities of charities. While there may be initial resistance and reluctance on the part of nonprofits and their board members to embrace greater governmental oversight and regulation, in the long-run, this oversight and regulation would likely benefit the nonprofit sector.

Nonprofit Investment Activities under Federal Tax Laws. Presently, the federal tax laws applicable to charitable organizations have limited application to the investment management and governance activities of charitable organizations. In fact, the Internal Revenue Service's only clear avenue of attack on a charity's decision to invest with Madoff under the federal tax laws is the jeopardy investment rules, which apply only to charitable organizations classified as private foundations.

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[2] Brown, *States May Be Quicker than IRS to Penalize Madoff's EO Investors*, 63 E.O. Tax Rev. 224, 224-25 (March 2009).
[3] Freda, *Private Foundation Managers Possibly Liable for Taxes on Failed Investments with Madoff*, 16 DTR G-2 (BNA January 28, 2009).

On March 5, 2009, Lois Lerner, the IRS Director of Exempt Organizations, said that IRS officials "at a very high level" were looking at questions raised by exempt organizations that were affected by Madoff, but no conclusions have been reached.[4] In the case of private foundations, specific issues of concern are the application of the jeopardy investment rules, the ability to recover past taxes paid on phantom net investment income, and the effect of the possible overvaluation of assets on prior years' minimum distribution requirements.

Jeopardy Investments. The jeopardy investment rules apply if a private foundation invests its assets in a manner that will jeopardize the accomplishment of its exempt purposes.[5] In general, an investment jeopardizes the exempt purposes of a foundation if the foundation managers (which generally includes directors and officers), in making the investment, fail to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation in carrying out its exempt purposes.[6] The Pension Protection Act of 2006 increased the amount of the initial tax imposed on the foundation from five percent to 10 percent of the amount invested effective for tax years beginning after 2006.[7]

A director or officer who participated in making the investment knowing that it jeopardized the foundation's exempt purposes is subject to a tax equal to 10 percent of the amount invested unless such participation was not willful and was due to reasonable cause.[8] A director or officer will be considered to have participated in the making of an investment "knowing" that it jeopardizes the exempt purposes of the foundation if the director or officer (a) has actual knowledge of sufficient facts so that, based solely upon such facts, such investment would be a jeopardizing investment, (b) is aware that such an investment under these circumstances may violate the provisions of the jeopardy investment rules, and (c) negligently fails to make reasonable attempts to ascertain whether the investment is a jeopardy investment or is aware that it is a jeopardy investment.[9] Participation is "willful" if it is voluntary, conscious, and intentional, but not if the foundation manager does not know that it is a jeopardizing investment.[10] A foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.[11]

If the investment is not removed from jeopardy after the imposition of an initial tax on the foundation, there is an additional 25 percent tax imposed upon the foundation and an additional tax of five percent imposed on any director or officer who refused to agree to part or all of the removal from jeopardy.[12] Directors and officers who are liable are jointly and severally liable for the tax and the maximum tax that can be imposed on the directors and officers in the aggregate is $10,000 for the initial tax and $20,000 for the additional tax.[13]

A foundation manager's reliance upon qualified investment counsel after full disclosure of the facts to the investment counsel will generally cause the foundation manager's participation to be

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[4] Freda, *IRS Ponders Issues for Private Foundations Affected by Madoff Securities Fraud Scheme*, 42 DTR G-5 (BNA March 14, 2009).
[5] I.R.C. § 4944.
[6] Treas. Reg. § 53.4944-1(a)(2).
[7] I.R.C. § 4944(a)(1).
[8] I.R.C. § 4944(a)(2).
[9] Treas. Reg. § 53.4944-1(b)(2)(i).
[10] Treas. Reg. § 53.4944(b)(2)(ii).
[11] Treas. Reg. § 53.4944(b)(2)(iii).
[12] I.R.C. § 4944(b)(1), (2).
[13] I.R.C. § 4944(d)(1), (2).

due to reasonable cause and not willful. But, such advice must be derived in a manner consistent with the generally accepted practices of persons who are a qualified investment counsel, and the advice must be expressed in writing finding that a particular investment will provide for the long- and short-term financial needs of the foundation.[14] But, the absence of such advice does not, in and of itself, give rise to an inference that the foundation manager's participation in the making of the investment was done knowingly, willfully, or without reasonable cause.[15]

