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## Perspectives - David Samuels and Themes Karalis of Duval & Stachenfeld LLP

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# THE ROOFTOPS PROJECT



## Perspectives

## David Samuels and Themes Karalis of Duval & Stachenfeld LLP

Federal and state law can impose compliance requirements affecting both disposing of and transacting in real estate by not-for-profit organizations. In a dialogue with The Rooftop Project's Jordan Moss and Professor James Hagy, **David Samuels** and **Themes Karalis** of the law firm Duval & Stachenfeld illustrate situations, including some unique to New York law and regulation, in which compliance and care are warranted.

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**RTP:** We are looking forward to talking with you in a few minutes more generally about regulatory compliance by not-for-profits of all mission types in connection with acquiring, funding, and disposing of real estate. And like so many aspects of both not-for-profit regulation and real estate law, there are important differences from state to state that can be unexpected and require local advice, so we know you will be using New York law for your examples. To demonstrate how complex the answers can be, let us start in a way at the end of the story, dispositions, and particularly by religious organizations, for which there are special provisions under New York law. What constitutes a "disposition," what requirements are there for State approval in New York, and how does this process work?

**David:** First, I want to broaden the way we look at it generally. When the New York Attorney General (AG) deals with dispositions of real estate, it encompasses all real property regarding religious organizations, and dispositions of all or substantially all of the assets of any non-religious not-for-profits. This is important, because even if you are not a religious organization, those sections of the law come into play if you are dealing with a disposition of all or substantially all of the assets of a not-for-profit.

**RTP:** Religious organizations often own the same property for decades or even for centuries. You mentioned leases of property, where the not-for-profit is leasing (as landlord) to another organization or individual (as tenant). If a religious organization has no plan to sell its property, are there other types of dispositions that can trigger the requirement in New York for regulatory approval by the AG?

**David:** The language of the statute indicates that it could be a sale or "any disposition." Section 12 of New York Religious Corporation Law talks about a sale, mortgage, or lease. With leases, any term of more than five years needs AG approval. I want to point out that there is also an approval requirement for mortgages. "Mortgage" appears in the Religious Corporations Law where it does not appear in the New York Not-for-Profit Corporation Law applicable to all types of not-for-profits. I am not sure whether an easement could be considered a disposition of property. But air rights would be an example of a disposition requiring AG approval that might not occur to everyone.

**RTP:** What if the arrangement involves another type of interest, such as a license to use the space?

**David:** If you are tying up property for more than five years, I do not think the regulator would like that. I would be very cautious here and go to the AG to see what they think.



**RTP:** Should it be obvious to organizations whether or not they are religious, or is there a grey area?

**David:** They should know. But if they do not know, that information will be found in the incorporation documents. A New York certificate of incorporation has to be done in a certain way to be classified under the New York Religious Corporations Law. And if you are a religious corporation, you file in a different place. You file in the county. You do not file with the Secretary of State, where corporations that are not religious would file.

**RTP:** Why are there no approvals required on acquisitions?

**David:** The potential for abuse is on the seller's side and not the buyer's side. Let us think of a situation where the organization is selling property. Often it happens because it is winding down because it cannot operate anymore. There is a risk that the members could pocket the funds, or if they want to do it more indirectly, sell it for less than the value, and take a kickback. That risk does not occur on the buyer's side.

**RTP:** If you are a foreign corporation (that is, a not-for-profit formed under the laws of another state) and have religious assets in New York, are you still subject to AG or court approval?

**David:** This is tricky to answer. Generally, I would say that if you have property in New York and you are a religious corporation, you are not going to be able to transfer title without the required approval. It essentially comes down to whether a title company will be okay with it.

**RTP:** Any disposition of real estate by a religious organization is subject to oversight under New York law. But, as you mentioned a moment ago, all types of not-for-profit organizations require approval in connection with a dissolution of the organization or a sale of "all or substantially all" of its assets. Are those situations similar from a regulatory perspective?

**David:** Transfers of real estate and dissolution of the organization sometimes come into play together. For example, if an organization has financial problems and is looking to dissolve, the transfer of the asset or property might be in contemplation of dissolution. In fact, part of the application process with the AG is to determine that you are getting adequate consideration. But it is also to show what you are doing with the proceeds and how that furthers your mission. Part of that is also to establish whether you are going to stay in business or not.

