

## Private Foundations and the Protection of Assets

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Mr. Ponzi has given me assurance that his promises to pay are good. I believe him.

— Statement from Judge Frank Leveroni, attorney for Charles Ponzi, as recounted in *Ponzi's Scheme, The True Story of a Financial Legend*, Mitchell Zuckoff, 2005, p. 182.

Events of the recent past, including the Foundation for New Era Philanthropy,<sup>1</sup> the Madoff investment scandal, and the just-emerging situations involving the Stanford Financial Group and the Walsh and Greenwood investment entities,<sup>2</sup> raise difficult and potentially fatal situations for charities who invested with those firms. Those scandals should also trigger a moment of reflection in the

<sup>1</sup>The Foundation for New Era Philanthropy, operated by John Bennett, was a notorious Ponzi scheme. The foundation raised more than \$500 million from 1,100 donors and embezzled \$135 million of that amount. It operated from 1989 until its collapse in 1995.

<sup>2</sup>The Walsh and Greenwood entities include the WG Trading Co. and WG Trading Investors LP in Greenwich, Conn., and Westridge Capital Management Inc. based in Santa Barbara, Calif. The FBI arrested Walsh and Greenwood on Feb. 25, 2009, on charges of misappropriating at least \$553 million. The investors included public charities and private foundations. See Steve Stecklow, Chad Bray, and Jenny Strasburg, "Pair Lived Large on Fraud, U.S. Says," *The Wall Street Journal*, Feb. 26, 2009.

minds of directors, trustees, and managers of all private foundations. This is because private foundations, unlike public charities or other types of exempt organizations, are subject to a stringent, restrictive set of excise taxes that are the result of scandals a half-century old.

One such tax is section 4944,<sup>3</sup> the tax imposed on a private foundation's investments that jeopardize the foundation's charitable purpose. This excise tax is 10 percent<sup>4</sup> of the amount of the investment and is paid by the private foundation. There is an additional 10 percent<sup>5</sup> excise tax on the foundation manager if that manager knew the investment would jeopardize the foundation's ability to carry out its exempt purpose, unless the participation is not willful and is due to reasonable cause. The manager's tax is capped at \$10,000 for the first-tier tax. The second-tier taxes for the foundation and its managers are imposed if the investment is not removed from jeopardy within the taxable period. Those excise taxes are 25 percent of the investment paid by the foundation and 5 percent of the investment paid by the manager, with the manager's second-tier tax capped at \$20,000 for each investment.<sup>6</sup> The tax period begins with the date the investment was made and ends on the date the notice of deficiency is issued or excise taxes assessed. Unfortunately, the preceding description of the mechanical application of the law fails to adequately grapple with the reality faced by those foundation officials who awake to the immediacy of financial fraud.

The most important issue that arises is whether private foundations have invested in such a way that jeopardizes their ability to carry out their charitable purposes. Certainly, in retrospect and in a very objective way, that is true regarding many that entrusted funds to Bernard Madoff. However, the test for purposes of the federal excise tax is whether *at the time of the initial investment* or at the dates of any subsequent investments, the foundation's investment decisions were sufficiently reckless to jeopardize the organization's assets and its ability to carry on its exempt purpose. Also, both private foundations and public charities must meet the fiduciary

<sup>3</sup>All section references are to the Internal Revenue Code of 1986, as currently amended and in effect.

<sup>4</sup>The excise tax is 5 percent for tax years beginning on or before Aug. 17, 2006.

<sup>5</sup>The manager's excise tax is 5 percent/\$5,000 for tax years beginning on or before Aug. 17, 2006.

<sup>6</sup>The second-tier manager's excise tax is capped at \$10,000 for each investment for tax years beginning on or before Aug. 17, 2006.

duty of care standard, which is enforced by state attorneys general. The decision on whether that standard is met requires a facts and circumstances determination of whether adequate due diligence was performed at the time of the investments, and whether adequate monitoring of the investments occurred — the same facts that will shield foundation officials from potential liability under federal excise tax.