The regulations under Internal Revenue Code section 4944 provide additional guidance regarding the duty of the foundation managers and the nature of the types of investments that could be jeopardy investments and clearly indicate that directors and officers should consider the need for diversification within the investment portfolio with respect to type of security, type or industry, maturity of company, degree of risk and potential for return.[16] In addition, the determination whether a particular investment jeopardizes the carrying out of a foundation's exempt purposes is to be at the time of the making of the investment and not subsequently on the basis of hindsight. Once it has been determined that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment is never considered to jeopardize the carrying out of such purposes, even if the investment subsequently results in a loss.[17]

As early as January 2009, Theresa Pattara, who serves as tax counsel to Senator Grassley, noted that directors of private foundations who invested all of their money with Madoff may be liable for taxes under the jeopardy investment rules because of lack of proper oversight. Ms. Pattara pointed out the difficulty of the determination due to its dependence upon the particular facts and circumstances, but indicated that a failure to conduct due diligence and instead rely upon a referral or personal relationship could cause problems for these foundations. She also has noted that it is obvious that any charity that was forced to close its doors due to its Madoff investments clearly had investments that jeopardized their exempt purposes.[18]

While the jeopardy investment rules have rarely been applied in the past, the continued focus on these rules in connection with the Madoff losses should generate concern among private foundations who invested with Madoff, and in particular those private foundations that lost all or substantially all of their assets, as well as the directors and officers of these foundations. Before deciding whether to proceed with the imposition of these taxes against private foundation under the jeopardy investment rules, the IRS will have to examine the likelihood of any significant tax recovery. The most significant tax is imposed on the charity itself, and many of the charities have no funds left. The limits on the foundation manager tax may make pursuit of these taxes by the IRS impractical. In addition, the statute of limitations may hinder the ability of the IRS to collect tax for all but a few years of the investment. In the meantime, affected foundations and their directors and officers should be gathering all available documentation associated with the decision to invest with Madoff in order to counter any claims of lack of due diligence in the event the IRS does decide to pursue excise taxes under the jeopardy investment rules.

Actions by the States. In light of the limited options available to the IRS, state attorneys general are being encouraged to investigate the charities with Madoff losses to determine whether these organizations or their governing bodies violated any applicable state laws. Attorneys general in Connecticut and New York have begun investigating private foundations within their states who

[14] Treas. Reg. § 53.4944-1(b)(2)(v).
[15] Treas. Reg. § 53.4944-1(b)(2)(v).
[16] Treas. Reg. § 53.4944-1(a)(2).
[17] Treas. Reg. § 53.4944-1(a)(2).
[18] Freda, *Private Foundation Managers Possibly Liable for Taxes on Failed Investments with Madoff*, 16 DTR G-2 (BNA January 28, 2009).

invested with Madoff, to determine whether these organizations breached their fiduciary duty of care.[19] This is an issue that affects not only private foundations, but also public charities. In states that have enacted either the Uniform Management of Institutional Funds Act ("UMIFA")[20] or the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"),[21] there is a statutory standard of care imposed upon directors of a charitable organization in connection with the management and investment of endowment and other investment assets held by the organization. Because UPMIFA was not adopted as a uniform act until 2006, investment decisions in a state that had UMIFA, but has now adopted UPMIFA, may be subject to different standards or laws depending upon when the investment was made.

UMIFA requires members of a governing board to exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision, considering the long- and short-term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.[22] UMIFA authorizes the governing board to delegate certain powers except as otherwise provided by an applicable gift instrument or applicable law relating to government institutions or funds. UMIFA's delegation authority permits the governing board to delegate its authority to invest and reinvest institutional funds to committees, officers, or employees of the institution or the fund, or to agents such as investment advisors, consultants, or managers. In addition, the governing board may enter into contracts with independent investment advisors, investment managers, banks, or trust companies to invest and reinvest institutional funds and pay compensation for such investment advisory and management services.[23] UMIFA does not set forth any express standard of care for the selection of investment managers or advisors, although the comment to this provision states that "[r]esponsibility for investment policy and selection of competent agents remains with the board under the…standard of business care and prudence."[24]

Under UPMIFA, directors must act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[25] UPMIFA adopts concepts of modern portfolio theory and requires management and investment decisions to be made in the context of the institutional fund's entire portfolio of investments, rather than on an asset-by-asset basis, as part of an overall investment strategy with risk and return objectives reasonably suited to the institutional fund and the institution.[26] In making investment and management decisions, the

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[19] Freda, *IRS Using State Agency Actions to Trigger Audits of Exempt Organizations, Owens Says*, 42 DTR G-5 (BNA March 14, 2009).