If you are selling the property and then getting consideration that is going to carry on your mission, you have to explain what you are doing with the money. Sometimes that involves buying or renting another place, and, in certain instances, the AG will make you segregate part of the proceeds until you do that. If you are making the transfer because you are not viable anymore, then you need to explain what you are going to do with the proceeds of the sale in connection with the disposition of the property. What the AG does not want to see is an organization that is winding down doing something with its property that the AG does not see as appropriate.

**RTP:** What constitutes a disposition of "substantially all" of the property?

**David:** That is under the New York Not-for-Profit Corporation Law. There is no mathematical test. It is often thought of as more than half the value of the assets of the corporation. But again, it is not clear. There is nothing in the statute or case law, to the best of my knowledge, that says "substantially all" means 51 percent. That is a rule of thumb that many people use, but it can also be viewed as the extent to which that property impacts the organization. You could have a building that may be worth less than half the total of the organization, but perhaps the AG would think that is a substantial enough transaction that they want to be consulted on it.

**RTP:** Let's talk about process. Can you approach the AG informally about a proposed transaction first?

**David:** The AG always wants an organization to come to them first with the proposed petition and the contract. Sometimes I have even gone to them with a letter and set up a meeting, just to see how they feel about the deal because you do not want to go through the whole process of drafting documents to find out they want it done differently. I can call people there to set up an appointment, but I can also send them a letter outlining what is going to be in the contract. They are willing, in different contexts, to discuss it. It does not mean that you get a meeting overnight. But they would rather be consulted than not. The Charities Bureau does take calls directly from not-for-profits that are not represented. The AG cannot give legal advice, so one of the disadvantages of the not-for-profits doing it themselves is that they do not have the benefit of a lawyer on their side. Questions may not get framed the right way if it is not a lawyer framing the questions.

**Themes:** They also might not present the deal the way a lawyer would, not providing the entire picture.

**RTP:** Is it possible that such a call would raise a red flag with the AG about a proposed transaction?

**David:** The AG's office is a regulator. Any time you "put your nose under their tent" you are not sure what they are going to do. You have to be careful. If you are in a distressed situation, for example, and you call and identify yourself and you are looking to sell because you have problems, you could bring on an investigation. If you make an application to the AG, it is important to note that they are not limited to looking within the four corners of that application. They can pull your financial filings. This can lead to collateral review of other things. They have the ability to launch an investigation and can also condition the approval on the resolution of the investigation.

**Themes:** You could also call the AG and give them a hypothetical; you do not necessarily need to indicate who you or your client is.

**RTP:** Once you ask formally for approval, what is the general amount of time a not-for-profit can expect for the AG to review a proposed property disposition? And how is this reflected in the negotiations with the prospective purchaser?

**David:** If AG and court approval is required, a contract needs to be conditioned on that approval. When the not-for-profit sets a timeframe with the proposed buyer, these parties negotiate an outside date. That could be a year. It should not take that long, but you always have the variables of the application getting



reviewed within the AG's office by a paralegal as to form; then it needs to go to an attorney for comments. They may need more documents, they may ask for exhibits, and they may have questions. That is usually done orally. They usually get back to you within a month or two, but then it depends on how fast you can turn it around. It could then be three or four months, but it may go through more than one draft. A lot of it depends on how quickly you can get back to them.

In one case that was litigated, a sale was proposed by a charity, which was a religious organization that operated a senior center in the building. The charity was going to take the proceeds to rent new space. The sale contract was conditioned on the approval because you cannot, as a matter of law, transfer title without the approval. But they realized after they made the deal that it was improvident, because they could not find other space. So they sought the disapproval by the AG of their own contract because they realized they had made a mistake. There, the buyer alleged breach. One thing I learned from that case is that there cannot ordinarily be a breach of a contract involving a sale of property by a religious corporation unless there has been such approval by the AG or the court because, until there is such approval, there is no binding contract. Part of the purpose of the statute is to protect unsophisticated organizations against mistakes.