As previously stated, most states have empowered their attorneys general to oversee charitable trusts and corporations and to ensure that charitable assets are protected. To that end, the Revised Model Nonprofit Corporation Act<sup>7</sup> recommends that states, to protect the public interest, adopt generally accepted standards of conduct for nonprofit directors and officers. These recommended standards include the duty of care, the duty of loyalty, and the duty of obedience. Also, fiduciaries to a nonprofit must exercise due diligence and active oversight, even if the fiduciaries are volunteer board members with limited time. Although most states do not have the staffing to vigorously enforce these fiduciary standards, there appears to be a trend toward more interest in enforcement, particularly in California, New York, and Massachusetts.

#### The Headlines Aren't Good — What Can Be Done?

Each foundation that awakes to financial news that some of its investments have collapsed needs to retain documentation detailing the procedures that were followed in deciding to make those investments, and the continuing procedures it used in its decisions to increase or alter its investments. If questioned by the IRS or a state attorney general, the foundation managers will need to show that, when they made the investment, they exercised ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation. The IRS or states attorney general will then apply the previously mentioned facts and circumstances test to the actions of the manager(s). The factors that will be considered in this facts and circumstances test, as listed in the Treasury regulations, include whether the foundation managers took into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio regarding the type of security, type of industry, maturity of the company invested in, the degree of risk, and the potential for return. Particular scrutiny will be given to securities traded on margin, any trading in commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls, straddles, the purchase of warrants, and selling short. Generally, reliance on the written advice of counsel will satisfy the business care and prudence test. In that case the foundation manager tax would not apply to the manager,

<sup>7</sup>The American Bar Association drafted model language to offer state legislatures a template for charitable legislation. The revised language is available at [http://www.abanet.org/rppt/meetings\\_cle/2008/jointfall/Joint08/ExemptOrgCharitablePlanOrganGroup/BlackLetter.pdf](http://www.abanet.org/rppt/meetings_cle/2008/jointfall/Joint08/ExemptOrgCharitablePlanOrganGroup/BlackLetter.pdf).

assuming all material facts were disclosed to legal counsel. However, the jeopardizing investment excise tax against the private foundation could still be applicable.<sup>8</sup>

If the foundation is able to document that ordinary business care was exercised when the investment was made and that the investment did not jeopardize the foundation's ability to carry on its charitable activities, the regulations verify that "the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of the investment, the foundation subsequently realizes a loss."<sup>9</sup> Any time the terms of the investment are changed, a new investment will be deemed to have been entered into and the ordinary business care and prudence test will need to be met regarding that new investment date as well. Any investments that are gratuitously transferred or acquired by the foundation are not subject to the jeopardizing investment excise tax, unless the investments are altered in any way after the acquisition.

For many private foundations, this factual determination will depend on the types of investments that were made. Many investors invested in other hedge funds, which then invested with Madoff. The blogs, e-mails, and general chatter on the Internet indicate that statements received reflecting the Madoff investments were sketchy, at best. There were other warnings as well. An article in *Barron's* in 2001 reported the following:

What Madoff told us was, "If you invest with me, you must never tell anyone that you're invested with me. It's no one's business what goes on here," says an investment manager who took over a pool of assets that included an investment in a Madoff fund. "When he couldn't explain how they were up or down in a particular month," he added, "I pulled the money out."<sup>10</sup>

The Securities and Exchange Commission's complaint, filed on December 11, 2008, in federal court in Manhattan, alleges that Madoff and Bernard L. Madoff Investment Securities LLC have committed a \$50 billion fraud and violated a variety of provisions in the Securities Acts. The complaint alleges that Madoff, just before the filing of the complaint, informed two senior employees that his investment advisory business was a fraud. Madoff told those employees that he was "finished," that he had "absolutely nothing," that "it's all just one big lie," and that it was "basically, a giant Ponzi scheme."<sup>11</sup>

Even where foundations did not invest directly with Madoff, a factor to consider is whether the investments were monitored appropriately and whether the private foundation managers understood the statements and the foundation's investments. It may be that as long as the "too good to be true" annual returns on their investments remained solid, there was little concern with how those returns were managed by Madoff in a market that was increasingly volatile. Will those managers be able to meet the business judgment test? It depends on the scope of

<sup>8</sup>Reg. section 53.4944-1(a)(2)(i).

