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Client Alert

A report for clients and friends of the Firm

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Four Times Five Is [Fifty] and Four Times Six Is [Eighty]: *A Discussion of Investment Management Practices for Charities in the Wake of Madoff*

Alice in Wonderland confessed it long before Bernard L. Madoff could: "I can't explain myself I'm afraid, Sir, because I'm not myself you see."

By now, you have all heard the story of Bernie Madoff, the "grandfather" of Wall Street and former chairman of the Nasdaq Stock Market, who was recently exposed for allegedly running a $50 billion Ponzi scheme. Although Madoff said that "it's impossible for…a violation to go undetected, certainly not for a considerable period of time," Madoff managed to do just that, by most accounts, for more than a decade.

This Client Alert discusses (i) the Madoff scheme and what went wrong; (ii) the investment management responsibilities of charity boards; (iii) the Madoff scheme's effect on charities; and (iv) the recommended best practices and procedures charities should implement going forward.

I. What Went Terribly, Terribly Wrong?

It has been reported that Bernie Madoff promised his investors returns of up to twelve percent. A few charities are reported to have passed on Madoff's offer to invest with him because Madoff would not provide enough information about how he achieved such consistently high returns. Several charities believed they had conducted sufficient diligence and invested with him. Other charities took Madoff at his word or the words of others, sometimes conducting little or no due diligence, and decided to invest their money with him. Additionally, some charities did not diversify their investments and instead invested virtually all of their assets. What's more, when they invested with Madoff, some of these charities did not enter into written agreements with Madoff regarding the scope of his investment management and did not review their investment statements from Madoff, but looked only at bottom-line return. In December, 2008, Madoff reportedly confessed to running a $50 billion Ponzi scheme, subjecting his investors to substantial losses, even collapse for some. Madoff has since been charged with securities fraud.

II. Investment Management Responsibilities of Charities

The directors or trustees (collectively, "directors") and officers of a charity have a fiduciary duty to protect that charity's charitable assets. Thus, the issue for charities that invested with Madoff and lost money is not just that they lost thousands, if not millions, of their funds. The real issue here is whether these directors and officers breached their duty of care to their organization – i.e., whether the directors and officers of these charities can say that, based on their due diligence, the investment with Madoff seemed to be a good one.

A. State Law Standard of Care

The basic standard of care for directors of charities is provided for in each state's nonprofit laws. In New York, the Not-for-Profit Corporation Law (the "Law") provides the basic standard of care for directors of nonprofit corporations. The Law further provides that directors shall discharge their duties "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Moreover, the Law provides that in investment management and making and retaining investments, a governing board shall consider, among other relevant considerations, the long- and short-term needs of the corporation in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions. When directors and officers do not perform their duties to the charity, they may be liable to the charity.

When the board does not make the investment decisions itself and instead delegates the investment management to a professional investment advisor or an asset manager, the board is still responsible for those investment decisions. Several states, including New York, soften this responsibility and provide within their nonprofit laws that directors and officers, when acting in good faith, may rely on information, opinions, reports or statements prepared or presented by officers or employees of the corporation, counsel, accountants or other persons as to matters which the directors or officers believe to be within such person's professional or expert competence. There is an important caveat, however. Directors and officers can rely on this information so long as in so relying they are acting in good faith and with that degree of care required by a director or officer. In other words, if an investment sounds great, but the investment strategy is not adequately transparent, the board should ask questions, lots of them, even if the board is not making the investment directly.

B. Uniform Investment Standards for Charities

Several uniform laws exist which set forth standards for the management and investment of charitable funds. These uniform standards provide additional protections for charities and also protect the interests of donors who want to see their contributions used wisely. Generally, these laws provide that the uniform standard for investing and managing charitable assets is the prudent investor standard. Accordingly, a charity or those who are responsible for managing its funds should (i) act in good faith, with the care that an ordinarily prudent person would exercise; (ii) incur only reasonable costs in investing and managing charitable funds; (iii) make a reasonable effort to verify relevant facts; (iv) make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy; (iv) diversify investments, unless due to special or extraordinary circumstances; (v) dispose of unsuitable assets; and (vi) in general, develop an investment strategy appropriate for the fund and the charity.

Importantly, management and investment decisions about an individual asset must be made not in isolation, but rather in the context of the portfolio of investments as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the charity. These standards follow the modern portfolio theory of investment decision making. In managing and investing charity's funds, in addition to their duty of care, directors have a duty of loyalty to the charity and a duty to investigate, which requires directors to investigate the accuracy of the information used in making investment and management decisions.

III. Effect on Charities

A. Losses and Collapses

Many charities have suffered significant losses because of Madoff's scheme and also may have Form 990 reporting issues. Charities that invested with Madoff but did not suffer any losses may still have issues with their Form 990 reporting since it is unclear whether the income that they earned from Madoff investments during those open years was an accurate reporting of the income that they received. Moreover, many charities are being forced to shut down operations because their entire endowments, which were invested with Madoff, have been lost.

B. Enforcement Actions

Attorneys General in certain states, including Connecticut and New York, are examining, among other things, whether directors of charities in their states failed in their fiduciary responsibility to protect charitable assets invested with Madoff, directly or indirectly. The Connecticut Attorney General has stated that he is launching his investigation to both help Connecticut charities recover as much as possible from the Madoff scheme and to determine whether directors of these charities breached their fiduciary duties. The Connecticut Attorney General has narrowed his focus to specific violations of a charity's investment and conflict of interest policies. The New York Attorney General has stated that his office is investigating "frauds on charities and people who may have defrauded charities."