**Themes:** Often times, your buyer is going to want an outside date as to when the AG and any court approval is going to be done, because they do not want to be hanging out there for three years while you are getting your approval. They want to make sure you are getting your approval in a timely manner. So you want to go to the AG first to be sure that they will approve it. It is a good first step to see that you can get the approval by the time your contract calls for. After that, usually the buyer has an out if you cannot get your approval in a certain time frame.

**David:** As Themes indicated, a buyer is not going to want to be stuck forever. We have put clauses into our contracts on the buyer's side, because the buyer has a stake in the process, so that they are able to see the petition (even though the petitioner is always the seller) before it is submitted to make sure it is in good shape.

**RTP:** Let us say some organization wanders into the process, knowing nothing about this. Starting with the contract and finishing with recording the deed, what are the hurdles that will cause them to become aware of it?

**Themes:** From our perspective, we guide them through the process and what needs to happen. We will speak to the title company to see what they are requiring in addition to what we know should be required. We also talk to the client and to the title company about transfer taxes and whether they will apply to the transfer—that is a big component. We worked with one organization that was shocked that they had to pay transfer taxes. Certain organizations may be exempt from either city or state transfer taxes, but that is something I consult on with the title company and our firm's tax department.

**RTP:** If a religious organization is not aware of the requirements and takes a deed to the county recorder, is it going to be blocked?

**Themes:** They would not take it to the recorder themselves; they would take it to a title company. So I would think that it would get blocked there. The title company is not going to attempt to record a deed from a religious

organization because they know the rules. Usually the title company will ask for the organizational documents in order to determine whether it is a religious organization and therefore requires the necessary approvals.

**David:** The purchaser is at risk if a required approval has not been obtained, because the AG can rescind the deal. And I do not believe there is a statute of limitations, a time limit, for the government to act on that.

**RTP:** Is there a typical list of what the AG requires for an application to be submitted?

**David:** If you apply to sell property, they are going to want to see your financials, your certificate of incorporation, amendments to your certificate, and your bylaws. They always want to make sure that you comply with your bylaws for the approval process. If you are a religious organization, for example (not the Catholic Church, which is hierarchical), you need congregation approval and a board approval. The AG is actually going to want to see the vote; they are going to want to know the numbers of the congregation and the board, and they are going to look at the quorum requirements. They want to make sure that some congregants or people on the board have not pushed through a sale that has not been approved by the congregation.

**RTP:** Are these processes public? Can they be picked up by the media?

**David:** The media is not ordinarily going to pick this up while it is in process at the AG's office. When there was a court requirement, in theory, it could be picked up because anything filed in court the media can see. If you have finalized a petition to the AG, it is not the same because you are not docketing something you can see. It could be subject to a Freedom of Information request, but how would anyone know to ask?

**RTP:** Organizations may note one of the expressed standards as "ensur[ing] the corporation's mission is pursued." What does this mean in the context of the review?

**David:** The issue of mission is always a broad one. If you are a religious organization doing various social service things, there is no requirement that you do them all or keep doing them all if you do not have the demand or resources for it. There may be an issue if you have resources specifically for that purpose and if those resources are restricted or not. What do you do when you sell the building? What else are you going to do? They are not likely to have a problem as long as what the organization is doing fits within that overall mission.

**RTP:** Is there a way to amend an organization's mission purpose?

**David:** One of the reasons the AG gets involved in terms of use of assets is to ensure organizations are using the funds in furtherance of their missions. Any amendment to your certificate of incorporation still needs AG approval. Even if an organization is able to amend its mission, any funds designated for a certain purpose would still need to be spent down for that purpose, and not for the new purpose. Because that was your purpose at that time (of the donation), the funds have to be spent that way. What I would always advise a client is to segregate the funds, and make sure the old money is spent down before any of the new money is spent. The AG wants to make sure you are not changing your mission and in doing that changing how you are using the funds.



**RTP:** Other than segregating proceeds of a sale or transfer, are there restrictions on what organizations can do with the proceeds?

**David:** It really depends on the approval from the AG; sometimes they will seek to impose restrictions that might be narrower than what you were asking for. It used to be that you needed a court order for these types of transactions, but after the Nonprofit Revitalization Act, the AG has the authority to approve the transactions without having to go to court. But whether it is an AG approval or a court approval, an organization is required to comply with whatever the AG or court orders in terms of what you can do with the proceeds.