<sup>9</sup>*Id.*

<sup>10</sup>Erin E. Arvedlund, "Don't Ask Don't Tell," *Barron's*, May 7, 2001.

<sup>11</sup>SEC, Litigation Release No. 20889, Feb. 9, 2009.

the investments made, the contemporaneous documentation retained by the foundation illustrating any due diligence engaged in by the foundation, the diversification of investment policies of the foundation, and the amounts at issue. For those managers who invested all, or almost all, of the foundation's assets in one investment fund, even if that fund is diversified internally, that may be a difficult test to meet.<sup>12</sup> The financial statements received by the private foundation will also need to bear scrutiny and provide reasonably diligent explanations regarding the investments, the return on investment, the diversification of assets within the fund, and other information that would help support the fiduciary standards imposed on foundation managers, even if that information ultimately is determined to be false.

Applying the business judgment test in the context of investments with Stanford International Bank, private foundations may have considered the certificates of deposits to be a safer investment than the stock market. However, new allegations by the SEC indicate that was not so. The investment advisers used by Stanford investors allegedly were handpicked by Mr. Stanford and not independent advisers.<sup>13</sup> Although the facts are still being revealed, any investments with a Stanford entity may also result in substantial losses for the investors.

Carolyn Weiss, Healthcare Foundation of New Jersey's CFO, is one executive who did perform extensive due diligence and avoided the Madoff investments. Her organization had no exposure as a result of the Madoff scandal. In an interview with *The New Jersey Jewish News*, she said that she looks for a specific form filed with the SEC known as SEC form ADV. She reported that some of the information included on that form would have tipped off careful investors. According to Weiss, Madoff did not always file the SEC form, which is another red flag. She said, "There's a lot of information out there; you've got to read it."<sup>14</sup> The question for the IRS is whether this heightened level of due diligence is necessary to meet the standard required in the code and accompanying regulations.

Daniel E. Smith of Benefit Technology Inc. has put together an interesting compilation of information for Nicholas Kristof of *The New York Times*, providing a preliminary list of the foundations that have ties to

Madoff. Smith also lists information from a variety of sources, including the foundations' Forms 990-PF.<sup>15</sup> Many of the Forms 990-PF reflected substantial rates of return on the Madoff investments, even though reporting occurred during a difficult economic environment. However, is that enough of a red flag to cause a manager, exercising reasonable business judgment, to start asking questions and demanding answers and/or his money?

Few tracks exist regarding enforcement of section 4944: There are few court cases, revenue rulings, or private letter rulings that are even slightly relevant to this situation, perhaps because of the historic conservative investment strategies of many foundations. However, in *Thorne v. Commissioner*, 99 T.C. 67 (1992), the Tax Court reviewed the IRS's determination that Thorne was liable for the second-tier foundation manager tax because he had not removed the jeopardizing investment from jeopardy. The court ultimately found that he was not liable for the excise tax because he did not receive a notice or request to remove the jeopardizing investment, thus there was no "refusal to correct." Also, the court found a split burden of proof, in which the foundation must prove by a preponderance of the evidence error in the IRS's deficiency determination of the excise tax imposed for a jeopardy investment.

However, the commissioner must prove knowing, willful, or fraudulent conduct by clear and convincing evidence for purposes of the excise tax imposed on the manager(s). For purposes of this opinion, the court assumed that the foundation at issue was liable for the section 4944 excise tax. The foundation had invested all of its assets in a Bahamian bank which, unknown to the manager, had lost its business license many years earlier. The manager relied on the verbal advice of a tax adviser and did not verify the bona fides of the bank. The court did not indicate the presence of any contemporaneous written records exhibiting due diligence. Thus, the court relied on a technicality to absolve the foundation manager of liability under section 4944, while finding that Thorne was liable for penalties under section 6684 for conduct that was willful and flagrant regarding excise taxes imposed under section 4945 for taxable expenditures.