[20] The Uniform Management of Institutional Funds Act ("UMIFA") was designed by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") to provide guidance and authority to charitable organizations concerning the management, investment, expenditure, and delegation of management and investment duties of funds held by such organizations. UMIFA, which was approved by NCCUSL in 1972, was enacted in 47 states and the District of Columbia, (although many of these states have recently enacted or are considering the new Uniform Prudent Management of Institutional Funds Act, which is discussed below).

[21] The Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), which was approved by NCCUSL in 2006, was designed to provide better guidance for investment management of funds held by charitable organizations and to set forth a new set of rules for the prudent investment of those funds. UPMIFA expands upon (and in some cases modifies) the principles set forth in UMIFA and provides a more unified basis for charitable fund management by adding express standards for management and investment decisions, expenditure decisions, and the delegation of management and investment duties.

[22] UMIFA § 6.

[23] UMIFA § 5.

[24] UMIFA § 5, Comment.

[25] UPMIFA § 3(b).

[26] UPMIFA § 3(e)(2).

following eight factors are to be considered: (a) general economic conditions, (b) the possible effects of inflation or deflation, (c) the expected tax consequences, if any, of the investment or strategy, (d) the relation of each investment to the entire portfolio, (e) the expected total return from income and appreciation, (f) other resources of the institution, (g) the need for distributions and preservation of capital, and (h) any special relationship or value of the asset to the institution's charitable purposes.[27] Unlike UMIFA, UPMIFA expressly requires diversification of assets and re-balancing of the portfolio upon receipt of new assets.[28] For advisors with special skills or expertise, it raises the standard of care to a level consistent with those skills and imposes a duty to use such skills or expertise.[29]

Under UMIFA, an institution was permitted to delegate management and investment decisions without being held to an express standard in such delegations. UPMIFA requires such delegation to be made in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.[30] This standard applies to the selection of an agent, the establishment of the scope and the terms of the delegation, the supervision of the agent, and the periodic review of the delegation.[31] UPMIFA expressly states that the agent to whom investment authority has been delegated, by accepting such delegation, has a duty of reasonable care to comply with the scope and terms of the delegation and is subject to the jurisdiction of the court of the state in all proceedings related to the delegation or the agent's performance.[32]

The general duties that are imposed on the boards of charitable organizations are derived from common law, although many states have incorporated these concepts into either special acts, such as UMIFA and UPMIFA or statutes governing nonprofit or nonstock corporations.[33] Under common law, a director has two primary duties: a duty of care and a duty of loyalty.[34] The duty of care generally looks at the manner in which directors make decisions on behalf of the organization and requires that a director participate in decisions, be reasonably informed, act in good faith, and act with the care of an ordinarily prudent person in similar circumstances.[35] A director is permitted to rely on others such as employees of the organization or experts, such as lawyers, accountants, appraisers, investment advisors, and others.[36] Generally, courts will take into account the director's responsibilities with regard to the particular corporation, the information available to the director at the time a decision is made, and any special expertise of the director.[37] The courts generally do not second-guess business decisions, as long as the directors made a reasonable effort to make an informed decision.[38] The duty of loyalty requires a director to act in the best interests of the charitable organization and to put the interests of the charitable organization before his or her personal interests.[39] There is sometimes reference to a third duty imposed on directors – the duty of

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[27] UPMIFA § 3(e)(1).
[28] UPMIFA § 3(e)(4) & (5).
[29] UPMIFA § 3(e)(6).
[30] UPMIFA § 5(a).
[31] UPMIFA § 5(a).
[32] UPMIFA § 5(b) & (d).
[33] *See, e.g.,* Va. Code § 13.1-870 (director has duty to use good faith judgment and act in best interests of corporation); Tex. Bus. Org. Code § 22-221.
[34] Hopkins, *The Law of Tax-Exempt Organizations* § 5.3(b); Siegel, *A Desktop Guide for Nonprofit Directors, Officers, and Advisors-Avoiding Trouble While Doing Good* § 4.2 (2006).
[35] *See, e.g., Meyers v. Moody*, 693 F.2d 1196 (5th Cir. 1982), *cert. denied* 464 U.S. 920 (1983). *See generally* Hopkins § 5.3(b), at 135.
[36] *See, e.g.,* Va. Code § 13.1-870.B.
[37] 1A *Fletcher Cy. Corp.* § 1032.
[38] *Resolution Trust Corp. v. Acton*, 844 F. Supp. 307 (N.D. Tex. 1994).
[39] 3 *Fletcher Cyc. Corp.* § 837.60; Hopkins § 5.3(b), at 135; Siegel § 4.2, at 83-84. *See, e.g., Pepper v. Litton*, 308 U.S. 295, 310-11 (1939); *Mills v. Withers*, 483 S.W.2d 339 (Tex. Civ. App. 1972).