As an example, in the last several years, our firm completed a transaction where we sold a nursing home. Ordinarily, the proceeds would have had to go to another nursing home. But we persuaded the AG that the parent company of this nursing home had services that were not the same services, but primarily served seniors. The AG agreed to require that the proceeds be used for programs for people over 60. So that is broader than the requirement that the funds go to another nursing home, but had to be used for people over the age of 60.

**RTP:** What form does the AG's response take?

**David:** Now that you do not necessarily have to go to court, they have an AG approval form that is akin to a court order with its own index number. The AG approval form is equivalent to what would have been a court order, and they sign it. You then take it to the title company, but it does not get recorded.

**RTP:** Most of our discussion thus far assumes the assets are not donor-restricted. If the original property donation was restricted, should we presume that the AG would be curious about that, which would add another layer to the analysis?

**David:** That is where cy pres would come in. *[RTP note: Cy pres is a state law process in which a charity seeks permission in state court to vary the terms of a restricted gift to enable it to be used for other purposes where the original purpose is arguably no longer possible or not consistent with the needs of the organization and the donor's presumed original intent.]* Obviously, first you go to the donor to try to get them to release the restriction. So we will ask whether there are restrictions attached to certain properties, how the organization acquired the property, and whether the property was donated.

**RTP:** What is the test used to obtain cy pres relief?

**David:** When you are looking for cy pres relief, you have to show it is impossible or impracticable to continue to use the funds or property consistent with the original restriction or purpose. But you also have to look to the intent of the donor. It is a tricky analysis to determine the primary aim of the donation.

**RTP:** What if the organization cannot figure out whether the original donation is restricted?

**David:** This is a frequent issue. Whatever a board does, a board can undo as long as it was the board that took that action. But if the board solicited the funds on that basis for a restricted purpose, then it is not board-created. What can end up happening, too, is that funds get co-mingled. Then, in order to determine whether the funds are restricted, accountants (or attorneys or other outside

professionals) have to end up going back (sometimes decades) and looking at the old records to see what they can find in terms of how these funds were set up or how the funds were solicited. I have assessed letters from donors to see how specific they were. Generally, the donor has to be very specific about the restriction—or it is not restricted. Sometimes, there is not documentary evidence to support the restriction, and those funds may be taken out. It is important to remember that if a donor is still around, they can always release a restriction. If a donor is not alive, you have to seek cy pres relief.

**RTP:** The New York AG online resources for not-for-profits refer to "quasi cy pres." How is this different than "cy pres"?

**David:** Quasi cy pres comes into play if you are changing the purpose of the organization—if using the proceeds for the original purpose is not practicable anymore. The AG has the ability to be flexible in how the proceeds are earmarked. If the AG is not persuaded, they have the ability to restrict the use of the proceeds. They can also say that they will not approve it without getting a court order. Either way, the court is the last resort. But we know that if the AG as the primary regulator says no, it is not going to be easy to persuade a judge to overrule the AG. The AG has broad deference in this area.

**RTP:** If what is proposed is not a sale but the transfer of real estate to a not-for-profit organization with a similar mission (or even a lease to another charity as the tenant), how is the adequacy of consideration—the value paid or exchanged for the property being transferred—assessed for regulatory purposes?

**David:** That happens. Certainly the analysis is different when you are transferring to a similar, charitable organization. Sometimes the AG will require that you get an appraisal even if the aim is not to get maximum revenue. We explain to the AG that the paramount concern is carrying on the mission and that charging too much rent, in a leasing situation, for example, could make it difficult for the newly formed entity to carry on. So we are making full disclosure whether it is a lease or a sale for less than fair value, and we are explaining why.

The two-part test for the AG when dealing with a not-for-profit entity is mainly: one, are you getting adequate consideration and, two, is it consistent with the mission? The modification to the analysis here is that the need to get adequate consideration does not kick in because you are helping that other charity by transferring for less than full consideration, just as charities can make grants to other charities.

**RTP:** Let's move our focus now from dispositions and dissolutions to fundraising for new projects, whether a property acquisition, new construction, or renovations. From a compliance perspective, what would you advise a not-for-profit looking to solicit funds for a new project?