In recent testimony before the Senate Finance Committee,<sup>16</sup> IRS Commissioner Douglas Shulman noted during the question and answer session that "[Section 4944] is a tool that is available to us that we certainly will consider" in deciding whether the IRS will take steps to impose taxes on board members of private foundations which invested in Ponzi schemes.<sup>17</sup>

As indicated in *Thorne*, section 6684 provides another penalty the IRS could use to exact additional amounts

<sup>12</sup>See reg. section 53.4944-1(d), Example 3: "After careful research into how best to diversify [the private foundation's] investments, provide for [the private foundation's] long-term financial needs, and protect against the effects of long-term inflation, [the foundation manager] decides to allocate a portion of investment assets to unimproved real estate." The regulation concludes that the investment will not be classified as a jeopardizing investment; see also TAM 8101007 (Oct. 15, 1980): "The trustee . . . must evaluate an investment in such a manner that makes preservation of the fund the primary consideration. In addition to considering the risk of a particular investment, the trustee, generally, must also distribute the risk of loss by reasonable diversification."

<sup>13</sup>Complaint, *Securities and Exchange Commission v. Stanford International Bank Ltd.*, filed in the District Court for the Northern District of Texas, Dallas Division (Feb. 16, 2009).

<sup>14</sup>Johanna Ginsberg, "Dodging Madoff Bullet, Agencies Remain Wary," *The New Jersey Jewish News*, Jan. 1, 2009.

<sup>15</sup>See [http://graphics8.nytimes.com/packages/pdf/opinion/madoff\\_exposure\\_7.pdf](http://graphics8.nytimes.com/packages/pdf/opinion/madoff_exposure_7.pdf).

<sup>16</sup>Senate Finance Committee Hearing: Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation (Mar. 17, 2009).

<sup>17</sup>"IRS Considers Taxing Trustees of Funds That Were Victims of Madoff Scam," by Grant Williams, *Chronicle of Philanthropy* (Mar. 26, 2009).

from the foundation managers and/or private foundations. In any situation in which a taxpayer becomes liable, in part, for a private foundation excise tax by reason of any act or failure to act that is not due to reasonable cause, the person "shall be liable for a penalty equal to the amount" of the excise tax. Thus, if the IRS concludes that a private foundation made jeopardizing investments and the conduct was willful and flagrant, this penalty tax will act to double the taxpayer's liability.

The recent private letter rulings that have been issued interpreting the jeopardizing investment excise tax deal largely with whether it will apply when one private foundation transfers assets to another private foundation.<sup>18</sup> While the IRS, as a standard procedural matter, reviews a foundation's compliance with all the private foundation excise taxes in each examination, greater scrutiny may be in the offing. Congress recently passed legislation doubling the first-tier excise tax on the foundation from 5 percent to 10 percent, and remarks by a Senate Finance Committee staffer indicate that there is concern from Finance Committee ranking minority member Chuck Grassley, R-Iowa, and others on the Finance Committee that these rules need to be enforced. The minority tax counsel on the Finance Committee, Theresa Pattara, spoke with *The Chronicle of Philanthropy* recently and said:

I'd be curious to know if any of those foundations considered the impact of [section] 4944 before they made those investments. It would be fair to ask for board minutes, the thought processes, and the decision making they went through before putting all their money at risk.<sup>19</sup>

Her boss, Senator Grassley, has said private foundation excise taxes should be extended to public charities: "Better transparency of investments might help to prevent this kind of mess in the future. It may be time to re-examine that reform."<sup>20</sup> Whether and how the IRS might respond to the reports of foundation investments in Madoff and similar Ponzi schemes is unknown. Equally unknown are important details of the foundation fiduciaries' actions in making the investments. A final unknown is the extent to which the failed SEC review of Madoff will be a factor in any IRS or state attorney general review. Foundations pointing to the abortive SEC investigation should be prepared to demonstrate contemporaneous knowledge of the investigation and its conclusions before making investment decisions, an unlikely fact pattern given the date and circumstances of the SEC review. Nevertheless, if reasonable due diligence was conducted it would seem that a good case could be made that reasonable care and prudence was exercised by the private foundations and their managers. However, there