Although unlikely, there also may be claims from the public, sponsors, and the Internal Revenue Service ("IRS") against charities that have suffered tremendous losses as a result of their investment with Madoff. These suits must overcome issues of standing and appropriate relief, however. An IRS spokesman reportedly has stated that, at present, he does not know of anyone at the IRS who is examining the role of board members in the Madoff scheme.

IV. Going Forward Post-Madoff

Post-Madoff, we recommend that charities review and implement the following policies and practices.

Charities that have been affected by Madoff should retain counsel that will help them maximize their recoveries and develop and implement recommended procedures and policies, including the Investment Policy Statement and the Conflict of Interest Policy that we describe below. Charities that have not been affected, but would like to create better investment and management policies, also should retain counsel to create these policies. Charities that currently are under investigation by their state's Attorney General should retain counsel in order to help them with organizing and preparing documentation of their investment due diligence process and any relevant records, including board minutes. Many charities have adequate investment procedures in place, but should retain counsel to aid them in any investigation, including any requests for documents, testimony, or both. Charities that have elected to dissolve should retain counsel to help them with the dissolution process and to transfer any remaining assets to charitable organizations in accordance with their organizing documents.

All charities should use counsel to review their investment and management strategies, their due diligence processes, their director and officer liability insurance policies, and the responsibilities and duties of their directors and officers, including the duties of care and loyalty and the board's role as a fiduciary. Charities should work with counsel to develop internal governance and investment policies that are transparent, encourage disclosure and accountability, and provide for checks and balances.

Specifically:

(i) Transparent Investment Management. If an investment manager states that it cannot disclose its investment strategy, this lack of disclosure should raise concern with the charity. At a minimum, a manager should provide a charity with the holdings in its management portfolio and make available detailed information about exactly where the money is and how it is handled. There is no reason for a charity to base its investment decision and management of that decision with a "Trust me." Practically, a director or officer is not required to understand every aspect of a charity's investment, but should be able to come to a reasonable judgment that the investment they have caused the charity to enter into is a good one.

(ii) Monitoring. Directors should continue to monitor the investment decisions that they have made. They should review the charity's periodic investment statements and understand the charity's investments as opposed to solely focusing on the investment's rate of return. Directors also should monitor the organizational structure of the investment managers used in the portfolio – for example, if a key person in the organization has left, the directors should consider how this absence may affect the fund's performance. On an ongoing basis, directors also should ensure that the charity's investments are not in violation of the charity's Investment Policy Statement and Conflict of Interest Policy.

(iii) Familiarity with Applicable Laws. Directors and officers should become very familiar with the laws and rules that govern their roles and responsibilities within the charity. See, for example, two booklets from the New York Attorney General that help directors and officers of not-for-profit corporations to understand and carry out their fiduciary responsibilities to the organizations that they serve.

(iv) Investment and Management Decisions. Investment and management decisions should be made, among other things, in light of general economic conditions, the possible effects of inflation or deflation, and the needs of the charity and the charitable fund to make distributions and to preserve capital. Importantly, charities should diversify. Diversification does not only mean that the advisor the charity uses invests in various stocks. Diversification also implies that the advisors themselves be diverse and that not all investments should be made with the same advisor. Fiduciaries should realize that a low return based on an investment that was made based on proper due diligence is not a bad thing, but an investment with great returns that they know nothing about is terrible. In other words, the ends do not justify the means. Instead, it is all about process.

(v) Implementation of Key Policies. Charities also should develop and implement certain policies to ensure that directors make correct investment and management decisions, including, in particular, an Investment Policy Statement and a Conflict of Interest Policy. The Investment Policy Statement should (1) explain the charity's acceptable level of risk and expected return; (2) describe the types of assets in which the charity can invest; (3) describe how investment managers and advisors are selected; (4) explain the charity's strategy for diversification of its investment portfolio; (5) memorialize the steps of the due diligence process used to evaluate prospective investments; and (6) provide for performance review and evaluation of each investment. The Conflict of Interest Policy should identify when professional interests of the charity or personal interests compete with each other and also should set rules for managing potential conflicts. Specifically, the policy should (1) include a duty to disclose any actual or possible conflict of interest; (2) describe how to determine whether a conflict of interest exists; (3) provide procedures for addressing the conflict of interest and any violations; and (4) provide for annual review of the policy. A copy of the IRS model Conflict of Interest Policy is here. Importantly, charities also should develop a due diligence policy for its investments.

(vi) Jeopardizing Investments. If a private foundation makes any investments that would financially jeopardize the carrying out of its exempt purposes, both the foundation and the individual foundation managers may become liable for excise taxes on these jeopardizing investments. Jeopardizing investments generally are investments that show a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation for it to carry out its exempt function. Although no investments are per se a violation, private foundations should be aware that the following investments are suspect: (1) trading on margin; (2) trading in commodity futures; (3) investments in working interests in oil and gas wells; (4) puts, calls, and straddles; (5) purchase on warrants; and (6) selling short. Lack of portfolio diversification also is suspect. In light of the adoption by most states of the Prudent Investor Rule, a foundation's directors should judge the prudence of the foundation's investments using total portfolio investment theory.

In sum, in light of their duties of care and loyalty, directors and officers should ensure that a charity's decision-making process for its investments is careful and deliberate. Moreover, directors and officers should ensure that the charity has key policies and procedures in place to guide their investment and investment management decisions.

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