**David:** In a hypothetical situation where a client is looking to solicit funds to construct a new building and there will be some big gifts coming in, we suggest that they do written pledge agreements, which makes clear that the gifts are not only for the construction of the building, but are also for the maintenance of the building or any other purpose. Of course, there will some people who do not want the funds used for "any other purpose" except for the construction or maintenance of the building. But even that is better than just having the funds be for the construction of the building. At least then you can put the funds for maintenance in a reserve and use it to maintain the building over time.



**RTP:** What would you suggest from the donor's perspective?

**David:** A sophisticated donor has to be very careful, especially if making a large gift. There are limitations on donor standing to bring claims even over their own gifts, unless they preserve their right to enforce the claim. There are cases that go both ways on this. Board members have the right to enforce restrictions. Donors do not always have that right. There is a limit on standing, often because you do not want any donor who ever gave you a gift to sue you. Someone who gives a large gift may include in their gift instrument the ability to enforce the restriction.

**RTP:** These approvals are one element of the broader fiduciary obligations to which not-for-profit directors or trustees of both religious and non-religious corporations in New York are subject, just like in other states.

**David:** Yes. Directors and trustees have fiduciary obligations to oversee and preserve and protect charitable assets and not to engage in imprudent transactions. One relevant example is a charitable organization that has been hemorrhaging money and is desperate to make a sale, but there is a real question about the way they have been operating. I would say to that organization, "Let us get these other issues resolved first." If you have problems and you have addressed them before you go to the AG, it is always better with the regulator, even if the issues are not fully resolved. This can come up in any number of contexts. Let us say you are looking to sell a building, and the use of the funds was restricted, but you misspent them. That is something the AG can find out. But you can take remedial steps to deal with what the charity did improperly by misuse of the prior funds before you make a new application.

**RTP:** If you were a trustee who was uninvolved in the earlier phase, you might particularly have an instinct to address the past impropriety with the AG.

**David:** You might have to do that anyway. For example, in a non-real estate context, Themes and I had a client that had restricted funds and they were looking for cy pres relief to use those funds for a different purpose in order to survive. But with some of those assets, they had already done that. We made a full disclosure, asking for *nunc pro tunc* relief [meaning authorizing something that has already happened in the past], to deal with both the restrictions going forward and with the funds that had already been improperly expended without AG approval. This could make the AG interested in the trustees at that point, but if the trustees were not putting the money in their pockets and it was an innocent mistake in the interests of the organization, I did not see a serious risk that they were going to charge individuals. But, I did make it clear that if the AG had found out about what they had done and they did not volunteer it, they would have a real problem. In addition, our law firm would not have agreed to do the application without full disclosure to the AG.

**RTP:** In the case where some board members have a conflict of interest, say, because they have an interest in the transaction as the seller or buyer on the other side, and need to recuse themselves from the board's decision-making, what should happen if there are insufficient disinterested trustees remaining to constitute a quorum?

**David:** Three is the minimum number of board members you need on your charitable board in New York. The way the law has now been clarified, you do not destroy a quorum by having the conflicted people leave the board

meeting. The enactment of the New York Nonprofit Revitalization Act of 2014 created that problem, but there have been various amendments that have now cleaned that up. This means that interested trustees will be considered for quorum purposes. Theoretically, you only need one disinterested trustee. If no one is left in the room, you have a problem.

**RTP:** The Nonprofit Revitalization Act has dollar amount thresholds for a charity's annual budget that determine whether the organization has the obligation to obtain an audit, or an accountant's review, or to file an unaudited report. Might a capital campaign one year for the acquisition, renovation, or repair of real estate bump a charity's gross revenues into a higher category that year under the Act?

**David:** Yes.

**RTP:** Executive Law Article 7A of the New York Charitable Solicitation Law indicates that a not-for-profit (unless exempt) must register with the Charities Bureau and pay an annual filing fee before soliciting funds in New York. This includes government grants as well as donations. Must a not-for-profit register before it applies for grants, before knowing whether it will receive any?

**David:** You have to register with the AG before you file for government grants. Rarely will an organization be applying for grants where it is not otherwise already soliciting funds.

**RTP:** The New York AG's resource materials suggest that organizations include their conflict-of-interest policy in the organizations' bylaws, but that including that language in the bylaws is not required by the statute. What is your viewpoint?