<sup>18</sup>See LTR 200832029 (May 15, 2008), Doc 2008-17342, 2008 TNT 155-32. The transfer of assets from one private foundation to another private foundation with similar exempt purposes does not constitute an investment that jeopardizes the transferor private foundation's exempt purposes under section 4944.

<sup>19</sup>Ben Gose, "Trustees Could Be Held Liable for Decisions in Madoff Case," *The Chronicle of Philanthropy*, Jan. 15, 2009.

<sup>20</sup>*Id.*

is always the possibility that the IRS will assert those excise taxes in the coming years as part of future examinations. Any private foundation or charitable trust with investments that incurs significant losses should proactively gather the documentation that is needed to show that ordinary business care and prudence was exercised. Clearly, the unfortunate experience of those foundations that did invest with Madoff underscores the need for all foundations and charities to undertake and document due diligence regarding current and future investments.

On April 8-9, 2009, the Bernard L. Madoff Investment Securities (BLMIS) bankruptcy trustee, Irving Picard, filed two largely identical suits in Federal Bankruptcy Court in the Southern District of New York, in an attempt to "clawback" \$150 million that was paid to Banque Jacob Safra (Gibraltar) for the investor Vizcaya Partners Limited located in the British Virgin Islands.<sup>21</sup> Vizcaya Partners, through Safra, invested more than \$327 million with BLMIS starting in January 2002. On October 31, 2008, BLMIS wired \$150 million to Safra, apparently for the benefit of Vizcaya. Since the October 31<sup>22</sup> date is within the 90-day period before the bankruptcy filing date, that is, the preference period, the Trustee can file suit to try and "claw back" the funds into the bankruptcy estate, to be shared ratably by all general unsecured creditors. However, Vizcaya Partners may be able to argue that the payment was "in the ordinary course of business," a defense allowed under section 547 of the Bankruptcy Code.<sup>23</sup> There may be other defenses available to Vizcaya as well, depending on the facts of the situation.<sup>24</sup>

An issue for any private foundation with Madoff investments is whether the foundation is at risk for a similar clawback action. Each private foundation with such an investment will need to analyze any payments it received from BLMIS in the days preceding Madoff's collapse. Relevant questions to review include whether any payments from BLMIS were made during the 90-day preference period (one year if the payment is to an "insider"). If so, then the private foundation investor may be at risk for involvement in a clawback suit, and ultimately be required to either voluntarily pay back some or all of those payments, or defend against the allegations. The Bankruptcy Code generally allows the Trustee two years from the date the bankruptcy petition

<sup>21</sup>Senate Finance Committee Hearing: Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation (Mar. 17, 2009).

<sup>22</sup>*Irving H. Picard, Trustee for SIPA Liquidation v. Vizcaya Partners Limited and Banque Jacob Safra (Gibraltar) Ltd. a.k.a. Bank J. Safra Limited*, Complaints 09-01153 (Apr. 8, 2009) and 09-01154 (Apr. 9, 2009), United States Bankruptcy Court Southern District of New York (Manhattan). [NOTE: Complaint 09-01154 appears to be a corrective filing, to prevent Vizcaya from filing counterclaims before repaying the \$150 million at issue, pursuant to section 502(d) of the Bankruptcy Code.]

<sup>23</sup>11 U.S.C. section 547. The small body of law on whether investors redeeming from a Ponzi scheme can rely on the section 547 "ordinary course" exception, while not uniform, suggests that an investor/creditor making occasional withdrawals may have difficulty invoking the exception.

<sup>24</sup>N.Y. C.P.L.R. section 213.

was filed to bring a clawback, or avoidance, claim. In the event any payments were made “in the ordinary course of business,” the foundation may have a valid defense.

