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Board Talking Points: Asset Transfers

Current economic conditions have forced many New York not-for-profit organizations to make tough decisions to keep necessary programs running. To raise much needed capital, some organizations may consider selling or leasing a majority of their assets. Others who are facing insolvency may need to sell assets to avoid bankruptcy. New York State law, however, requires certain nonprofit corporations to seek the authorization of the State Attorney General and the Court prior to transferring all or substantially all of their assets.

1. When is it necessary for a nonprofit organization to get authorization prior to a transfer?
2. What constitutes a transfer of "substantially all" assets?
3. What if the underlying assets are subject to donor restrictions?
4. What does quasi-*cy pres* mean?
5. What are the mechanics of the transfer or sale of assets?
6. Are there any special considerations if the nonprofit is in severe financial distress?
7. What else should the board consider when contemplating a transfer of assets?

Discussion Points

Below are some specific questions that the board of a nonprofit corporation may wish to ask as it considers whether to dispose of all or substantially all of the corporation's assets.

1. When is it necessary for a nonprofit organization to get authorization prior to a transfer?

When a Type B or Type C (and in some instances Type D) nonprofit corporation formed under New York State law is selling, leasing or otherwise disposing of all or substantially all of their assets, it will be required to get authorization from the New York State Attorney General ("AG") and the New York State Supreme Court. A nonprofit corporation's type is specified in its certificate of incorporation and most charitable organizations are a Type B or Type C. To approve the transfer, the court must find that (1) the consideration given and the transaction terms are fair and reasonable to the nonprofit corporation and (2) the transaction promotes the purposes of the corporation or the interests of its members. Another important consideration is that the proceeds of the asset transfer must be used in a manner that is consistent with the nonprofit organization's purposes. The proceeds may not be used for the personal benefit of a director, officer, employee, member or any other interested party.

2. What constitutes a transfer of "substantially all" assets?

There is no exact formula to determine what "substantially all" of a nonprofit's assets are. According to the AG, "There is no fixed numerical or arithmetic measure of 'all or substantially all.' Court approval is required where the asset to be sold represents a large proportion of the corporation's total assets or where the sale of the asset may affect the ability of the corporation to carry out its purposes regardless of the percentage of the corporation's total assets represented by the sale." [1]

The rule of thumb is that "substantially all" is so large a proportion of the assets that if those assets were transferred or otherwise disposed of, the disposition would change the character of the nonprofit and its activities. In some cases, the court looks to see if a particular asset is the organization's most valuable possession. In determining the value of the asset, the court will look to the asset's fair market value, not its depreciated value or net asset value (*i.e.*, asset value less liability).

3. What if the underlying assets are subject to donor restrictions?

Many nonprofit organizations have assets whose use is restricted to specific purposes by donors. The nonprofit organization must use the restricted assets in a manner that is consistent with the directions of the donor. The AG will exert its authority to review and possibly disallow any transfer of an asset where the restrictions on an asset would not be honored or would be rendered unusable by the transaction.

Further, donor-restricted assets should not be pledged to creditors as security. The AG may find that creditors should not be allowed to seize donor-restricted assets with the aim of satisfying a lien. Allowing a creditor to gain possession of a donor-restricted asset may open the nonprofit to liability for fraudulently representing that the asset is available to the lender. Instead, the AG may seek to apply either the judicial *cy pres* or the statutory quasi-*cy pres* doctrine to the asset.

4. What does quasi-*cy pres* mean?

The quasi-*cy pres* doctrine requires that a nonprofit's assets be used for purposes that are substantially similar to the purposes for which the assets were given. If those purposes become impossible or impracticable, the Not-for-Profit Corporation Law (N-PCL) sets the procedures to follow to seek relief. When evaluating a proposed asset transfer, the court will review whether the transfer meets the quasi-*cy pres* standard by looking at five aspects of the transfer: (1) whether the assets were received through public solicitation or under the specific dictates of a trust or will; (2) what the nonprofit corporation's certificate of incorporation states that its purposes and powers are; (3) what services and activities the nonprofit corporation actually provides; (4) what the activities and purposes are of the entity that will receive the assets; and (5) the reasons why the board recommends the asset transfer.

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[1] Office of the Attorney General, *A Guide to Sales and Other Dispositions of Assets Pursuant to Not-For-Profit Corporation Law §§ 501-511 and Religious Corporations Law § 12, available online at:* http://oag.state.ny.us/charities/forms/sales.pdf

Thus when contemplating an asset transfer, a board must consider not only how the nonprofit's purposes and activities are promoted by the transfer but also how the assets will be used to continue those purposes and activities after the transfer is complete.

5. What are the mechanics of the transfer or sale of assets?

A nonprofit corporation must take several steps to gain approval for the asset transfer. The process of obtaining approval may require significant time and cost, which should be taken into consideration when negotiating the terms of the transfer with a proposed buyer or transferee.