**David:** It is not in the statute, but I do recommend it. For one, people remember what the policy is when they look at the bylaws. The AG sometimes goes over and above the statute in terms of what they like to see you do. One of the reasons they like to see it in the bylaws is because the statute technically requires that you make a disclosure about conflicts before joining the board. So they feel that by having the conflicts provisions in the bylaws, it is more likely that people will not be added to the board without complying with that.

**RTP:** Most organizations aspire to be well-managed and compliant. How can an organization avoid being of concern to the AG's office? What attracts regulatory attention?

**David:** If there are disputes or problems, and people complain. If people on the board are unhappy, they may go public. The AG gets some of its matters from complaints or things in the press. But they are not required to act on anything. Another way to attract the AG's attention is if you go to them with transactions that alert them to issues. Although the AG is a resource, they are not your friend. They might not help you the way you want them to, and you have to be careful.

**RTP:** If the AG is interested in your organization, how does that come to light? Do they call you? Do they sue you?

**David:** The AG will virtually never sue you without contacting you first. The way I have seen it happen the most is that they send a letter. It is usually not



a subpoena or lawsuit; they do not usually go through the process of formally serving a subpoena. They send a letter asking for information. Usually people comply without a subpoena, because you do not want to upset the AG's office and have them serve a subpoena. If you know that you are the subject of an AG investigation, you also have to preserve your records. A letter from the AG may even include a request to preserve records.

**RTP:** During major capital projects, a charity may handle larger funds and administer payment processes that are beyond its normal operations. What concerns should the organization (or might the AG) have, and how can the organization be best prepared for these events, including assuring sufficient internal controls?

**David:** The AG actually has an excellent brochure that they have had on their website for decades and that I share with clients, with recommendations for internal controls, including quarterly reports to the board, quarterly meetings, and comparing your performance to prior years. They have laid it out very well. This is what they say you should do, so please do it. The most important thing is getting the right accountant. A good accountant or auditor will look at internal controls, help guide a client in what they need to do, and will often know when a client will need legal advice. You do not have to hire a big four accountant to get good advice, but a good accountant will minimize an organization's risk.

**RTP:** Tell us a little bit about mergers of not-for-profit organizations.

**David:** Take, for example, charity A, a stronger established charity, and charity B, a smaller charity that may have financial issues and cannot afford to have its own separate management. Let us say that charity B wants to merge

into charity A to save on administrative costs and gain charity A's expertise. But it means that charity A is taking on a risk, because in such a merger, charity A takes on both the assets and the liabilities of charity B. You do not always know what you are getting, whether it has been mismanagement or a slip-and-fall lawsuit that is coming, or a disgruntled employee, or an environmental issue. I strongly recommend considering a plan where charity A becomes the sole member of charity B. We have done this a few times, but people do not think about it. Being the member means you pick the board, which means, in this example, that charity A picks the board of charity B. This means charity A has control, but you are still a separate entity with separate certificates, separate EIN numbers, separate filings, and you do not take on charity B's liabilities. You also do not have to go through the approval process (a plan of merger) with the New York AG, so you save on that. Now, an advantage of a sole member arrangement is that while you are the sole member, you are going to see any problems you did not already know about. You can then merge later or keep it as is. You have minimized the risk by not doing the merger too soon, where you do not know what you are taking on. That is not a disposition of all or substantially all. There is nothing in the statute that prevents this type of arrangement, and such a challenge by the AG has been overruled by an appellate court.

Jordan Moss (Class of 2017) concentrates her studies on real estate law. To expand her knowledge and understanding of real estate law, she enrolled in Landlord-Tenant Law and Corporate Real Estate. She also has an interest in helping innocent persons overturn wrongful convictions and is associated with the school's Post-Conviction Innocence Clinic. She currently works as a paralegal for a real estate law firm. She received her Bachelor of Arts Degree in Legal and Policy Studies from Fordham University.



**James Hagy** is Distinguished Adjunct Professor of Law at New York Law School. He also founded and directs The Rooftops Project at New York Law School's Center for Real Estate Studies. More information about The Rooftops Project and Professor Hagy may be found at [www.nyls.edu/rooftops](http://www.nyls.edu/rooftops).

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