obedience. Under this duty, directors are required to comply with all laws applicable to the organization, act in accordance with the organization's articles of incorporation and bylaws or other relevant governing documents, and act in furtherance of the charitable organization's exempt purpose or mission.[40]

Key aspects of any claim under state laws will be the extent to which pre-investment due diligence was undertaken, as well as whether the investments, once made, were monitored regularly. If decisions to invest were made with little or no due diligence, particularly if the organizations were told not to ask questions, there may be a greater likelihood of a breach of duty. On the other hand, an organization that received information, even though false, may have exercised appropriate due diligence and should not be held accountable for another's fraud. Again, to protect against state claims of breach of fiduciary duty, charities, whether public charities or private foundations, that invested with Madoff should document the due diligence that was performed in connection with the making of the investment and the monitoring of the investment. These foundations should also be taking all appropriate and practical or feasible steps to recover the funds invested with Madoff. Of particular concern under state law will be the failure to diversify for those organizations that invested all of their funds with Madoff. Other concerns may be the lack of formal, written agreements with Madoff and the failure to question statements provided by Madoff. States will also have to carefully consider whether to pursue these claims taking into account the likelihood of recovery, state protections afforded to volunteer directors and officers, and other considerations.

Madoff's Legacy. While the immediate damage caused by Madoff's fraud is obvious given the magnitude of the losses suffered by a significant number of charities, Madoff's long-term legacy to the charitable community may actually be beneficial to the nonprofit sector in the long-run. Madoff's long-term legacy to charities is likely to involve greater regulation of investment activities, particularly at the federal level. On the one hand, there are calls for changes to the laws to penalize those who permit a charity to make imprudent investment decisions. In a recent letter to Senators Baucus and Grassley, dated March 25, 2009, submitted in response to specific questions raised by Senators Grassley and Baucus, William Josephson, former head of New York State Attorney General's Charities Bureau, recommends changes to the jeopardy investment rules as they apply to private foundations and application of the excise tax on jeopardy investments to public charities. Mr. Josephson stated in his letter: "The legislative change that I think should occur first…is serious reconsideration of the entire substance of Internal Revenue Code Section 4944 which relates to so-called jeopardy investments. It should also be made applicable to all public charities, as well as to private foundations, and enforceable by states' charity officers by amendment of Code section 508(e). It should become a comprehensive prudent investor and investment oversight provision, not displacing state laws,…but with sharp and strong excise teeth." Mr. Josephson also recommends increasing the tax on foundation managers and making it applicable even if no tax is imposed on the organization. In fact, he would suggest that no tax be imposed on the organization.

While most states already have statutes that impose certain duties on directors in connection with investment management of nonprofit assets, such as UMIFA or UPMIFA, more enforcement activity may occur at the state level as a result of Madoff losses in the charitable sector. In the short-run, these changes may make it more difficult for nonprofits to attract qualified individuals to serve as directors and officers in a volunteer capacity. Ultimately, however, the Madoff scandal may force all charities to pay greater attention to investment decisions and activities. In the future, nonprofit organizations and their directors and officers are more likely to provide greater attention to the processes associated with the investment of the organization's assets.

[40] Hopkins § 5.3(b), at 135-36; Siegel § 4.2, at 84.

Organizations will be forced to adopt and adhere to well-crafted and thoughtful investment policies and procedures. Directors and officers will insist on adherence to these policies and procedures when making investment decisions and are more likely to monitor the investment performance and activities of advisors and managers. This increased focus on adherence to procedures and policies will ultimately serve the nonprofit sector well. In light of the wrongdoing that has surfaced not only with Madoff, but with other investment managers, this increased oversight and regulation should ultimately prove to be beneficial to the nonprofit community in the long-term.