Step 1: Obtain an Appraisal of the Assets

Although an appraisal of the assets is not explicitly required by statute, a petition without an appraisal may be rejected by the AG because an appraisal is usually necessary to determine whether the terms of the transaction are fair and reasonable. In some cases, the nonprofit corporation may be able to use audited financial statements or published stock prices. The appraisal should be prepared by a professional appraiser who is completely independent from both the buyer and seller.

Step 2: Obtain Board and Membership Approval

The board must approve the transaction by at least a 2/3 affirmative vote unless the nonprofit's certificate of incorporation or bylaws provide otherwise. If the nonprofit has voting members, the transactions must also be approved by 2/3 of the nonprofit's membership at an annual or special meeting of the members. If the board is comprised of 21 or more directors, a majority affirmative vote will satisfy the requirement. If the transaction involves a transfer of assets to a director or officer, the director’s or officer's interest in the transaction must be fully disclosed to the board and the voting members and the transaction must be approved by the affirmative vote of "disinterested directors" (*i.e.*, those directors who will not directly or indirectly receive any benefit from the transaction). Such an "interested person" transaction would also need to satisfy federal tax law procedures known as the excess benefit transaction approval procedures, which parallel state "interested person" rules.

Step 3: Draft the Petition

The nonprofit must draft a petition for submission to the AG and to the court that details the terms of the transaction and place the transaction in the context of the nonprofit's overall activities. Once drafted, the petition must be "verified" by a notary that the petitioner has sworn to regarding the accuracy of the petition's contents under the penalty of perjury.

Step 4: Submit the Petition to the AG's office

In the overwhelming majority of cases, the court will not approve a transaction that does not have the AG's endorsement. Thus, submitting the petition to the AG before filing the petition with the court is a critical step in the process. If the AG has no objection to the petition, it will provide the court with written confirmation, usually by endorsing the proposed order. With the AG's confirmation, the court may not require a hearing and the 15-day waiting period to allow the AG to review the petition will be waived.

Step 5: File the Petition with the Court

After submitting the petition to the AG's office, the petition should be filed with the supreme court of the judicial district or county court in the county where either (i) the nonprofit has its office or (ii) the principal place where the mission of the nonprofit is to be carried out.

Step 6: Have a Hearing on the Petition

In most cases, if the AG has endorsed the petition, a hearing will not be necessary. A hearing may, however, be required in unusual circumstances where the AG has not provided a recommendation or there is insufficient evidence upon which to make a decision. At such a hearing, the court may permit any interested person to appear and explain why the application should not be granted. In cases where the nonprofit is insolvent or its assets are insufficient to cover all of its debts and liabilities, the nonprofit's creditors may be given notice of the proceedings.

Step 7: Receive Authorization for the Transaction

The court issues the signed order, thereby authorizing the nonprofit corporation to proceed with the transaction. If the transaction involves real estate, the title company or others may require copy of the order as a condition precedent to closing.

6. Are there any special considerations if the nonprofit is in severe financial distress?

Even if a nonprofit is insolvent or is in severe financial distress, it cannot transfer all or substantially all of its assets without considering the statutory requirements of the N-PCL. If a transfer of all the nonprofit's assets is the only way to preserve the mission of a nonprofit in financial distress or to avoid bankruptcy, then the nonprofit will have to make that case in its petition. Courts prefer that a distressed nonprofit transfer its assets to an organization that provides similar services or has similar purposes rather than filing for bankruptcy. If the distressed nonprofit cannot find a suitable organization to purchase or assume the assets, a change in the nonprofit's mission through a sale of its assets will only be approved if it can demonstrate that it has carefully considered alternatives that would preserve its mission, but was unable to find a viable alternative.

If the nonprofit is insolvent, the process of obtaining the court's approval will also require additional time. Creditors of a distressed nonprofit may be given notice of the proceedings and the opportunity to appear and explain why the transfer should not be approved. If the nonprofit has already sought protection from its creditors under the federal bankruptcy laws, a sale of the nonprofit's assets may be permitted pursuant to a plan of reorganization or liquidation. In these cases, in addition to complying with federal bankruptcy law, the sale must also comply with all the requirements of a typical transfer of assets by any nonprofit corporation under New York law.

7. What else should the board consider when contemplating a transfer of assets?

Directors of nonprofits are generally not held personally liable for approving an asset transfer, if the decision to enter into the transaction is made in good faith, involves no conflict of interest, and the director makes an effort to understand the terms of the transaction. If not, an action may be brought against a director to account for his/her conduct in neglecting to fulfill his/her duties. In addition, the transaction may be set aside by the court and injunction may be obtained to prevent the transaction from occurring. For this reason, it is imperative that a director fully disclose any potential interest in a proposed transaction before seeking the approval of the board, the members or the court.