Another tool for the bankruptcy trustee is to bring an action for the avoidance of fraudulent transfers. In New York, the statute of limitations usually permits fraudulent transfer suits until six years after the transfer took place.<sup>25</sup> Both New York state law and the Bankruptcy Code specify that a transfer made with actual or constructive intent to hinder, delay, or defraud creditors is a fraudulent transfer that may be set aside. In addition, fraudulent transfer claims may attempt to claw back both false profits and a return of the principal investment, in certain circumstances. A good faith defense may be available to certain investors, generally those who are not the initial transferees.<sup>26</sup> We note that in the 1995 collapse of New Era Philanthropy, all those who received cash payments just before the collapse agreed to share some of their proceeds with other victims. Many of the investors in New Era Philanthropy were public charities or private foundations. The settlement was presumably accomplished in order to avoid litigation.

To the extent that a private foundation has any capital gains for tax year 2008 that would otherwise be subject to the section 4940 excise tax on investment income, the private foundation may offset those capital gains with any capital losses suffered as result of their Madoff investments.<sup>27</sup> However, those capital losses may not be used to offset gross investment income, nor may the capital losses be used to offset capital gains in prior or future tax years.<sup>28</sup> There is no provision in the statute or Treasury regulations relating to the allowance of a theft loss as an offset to the section 4940 excise tax, and there is no indication that the IRS will issue guidance on the topic. However, given the dire situation in which the

Madoff investments have left some private foundations, it may be beneficial to seek a private ruling if the private foundation has ordinary investment income in 2008 that could theoretically be offset by a theft loss under the more general rules set forth in section 165 for business and personal losses.<sup>29</sup> Also, if the private foundation now believes it overstated its net investment income in prior years resulting in section 4940 excise taxes, there may be an opportunity to claim refunds for those amounts paid on “phantom” investment income. Foundations should consult counsel with expertise in private foundation excise taxes before making decisions in reaction to failed or underperforming investments.

Fittingly, the Madoff Family Foundation, Bernard Madoff, president, reported on its Form 990-PF that on December 31, 2007, the Madoff Family Foundation’s assets had a fair market value of \$19,125,499 with \$19,060,372 invested with B.L. Madoff investments. The Form 990-PF also reported capital gains in the amounts of \$1,350,806, \$51,099 in 2007 from the “sales” of securities in the B.L. Madoff accounts, and “dividends” in the amount of \$719,594. It is doubtful that the president of the Madoff Family Foundation will be able to escape the section 4944 excise taxes for jeopardizing the investments of the Madoff Family Foundation, or the section 6684 penalty. It is unknown whether the Madoff Family Foundation received any payments in the latter part of 2008.<sup>30</sup> Curiously, the Mark & Stephanie Madoff Foundation and the Deborah & Andrew Madoff Foundation, both formed by Madoff children, do not appear to have invested any of their foundations’ assets with Bernard Madoff.

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<sup>25</sup>See 11 U.S.C. section 548(c); 11. U.S.C. section 550; N.Y. Debt. & Cred. section 272 with regard to the good faith defense.

<sup>26</sup>See 11 U.S.C. section 548(c); 11. U.S.C. section 550; N.Y. Debt. & Cred. section 272 with regard to the good faith defense.

<sup>27</sup>Reg. section 53.4940-1(f)(3).

<sup>28</sup>Section 4940(c)(3).

<sup>29</sup>See generally Rev. Rul. 2009-9, IRB 2009-14, Doc 2009-5872, 2009 TNT 50-6 (Mar. 17, 2009), and Rev. Proc. 2009-20, IRB 2009-14, Doc 2009-5873, 2009 TNT 50-5 (Mar. 17, 2009), regarding theft loss treatment of Ponzi scheme losses under section 165.

<sup>30</sup>“Madoff ‘Clawback’ Is Sure To Get Messy,” by Joanna Chung in New York and Brooke Masters in London, Financial Times: FT.com (Feb. 25, 2009).